



OECD Economics Department Working Papers No. 288

Public Spending in Mexico:
How to Enhance Its
Effectiveness

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Marcos Bonturi**

<https://dx.doi.org/10.1787/314432213841>

Unclassified

ECO/WKP(2001)14



Organisation de Coopération et de Développement Economiques
Organisation for Economic Co-operation and Development

02-Mar-2001

English text only

ECONOMICS DEPARTMENT

ECO/WKP(2001)14
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PUBLIC SPENDING IN MEXICO: HOW TO ENHANCE ITS EFFECTIVENESS

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by
Bénédicte Larre and Marcos Bonturi

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ABSTRACT

Public sector reforms and a refocusing of spending, partly through privatisation, have created a leaner and more effective government in Mexico. Primary expenditure, at around 18 per cent of GDP in 1999, is less than half the average for the OECD. At the same time, there are important spending requirements to create the basis for strong sustainable growth over the medium term. The backlog in basic infrastructure is considerable and areas such as education and health will require a steady expansion of budget resources. Specific measures to fight poverty are also needed. Inadequate tax resources and a heavy reliance on volatile oil-related revenue have been important factors impeding the development of essential public programmes. In this respect, given the sizeable marginal economic and social benefits of increasing spending in the above areas, it would be appropriate to raise the low tax-to-GDP ratio over the short to medium term. It is also essential that public spending be effective, which depends on improving the efficiency of the public administration. Since 1997, a comprehensive reform strategy has addressed many of the problems of administrative inefficiency. There are, however, still several areas in which public expenditure management and control can be improved, particularly via greater Congressional involvement and a streamlining of procedures within the Executive branch. Such changes should be consistent with the government's ability to enforce a hard budget constraint. Recent moves by the Executive to simplify the currently complex process of spending approval are to be welcomed. Efficiency would be further enhanced if market-based instruments for the provision of public services were more widely used.

JEL classifications - H0, H1, H4, H5, H61

Keywords: Government expenditure, public management, fiscal transparency, Mexico

RÉSUMÉ

Les réformes du secteur public et le recentrage des dépenses, en partie grâce aux privatisations, ont permis d'alléger l'administration publique au Mexique et de la rendre plus efficace. Les dépenses primaires représentent 18 pour cent du PIB environ en 1999, moins de la moitié de la moyenne de l'OCDE. En même temps des dépenses importantes doivent être engagées pour établir les bases d'une croissance forte et durable à moyen terme. Il y a des carences considérables au niveau des infrastructures de base; et dans des domaines, tels que l'éducation et la santé, il faudra que les ressources budgétaires augmentent régulièrement. Il faut aussi prendre des mesures spécifiques pour combattre la pauvreté. Des ressources fiscales insuffisantes et une forte dépendance à l'égard des recettes pétrolières ont constitué des freins importants au développement de programmes publics essentiels. A cet égard et au vu des avantages marginaux économiques et sociaux considérables qui résulteraient d'un accroissement des dépenses dans les domaines énoncés plus haut, il conviendrait de relever, à court comme à moyen terme, le ratio prélèvements obligatoires/PIB, qui demeure faible. En outre, il est essentiel que la dépense publique soit efficace, ce qui dépend de l'amélioration de l'efficacité de l'administration publique. Depuis 1997, dans le cadre d'une stratégie de réforme globale, des mesures ont été prises pour résoudre les problèmes qui nuisent à l'efficacité de l'administration. Cependant, il y a encore plusieurs domaines où l'on pourrait améliorer la gestion et le contrôle des dépenses publiques, notamment grâce à une plus grande participation du Congrès et à une rationalisation des procédures au sein de l'Exécutif. Ces changements devraient préserver la capacité du gouvernement à imposer la rigueur budgétaire. Les mesures prises récemment par l'Exécutif pour simplifier et rationaliser le complexe processus d'approbation des dépenses sont les bienvenues. Une plus grande utilisation des instruments de marché pour la fourniture de services publics permettrait d'accroître encore l'efficacité.

Classification JEL - H0, H1, H4, H5, H61

Mots-clés : Dépense des administrations publiques, gestion publique, transparence budgétaire, Mexique

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PUBLIC SPENDING IN MEXICO: HOW TO ENHANCE ITS EFFECTIVENESS

Bénédicte Larre and Marcos Bonturi¹

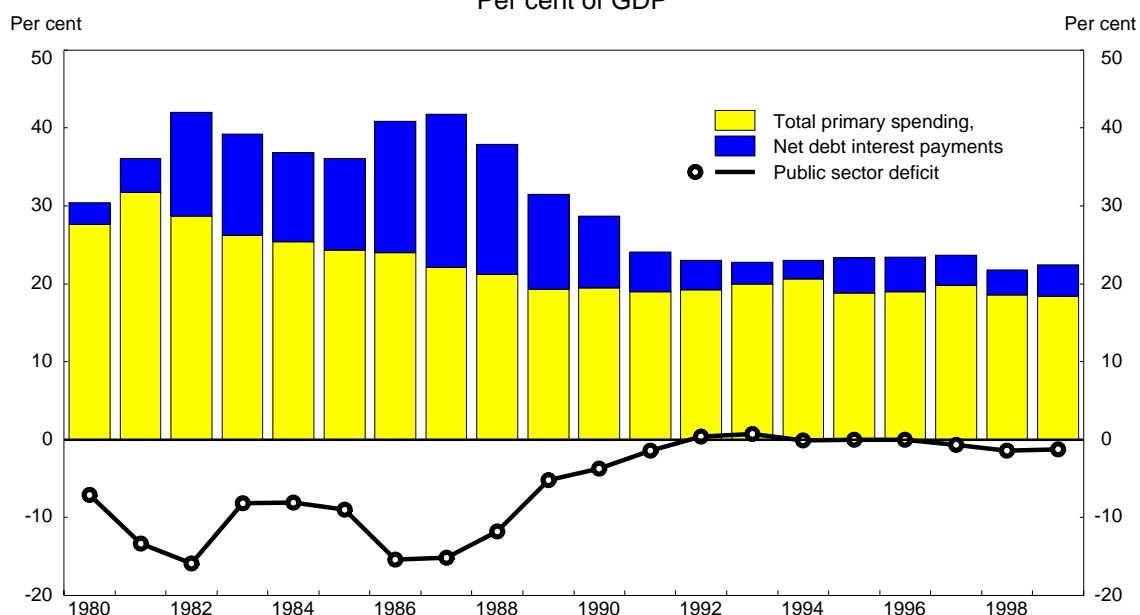
Introduction

1. Mexico has one of the lowest levels of public spending in relation to GDP among OECD countries: about 20 per cent of GDP for the general government, compared with an OECD average of some 45 per cent.² This is not just related to the level of development of the Mexican economy. Relatively low spending in Mexico results from a sustained effort at fiscal retrenchment following the debt crisis of the early 1980s to restore macroeconomic balance (the financial deficit of the public sector had peaked at 16 per cent of GDP in 1983). Over a little more than a decade, in terms of spending, the public sector has shrunk from over 40 per cent of GDP (the 1987 all-time high) to 22 per cent in 1999, for the broad public sector, including public enterprises (*Figure 1*). To the extent that the reforms of the 1980s and early 1990s went beyond the immediate purpose of stabilising the economy, including privatisation and deregulation and a refocusing of priorities, lower spending has been associated with efficiency gains: the decline in spending did not induce as large a loss in actual services delivered. Moreover, partly because consolidation led to a large cut in interest payments, primary spending was less affected. Finally, over the period 1995-2000, available resources were shifted towards social programmes -- education, health, social security, housing and poverty alleviation. The revenue from privatisation was also partly channelled to such programmes -- as were resources freed by the consequent reduction of transfers to enterprises. The refocusing of spending is illustrated by the fact that over the 1995-2000 period, social spending per head increased by nearly 13 per cent, while spending per head declined by 5.2 per cent. Nevertheless, as the 1999 *OECD Economic Survey of Mexico* showed, the revenue raising capacity of the tax system is still insufficient, due to the existence of large-scale preferential treatment and inadequate tax compliance. Despite efforts made to expand core spending programmes, constraint on tax revenue may have held back

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1. This paper was originally produced for the 2000 *OECD Economic Survey of Mexico*, which was published in July 2000 under the authority of the Economic and Development Review Committee. The authors are respectively senior economist and economist on the Mexico/Portugal Desk in the Economics Department. They are indebted to Robert Price (Head of Division) for substantial drafting contributions and to Val Koromzay, Andrew Dean and Jon Blondal for valuable comments. Special thanks go to Sylvie Toly for technical support and to Janice Gabela and Laura Schaub for technical preparation. The paper has benefited from discussions with numerous Mexican experts, in the private sector, as well as in ministries and government agencies responsible for policy-making in this area.
 2. International comparisons as a rule are based on general government accounts, compiled on a national-accounts basis (including state and municipal governments), which are available over the period 1988-97. Because of the limited data availability, longer-term trends are based on the public sector accounts presented in the budget for Mexico, which cover the federal government and public enterprises under budgetary control (see Annex I, *Table A1* on the "Structure of the Public Sector"). Federal government spending is often used instead of that of general government, but this does not have a very significant impact on the outcome because the states have very little power to tax and derive the bulk of their revenue from federal government transfers.

spending in areas where potential social and economic returns are high, such as investment in education, health and physical infrastructure. Correcting existing imbalances and deficiencies could well imply that government spending will probably have to rise relative to GDP. If so, the expansion will need to be at a pace which does not put unsustainable cost pressures on the productive sector. At any rate, efficiency issues will need to be addressed, measures to increase tax revenue will only be acceptable if the population at large perceives that public spending is effective.

Figure 1. Trends in public spending and the budget deficit (1)
Per cent of GDP



1. Federal government and public enterprises under budgetary control.
Source: Ministry of Finance.

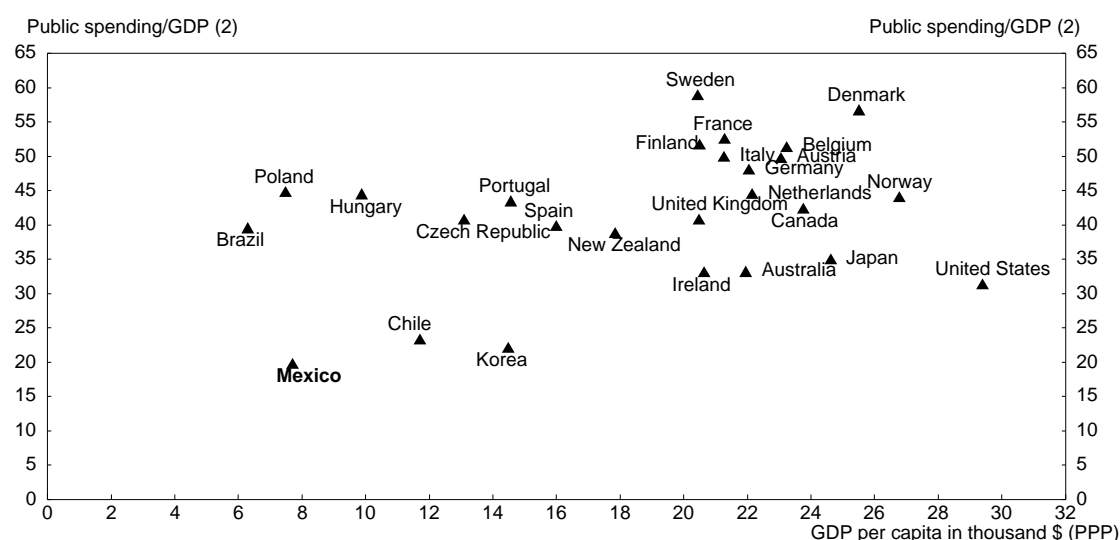
2. This chapter reviews the major issues involved in enhancing the effectiveness of public spending in Mexico, identifying key areas for policy action. It begins with an overview of spending trends over the past fifteen years or so, and highlights prospective financing needs in a country characterised by economic and social features that are different from most other OECD countries. It then analyses some of the main issues impinging on the effectiveness of spending, reviewing aspects of public administration and budgeting and examining the scope for the introduction of market-based mechanisms to improve public sector performance. The on-going devolution of spending responsibilities to states and municipalities raises a number of issues, which are discussed in a separate section. The final part of the chapter gives recommendations for further action.

Characteristics and determinants of public spending

Main characteristics of public outlays

3. After the sharp decline which occurred during the 1980s, general government spending has averaged around 20 per cent of GDP in Mexico, as against 35 to 65 per cent in the other countries in the area.²⁹ Even allowing for the fact that Mexico uses tax credits as well as social transfers to effect a certain amount of redistribution to low-income workers, the spending differential with most of the other OECD countries is significantly larger than 15 percentage points. Relating public spending to the level of development of the Mexican economy (*Figure 2*), the picture is less clear, however: Chile and Korea also have relatively low spending ratios, while Brazil and some eastern European countries at similar levels of development have had much higher spending.

Figure 2. Government spending and the level of income (1)



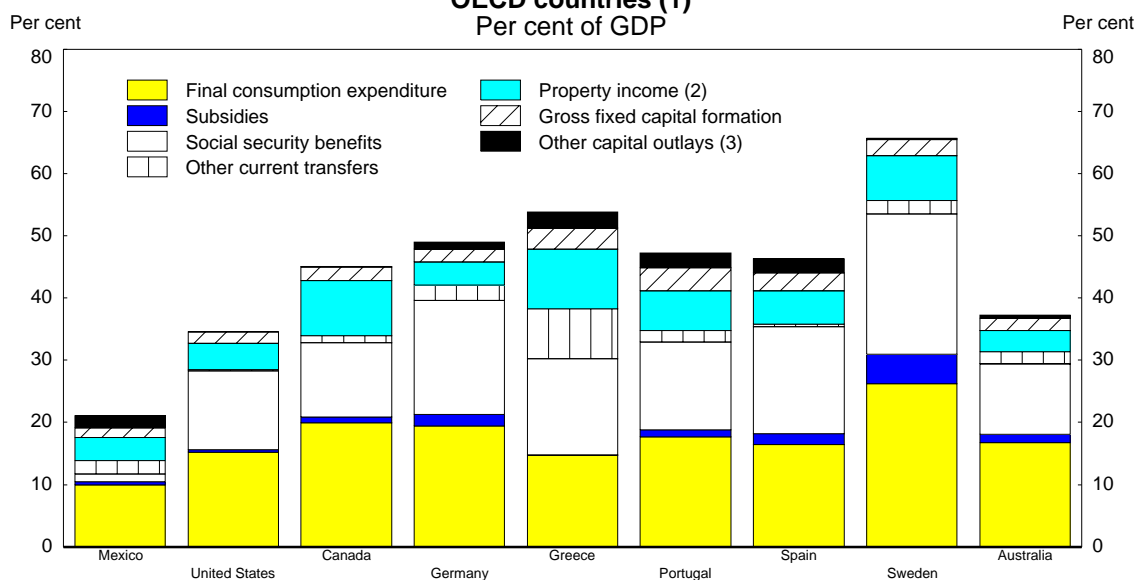
1. 1997 or nearest year available. Central government for Brazil and Chile.
 2. Public spending is defined as the sum of current outlays and net capital outlays.
- Source : INEGI; IMF; OECD, National Accounts.

4. The structure of spending by economic category shows two main differences between Mexico and the other OECD countries. First, social security outlays, although increasing, are still low by OECD standards, reflecting Mexico's limited degree of social protection (*Figure 3*). Second, capital outlays (fixed investment and capital transfers) are relatively high, with Mexico in a position similar to certain other countries, such as Spain and Portugal, that also devote a large portion of their budgets to capital spending.³

3. Outside the OECD area, in other Latin American countries with a level of development comparable to that of Mexico, the share of capital outlays in total spending is typically higher than in the industrialised economies (IDB, 1997).

However, as a proportion of GDP, investment is not as great in Mexico as in those countries, which receive substantial transfers from the European Union. Under a functional classification, education, which has been given high priority, represents the largest category of general government spending. Its share in public final consumption has expanded in the past ten years to reach 37 per cent of the total, a ratio that is significantly higher than in other OECD countries (*Figure 4*).⁴ As a share of GDP, current spending on education, although it is the highest historically, remains low by OECD standards, especially when taking account of the relative size of the youth population in Mexico. The decline in current spending has been the largest for the category of economic affairs, which include sectors of activity such as industry, transportation and communication which have undergone large-scale privatisation: at the end of the 1990s this category accounted for 8 per cent of the total, a proportion in line with other OECD countries.

Figure 3. General government spending by economic category in OECD countries (1)



1. In 1997 or nearest year available.

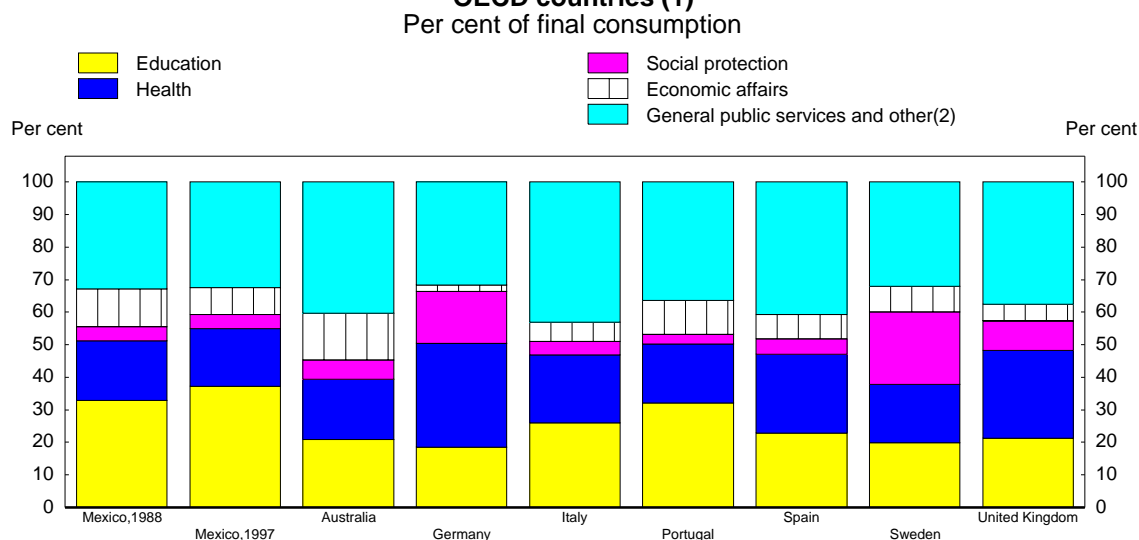
2. Including interest payments.

3. Increase in stocks, purchases of land and intangible assets (net) and capital transfers to other sectors.

Source: INEGI; OECD, National Accounts.

4. In the case of Mexico, the functional classification of government spending is available only for final consumption expenditure. So the comparison among countries in the text (as in *Figure 4*) refers to this sub-component only, not taking account of other types of spending, such as investment and transfers.

Figure 4. General government final consumption by functional category in OECD countries (1)



1. In 1997 or nearest year available.

2. Includes public order and safety, housing, cultural and unallocated expenditure.

Source: INEGI; OECD, National Accounts.

Factors behind the low spending ratio

5. Government spending has undergone a number of adjustments in recent years, including structural changes, which taken together can explain the fall in the public spending ratio to its low level. Two main factors have been at play: privatisation and reduced interest payments.⁵ Considering the federal government alone, interest payments were reduced by nearly 11 percentage points of GDP in the five years to 1992, a fall facilitated by the launch of a process to restructure the debt and by using the proceeds of privatisation to reduce the stock of public debt. The banking sector support package introduced after the 1994-95 peso crisis created debt service obligations for the government equivalent to 0.7 to 1 per cent of GDP a year.⁶ But at around 4 per cent of GDP, the ratio of interest payments to GDP now stands below the

5. Federal government spending has also been affected (since the early 1990s) by the progressive devolution of responsibilities to sub-national levels of government (states and municipalities). But the process has affected the composition of federal spending rather than its level, since the federal government is the main source of financing of sub-national levels of government, funds being channelled as federal transfers. The decentralisation process (fiscal federalism) and related policy issues are reviewed in a section below.

6. The budgetary cost of the financial sector bail-out was estimated at 20 per cent of GDP in 1999 -- an assessment that is subject to revision. Appropriations to pay down the real component of debt service are provided in each year's budget (for more details see OECD, *Economic Survey of Mexico*, 2000, Chapter IV).

OECD average. Federal government primary spending, after a steady decline in the 1980s, increased in the early 1990s, and has fluctuated in a range of 12 to 14 per cent of GDP since 1994 (*Figure 5, panel A*).

6. The federal government budget tells only part of the story about state involvement in the economy. The public enterprise sector was prominent until the mid-1980s, but it has been significantly downsized since 1986, reflecting the government's strategy of disengagement from a large number of productive activities in order to refocus on essential functions. The total outlays of public enterprises were brought down to around 7 per cent of GDP in 1999, against 18 per cent in the mid-1980s (*Figure 5, panel B*). More significantly from the perspective of government spending, as public enterprises were either privatised or shut down, the federal government's transfers and subsidies to businesses were drastically reduced (*Figure 6*). The public enterprise sector now is structurally in surplus -- thanks to PEMEX and the social security institute IMSS -- thereby contributing positively to the consolidated budget.

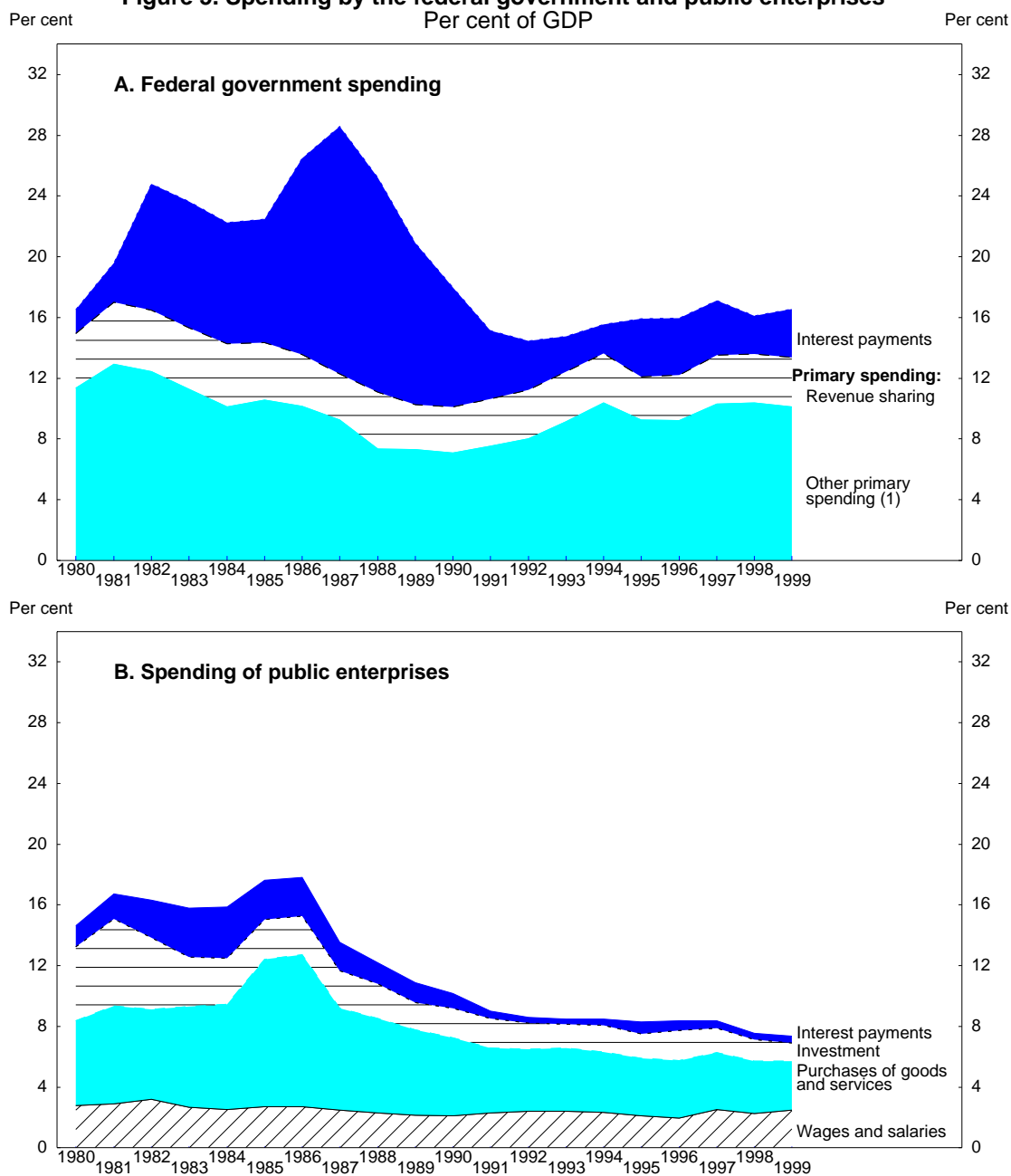
Volatility of public spending

7. Public spending has been vulnerable to exogenous shocks. Since the early 1990s, public sector financial accounts have remained nearly in balance, fluctuating between a surplus of 0.7 per cent and a deficit of 1.25 per cent of GDP. The fact that budget outcomes have been relatively stable in the past few years is remarkable given the vulnerability of government revenues to volatile international oil prices. The experience of the 1997 to 1999 budgets shows that the government has tended to respond to unexpected revenue developments by adjusting expenditures. In both 1997 and 1999, revenue was somewhat higher than originally budgeted -- by 0.7 and 0.2 percentage point of GDP -- as a result of buoyant economic activity and higher oil prices, respectively. In 1998 on the other hand, falling oil prices led to a revenue shortfall equivalent to 0.9 percentage points of GDP. In each year, spending was cut or increased so that the financial deficit outturn was very close to the original target, creating some short-term volatility in government outlays. Although this has not caused major problems, additional efforts are needed to stabilise public sector revenue. The creation of a stabilisation fund for revenue windfalls, as set out in the budget decree for 2000 (*Box 1*), can help dampen the impact of external shocks on revenue, and hence on spending, provided clear rules are established for investment and disposal of the accumulated funds.

Box 1. Creation of a stabilisation fund

Windfall provisions have been negotiated with every budget since 1998 (see *Box 3* below). In 1998 and 1999, windfall revenues above a certain level were automatically used for debt redemption. The 2000 budget was the first that included a stabilisation fund. According to the budget rules, the first 0.9 per cent of additional revenues, from oil or other sources, would automatically raise spending authorisations. Beyond that, windfalls have been earmarked proportionally, 60 per cent for debt redemption and 40 per cent for the creation of a stabilisation fund. This should reduce the volatility of spending in the face of changes in international oil prices. By early 2001, the newly created fund had accumulated about US\$1.1 billion, but clear rules were yet to be established for the money accumulated to be drawn down.

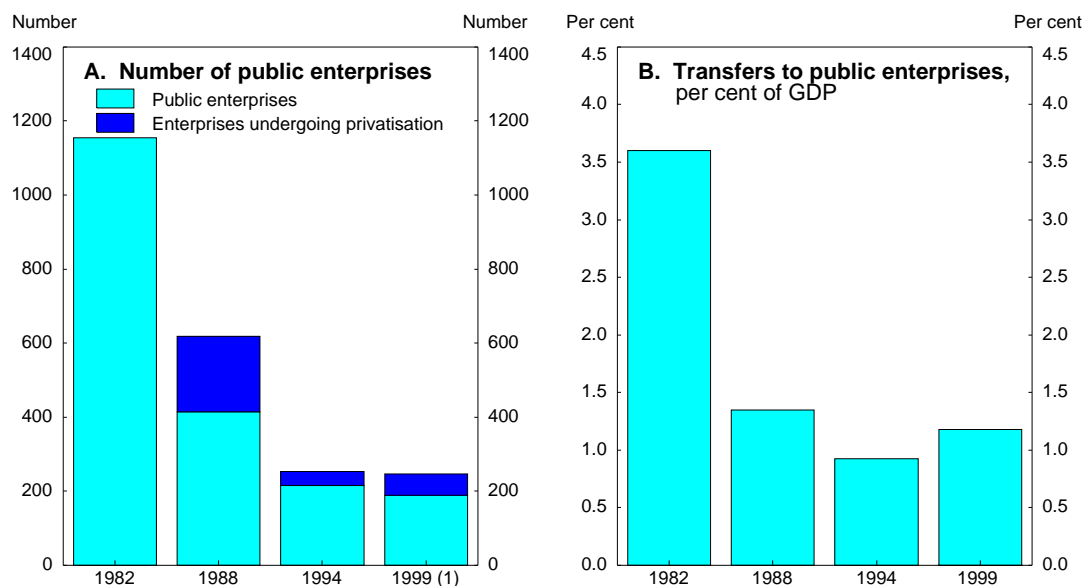
Figure 5. Spending by the federal government and public enterprises
Per cent of GDP



1. These expenditures are called "programmable" in the Mexican budget accounts.

2. First quarter 2000 at annual rate.

Source: Ministry of Finance.

Figure 6. The privatisation process and its impact on public spending

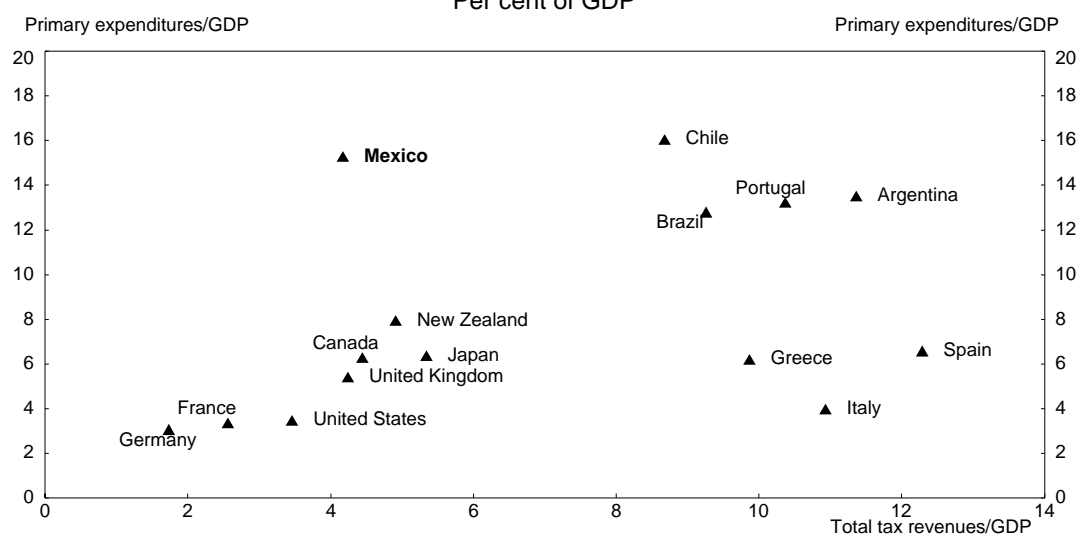
1. On 13 August 1999.

Source: Ministry of Finance.

8. Revenue shocks have thus typically been absorbed by adjustments to spending, although core social programmes were increased. As a result, government spending has been characterised by some short-term volatility (*Figure 7*). This is undesirable both from a macroeconomic standpoint -- since government spending may have exacerbated the cycle -- and in terms of the effectiveness of spending planning and control. The cuts and delays which have been implemented have almost certainly affected infrastructure programmes essential to the country's development. In the case of road infrastructure for instance, public resources available in 1998 -- a year of severe budget adjustments -- allowed the financing of only about half the requirement for maintenance of the federal road network.⁷

7. E. Jimenez (1994) notes that during the periods of adjustment, between 1979 and 1989, the governments of a number of developing countries had a tendency to maintain spending on social services (at least in relative terms), with infrastructure suffering the bulk of the cuts. These funding constraints may have affected sectors in which there had been excess capacity; in some other cases, infrastructure outlays may be carried out by the private sector; but the risk of jeopardising long-term growth potential cannot be excluded. Cf. E. Jimenez (1994), "Human and physical infrastructure", World Bank, *Policy Research Working Paper*, No. 1281, April. In Mexico, to reduce the volatility of infrastructure spending, a trust fund was created at the end of 1997, with part of privatisation revenue (FINTRA). Its first objective was to finance road infrastructure. In 1998, its focus shifted to financing development of the South-East regions and the fund's name was changed to FIDES.

Figure 7. Coefficient of variation in primary expenditures and tax revenues (1)
Per cent of GDP



1. The coefficient of variation is the standard deviation divided by the average of the tax/GDP ratio (including social security contributions) and primary expenditures in per cent of GDP of general government (federal government for Mexico and central government for Chile). Sample period is 1980 to 1998 or nearest years available.

Source: IMF, Government Finance Statistics ; OECD, Revenue Statistics and Analytical Data Bank ; OECD's calculations.

Stable general government employment and wages

9. The public sector now accounts for a relatively small proportion of the economy, as measured by its share in total employment as well as in GDP. By 1997, general government accounted for 11 per cent of aggregate employment, compared with 15 per cent in the United States and nearly 20 per cent in Europe and Canada (*Table 1*). Even if public enterprises are included, employment in the broad public sector still accounted for only 12 per cent of total employment in Mexico in that period. The total wage bill, which still represents a relatively large share of government spending, declined somewhat as a proportion of GDP, to 8 per cent in 1997, compared with 10 per cent in the United States and generally more in Europe (on national-accounts data). These outcomes stem from the fact that wage increases in Mexico have been moderate, and general government employment has remained stable overall. In periods of high inflation, decreases in real salaries have been recorded, contributing to the adjustment of public spending; while some of the losses have been made up since 1996, in several cases pay levels are still lower than they were before the 1994 crisis.

Table 1. **General government employment**¹

Per cent of total employment

	1988	1993	1997
Mexico	12.8	12.0	11.5
(Including public enterprises)	16.5	13.6	12.9
United States	14.8	15.3	14.5
Japan	8.3	8.2	8.3
Germany	15.6	13.6	12.9
Canada	20.7	22.7	20.6
Greece	11.6	12.2	12.7
Portugal	..	18.1	..
Spain	13.0	15.4	15.6
Turkey	8.3	8.0	..
OECD average ²	16.9	17.5	18.1
OECD Europe average ²	17.9	18.6	19.3

1. General government (national accounts basis), excluding public enterprises.

2. Unweighted average of available data.

Source : INEGI; OECD.

An effort to rationalise subsidies

10. Deregulation and the development of market mechanisms have been accompanied by a steady reduction in subsidies since the mid-1980s.⁸ Subsidised loans to industry have been gradually eliminated; and subsidies to agriculture changed in nature, with a shift away from credit and marketing subsidies towards direct income transfers and support for productivity-enhancing investment.⁹ Recognising that the redistributive objectives inherent in social policy are ill served by general subsidies which imply substantial dead-weight losses, the authorities have endeavoured to scale back the various consumer subsidies in place. At the same time, some degree of compensation has been offered to low-income families (targeted transfers, tax credits, etc.). For instance, general subsidies for the consumption of *tortillas* (a staple of the Mexican diet) were cut back gradually until they were eliminated altogether in 1999. But programmes providing targeted food subsidies to families in extreme poverty in urban areas have been maintained.¹⁰ And a growing proportion of budget resources has been earmarked for direct transfers, for the most part targeted at rural or marginalised areas where extreme poverty is found (see below). Altogether, since the *tortilla* subsidies had typically been concentrated in urban areas, which as a

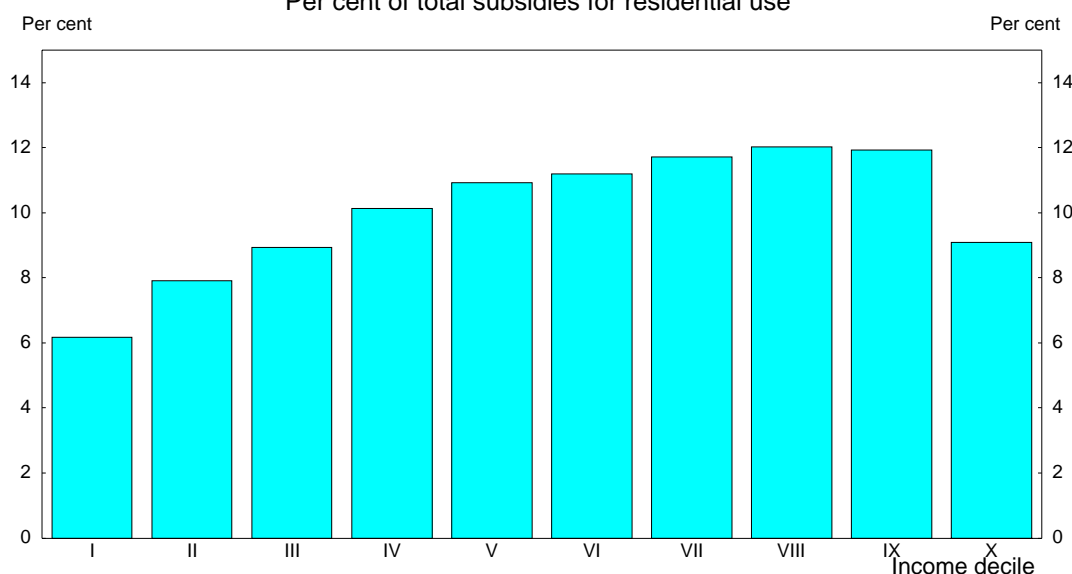
8. On a national-accounts basis, government subsidies were trimmed to 0.5 per cent of GDP in 1997 -- a proportion comparable to that of the United States; at the same time, in a number of European countries they represented 1.5 to 2 per cent of GDP (4.7 per cent in Sweden).

9. The programme for direct support to farmers, PROCAMPO, was established in 1993-94, as a result of NAFTA. It provides income support to producers, in proportion to cultivated areas and is largely concentrated on smaller-size production units. Spending on rural development has decreased mainly as a result of the reduction in credit subsidies; but resources channelled to poverty alleviation in rural areas increased considerably between 1994 and 1999.

10. CONASUPO, the public enterprise that had purchased, sold and distributed maize, was shut down in 1999. General subsidies for tortilla prices in urban areas were eliminated. However, the federal government continues to provide support for the marketing of maize (a subsidy paid to producers), and a number of special programmes targeted at families in extreme poverty in urban areas have been maintained: programmes subsidising the acquisition of tortillas and for the distribution of milk.

rule are less disadvantaged than rural areas¹¹, the adjustment has led to some shift of resources from urban to rural areas.

Figure 8. Incidence of subsidies to electricity consumption (1)
Per cent of total subsidies for residential use



1. The subsidies for residential users implicit in the tariff structure of the two public electricity companies (CFE and LFC), 1999, as published in "Proyecto de Presupuesto de Egresos", November 1999.

2. The first decile corresponds to the poorest households.

Source: Ministry of Finance.

11. Despite the trend towards elimination of general subsidies, the consumption of electricity and water continues to be subsidised. The total implicit amount of these subsidies represented a little more than 1 per cent of GDP in 1998-99. Electricity subsidies for residential consumers totalled 22.4 billion pesos in 1999 (0.5 per cent of GDP).¹² Although granted according to a scale that varies by volume of consumption, the subsidies have a regressive impact, because the bulk of the benefits accrue to middle and high-usage

11. In urban areas, low-income groups are expected to benefit from broader-based social policies, which have been strengthened, notably through a better access to basic education and health care and improvements stemming from the new social security law in effect since mid-1997. These groups can also have access to training programmes; and, with regard to workers in the formal sector, the income tax system performs some redistribution via tax credits, introduced in 1994 and expanded in 1996.

12. These estimates refer to implicit subsidies benefiting residential consumers, as a result of the tariff structure in force in 1999. In addition consumers from rural areas reap benefits from electricity subsidies amounting to some 0.1 per cent of GDP (Ministry of Finance, *Presupuesto de Egresos*, November 1999).

consumers, and hence persons with middle or high incomes (*Figure 8*).¹³ Most of the water subsidies go to the rural sector, which also enjoys subsidies for electric power consumption, along with indirect subsidies in the form of preferential treatment under the current tax regime (tax exemptions and preferential VAT and income tax regimes). Water subsidies for the sector were estimated at 28.4 billion pesos in 1998, or 0.7 per cent of GDP (14 per cent of agricultural GDP). Subsidising consumption in this sector gives rise to a dead-weight loss since, as with electricity, those who derive the most benefit in absolute terms are large consumers, who in this case are large farming operations.¹⁴ Moreover, subsidising water prices creates distortions, leading to excessive consumption of water, which runs counter to environmental policy objectives. More generally, the issue of which categories of households ought to receive compensation if water or electricity subsidies were eliminated is a political one, closely tied in with the government's redistributive agenda. Nevertheless, this should not obscure the fact that, by eliminating these subsidies, it would be possible to free up additional resources for spending that would yield higher economic and social returns.

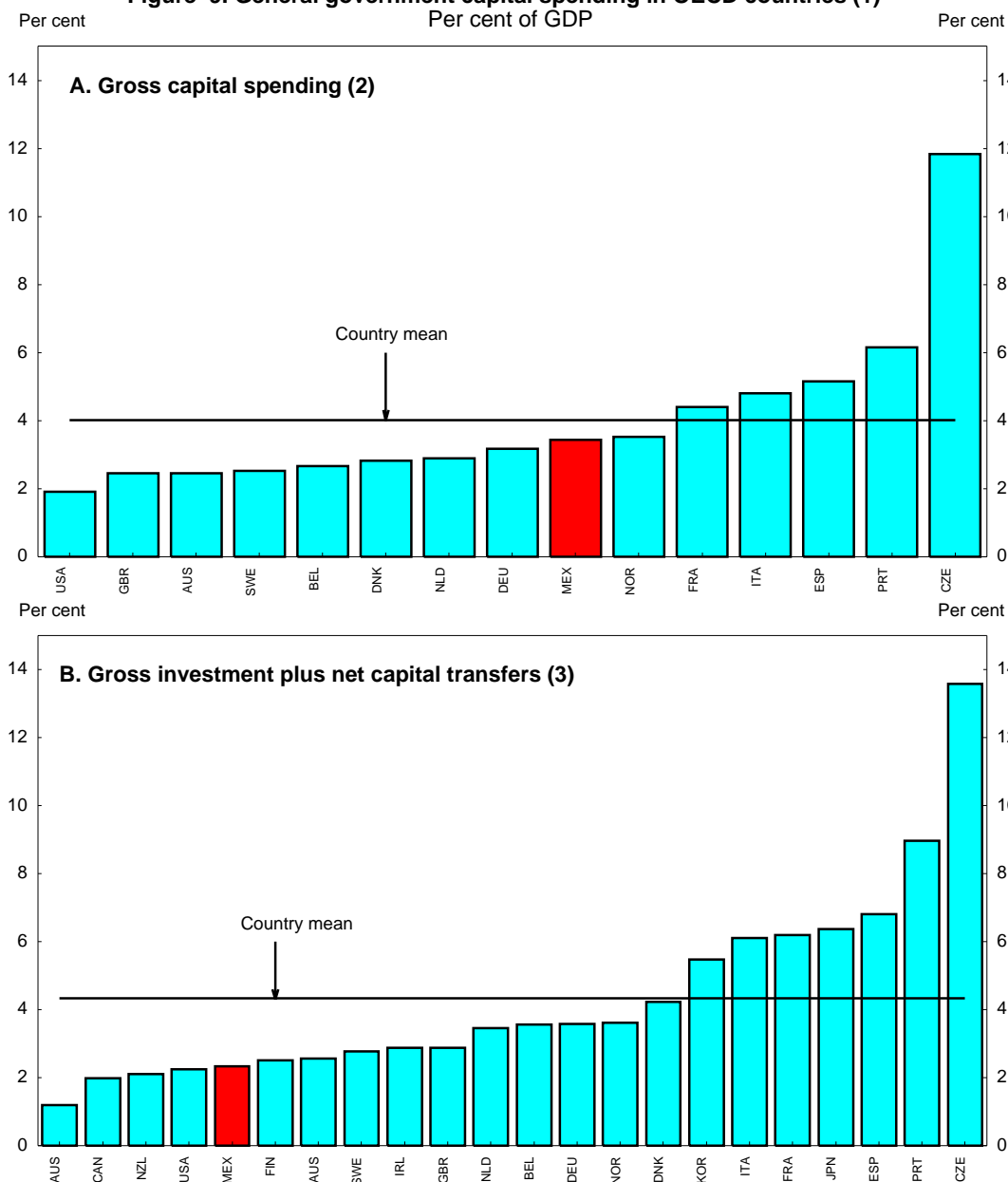
Reorientation of public investment

12. General government capital spending (investment and capital transfers), excluding public enterprises, has remained at about 3 per cent of GDP over the past decade. About half of this is gross capital formation, which is low compared with the rest of the OECD (*Figure 9*). In contrast, investment in the broad public sector (including public enterprises) has fallen sharply, from a peak of about 10 per cent of GDP in the early 1980s to 3½ per cent in the mid-1990s, reflecting the privatisation process and the economic liberalisation that accompanied it (*Table 2*), although there have been off-budget projects carried out in the energy sector since 1997 (PIDIREGAS, see below). The most marked cut-back was in the communications and transport sector, especially in infrastructure construction -- railways, ports, airports, telephones and satellites -- since virtually all the enterprises have been privatised, or are in the process of being privatised. In 1998-1999 almost half of public sector investment was concentrated in the energy sector, reflecting essentially the activity of the two main state enterprises, PEMEX and CFE. About a tenth of the total went to roads, and 5 per cent went to drinking water and waste water treatment infrastructure.¹⁵ A comparison of ownership structure of the major players in key service sectors shows that Mexico is in an intermediate position among OECD countries in terms of private participation and regulatory reform (*Table 3*).

13. With regard to the residential use of electricity, official estimates show that families from the lowest three income deciles capture only 23 per cent of the total implicit subsidy, while the highest three deciles together receive 33 per cent of the value of the subsidy.

14. It should be noted that half of the persons working in rural areas do not own their land, and that among landowners, nearly 46 per cent produce for their own consumption. As a result, only a small minority of consumers benefit from subsidies (direct or indirect) to the sector, whereas it is in rural areas that the poor population is concentrated.

15. Water, sewage and waste water treatment ("social supply" in the Mexican terminology) is a component of urban development. Public investment in rural and urban development has been falling over the years. Details of public investment by sector are shown in *Annex I Table A3*. In the year 2000, gross investment by the federal government is estimated to have increased by 0.3 percentage points of GDP, to reach the highest ratio in a decade.

Figure 9. General government capital spending in OECD countries (1)

1. 1997 or nearest year available.

2. Gross capital formation plus purchases of land and intangible assets (net) plus capital transfers to other sectors.

3. Gross capital formation plus purchases of land and intangible assets (net) plus capital transfers (net).

Source : OECD, National Accounts.

Table 2. **Gross fixed capital formation by the private and the public sectors**

Per cent of GDP

	Total national	Private			Public ¹		
		Total	Construction	Machinery and equipment	Total	Construction	Machinery and equipment
1960-1964	16.8	12.6	n.a.	n.a.	4.2	n.a.	n.a.
1965-1970	19.2	13.1	n.a.	n.a.	6.1	n.a.	n.a.
1970-1974	20.0	13.3	6.7	6.6	6.7	4.6	2.1
1975-1979	20.7	12.3	6.2	6.1	8.5	5.4	3.0
1980-1982	23.0	13.0	5.5	7.5	10.0	6.9	3.1
1983-1984	15.5	9.2	5.1	4.1	6.3	4.8	1.5
1985-1989	17.1	11.8	6.5	5.4	5.3	4.2	1.1
1990-1994	18.5	14.6	6.7	7.9	3.9	3.2	0.8
1995-1997	15.4	12.0	5.9	6.1	3.4	2.8	0.6

1. Including public enterprises. The breakdown of public investment, by sector, is shown in Annex Table A3.
Source: INEGI, National Accounts.

Table 3. **Ownership structure in key service sectors¹**

	Railways		Air travel			Electricity		Telecommunications ³
	Ownership of largest operator		State ownership	State share-holdings (per cent)	Restrictions in force ²	Government participation	Restrictions in force ²	State share-holdings (per cent)
	Infrastructure	Freight						
Mexico	Private	Private	Yes	55	No	Yes	Yes	0
United States	Private	Private	No	0	No	Yes	Yes	0
Canada	Private	Private	No	0	Yes	No	..	0
Australia	No	0	.. ⁴	Yes	No	67
New Zealand	Private	Private	No	0	No	Yes	No	0
Germany	Public	Public	No	0	No	Yes	No	61
Greece	Public	Public	Yes	100	No	Yes	Yes	65
Portugal	Public	Public	Yes	100	No	Yes	No	25
Spain	Public	Public	Yes	94	No	Yes	No	0
Turkey	Public	Public	Yes	98	Yes	Yes	Yes	100

1. As of September 1998.

2. The number of competitors is restricted in at least some domestic markets by law or regulations.

3. Public ownership in what were previously the public telecommunications operators. More details are available in O. Boylaud and G. Nicoletti (2000) "Regulation, market structure and performance in telecommunications", OECD, *Economics Department Working Papers*, No. 237.

4. Australia ended its duopoly policy and deregulated its domestic aviation market in 1990. Nevertheless, in practice, the market continues to be dominated by the two incumbent airlines.

Source: OECD; OECD, International Regulation Database.

13. Investment continues to lag in several areas. Investment in the energy sector, for example, is held back by budgetary constraints despite the fact that needs are growing. According to official estimates, electricity demand will rise by 6 per cent per year in the coming period. But the fact that electricity prices for residential consumers are too low (federal government subsidies for electricity prices have increased in

recent years) has limited the ability of the public electric companies (CFE and *Luz y Fuerza del Centro*) to invest in new capacity. To meet the higher investment requirements in the energy sector, and considering the legal and constitutional impediments to private initiative in this sector, the government has introduced various forms of private financing mechanisms to make up for the insufficiency of public funds (including the use of PIDIREGAS). These mechanisms have helped to finance investment in new capacity and the modernisation of existing capacity, but at the same time they have created fiscal obligations that will have to be met in the longer term.¹⁶ They are thus an imperfect substitute for opening the sector to private initiative; and electricity tariffs for residential consumers will have to be raised.

14. In the education sector, there is a considerable backlog in investment: for instance, to allow a catch up on renovation and maintenance of school buildings and for basic equipment at the basic education level, an estimated 20 billion pesos would need to be spent. Such an amount would be twice the investment budget in 1998 for the entire education sector. It also seems likely that some infrastructure investment which could have a high social return has suffered from budget constraints in recent years, especially the maintenance and modernisation of public infrastructure, for example drinking-water supply networks and roads, an item of expenditure which in many countries turns out to be particularly vulnerable to budget cut-backs. Although spending on infrastructure by state and municipalities has increased, partly substituting for lower federal spending, there are still important deficiencies in Mexico's infrastructure as illustrated by the fact that 14 per cent of the population still did not have access to drinking water in 1997 and 27 per cent had no water treatment system, which puts Mexico behind Brazil and Chile for example.

Factors affecting future public spending

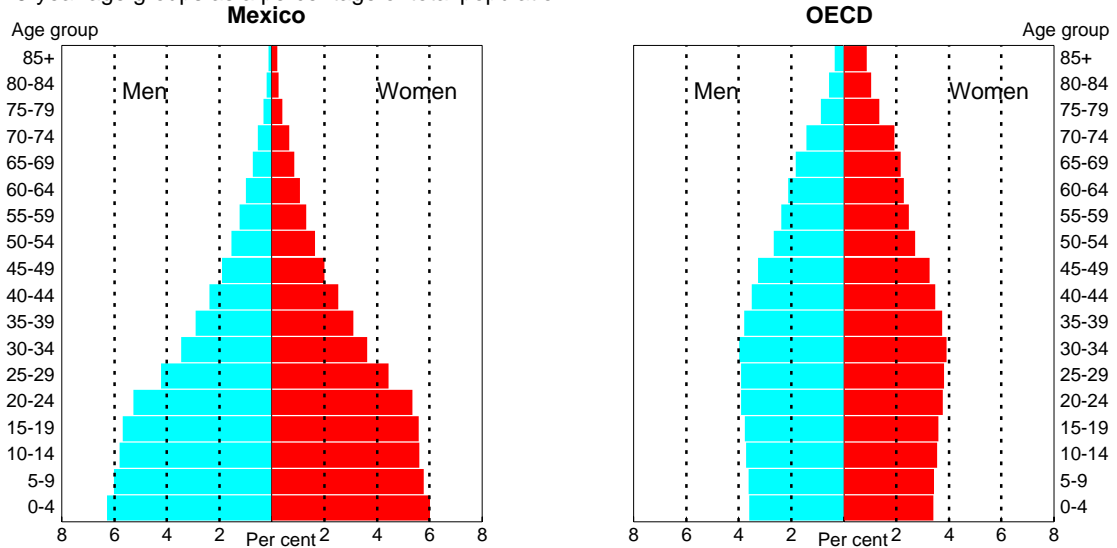
15. While lower interest payments and a refocusing of spending priorities may have helped to increase the efficiency of public spending, the relative scarcity of budget resources and a heavy reliance on volatile oil related-revenue are likely to have hampered the federal government's efforts to achieve better results on certain essential functions. For Mexico to reap fully the benefits of its integration into the world economy and achieve better balanced growth, a sustained effort is needed to enhance human capital and secure a steady investment effort. Furthermore, as recognised by the authorities, there is a need to ensure that output growth raise living standards of the population at large, including the poorer segments. Mexico has one of the lowest per capita income in the OECD and income distribution is more unequal than in other member countries apart from Turkey, so that a significant proportion of the population lives in conditions of extreme poverty. A more even distribution of income -- achieved by raising the lower categories -- is desirable, both in its own right and so as to maintain a consensus on the general economic strategy.¹⁷ The section below begins with a discussion of spending requirements to establish the basis for sustained development. This is followed by a review of equity issues and distributional aspects in public spending.

16. The financial and administrative issues raised by the various contracting out mechanisms for public investment are examined in a section below.. A reform proposal for the electricity sector had been submitted to Congress in February 1999, but it was not approved. Reform of the sector is again on the political agenda, with the new administration announcing that a reform proposal would be put to Congress in 2001.

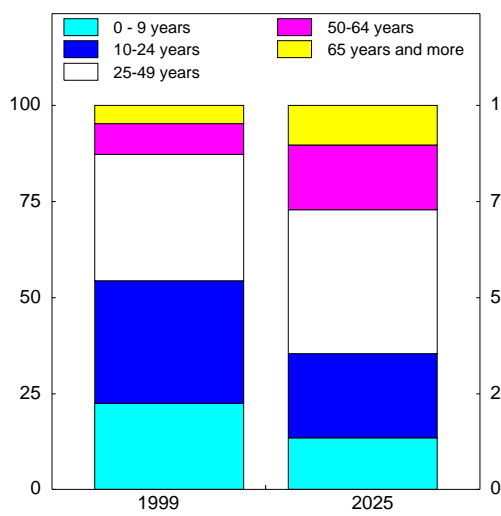
17. The example of the Chiapas upheaval in January 1994, to the extent that it stemmed from social inequities and contributed to the capital outflows during that year, illustrates the high costs of social unrest for a country, such as Mexico, that is vulnerable to turnarounds in investors confidence.

Figure 10. Age structure of the population and dependency ratios

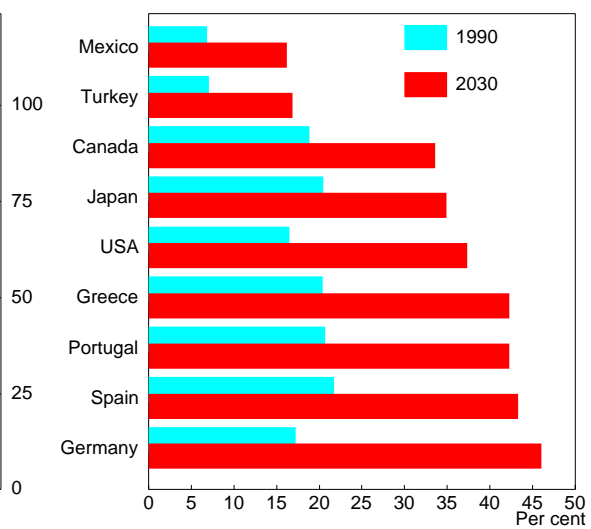
A. Population structure in 1995 in Mexico and OECD area:
5-year age groups as a percentage of total population



B. Estimated Mexican population: 1999 and 2025
Age groups (1) as a percentage of total population



C. Dependency ratios (2) in 1990 and 2030



1. Men and women.
2. Ratio of elderly population (65 years and over) to working age population (15-64 years).
Source: IMSS; United Nations; OECD.

The role of public spending in economic development

16. The effects of public investment on growth are not clear-cut, since the allocation of scarce capital resources is not necessarily based on rates of return and the effect may be to crowd out more productive private investment. Empirical investigation on the role of public infrastructure investment conclude that the effects are probably beneficial, but a great deal of uncertainty is attached to the magnitude of the effect.¹⁸ However, relations found to be insignificant for developed countries may be relevant when less developed countries are considered. Empirical analysis for Mexico and several other Latin-American countries do suggest that public infrastructure spending can exert a clearly positive effect on economic growth and may even be an essential complement to private investment, in countries where physical and human capital are relatively undeveloped. Broadly speaking, empirical studies for Mexico conclude that public investment has had a positive effect on economic growth, stemming mainly from the positive externalities generated on the output of the various sectors and regions. Notwithstanding crowding out effects in the short term, infrastructure investment appears to be positively correlated with private sector GDP growth. However, in order for such investment to have a net positive impact, the increase in spending on social infrastructure needs to be financed by an increase in tax revenue rather than a widening in the government's deficit, and the scale of such an increase needs to be modest.¹⁹

17. Certain features of the Mexican economy shape the design of public spending policies. The country is undergoing a demographic transition: the annual population growth rate has fallen from over 3 per cent in the 1960s and 1970s to about 2 per cent since 1980 (*Figure 10*). The population boom and the changes in the age structure of the population are creating pressures on several fronts. The proportion of the school-age population is larger than in other OECD countries; also, with the improvement in enrolment ratios, there has been a shift in demand from the primary to the secondary levels. Given the rapid growth of the population now reaching working age (3 per cent, or 1 million people, a year), a special effort needs to be made to facilitate the transition from school to work. Furthermore, in a changing environment, the adult population must have access to training programmes in order to adapt their skills to new needs. In the longer term, additional pressures will arise because of ageing population -- higher dependency ratios for pension systems and increased demand for medical care -- in Mexico, as in other OECD countries -- though later than in most of these.

Human capital development is a priority

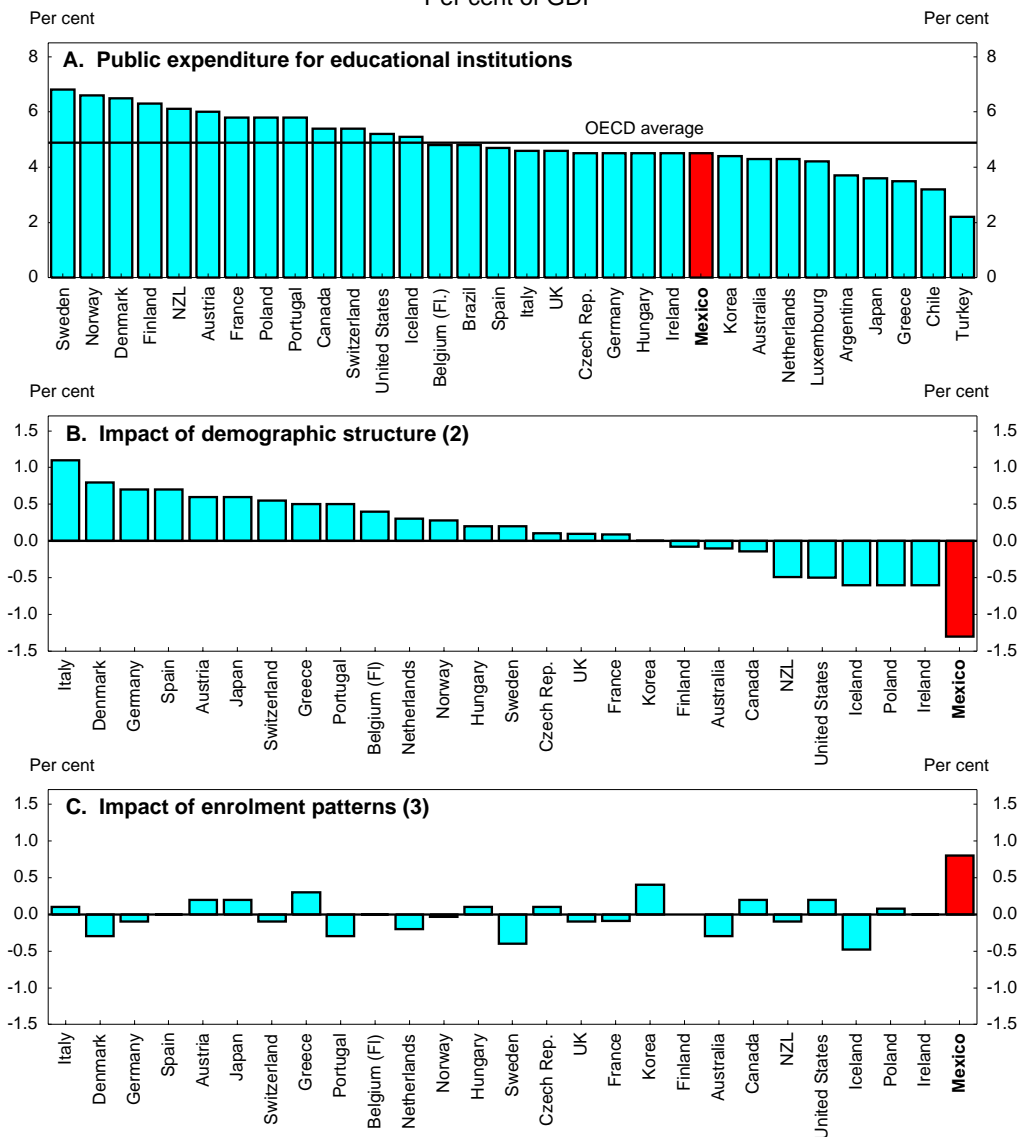
18. Public spending on education was spared during the episodes of expenditure adjustment since it has been considered to have priority. However, after a steady rise during the past ten years, spending on education, at 6 per cent of GDP in 1999, is still below the OECD average. Adjusted for the demographic structure (the school-age population is one of the highest in the OECD), Mexico is at the bottom of the

18. Based on OECD, *The Growth Literature Review (forthcoming)*.

19. S. Cid has highlighted the complementarity between public investment and private sector growth in Mexico: the crowding-out effect seems mainly short term, but after six to seven years, a significant positive relationship emerges between infrastructure investment (road, airports and drinking water supply) and private sector GDP growth. A similar positive effect was noted by Nazmi and Ramirez (1997) for Mexico and by Jimenez (1994) for several Latin American countries. Feltenstein and Ha (IMF, 1996), using a general equilibrium model, concluded that an increase in real spending on public infrastructure has a positive effect on growth in Mexico; however the increase in spending should remain modest and should preferably be financed by raising tax revenue, so as to limit the negative impact that too high a rise in real interest rates would otherwise have. See S. Cid (1999), "Los efectos de la inversión pública sobre la producción privada en México", No. 8, ITAM, and A. Feltenstein and Jiming Ha (1996), "An analysis of the optimal provision of public infrastructure: a computational model using Mexican data", *IMF Working Paper 96/13*, February.

scale (Figure 11). Furthermore, private expenditure on education is still marginal. The increase in funding nevertheless made possible an increase in the number of staff, partial catch-up of salaries and renewal of the capital stock. Substantial progress has been made in recent years in terms of school attendance rates and the number of children completing schooling, but it is still insufficient. Recent reforms that have overhauled and modernised school curricula are likely to have induced qualitative improvements. The

Figure 11. Expenditure on education (1)
Per cent of GDP



1. In 1997, except Turkey (1995), Brazil (1996).
 2. Increase/decrease in expenditure on education if the proportion of the population aged 5 to 29 was at the OECD average.
 3. Increase/decrease in expenditure on education if enrolment patterns of 5 to 14 year-olds (up to upper secondary) were at the OECD average.
 Source: OECD, Education at a Glance, 2000.

authorities have also taken measures to develop technical education and general training programmes to facilitate the transition from school to work. Demographic changes and the progress made in lower level enrolment are now putting pressures on the secondary level, making it necessary to increase capacity and upgrade teachers' skills. These pressures in turn imply a steady expansion in the education budget.²⁰

19. Regarding labour market policies, the intense process of modernisation and restructuring of the economy and the scale of the resulting labour displacement, has prompted the authorities to widen the scope of training programmes in recent years. However, the share of public resources spent by Mexico on active labour market measures is still small in comparison with other OECD countries -- and there are no passive measures.²¹ The effectiveness of active measures to enhance the skills and adaptability of the labour force depends, as in other countries, on the application of stringent selection criteria.

Pressures from the health and pension systems²²

20. The provision of adequate health and social security services can also promote conditions conducive to a rise in productivity, provided social security settings do not create distortions in the organisation of business activities and the labour market. As regards health care, despite a steady improvement, Mexico is still facing a relatively high incidence of infant mortality, malnutrition and infectious diseases. While the population is young, increasingly the health care system will have to respond to the needs of a growing number of older people, whose diseases call for costlier services, as evidenced by higher-income countries' experience. In 1994, about 10 million people (11 per cent of the population) did not have access to health care in Mexico -- whether public services or social security. Significant progress has since been made in developing the supply of medical services and improving the quality of care dispensed in public hospitals and health care units for the uninsured population. The size of the payroll and wage levels of employees from the national public health system were increased, and investment in the sector expanded. The scale of the measures taken is reflected in the sharp rise in public spending both directly by the federal government and in the transfers to States to enable them to perform their functions in these areas. At present, most of the population receives at least basic health care.²³ Although increased

20. The number of pupils in primary education (6-11 year-olds) was virtually stable between 1996 and 1999, at 13 million, whereas the number of pupils rose by 3 per cent a year in the 12-15 year-old age group, and by 6 per cent a year in the 15-18 year-old age group. Official estimates (made in accordance with the OECD) suggest that on the basis of current costs in Mexico, it would be necessary to spend each year an additional 1.4 per cent of GDP to attain school attendance ratios comparable with the OECD average for compulsory schooling.

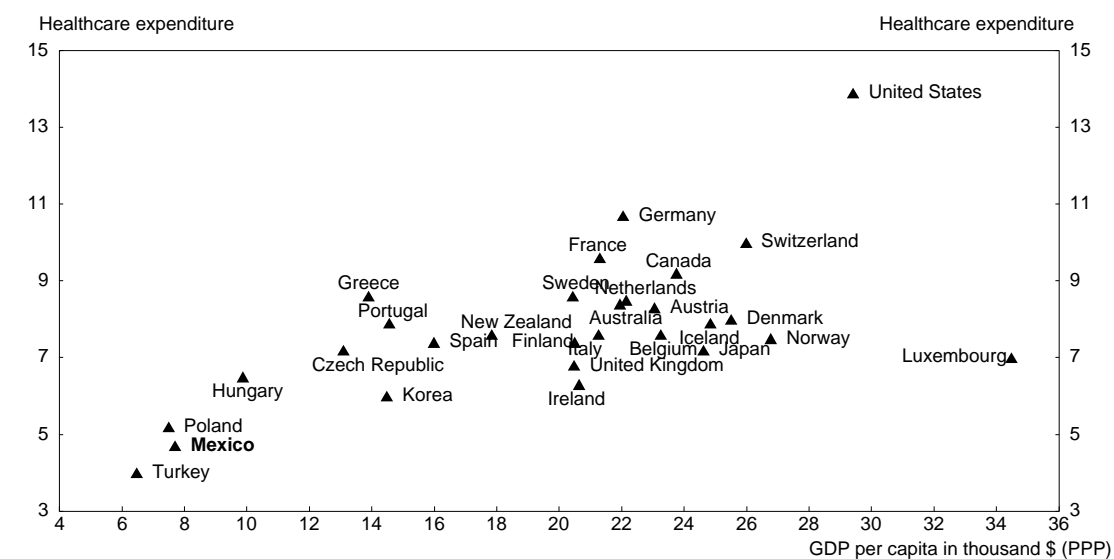
21. There is no unemployment insurance system in Mexico. As a partial substitute the government has developed temporary employment programmes in the rural areas. Moreover, training scholarships for urban workers were used to some degree in the aftermath of the 1994-95 peso crisis to provide an emergency safety net to those who had lost their jobs. Since then, the scale of these training programmes was expanded and they have become more focused on their original purpose, which is to facilitate workers' insertion in productive activity. There are public employment services (PES) but in the absence of unemployment insurance, job-seekers do not necessarily pass through them. The main role of the PES is to provide information to job seekers. To allow them to perform this role effectively, PES activities need to be developed, and in particular co-ordination between regional agencies, and co-ordination between the PES and training programmes, need to be strengthened.

22. The reforms of the health system and social security pension scheme were examined in detail in the 1998 *OECD Economic Survey*. An update of more recent progress is presented in the 2000 *Economic Survey (Chapter IV)*. The section here touches mainly upon the implications of measures taken for public spending and the outlook for the future.

23. Federal spending on health increased by 14.6 per cent overall in the period 1994-2000, with the uninsured population benefiting from the greatest increases. A programme was introduced to extend first-level health

resources over the last five years have aimed at reducing inequities, there are still some significant differences in the quality of services provided (see section below). In the long term, as per capita income increases and the population ages, health care demand will inevitably rise (*Figure 12*).

Figure 12. Healthcare expenditure and GDP per capita (1)
Per cent of GDP



1. In 1997.

Source: OECD, Health Data 99.

21. A fundamental reform of the Mexican social security institute (IMSS) for workers in the private sector was undertaken in 1997. Its main objectives were to widen social security coverage and establish financial viability of the system, while reducing distortions created in the labour market. For the health segment of social security, in particular, the costs of contribution to the system -- for employers and employees -- are being gradually reduced. As a counterpart, the funding from the general budget is increasing.²⁴ The new financing scheme, by lowering the cost of registration to social security, will facilitate job creation in the “formal” labour market sector, which is the best option for raising productivity and real income over the medium term. Moreover a mechanism has been established for voluntary affiliation to the system. As the coverage of the social security system widens, it will create upward pressure on the federal government’s contribution. Official forecasts put the cost of the financing reform of the health segment of the IMSS for the federal government at about 0.5 per cent of GDP per year.

coverage to all the population, especially in rural areas. Though combined actions at both federal and state levels, in 2000, the public health system covered 17.4 million persons more than in 1994.

24. Employers and employees’ contributions have been lowered, with the full effect of the adjustment coming through in 2007, while the share of federal government funding to the scheme has been raised. The 1998 OECD *Economic Survey*, contains a detailed analysis of the IMSS reform.

22. The pension scheme for private sector workers (IMSS) also underwent a sweeping reform with the introduction of a funded system in place of the old pay-as-you-go system. This reform, implemented as from mid-1997, will have a fiscal cost which is estimated by the authorities at about 0.7 per cent of GDP per year during a period of twenty years, falling gradually thereafter. The fiscal cost includes the introduction of a guaranteed minimum pension and a transitional cost representing the difference between the amounts accumulated by workers on their individual accounts and the pension they would receive if they opted for the old system.²⁵ Mexico is thus one of the few OECD countries to have introduced a funded pension system, the transitional cost borne by the government being relatively moderate given the demographic structure but also because the reform only applies to the private sector. Altogether the IMSS reform, concerning both the health and pension segments, has meant that a greater amount of resources are drawn from the general budget: the resulting increase in the federal government's contribution to the IMSS is estimated at a little more than 1½ percentage points of GDP per year. By contrast, the pension schemes of federal and state civil servants, which are run by distinct Social Security Institutes at federal and state level (ISSSTEs), were not reformed, and they still operate on a pay-as-you go basis, storing up contingent liabilities for the future, which have not been quantified.

Equity issues in public spending

23. Macroeconomic stability and wide ranging structural reforms are at the core of a strategy to increase living standards in a durable manner, but in Mexico as in many industrialising economies, from Latin America especially, specific policies are also required to correct uneven income distribution and fight extreme poverty. Questions of equity arise particularly in areas like education and health care. An important objective of public spending on education is to improve equality of opportunity between socio-economic groups and between regions, more specifically to give disadvantaged groups the opportunity to acquire the knowledge and skills that will affect their future ability to earn an income. Despite the improvement in school attendance rates -- as high as 90 per cent and more in primary schooling -- the probability of completing schooling remains closely correlated with the parents' level of income. For public education to achieve a greater depth and coverage, both the quality and the volume of resources allocated to public education services -- especially those provided to low-income categories -- are crucial. It is not easy to evaluate the impact of education services from a distributional point of view, since it requires taking three factors into account: first, the relative cost of the various types of services; second, the extent to which access to services is equitably distributed between the various population groups; third, the characteristics of the groups that have access to services.²⁶ In the case of higher education, the unit costs are higher than for other levels of education; free tuition benefits most the minority that reaches this level, i.e. the most well-off part of the population. Even for compulsory schooling, the opportunity cost of completing the cycle may be too high for the children of low-income families.²⁷ For this reason it is not enough to improve services offered; it is also necessary to put in place specific instruments aimed at the most disadvantaged families to give them an incentive to send their children to school. (Poverty alleviation programmes developed since 1996 incorporate such demand-side measures, as will be seen below.)

25. The estimates were published in the National Development Financing Programme (PRONAFIDE, 1997). The implementation of the new pension scheme was examined in successive OECD *Economic Surveys of Mexico* from 1997.

26. The impact of public expenditure, and recommended policy adjustments, are discussed in particular in D. van de Walle (1995) "Public spending and the poor", (World Bank, *Policy Research Paper*, No. 1476). Also see IDB (1998), *Annual report*.

27. In addition, in the most remote regions, transport costs increase the cost of access to basic public services, such as education and health.

24. The same kind of equity questions may be raised about the impact of health services. It is recognised that the quality of care delivered by the social security system, which covers only about 70 per cent of the population (the IMSS plus a number of institutions for public sector employees) is superior to that provided by the federal or state public health system (SSA), which is accessible to the uninsured population. The care provided by the IMSS is used by segments of the population that are relatively privileged in that they have a job in the formal labour market. Several aspects of the IMSS reform, in particular the newly-created mechanism to provide families with cover for a low fixed contribution, are aimed at improving the equity of the system. The pension reform also has a redistributive component in favour of low-income workers, since the government makes a lump-sum transfer to the savings account of all workers regardless of their wage level.

25. As noted above, despite substantial efforts made in Mexico, social expenditures remain low by OECD standards, even including targeted programmes to fight extreme poverty (*Figure 13*). In addition, little redistribution is achieved through the tax system. Regarding taxes, as demonstrated in the special chapter of the 1999 *OECD Economic Survey*, the exemptions and preferential regimes benefiting certain sectors of activity have little economic justification and are not redistributive. Furthermore, under the VAT regime, the extensive zero-rating of goods narrows the basis of taxed consumption; it complicates administration, and it is an inefficient mechanism for redistribution of income. Regarding the individual income tax, the tax credit is hardly equitable with regard to families since it is calculated on the basis of personal income and, unlike similar systems in other OECD countries, does not take into account the number of dependent children. As for tax expenditures, across-the-board subsidies which continue to be paid even when their purpose is unclear are not redistributive.

Poverty alleviation

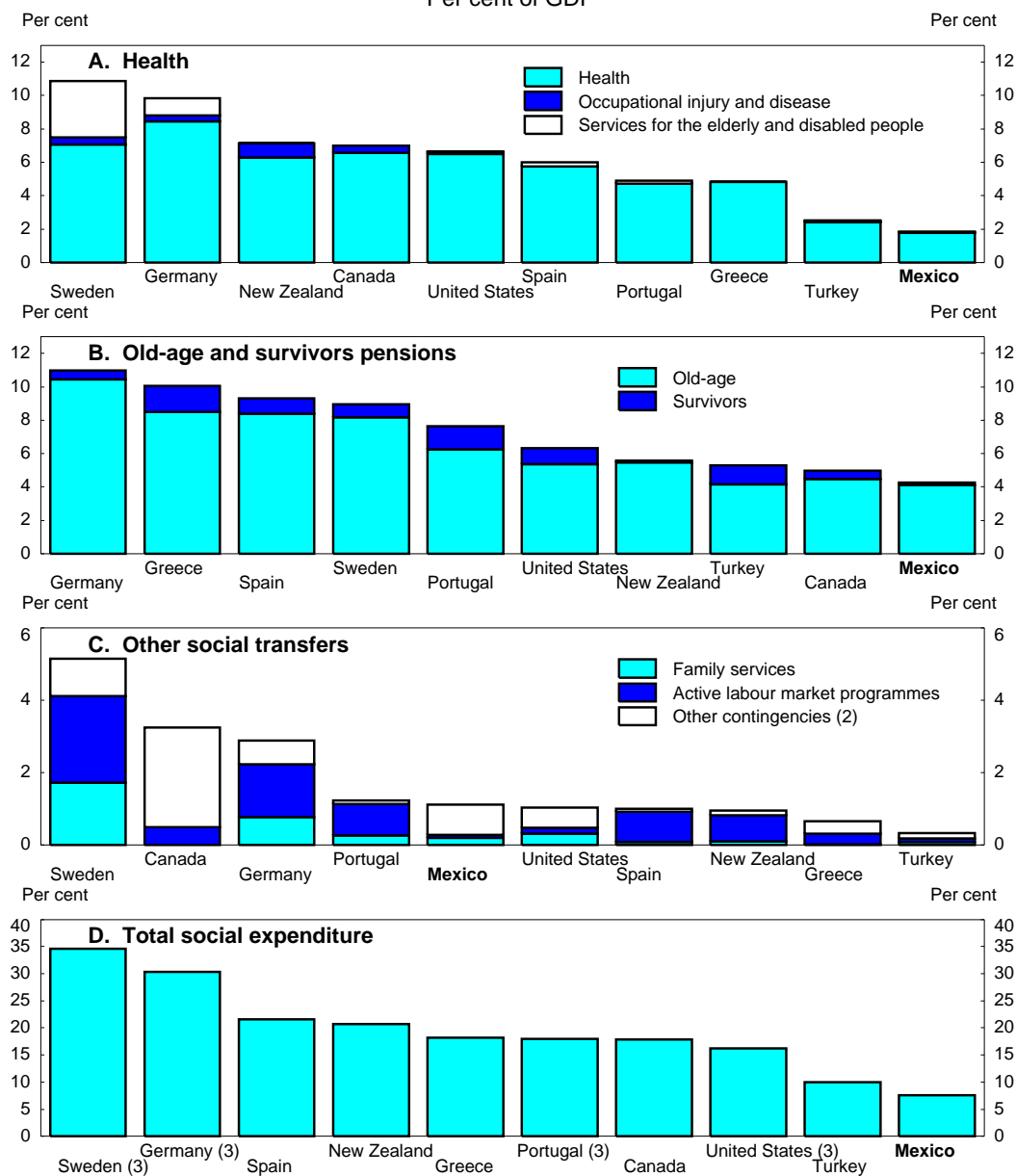
26. Recognising that economic expansion and broadly-based social programmes are not sufficient to reach all social categories and all regions, the authorities have implemented specific measures targeted at the most disadvantaged groups. This approach is not new but the current administration has widened the scope of social policy and sought to strengthen its effectiveness and redistributive impact by means of new instruments. In addition to improvements in social policy in general, the authorities have developed a specific strategy for alleviating poverty. It has three main thrusts: to create opportunities for earning an income in order to facilitate the involvement of families in productive activity; to develop basic infrastructure (drinking water, rural roads, rural telephones), and to enhance human capital.

27. The measures to enhance human capital concern both supply and demand. The supply-side measures aim at improving the quantity and quality of educational and health services. At the Federal level, action has been taken to enhance the supply of education services in 31 000 marginalised rural communities, in particular, through the distribution of books and equipment. Likewise in the health sector, targeted programmes provide free basic health care to the uninsured population, through the delivery of a minimum set of preventive services, encompassing family planning, immunisation, pre-natal attention and other basic actions.

28. At the same time, demand-side measures have been introduced, such as school breakfasts and school grants.²⁸ One of the main demand-side instruments of the new strategy is the integrated Education, Health and Nutrition Programme (PROGRESA) introduced in 1997. The PROGRESA programme currently in place has three features which enhance its effectiveness: it takes an integrated approach so as to achieve synergies between basic education, health and nutrition; the targeting mechanism is fairly

28. The scale of the school breakfast programme doubled its coverage between 1994 and 2000, expanding from 2.1 to 4.6 million children daily when considering federal and state resources channelled to it.

Figure 13. Social expenditure in OECD countries (1)
Per cent of GDP



1. 1997 for Mexico, New Zealand, Turkey and the United States; 1996 for Canada, Germany and Portugal; 1995 for Sweden and Spain; 1993 for Greece. Spending on education is recorded separately, see Figure 11.
 2. For Mexico, mainly targeted programmes of Solidaridad.
 3. Mandatory private social expenditures (amounting to less than 1.5 per cent of GDP) are included in the total.
- Source: OECD, Social Expenditure Database.

innovative and transparent; and the amount of transfers to beneficiaries is calculated according to transparent and uniform criteria, thereby reducing discretionary power.²⁹ The budget devoted to PROGRESA has risen steadily since its creation, to 0.20 per cent of GDP in 2000. At the end of 1999, PROGRESA covered 2.6 million families, representing around 80 per cent of the families in a situation of extreme poverty in rural and semi-urban areas. According to indicators of results for a sample of communities, the programme has had a net positive impact on the welfare of the families covered by it, in terms of improved children's school attendance rates, higher spending on food and children's clothes, better nutritional status of under-five year-olds and increased use of health services. Although the biggest concentration of poverty, as well as the most severe incidence, are in rural or semi-rural areas, about 1.2 millions of urban families are also living in conditions of extreme poverty. PROGRESA could be expanded to urban areas. If the authorities decide to extend the programme, the targeting and operation mechanisms would have to be adjusted so as to maintain incentives to work; and it should replace existing targeted programmes in urban areas, such as the *tortilla* and milk programmes.

Constraints and options

29. The above analysis has shown that the low level of tax revenue has imposed a constraint on public spending, while there are important needs to be met (human and physical capital development) to secure better balanced growth over the medium-term and improve the distributional outcome. This raises public choices issues, most notably about whether or not to increase debt, raise tax revenues or maintain low spending levels. Deficit financing is not an option because it would add to government liabilities, which are already substantial when taking account of fiscal obligations related to the financial rescue package and those resulting from the IMSS reform -- a well as those associated with the inevitable reform of the public sector pension system. Moreover, the unfavourable effects that deficit financing would produce on investors confidence would outweigh marginal benefits of the spending it would allow. Public choice would thus seem restricted to a single option: keeping a small-sized government, with a low tax burden and limited spending, while increasing the tax take in order to finance expenditure with high marginal economic and social benefits. Based on a detailed analysis of the Mexican tax system, the OECD has come to the conclusion that, although the general tax regime is adequately designed, changes would be appropriate to raise the low tax-to-GDP ratio over the short to medium term³⁰. Among the measures that could be taken over the coming years, those that reduce the scope of preferential regimes in consumption and income taxation on the one hand and efforts to strengthen tax administration and control are the most appropriate to increase tax revenue, without having adverse effects on efficiency. Considerations related to income distribution would also have to be taken into account. But changes that raise tax revenue, even when well designed, tend to raise political difficulties. They may only be acceptable if the marginal benefits from higher taxes are clear, and hence if the public at large perceives that government spending is effective.

30. Thus far, methods of budgeting, management and reporting have facilitated control of spending levels. Indeed past experience (for instance the consolidation phase of 1987-92) has shown that spending cuts were successful in bringing down the budget deficit -- and improving efficiency in some cases.

29. Other important features are the fact that: first, the responsibility of beneficiaries is involved, since benefits are conditional on families complying with school attendance obligations and medical visits; second, the recipient of the monetary transfer is the mother. *Annex II* provides more details on PROGRESA, reviewing its main features and achievements.

30. The OECD, *Economic Survey of Mexico, 1999*, included a detailed review of the Mexican tax system (see Chapter III in particular); the following year, noting that no progress had been made to strengthen the revenue raising capacity of the tax system, the recommendation to move ahead with tax reform was reiterated (cf. *Economic Survey of Mexico, 2000*).

However budgetary and management practices may not have been as successful in ensuring value for money. The criterion used for evaluating results in relation to needs has often been measuring inputs, i.e. the share of expenditure allocated to one programme or another. But, as with many other OECD countries, Mexico is increasingly seeking to introduce more appropriate mechanisms for evaluating the effectiveness of expenditure.

Issues in public management and budget

31. A significant factor influencing the effectiveness of public spending is how efficient the public administration itself is. Although many reforms were attempted in the 1980s and early 1990s, in 1995, the then incoming administration still felt that serious problems existed.³¹ It diagnosed four main shortcomings of the public administration:

- *Excessive centralisation and concentration.*³² Spending decisions were heavily centralised in two ways: most decisions were taken at the Federal level to the detriment of states and municipalities; and within the central administration, decision making was concentrated in the Ministry of Finance at the expense of line ministries (concentration). This facilitated budgetary control and co-ordination, but made resolution processes longer, restricted management ability and hampered the administration's capacity to respond to citizens' demands.
- *Complex bureaucratic procedures and regulations.* The response of agencies was sluggish and their accountability low, creating opportunities for waste of resources, lack of good judgement and corruption.
- *Lack of incentives for agencies and line ministries to be efficient.* Performance evaluation criteria at the programme level were often badly designed or non-existent.
- *Lack of status and professionalism among public servants.* Incentive mechanisms for the promotion of good performance, honesty, loyalty, effort and creativeness were inadequate. Differences in contracts and working conditions between unionised and non-unionised employees were significant, leading to low morale among public servants. Training opportunities were limited and staff performance evaluation was ineffective.

32. A comprehensive reform strategy for the modernisation of administrative and budgetary processes was launched in 1997, its centrepiece being the Budget Reform System (*Reforma del Sistema Presupuestario, RSP*). This is composed of several programmes that intervene at different parts of the budget cycle, complementing and reinforcing each other (*Box 2*).³³ In addition, efforts have been made to strengthen the control and auditing functions of the Executive branch, to improve human resource management, to give more responsibilities to line ministries and to enhance transparency. Concomitantly,

31. See Federal Executive Power, 1995, "Programme for the Modernisation of Public Administration".

32. "Concentration" and "deconcentration" refer more specifically to the relation between central budgetary institutions, such as the Ministry of Finance, on one hand and line ministries and independent agencies on the other. "Centralisation" and "decentralisation" generally refer to the relation between the federal government and sub-national levels of government (states and municipalities).

33. The reform strategy has been conceived to span over a decade, with the first phase, laying the basis for the modernisation process, ending with the present administration in 2000. The second phase, from 2001 to 2005, has been conceived as to improve and consolidate processes, with the third phase, starting in 2006 and open-ended, leading to the strengthening of institutions.

state and local governments have been given greater discretion in spending decisions. These initiatives have started to produce the desired results, even though the pace of change has been uneven. While some reforms have been completed, others are still in the “pilot programme” stage. Much progress has been made in increasing the transparency of government, improving audit and control systems, introducing positive incentive mechanisms, reducing the discretionary powers of the Executive and decentralising spending decisions. However, Mexico’s public administration, although rapidly changing, is still characterised by high concentration, lack of managerial flexibility and inadequate human resource policies and practices. The section below reviews the main reform accomplishments, and attempts to determine the scope for further progress. It concentrates on four main areas: budget processes and procedures, human resource management, the role of the market in improving public sector performance and issues related to the devolution of spending responsibilities.

Box 2. The budget reform system (RSP)¹

The New Programmatic Structure (NEP)

The NEP has been designed as a framework to evaluate and improve the efficiency of public spending through the determination and codification of the main public sector objectives. Each objective is described in terms of functions and sub-functions, with subsequent disaggregations allowing a three-level match between objectives, their respective programmes and individual administrative units in charge of their implementation. This programmatic organigramme is designed as a tool to facilitate the planning, drafting, approval and implementation of the budget. In the budget planning and drafting stage, the NEP is designed to foster closer co-operation between budgetary authorities in the Ministry of Finance and officials in line ministries and independent agencies -- either managers responsible for spending decisions or executives in charge of strategic planning. At the budget approval stage, it is an important input into discussions in Congress, as it allows a better link between government objectives and functions and approved appropriations. Finally, at the implementation stage, it has facilitated the introduction of performance indicators, enhancing the evaluation and monitoring of governments’ programmes and activities and feeding into the new performance evaluation system (SED) described below. The NEP was first implemented with the 1998 budget and is at present at its consolidation phase. Results have been positive, especially in the drafting and approval stages. Its usefulness as a tool for strategic planning has been below initial expectations, however, leading to a review of some aspects of the methodology applied.

The Performance Evaluation System (SED)

The SED is being developed as a system of budgetary monitoring and evaluation. It is designed to measure the performance of the administration and to evaluate the effectiveness and the social impact of public spending. It is also expected to lead to better overall accountability. The SED encompasses the use of performance indicators, introduced by means of performance agreements signed between budgetary entities (SECODAM, Ministry of Finance) and other ministries or independent agencies. In exchange for signing these agreements, ministries and agencies obtain enhanced flexibility in managing their budgets. By 2000, several important public entities had signed performance agreements -- including IMSS, ISSSTE and parts of PEMEX -- representing about a third of total budget expenditures.

The SED is also meant to serve as a planning instrument. For that purpose, the introduction of performance indicators has been complemented by new information systems that incorporate costing and strategic planning techniques. The SED should also feed back into the control cycle, as performance audits become part of the annual control and evaluation programmes of SECODAM's internal auditing units -- they will verify the strategic planning process and determine whether it is in conformity with their programmatic objectives.² The SED was first introduced in 1997, but early performance indicators, often borrowed from the private sector, turned out to be poorly adapted to the characteristics of the Mexican public administration. Moreover, institutional barriers prevented the creation of a well-designed incentive mechanism of sanction and rewards. Finally, the absence of an ingrained administrative culture and simple resistance to change led to an overall rethinking of the system. A new conceptual and methodological framework is now being developed, while pilot programmes have started with several agencies and ministries.³

The Integral System of Public Income and Expenditure (SIAFF)

The SIAFF represents an effort to improve financial management and is operated in conjunction by the Ministry of Finance, the Bank of Mexico and SECODAM. Through the introduction of a more modern budgetary and payment information system, the registration and control of financial operations is being simplified. The principal objectives of SIAFF are to promote a more efficient management of resources, providing better information regarding the execution of spending, while at the same time ensuring timely payment to suppliers. The system is in the pilot programme stage; its completion is scheduled for the next administration (whose term in office runs from 2001 to 2006). When completed, an electronic communication network will link all participants in spending decisions, who will have access to all relevant information about the different processes and phases of disbursement approval. The SIAFF is also meant to provide up to date information on public finances to the Executive and Legislative branches, enhancing their control function.

The Integral System for Human Resource Administration (SIARH)

The SIARH is designed as an instrument to enhance human resource management (HRM) and budgetary control of payroll costs. When fully operational, it will contain relevant information on public servants and provide for the harmonisation across ministries and agencies of certain HRM practices. For instance, a unified "national affiliation system" for public servants will be created and a single payroll will be introduced, including a single pay and grade scale. The SIARH is also expected to enhance transparency on payroll and other HRM practices and facilitate personnel mobility within the public sector. The system is still in its early stages -- only seven Ministries have implemented it.

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1. In addition to programmes described here, several other programmes have been implemented to improve the efficiency of the budget process by introducing more modern information technology. Moreover, a process of deregulation of budget procedures was initiated in 1997.
 2. They will also verify the consistency of objectives of different hierarchical levels with those that are overall for line ministries or agencies.
 3. Indicators have started to be used to measure performance in a number of ministries and agencies. For the 1999 budget, the number of indicators in the federal budget that are subject to a specific follow-up programme reached 73 -- up from 39 in 1998. Agreements have been signed in the health, education and agricultural sectors, but their use is still not widespread. The new pilot programmes have put great emphasis on training of managers, who take courses on strategic planning, costing, and the development of basic information before signing performance agreements. Over two years, 6 000 high and mid-level managers/public servants have been trained.

Strengths and weaknesses of the budget process

33. Budget planning at the federal level covers the central administration and several public enterprises. Until recently, the budget process was highly concentrated, with two entities -- the Ministry of

Finance and the Ministry of the Comptroller-General and Administrative Development (SECODAM), both part of the executive branch -- having wide prerogatives over drafting, implementation and control. This helped achieve budget discipline, but implied costs in terms of efficiency, transparency and democratic control. To address this problem, important steps have been taken in the past three years to transfer decision-making to line ministries and agencies and to enhance legislative oversight of the budget process.

Historically, concentration of powers helped achieve budget discipline...

34. In Mexico, the budget is drafted by the Executive branch, which has the prerogative to set the overall budget stance and its underlying macroeconomic projections. Two separate bills -- one for expenditures and one for revenues -- are sent to Congress, which can alter them as long as the budget stance is not loosened (*Box 3*).³⁴ Within the executive branch, the Ministry of Finance plays a leading role in drafting and managing the implementation of the budget. It initiates the drafting process and negotiates with line ministries and independent agencies their respective programmes, before presenting the draft budget to Congress for approval.³⁵ Until the reform process started in 1997, these negotiations required considerable administrative inputs from all sides involved. In a “bottom-up” approach, line ministries bid for resources, while the Ministry of Finance reviewed their claims, compared their worth and decided on expenditures, programme by programme. Virtually all spending decisions taken at the line ministry or agency level had to be reviewed by the Ministry of Finance for approval before the disbursement of funds. This heavily centralised system worked well in providing the budget discipline absent in many other countries for two main reasons. First, strong executive prerogatives meant that budgets were less vulnerable at the drafting stage when faced with pressure from interest groups for increased spending. In general, as benefits from public spending are usually more targeted than its costs (taxation), there is a tendency for the net marginal benefit from spending to be overestimated, which may create a “deficit bias” in public finances, which is the larger the more fragmented a budget process is.³⁶ In Mexico, this did not occur, even after political fragmentation led to an effective division of power between political parties, with no party having an absolute majority in Congress. Second, the concentration of budget decision-making in the hands of a single ministry helped impose an effective hard-budget constraint on line ministries and independent agencies -- appropriations were indeed seen as the maximum authorised amount of expenditures. As a result, contrary to what occurred in many other OECD countries, spending overruns were rare.

34. The macroeconomic projections underlying the budget are also the exclusive responsibility of the Executive, including that for oil revenue, which normally accounts for over a quarter of total fiscal revenues. These projections have generally been realistic, and may even have tended to err on the side of caution: in recent years, the need for budget revisions has derived mostly from unforeseen circumstances.

35. Another budget entity is the Inter-secretarial Commission of Financing and Expenditure, which plays a consultative role in the drafting process by providing a forum for the setting of overall budget priorities. The Commission is composed of the Ministry of Finance, the Ministry of the Comptroller-General and Administrative Development (SECODAM), the Ministry of Trade and Industrial Development (SECOFI), the Ministry for Labour and Social Security (STPS) and the Ministry of Social Development (SEDESOL).

36. See von Hagen and Hallerberg (1997), “Electoral Institutions and the Budget Process”, in *Democracy, decentralisation and deficits in Latin America*, 8th Forum on Latin American Perspectives, IBD/OECD.

Box 3. The budget process

The approval process

In Mexico's bicameral legislative system, both houses participate in decisions pertaining to revenues, but only the lower house is involved in approving expenditures. It can modify the budget draft, reducing overall expenditures or specific appropriations. To increase expenditures, new sources of finance need to be established. The legislative approval process cannot normally take more than a few weeks -- between the submission of the draft on 15 November and the deadline for its approval on 31 December. This time span is too short to allow full scrutiny by Congress, especially since its institutional involvement in earlier stages of drafting is generally kept to a minimum. In many OECD countries, a minimum of two to three months is allowed for meaningful budget discussion and Congress (or Parliament) has a much more active institutional role in the budget drafting process¹.

Newly-created legislative bodies

In April 1998, the House of Representatives created a technical, non-partisan, specialised unit responsible for analysing public finances. The unit is in charge of preparing the elements needed by parliamentary commissions, groups and Representatives to conduct their legislative tasks concerning the budget. It has considerably increased the legislative body's technical capabilities on budgetary matters, enhancing the effectiveness of its oversight functions.

In 1999, the creation of the *Auditoría Superior de la Federación* was approved by a constitutional amendment. This body -- a technical, independent non-partisan agency linked to the Legislative Branch -- is not yet fully operational, pending approval of secondary laws by the Senate. Its role will be to audit public expenditures, including the possibility of auditing during the year, when irregularities are reported. It will then be able to determine liabilities and penalties for public servants deemed responsible. The combined activities of this new agency and of SECODAM is seen as strengthening the control system, by enhanced legislative oversight of the budget process.

Budget provisions for revenue shortfalls and windfalls

In the case of Mexico, the budget is particularly vulnerable to external shocks such as changes in international oil prices. Rules for revising the budget are not enshrined in the Mexican Constitution. Until 1998, shortfalls automatically triggered budget revisions, while windfalls could be disposed of under sole Executive discretion. Typically, extra revenues were used either for debt redemption or were accumulated in an "infrastructure fund", the use of which has not always been entirely transparent.

Until 1997, shortfall and windfall provisions have been negotiated between the executive and legislative branch each year at the time the original budget was prepared. The procedure for spending adjustment normally varies according to the size of the discrepancy. If windfalls or shortfalls are relatively small -- typically less than 1 per cent of total budget revenues -- authorisations for increased spending or borrowing are automatic. In the case of wider shortfalls, spending cuts are mandatory. Larger windfalls on the other hand are earmarked for public debt redemption and/or the accumulation of contingency funds.

Extraordinary spending for natural disasters

In order to reduce the budget's vulnerability to natural disasters, since 1996 the government established a new Natural Disaster Fund (*Fonden*) in the federal budget. It provides the resources necessary to repair damage caused by a natural disaster without violating spending limits for the year.

1. In Sweden, for instance, the committees of Parliament play a key role in budget deliberations, participating actively in the drafting process, in close consultation with the line ministry or independent agency involved.

...at the expense of efficiency, transparency and democratic control

35. Nevertheless, the system was flawed in several respects, including the lack of effective democratic oversight, excessive bureaucracy and inefficiency. The absence of any provisions for oversight of the assumptions underlying the budget, either by Congress or by an independent agency, gave rise to criticisms of the system on the grounds that it lacked transparency. Excessive concentration also implied significant administrative costs, with line managers often complaining of excessive bureaucracy. Together with quantitative restrictions on the number of staff that could be hired and on setting wages and other terms of employment, these restrictions seriously hampered the flexibility of managers. They also prevented the more widespread use of market-based instruments to improve public sector performance, such as contracting out (see below). As a result, they significantly impinged on the efficiency of public spending.

Recent reforms have started to redress the balance...

36. Since 1997, reforms have started to transfer budget prerogatives away from the Ministry of Finance. In exchange for signing performance agreements, line ministries and agencies have been granted increased autonomy in managing and allocating their budgets. Recent measures have expanded the use of *ex post* controls by transferring the responsibility of budgetary authorisations to line ministries and agencies. This concerns capital projects and other investment projects, as well as budgetary modifications, amounting to two-thirds of net expenditure. In addition, actions to deregulate and improve intra-government information channels -- deriving in large part from the implementation of a new electronic network and the simplification of budget rules -- have speeded-up internal procedures, reducing administrative costs.³⁷ This in turn should lead to an increase in the overall efficiency of the public administration. At the same time, Congress has acquired new powers of oversight. Provisions to deal with revenue shortfalls and windfalls have been incorporated into the budget, adding transparency to the drafting process, and a legislative auditing body (*Auditoría Superior de la Federación*) has been created, increasing the accountability of the Executive branch.

...but changes should be consistent with the enforcement of a hard-budget constraint

37. Although it would be desirable to move further with the de-concentration process, the speed of budget reforms is in large part conditioned by the need to maintain overall fiscal discipline. As a result, and in spite of the significant progress made in the past three years, reform efforts are still at an initial stage and central budgetary agencies (the Ministry of Finance and SECODAM) maintain overall control of spending decisions. In order to move forward, mechanisms need to be found to ensure that changes are consistent with the government's ability to enforce a hard-budget constraint. In that regard, the newly-created Legislative auditing body could play an important role. By strengthening Congress's auditing and control functions, it would allow it to perform a more systematic evaluation of programmes. In turn, this would permit a revision and re-adaptation of present control mechanisms within the Executive branch. By enhancing the accountability of managers, and imposing penalties and liabilities when necessary, more effective programme evaluation will increase managers' responsibility for their actions and allow a further increase in their flexibility with regard to budget decisions.

37. The regulation for the execution of public expenditure (contained in the Handbook of Budget Rules) has been considerably streamlined. By 2000, rules had been reduced by almost two-thirds relative to the situation in 1997.

Incentive mechanisms: audit, control and evaluation systems have become more efficient

38. In Mexico, the public sector audit and control system is the responsibility of the Ministry of the Comptroller-General and Administrative Development (SECODAM), which is the internal control department within the Executive Branch. SECODAM performs its function through a network of auditing units, each with responsibility for a single ministry or agency.³⁸ Until the end of 1996, several restrictions hindered the performance of audit and control systems, including the fact that auditing units were not under the effective control of SECODAM, but often of the ministry or agency being audited. Also, legal barriers made it time-consuming and cumbersome to impose sanctions on public servants. Since then, changes have been made, so that internal audit and control systems now work relatively well. For instance, auditing units -- although remaining administratively linked to line ministries and independent agencies -- have now to abide by regulations and guidelines issued by SECODAM, which also directly appoints their key civil servants. Incentive mechanisms have also improved significantly with the introduction of a performance evaluation system (*Sistema de Evaluación del Desempeño, SED*) as part of the overall budget reform process (RSP). Until 1997, few indicators were available as benchmarks to evaluate performance. The SED is based on performance agreements signed with line ministries and agencies and designed to feed into the control cycle.

Government has become more responsive and bureaucratic procedures have been simplified

39. Until recently, Mexican public administration practices have been characterised by low levels of transparency, which derived to a large extent from excessive executive powers. This concentration of power was often associated with lack of accountability and instruments allowing effective oversight by public opinion and elected representatives. Lack of transparency concerned both budget processes and procedures and human resource management issues. In the past few years however, significant efforts have been made to improve matters in this area. Accompanying the opening of the political process, innovations have included full disclosure of public servants' salaries and benefits and enhanced public oversight of the budget process, with less scope for Executive discretion in spending.³⁹ Procurement practices have also been significantly modernised, with initiatives such as the "Electronic System of Government Procurement" (COMPRANET) leading to more transparency in tendering, including through the publication of information on the winning bid (*Box 4*). Finally, administrative procedures have been simplified and made more accessible to the general public through measures to reduce excessive bureaucracy and through the publication of administrative requirements on the Internet. An automatic approval process was also introduced for some procedures, with approval implicit in cases where the administration's response exceeds a pre-established time frame. These measures have led to a marked improvement in administration's responsiveness to citizens' demands and have also reduced opportunities for unethical behaviour. Simpler and faster procedures, combined with less personal interaction between

38. Internal audit units are empowered to determine the opportunity and scope of audits, and enjoy operational flexibility to design their programmes according to the characteristics of the line ministry or agency of their responsibility. An annual audit and control programme with monthly or quarterly interim reporting requirements is generally prepared for each of ministry or agency. The Ministry of Finance retains some residual responsibility for ensuring that the budget exercise proceeds as planned and deviations are detected and corrected in time.

39. For instance, the "secret expenditures" component of appropriations, which was at the complete discretion of the Presidency and outside the control of auditing authorities, reached a peak of over 0.1 per cent of GDP in 1993, but was gradually reduced thereafter and was eliminated in the 2000 budget. This component, known as the "*Erogaciones contingentes*", was included in the budget appropriation line 23 ("*Ramo 23*"). It was considerably reduced from 1.5 billion pesos in 1993 (0.1% of GDP) to a residual 50 million pesos in 1998 and 1999 (but funds were not spent), before being entirely eliminated in 2000.

citizens and the administration, have significantly diminished the previously common practice of charging fees for “queue-jumping”. In addition, since 1999, all federal agencies have been required to publish “rules of operations” in the Federal Register, specifying clearly the criteria for selecting beneficiaries of each programme and performance indications for evaluation. This innovation seeks to increase efficiency, transparency and accountability.

Box 4. The Electronic System of Government Procurement (COMPRANET)

COMPRANET has been developed by SECODAM as a universal, public-access system for carrying out public sector tendering. It has been designed as a way to make government procurement more efficient and transparent, including through the reduction of transaction costs and of opportunities for unethical behaviour. This electronic system on Internet contains invitations for tender, required bidding documents and a system of electronic tendering, which allows suppliers and contractors to submit bids. Finally, after a tender is assigned, information on the winning bid becomes publicly available, greatly increasing the transparency of the process.

The system became fully operational at the end of 1999, with the inclusion of all procurement processes for the acquisition of goods and for the contracting of services and public works by all Secretariats, agencies and entities of the Federal Government. Results have so far been extremely encouraging. The number of bids through COMPRANET averaged about 2 000 a month in the two years to June 1999, with over 20 000 firms using it regularly. More significantly, SECODAM estimates that the system has led to considerable savings to the public purse, with average savings ranging from 15 to 25 per cent depending on the type of goods or services tendered.

Features of human resource management

40. Human resource management (HRM) is a key ingredient for increasing the efficiency of government. In Mexico, as elsewhere, HRM policies and practices have been under review in the context of an overall public sector reform strategy. Even though significant progress has been made in the past few years, there is still insufficient management flexibility at the line ministry or independent agency level. Moreover, the public service is characterised by a two-tier system, which leads to insufficient flexibility of staffing policy at the operational level and excessive mobility at the managerial level.

Policies and practices have improved, but managers still lack flexibility

41. Before the reform process started in the mid-1990s, HRM policies in Mexico could have been described as the worst of both worlds, combining multiple ministry-level personnel practices with the lack of operational autonomy by managers. Formal control was concentrated in the hands of SECODAM and the Ministry of Finance, which had full oversight on decisions by line ministries or agencies, their authorisation being required for changes in personnel status, and other decisions implying spending commitments, such as training. Managers often complained that the response time for authorisations was long and that the process was cumbersome and lacked transparency. Furthermore, pay scales were static and allowed for no incentive pay mechanisms. In spite of this heavy formal control, each ministry or agency had its own payroll and personnel management system. Criteria for hiring, advancement and promotion differed considerably among different ministries and agencies (with salaries and posts not necessarily corresponding to the same level of responsibility across public entities), hampering the mobility of civil servants within the public sector. Bonuses accounted for almost half of the payroll and fringe benefits for senior civil servants were substantial, but no clear criteria existed for their allocation between or within ministries, leading to considerable inequities. Control and budget authorities often complained that information on the assignment of individual workers to different tasks was scarce, that line ministries’ practices were often opaque and that no instruments were available to force them to comply

with regulations, preventing effective oversight. Finally, this lack of transparency led to low morale, opening opportunities for unethical behaviour.

42. -Starting in 1995, the authorities began to address these problems with a set of complementary reforms. First, new programme-wide performance evaluation systems have offered managers increased flexibility in exchange for signing performance agreements. Through this programme, line ministries and agencies have been released from several *ex ante* authorisation procedures. Second, new or updated HRM regulations were issued and an unified information system (the SIARH Programme) was implemented, increasing transparency and expediting authorisation requirements on personnel decisions. Third, policies have been implemented to rationalise and increase the transparency of the pay and benefit scales, including through the establishment of a minimum salary-bonus ratio (four to one) and the setting of a flexible but unified pay scale designed to eliminate inequities. This has been complemented in 2000 by the issuance of a "Pay and Benefit Handbook" by the Ministry of Finance, establishing the basis for a more modern compensation system which will facilitate the implementation of merit-based remuneration schemes. Finally, a system for evaluating the performance of public sector employees is slowly being put into effect, starting with senior public servants -- guidelines have been recently issued in this regard (*Box 5*).

Box 5. Performance evaluation systems and incentive schemes for public sector employees

The systematic evaluation of public servants' performance is relatively new in Mexico. Until recently, the absence of such a system and the limited incentives to improve performance were determining factors leading to the low efficiency and unaccountability of public servants. Related problems of unethical behaviour and insufficient effort were also seen to occur. To address these problems, a series of initiatives have been taken. A system to evaluate spending programmes is being put into place gradually through the performance evaluation programme (SED). This will eventually be linked to the evaluation of managers' performance and be built into incentive schemes. Managers' remuneration already incorporates a variable component, although this is not linked to a systematic performance evaluation scheme. Another programme in a "pilot programme" stage allows managers to grant cash bonuses or extra vacation days for well-performing operational personnel. All in all, performance-related incentives have been introduced or broadened for several categories, including teachers and medical personnel, which account for about three-fourths of the total number of public servants.

Performance-related incentives have been in operation for primary school teachers since 1992. A grid system of steps and grades apply, with five steps to each grade. Step advancements generally depend on a myriad of factors such as seniority, professional performance, the following of training courses and the engagement in extra-classroom school activities.¹ This system introduces a significant element of performance-related incentive and has led to a general increase in primary teachers' real income. Although better than a system of automatic step advancement, this scheme does not guarantee continued good performance, since steps cannot be taken back. Furthermore, there are no limits on the number of step advancements by school, which encourages a certain degree of "step inflation" among many managers.

In 1997 and 1998 respectively, performance-related incentive schemes were introduced for secondary and tertiary education teachers and for medical personnel, the latter on a voluntary basis. These new schemes seem better designed than the one for primary teachers. Both new schemes operate through a point system that is used to calculate cash bonuses given in reward for good performance. In the case of teachers, bonuses go from 1 to 14 minimum wages, while for doctors, they can add between 20 and 40 per cent to base salaries. For teachers, points are given for seniority and statutory working hours. The quality of teaching performance carries the heavier weight however, generally accounting for 60 or 70 per cent of the total number of points. Medical personnel are evaluated in terms of

the level of responsibility and competencies, human relations and working attitudes, and professional development. These schemes work on an annual evaluation cycle, where salaries (including bonuses) can actually be reduced in the case of deteriorating performance. In the case of medical personnel there are limits to the number of bonuses given -- an added feature used to avoid "bonus inflation".²

1. With the decentralisation process, the criteria to determine step advancement vary among States, although most include a mixture of seniority and performance-related incentives. The criteria established to evaluate performance also vary among States.
2. In a single universe (such as a hospital or clinic), no more than 3 per cent of personnel can receive the maximum bonus of 40 per cent and no more than 24 per cent of personnel can receive any type of bonus.

43. These reforms are at different stages of implementation, but the process of rationalisation of pay and benefits scales has now been broadly completed.⁴⁰ This is likely to increase transparency and help in the gradual introduction of positive incentive mechanisms for the promotion of good performance, since new scales allow for movement within grades, the granting of bonuses and other incentive schemes. However, management flexibility at line ministry level has remained insufficient overall. Although reform initiatives have led to the simplification of administrative procedures and introduced new management tools, managers are still sometimes tied to a cumbersome system of *ex ante* bureaucratic approval procedures for most staffing decisions. As described above, more effective evaluation mechanisms, both from the Executive and Legislative branches, should in time allow for the replacement of these controls without jeopardising fiscal discipline. Before gaining enhanced flexibility on staff and pay matters, managers need to be made fully responsible for their decisions, which often have a strong inter-temporal effect.

The status of public servants: a two-tier system

44. Contrary to most other OECD countries, there is no broad framework for the public service in Mexico. Although the modernisation of personnel regulations described above has created the basis for the introduction of this framework, government proposals for a "Federal Civil Service Law" are still under discussion. A career civil service exists, but it applies only to employees of a few ministries or agencies.⁴¹ Besides career civil servants, several employees (present in all government entities) enjoy enhanced job security: they can only be laid off under special circumstances and after the payment of a significant indemnity.⁴² Known as "unionised" workers, they account for about half of total public sector employment and tend to have low mobility and skills, occupying to a large extent the lower echelons of the public

40. Besides salaries, most Mexican public servants draw significant fringe benefits. These account for 25 per cent of total payroll expenditures in basic salary of the federal government, a level considerably higher than in most other OECD countries.

41. This includes the foreign service within the Ministry of Foreign Relations, the teaching career within the Ministry of Education, the Electoral Commission, the Central Bank, the National Institute of Statistics and Geography, the Agrarian Professional Service, the Revenue Professional Service (SAT) and the Metrology Professional Service.

42. A discharged public servant is entitled to an indemnity equivalent to three months of salary per every year worked. "Unionised" workers are hired directly by the human resource department of each ministry or agency or appointed by the Public Sector Workers' Trade Union. According to the Federal law applying to Public sector employees ("*Ley Federal de Trabajadores al Servicio del Estado*"), half of all entry-level vacancies are filled by candidates fielded by the Union. Union by-laws establish rules for the selection of candidates, with family members of public sector employees sometimes being granted preferential treatment

service -- i.e. “operational” rather than “managerial” positions.⁴³ The great majority of managers do not enjoy job stability and more senior public servants are directly appointed by the Minister or other senior officers, who have complete discretion over hiring. Informal criteria based on personal relationships -- such as political loyalty or personal trust -- are often the main determinant of hiring decisions. These public servants are generally appointed for the term of an administration (six years), but can be laid off at any time without being entitled to an indemnity.⁴⁴

45. This two-tier public service system leads to three main problems. First, the high cost of dismissing “unionised” workers is seen as a serious constraint on the overall flexibility of human resource management. Second, the large number of appointees leads to low morale among workers at lower echelons, who often see their career prospects blocked by the arrival of people who are new to the service and younger than they are. Although it is justifiable that senior public servants should be appointed by an incoming administration, the present number of appointees -- estimated at about a seventh of total public sector employment, excluding special categories -- is excessive. Third, the high degree of mobility of middle management -- both within the public sector as well as between the public and the private sector -- often leads to insufficient institutional knowledge at managerial level. This rotation of expertise can be an advantage if it facilitates adjustment and allows a constant renewal of human capital in particular, through the infusion of private sector practices into the public sector. In Mexico, however, this mobility is often seen as excessive, leading to a lack of continuity at the senior and mid-level management level. The problem becomes acute in the transition between administrations, which lasts about 3½ months, when the large number of new appointees can deeply disrupt the functioning of the administration.

*The role of the market in improving public sector effectiveness*⁴⁵

46. In many OECD countries, efforts to improve public sector performance have included the introduction of mechanisms that increase the role played by market principles in public spending decisions. These market-based mechanisms include vouchers, user charges, contracting out and intra-governmental contracts. Their introduction is usually aimed at improving the allocative efficiency of public spending, while enhancing the responsiveness and accountability of public agents in the provision of public goods and services. In Mexico, the use of market-based mechanism is still undeveloped. No voucher or internal market schemes are in operation, while user charges apply only in a limited number of cases -- mostly in the health sector, where some services provided in Ministry of Health (SSA) facilities and in State hospitals draw fees. Contracting-out has been more broadly used, especially of cleaning and security services. However, more complex functions are not generally contracted out, in part because the contract process involves a considerable amount of red tape and significant administrative costs. This derives from the fact that most line ministries and agencies have limited autonomy in these matters -- SECODAM has to be consulted at most stages of the process. As line ministries autonomy is being increased, contracting out is expected to become more widespread in the near future. This is likely to be beneficial, since in many other OECD countries contracting out has led to substantial savings, -- of 15 to 25 per cent of related spending -- with a concomitant improvement in the quality of services provided.

43. Excluding special categories of public sector workers such as teachers, medical personnel and the military. These enjoy a special status and account, respectively, for 64, 7 and 13 per cent of general government employment.

44. A new saving fund, however, was created in 1998, into which the federal government contributes the same amount that employees save -- up to 10 per cent of their salary. This fund serves as a partial substitute for indemnities.

45. *Annex III* provides a more detailed discussion of the use of market-based mechanisms for public spending.

47. –Contracting out infrastructure development to the private sector has long been a common practice in many countries. More recently however, this relationship between the private and public sectors has evolved into one of partnership, where the private sector shares the risk of providing infrastructure rather than just building it. In such partnerships, private sector involvement extends through the entire life of capital projects, such as design, financing, construction and operation. These schemes are now often used to accelerate capital investment programmes in the context of tight budgets. Mexico has had one of the broadest experiences of any OECD country with these partnerships. This has included “build, operate, transfer (*BOT*)” projects and “build, lease, transfer (*BLT*)” schemes in power generating plants, substations, transmission lines, petrochemical processes and oil refineries, as well as a large-scale highway building programme.⁴⁶ These projects have met with significant success, with the exception of the latter: the private sector played a prominent role in building toll roads in 1989-1994, but flaws in the contracting out process led to high building costs and the inadequate spreading of financial risk. These weaknesses and the unforeseen circumstances of the 1995 economic crisis led to the bankruptcy of concessionaires and the re-nationalisation of toll roads (*Box 6*). As a result, no highway projects of this kind have been undertaken since 1995.

Box 6. The experience of Mexico with the contracting out of highway development and operation¹

In 1989, the government started contracting out its network of national highways through toll-based private finance initiatives. Through a concession system, the private sector signed contracts for the building, operation, maintenance, and exploration of new highways, with ownership remaining in the public sector. Given the tightness of the budget, this programme was conceived in order to free government resources for the construction of rural roads, which had a significant economic and social impact in remote areas of the country. Nine main highway axes, divided into sections, were commissioned. The call-for-tender notice and general conditions for the bidding process included, among other documents, detailed engineering studies, the project of the concession title, appraisal studies and the required maintenance standards. The winning bid was awarded the construction, the right to operate the project for the term of concession, and the obligation to carry out maintenance work. Competition was introduced for the overall project and not for each of the main activities.

Between 1989 and 1995, about US\$ 8 billion were invested by the private sector and more than 5 000 km of toll roads were built under this scheme. However, the volume of traffic on the highways was less than estimated, in part as a result of the high toll fares and the drop in domestic demand associated with the economic crisis of 1995. The problem was exacerbated by a large jump in interest rates, which increased the financial burden of the projects, leading to the bankruptcy of many concessionaires. Although the government was under no contractual obligation to bail out the concessionaires, some concession titles had guaranteed a minimum of traffic on the toll roads, as well as an extension of the term of concession until a certain rate of return was obtained on the investment. As a result, the government had to implement a bailout programme that cost the equivalent of 0.5 per cent of GDP. The bailout was also explained in the overall context of a systemic threat to the domestic banking system, which resulted from a multitude of factors².

1. For details of Mexico’s experience with contracting out highway development, please refer to *Public Management Occasional Papers No. 20*, OECD.
2. See various *OECD Economic Surveys of Mexico* for a description of the situation in the financial system.

48. –In part as a result of the experience gathered up to 1995, the Budget law was amended in 1996 to create new forms of financing infrastructure projects in the context of a tight budget and constitutional restrictions on private investment in certain sectors. Under a hybrid scheme known as PIDIREGAS, the private sector builds and finances infrastructure, mostly in the oil and electricity sectors, while the public

46. The total value of public works tenders amount to several billion dollars annually. In the 1996-97 period, tenders by PEMEX and CFE, the oil and electricity companies, averaged US\$2 billion a year.

sector pays for the contracted obligations after completion of the projects, theoretically using the benefits that these generate (*Box 7*). To the extent that these projects are profitable, the scheme is viable; however, when this is not the case, the scheme could result in a medium-term burden on the budget. In the electricity sector for instance, where residential consumer tariffs are subsidised, resulting pricing distortions may jeopardise the future profitability of current PIDIREGAS projects. In that case, contracting conditions are crucial to determine the adequate sharing of financial risk by the private sector and the build-up of non-provisioned contingent liabilities by the public sector.

Box 7. The PIDIREGAS scheme¹

Since 1997, some infrastructure development in Mexico has been financed through a scheme known as PIDIREGAS. This scheme has been conceived as an alternative means of financing public infrastructure projects in sectors where legal barriers prevent private investment and at a time when funding to the public sector was either too costly or unavailable. Under the scheme, the private sector finances and builds infrastructure, with no payment due by the public sector until completion. Only then, is the project recorded as investment spending in the public sector financial accounts. In theory, the revenues generated by the project will suffice to reimburse the cost of its construction overtime, so it should be budget-neutral. In practice, there are no contractual guarantees that this will be the case, with the public sector assuming the risk of eventual failure. In the meantime, the annual budget does not incorporate the build-up of contingent liabilities, which introduces an unhealthy element of lack of transparency in public accounts².

Projects built under the PIDIREGAS scheme are not private-public partnerships. The private sector builds infrastructure for the public sector, but it does not share the financial risk of the project. Although payment for the rendered service is deferred until the project is completed, implying an implicit financing from the private sector, the public sector is legally obliged to pay for the full cost of building the infrastructure project, regardless of its eventual rate of return.

1. "Proyectos de Infraestructura Productiva de Largo Plazo de Impacto Diferido en el Registro del Gasto" (Long-term projects for productive infrastructure, with deferred impact in recording of expenditure).
2. Even though no appropriations are immediately required when a PIDIREGAS project is initiated, it still needs to be examined and approved by Congress. Expenditures on PIDIREGAS projects have a *de jure* preferential status concerning future disbursements, not unlike standing appropriations. This derives from the fact that funding for the entire project is legally approved by the Lower House at the time the project is launched, even if its impact on financial accounts is deferred.

*Issues in fiscal federalism*⁴⁷

49. The decentralisation process has been pushed forward significantly in the past three years in so far as greater discretion has been given to state and local governments in spending. The objective is to bring decisions closer to citizens' needs. However, devolving spending decisions also requires that adequate administrative capabilities be developed at the sub-national levels of government. More spending responsibilities have been given to sub-national levels of government, mainly in the education and health sectors, but also in other sectors, such as local infrastructure, public safety and programmes to alleviate extreme poverty. States have been given more tax raising capacity and allowed to levy fees for some public

47. The Mexican administration outlined its reform strategy for fiscal decentralisation in the "Programme for a New Federalism 1995-2000", published in 1997. Conceptual issues related to fiscal federalism were discussed in the 1995 *Economic Survey of Mexico* (Annex 3), including a comparison of practices in various OECD countries. Fiscal federalism issues are also discussed in IDB, *Annual Report*, 1994; IDB, 1997, *Mexico: finanzas subnacionales*; A. Casella, 1999, *NBER Working Paper No. 7278*; T. Ter-Minassien, 1997, "Intergovernmental fiscal relations in a macroeconomic perspective: an overview", in *Intergovernmental fiscal relations*.

services. Overall however, their own revenue and local taxes have remained limited. The asymmetry between expenditure responsibilities and the capacity to generate revenue has created a substantial gap in states' budgets, which has been bridged by transfers from the federal government (*Box 8*).

Box 8. Transfers of federal resources to the states and municipalities

The federal government transfers resources to sub-national levels of government (states and municipalities) to finance their spending, using three main mechanisms:

- *Federal participations*: These transfers take the form of revenue sharing with sub-national levels of government (at a rate of some 3 per cent of GDP in 1990-99). They are determined automatically as pre-established percentage of revenue. Once the funds are transferred, the "federal participations" are considered as local resources.
- *Federal grants* ("*aportaciones federales*") were created with the reform of the Law on Fiscal Co-ordination in 1998. Through this mechanism, the federal government has been transferring resources to the states for specific programmes; defined annually, they reached nearly 4 per cent of GDP in 1999. The Federal resources are divided into funds earmarked for specific attributions: basic education, healthcare services, infrastructure, programmes to alleviate extreme poverty, consolidation of municipal finances and, since 1999, technological and adult education, and public safety. The mechanism provides legal security over resource availability; resources are apportioned among states according to transparent rules; the responsibilities of the three different levels of government over the execution, monitoring and accountability are precisely identified. The sub-national level acts as an agent of the federal government and must employ the resources for the specific purposes stipulated in the Law. Fiscal surpluses are kept by the states and municipalities.
- *Resource re-allocation agreements* (or decentralisation agreements). The central government may sign agreements with state governments to transfer resources and responsibility for designated uses thereof. The resources thus transferred to the states keep their status as federal resources, but matching local funds must be provided as well.

The states are also empowered to collect taxes, but their own resources have remained marginal (8.5 per cent of their total resources). As a result, for the most part decentralised spending continues to be reflected in the federal budget, as transfers¹.

1. "Federal grants" are part of the federal government's "programmable" spending. In contrast, transfers through revenue-sharing (federal participations) are considered as "non-programmable" spending for the federal government, as are interest payments on government debt.

50. The total amount of public spending under direct responsibility of sub-national levels of government represent some 7 per cent of GDP, with 3 per cent as revenue sharing and 4 per cent as federal grants. This altogether corresponds to about 60 per cent of federal tax revenue; ten years ago, it amounted to only a quarter. In parallel, the composition of government employment between federal and the sub-national levels of government has changed, with a shift from the federal level to local governments, following the devolution of responsibilities for education and health care services in particular (*Figure 14*). This trend is expected to deliver efficiency gains, reduction in operating costs and increased performance in service delivery. However, measuring fiscal decentralisation by the share of sub-national spending is an

51.

imperfect indicator of the autonomy of lower levels of government in actual fiscal policy making.⁴⁸ The rules for distributing resources among the states and municipalities have been made fully transparent. Financial resources transferred under the revenue sharing scheme are considered as local resources, once transferred, with local legislatures deciding on how to spend them. On the other hand, federal grants have to be used for the specific purposes established in the Fiscal Co-ordination Law.⁴⁹ They are spent by the states and municipalities; the audit function which was performed by the federal authorities until 1999, is now performed by both the federal and local Congresses. In the case of human resources, sub-national levels of government do not have complete autonomy in managing staffing and pay levels.⁵⁰ Since 1999, the Federal government has eliminated its discretionary powers to transfer resources to states, with a view to enhancing transparency and enforcing a hard budget constraint in states' finances.⁵¹

52. Heavy reliance of states on intergovernmental transfers -- in Mexico, states' own resources account for only 8.5 per cent of their total resources -- creates a wedge between local spending and local resources, and between benefits of government programmes and the cost to local tax payers, which may generate moral hazard. The use of transfers reduces accountability in expenditure management at the sub-national level of government, unless the transfers are in the form of block grants or involves co-financing. Follow-up and control mechanisms have been developed; but states' administrative and fiscal capacities are uneven and in some states, they may be insufficient, which also weakens fiscal accountability. Two key questions arise in this context: whether fiscal decentralisation may lead to a deterioration of sub-national finances; and whether such an occurrence would affect negatively the budget position of the central government (since in the event of financial difficulties, the central government would have to bail-out sub-national levels of government). A number of specific options to limit the scale of possible problems associated with furthering the decentralisation are taken up in the section below.

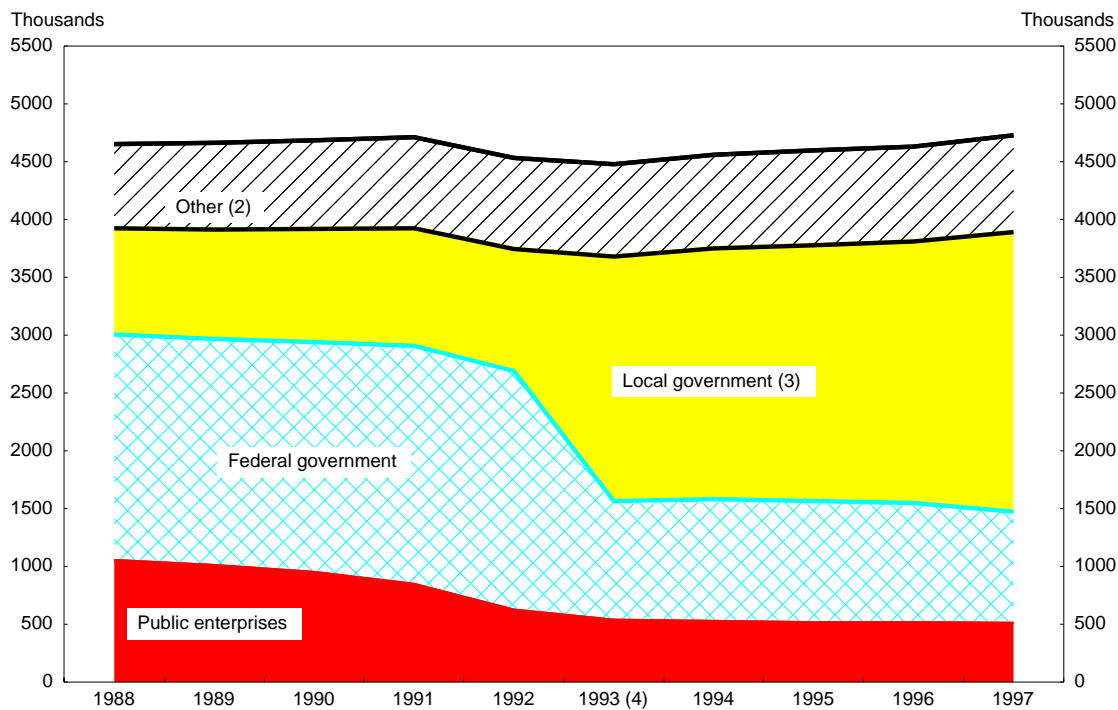
48. IDB/OECD Development Centre (1997), "Democracy, decentralisation and deficits in Latin America -- Fiscal decentralisation and macroeconomic stability."

49. The total amount of federal contributions under that scheme is included each year in the federal budget of expenditure (appropriation line 33); and clear rules have been established to allocate resources to each state and to the federal district for each of the seven specific funds. For instance, in the case of education and health services, which account for more than three-quarters of the resources transferred to states for a specific use, the allocation is mainly based on the cost of services provided. The distribution formulas between states and municipalities take into account population size and various indicators of poverty and needs.

50. The degree of autonomy of sub-national levels of government remains limited with regard to recruitment and salary adjustments (e.g. in education and health care); but their leeway is getting somewhat wider. For instance, there is now the possibility to introduce pay incentives at state level, and geographic bonuses.

51. Up to 1998 the federal government operated, through the Ministry of Finance, a programme transferring resources to state governments, primarily for amortisation of their debt. As a consequence, the share of states' spending in servicing debt was reduced -- from 7.9 cents of every peso they spent in 1995 to 2 cents in 1999. This reduction has helped to enforce a hard budget constraint on states and reduce risks of moral hazard.

Figure 14. Trends in public sector employment (1)
In thousands



1. Including all public enterprises (under budget control and outside).
 2. Includes social security system and public entities in the central government.
 3. State and municipal government.
 4. The fall in employment in the federal government recorded in 1993 reflects the decentralisation of education services to local governments.
- Source: INEGI, Sistema de Cuentas Nacionales de México, 1988-1997.

Assessment and agenda for further reform

53. There are many calls on expenditure to meet the needs of social development and infrastructure, but resources are tightly constrained since tax revenues remain low relative to GDP. Substantial progress has been made in cutting back and refocusing public spending in Mexico. Besides privatisation and deregulation, this has taken the form of steps to rationalise existing programmes, cuts in general subsidies and the use of more targeted programmes. At the same time, changes in public management have been made to enhance transparency and reduce arbitrary action. The main objectives in reorienting spending have been to improve the quality of services provided and to widen the coverage of these services to address basic needs of the population at large, including those in extreme poverty.

54. The question of whether the level of public spending is optimal for Mexico's level of economic development is impossible to answer exactly. However, an increase in tax revenue would seem appropriate in order to finance expenditure that would have considerable marginal economic and social benefits.⁵²

52. See the Chapter III in the 1999, OECD *Economic Survey of Mexico* for a detailed discussion on why and how to raise tax revenue from its current low level.

Certainly, the evidence from other advanced economies is that a rise in the proportion of public spending to GDP may be complementary to the growth process. At the same time, there are spending commitments that the government will continue to face over the coming years. The social security reform and the cost of the banking sector support package entail spending of over 2 percentage points of GDP per year for at least 10 years. Financing these expenditures will require in the medium-term a widening of the tax base. In this context, the priorities have to be clearly set out and advances in reforming the public administration and budgeting processes can play a key role.

55. Public spending on education, training and social development has been an important priority of the current administration, as attested by the continuous increase in the share of public spending allocated to those items. But as a proportion of GDP, expenditure in this area is still among the lowest in the OECD. Progress on social development in general is needed not just for its own sake, but also to ensure that the population at large benefits from economic progress. Past economic crises have caused widespread social distress, while the benefits of reforms have not always been tangible to the population at large. Social development, education and basic infrastructure thus remain a priority for public spending. In this respect, and subject to the existing budget constraint, the reforms under way provide the basis for future progress. Reducing general user subsidies is consistent with equity goals insofar as concentrating support solely on low-income categories, or establishing monetary compensation for low-income users would be both more efficient and progressive. The integrated poverty alleviation programme (PROGRESA) is commendable in many respects; if the authorities decide to extend its coverage to urban areas, it is important to adapt its targeting mechanisms and operation rules to maintain its cost-effectiveness and preserve incentives to work. Furthermore, it would have to replace existing targeted programmes (*tortilla* and milk). Specific actions need to be complemented by further measures to improve the effectiveness and equity of public spending, to widen the coverage of social security systems and to ensure their longer-term financial viability.

56. Achievement of fiscal discipline over several years has underscored the authorities' intention to maintain strong fundamentals in the face of external vulnerability. However, to make fiscal policy more effective and reassure markets on the maintenance of a responsible fiscal stance in the longer term, it would be useful if multi-year objectives were announced and set in a comprehensive policy framework. A step towards this was taken with the elaboration of a National Programme for Financing Development for 1997-2000. But the authorities have not yet been ready to go beyond a single administration term in their planning. To be useful, the medium-term framework should be updated at regular intervals with a planning horizon of fixed length. Even though subsequent administrations cannot be committed by a predecessor's actions, transparency would be enhanced if a benchmark were established against which to evaluate future actions. The framework should explain the principles guiding macroeconomic policies over a period of several years and the strategy for structural reform that backs it up. In setting out the budgetary requirements needed to establish the basis for sustained development, longer-run fiscal-related challenges will necessarily have to be taken into account to ensure that the budget is maintained in structural balance over time. These include the cost of the social security reform for private sector workers and that of the financial-sector support package, as well as the impact on the federal budget of the new fiscal relations with the states. Altogether these are estimated to amount to some 5 per cent of GDP per year over the next ten or twenty years. There are also future pressures relating to off-budget infrastructure projects contracted out to the private sector (PIDIREGAS) and pension liabilities for government employees, where pay-as-you-go schemes are in place. It is important that these elements are integrated into the overall fiscal planning framework.

57. The establishment of multi-annual budgets within a comprehensive macroeconomic framework would help avoid "stop and go" funding for social development projects. An action plan should be drawn up to meet needs in a more efficient way. It could identify the projects that should be carried out immediately and programme those that can be spread over several years. As regards investment, which has

been particularly vulnerable to revenue shocks, project planning in a medium-term framework would enhance continuity. Private initiative could also be facilitated in certain sectors, to take over from the state and finance the development of capacity and the modernisation of existing infrastructure. However, past experience shows that privatisation should not be carried out without the prior establishment of an appropriate regulatory framework.⁵³

58. Until recently, several problems hampered the effectiveness of public spending, including excessive concentration and centralisation, limited public management response, deficient incentive mechanisms and lack of instruments to improve the performance of public servants. To address these concerns, a comprehensive reform strategy has been adopted. Considerable advances have been made in several areas, such as the improvements in internal auditing and control systems and increased transparency and efficiency of budget procedures; in addition there is now much wider access to information. Legislative oversight of the budget process has also been greatly enhanced, in part as a result of the establishment of important specialised legislative bodies. Recent reform efforts have been in the right direction and are already leading to a more efficient public administration. Much more remains to be done, however. First, many of the on-going changes need to be pursued and consolidated in the years ahead. This will give line ministries and specialised government agencies further autonomy and flexibility in operational decisions; there are also outstanding problems in human resource management; and the process of decentralisation is incomplete and plagued by asymmetries. Reforms in these areas should not be delayed: because of synergies, lack of progress in one area is likely to diminish the benefits from other programmes and from the reform strategy as a whole. *Box 9* lists the main recommendations on how to further enhance the effectiveness of the public sector.

Box 9. Recommendations for enhancing the effectiveness of public spending

Setting spending priorities

The government sector in Mexico is relatively small, and this feature needs to be maintained. There is, however, room for some expansion and re-orientation of spending on priority items, based on the possibility of higher tax revenue and falling debt service. In this context, the government should:

- *Further disengage from productive activities, such as electricity supply; this would allow a continued refocusing of essential governmental functions and facilitate higher investment to meet growing energy demand;*
- *Phase out remaining general subsidies (electricity and water), while compensating low-income categories, by providing direct transfers or productivity-enhancement investment support;*
- *Increase spending in areas of high marginal social and economic benefit, such as basic health, education and infrastructure (drinking water supply, sewerage, etc.); and consideration should be given to extending PROGRESA to urban areas.*

53. The 2000 *OECD Economic Survey* reviews some of these issues, including telecommunications, and the proposed re-organisation of the electricity and petrochemical sectors; until these sectors are opened to private initiative, the mechanism permitting the private financing of some projects, as was developed between 1997 and 1999, should be regarded as a “makeshift” solution that risks undermining public finances.

Improving budget processes and procedures

The Budget process has been effective in achieving budget consolidation, but is short-term in approach. The following reforms are required:

Medium-term budget strategy

- *Set the budget in a medium-term framework.* Multi-year budget planning should be introduced in order to establish clearer benchmarks for infrastructure, and other long-term capital projects should have guaranteed funding before launch;
- *Give Congress more time to examine the draft budget.* Legislative oversight could be made more effective by increasing the time allotted for Congress to examine the budget draft, -- a change which would require a Constitutional amendment.

Flexibility and accountability

- *Strengthen newly-created legislative bodies and establish a system of effective accountability of managers.* The implementation of the new supervisory and auditing bodies linked to the Legislative branch should be completed and their role in the systematic evaluation of programmes increased. Clear objectives should be set and tools created to evaluate achievements; the implementation of a regular performance review cycle should be pursued;
- *Increase managers' flexibility.* The actions described above should serve to increase management accountability, which will permit further progress in giving managers enhanced budget prerogatives;
- *Improve intra-governmental information channels.* Initiatives such as the unified budget and payment system (SIAFF), expected to link participants in spending decisions by an electronic communication network, should be pursued.

Human resource management

- *Give managers greater autonomy* to link pay with performance and to exercise flexibility in selection, hiring and deployment of personnel, while ensuring that these decisions are consistent with fiscal discipline over time;
- *Reduce barriers to mobility at the operational level*, rationalising practices across entities. A reform of the social security scheme for government employees (ISSSTE) with a view to integrating it with the private IMSS system would facilitate pension portability between the private and public sectors;
- *Introduce measures to create a more professional civil service.* Long-term contracts should be introduced to retain experienced managers while allowing for greater re-adaptation of skills. Reform measures are needed to reduce inequities associated with the two-tier status of public servants. Consideration should be given to establishing a new civil service apparatus, while avoiding excessively generous job tenure.

The role of the market

- *Make better use of market-based instruments*, such as user fees, vouchers, internal markets and contracting out. Enhanced management flexibility could help in this regard.

Issues in fiscal federalism

The federal structure of the Mexican economy generates a complex assignment of tax and spending responsibilities which needs to balance equity and efficiency considerations. To obtain best advantage from the system, the following steps are required:

- *Improve administrative capabilities and information systems.* Training of civil servants at all levels of government should be developed. The diffusion and promotion of budgetary practices should be enhanced, through intergovernmental co-operation;
- *Encourage states and municipalities to improve collection efforts to enhance their revenue base.* The tax prerogatives of states and municipalities need to be widened. Real estate taxes in particular could become a more important source of revenue in the longer term;
- *Maintain a strong federal government role in keeping social cohesion.* The heterogeneity of the Mexican economy, including wide regional differences, calls for a strong social role at the federal level.

110. The collective experience of OECD countries shows that delegating some budget decisions from central management to independent agencies and line ministries can be conducive to greater efficiency and productivity. The main challenge for any reform strategy is to strike a balance between the respective prerogatives of central budgetary institutions and operational entities. Experience shows that for net efficiency gains from reform to be maximised, the “centre” should retain an important role in designing the overall budget and stating spending priorities; it should also be able to continue to impose a hard-budget constraint on other entities, including control of deficit financing and should maintain a capacity to develop, co-ordinate and implement policies. On the other hand, specialised agencies and line ministries should be given flexibility as to most operational decisions, including a large say concerning details of their budget, and should be granted more autonomy in introducing user fees, contracting out and other market-based mechanisms. While significant progress has been made in deconcentrating public management, further efforts should focus on three main issues. First, managers’ accountability should be increased by strengthening control mechanisms at both Executive and Legislative branches. Second, as control mechanisms become fully functional and effective, managerial flexibility on budgetary decisions should be enhanced by a further devolvement of responsibilities. Third, information channels within the government should be improved, since they can enhance the control function of central budgetary authorities and improve the efficiency of performance reviews, thus ensuring transparency and accountability.

111. There are also important issues to tackle in human resource management (HRM) policies and practices. Considerable progress has been made in this area, especially in redressing the balance between concentration and flexibility. HRM regulations have been simplified and the approval of personnel decisions speeded-up and made more transparent. Policies have also been implemented to rationalise and increase the transparency of pay and benefit scales, including through the establishment of clear mechanisms to link performance to pay. But reforms are at different stages of implementation and their full effects will take a number of years to come through.⁵⁴ These measures, as well as more recent efforts to increase the effectiveness of individual performance evaluation and enhance management flexibility,

54. Countries that have started experimenting with systems that link budgets with performance in the mid-1960s have taken several years to make performance measurement comprehensive and fully systematic. See “Performance Management in Government: Performance Measurement and Results-oriented Management”, *OECD Public Management Occasional Papers No. 3*, 1994, and “The Measurement of Performance in Government; Issues and Illustrations”, *Public Management Occasional Papers No. 5*, 1994.

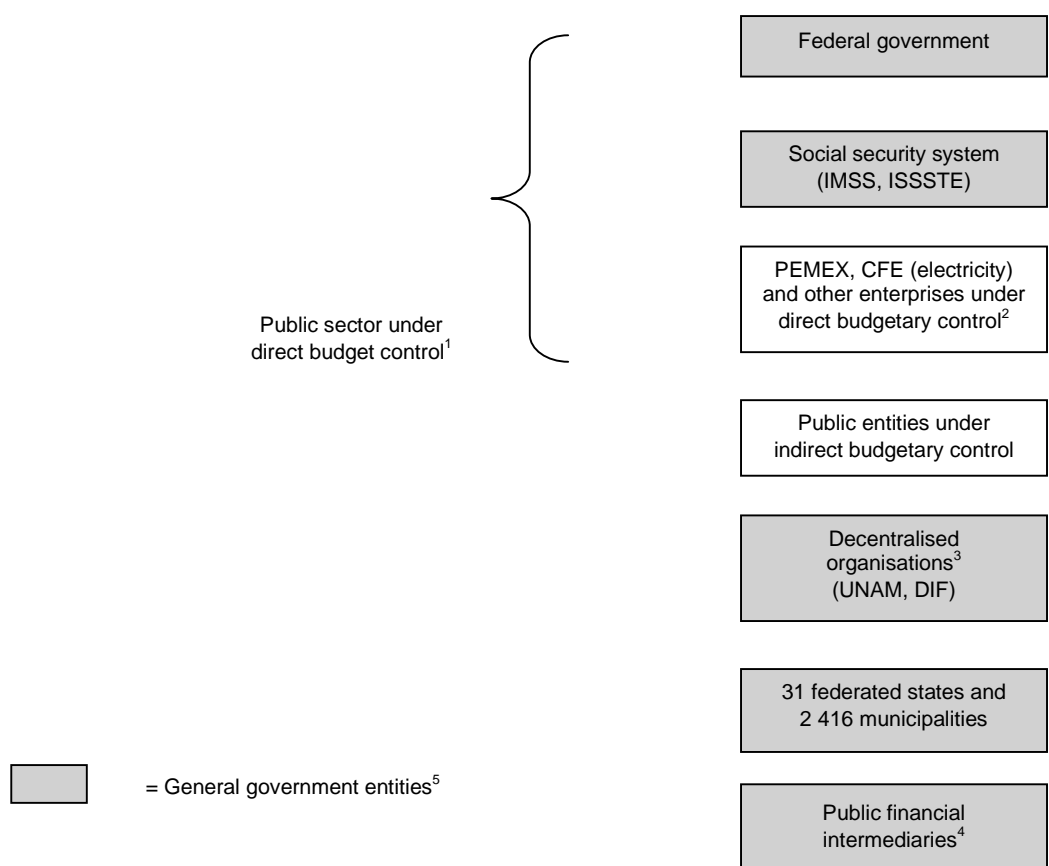
should be vigorously pursued. Other priorities should include measures to encourage operational level workers' transferability and mobility -- both intra-departmental and between the public and the private sector -- and the continuous development of human resources. If the decision is taken to create a career civil service for managers, particular attention should be paid to not reducing the flexibility of public sector staffing policies through excessively generous job stability provisions. Moreover, an appropriate incentive system should be fully in place before broadening the civil service, as a way to induce improved performance from managers. An alternative option to encourage continuity and the accumulation of institutional knowledge at intermediate and senior management level would be the institution of longer-term contracts, preferably going beyond the term of an administration. The hiring of junior managers through promotion or other transparent procedures rather than by appointment would give operational personnel broader career opportunities. In the case of unionised workers, the career focus would need to be changed, with less emphasis on job stability and more importance given to career development, mobility, and opportunities.

112. As regards devolution, the decentralisation of responsibilities to sub-national levels of governments has advanced rapidly under the current administration, with states and municipalities being given more spending responsibilities. But their taxing power has remained limited and most of their financing comes from federal transfers. In the longer term, it would be desirable to increase local tax revenue, but this will need to be done carefully to minimise administrative costs and to ensure that it does not create distortions. In any case, the federal government will need to keep a strong role to maintain social cohesion in a country as heterogeneous as Mexico. Clearly some regions would be able to raise the funds necessary to meet spending needs, while others, the poorest, would be unable to finance development spending. The mechanisms in place to allocate federal grants for specific basic education and health care, in particular (the two main components of *aportaciones federales*), seem well designed in this respect, to the extent that they are targeted and based on objective measures of expenditure needs. At present the states' and municipalities' finances do not present a risk to macroeconomic balance. But other countries' experience show that great caution should be exercised in this area. The efforts made in the past few years to control states' borrowing should be pursued. The degree of taxing and borrowing autonomy at sub-national levels of government would need to be consistent with national stability goals, so as to ensure that devolution of spending responsibilities does not jeopardise the current sound overall fiscal performance.

Annex I

Background Tables

Table A1. Structure of the public sector



1. The public sector under direct budget control comprises the federal government and the social security system (IMSS and ISSSTE) -- as well as a number of public enterprises, the oil company PEMEX and the electricity companies being the largest ones.
2. The number of public entities under direct budget control was reduced, through privatisation, to seven at the start of 2000. Besides the social security institutes and PEMEX, the largest ones are the two electricity companies (CFE and Luz y Fuerza del Centro). The national paper producer has been privatised. The national marketing corporation CONASUPO has been closed. By 2000, the privatisation of railroads and airports was also completed.
3. Producers of social and community services, including the university UNAM, and the national system for the integral family development (DIF).
4. Public financial intermediaries comprise development banks and development trust funds. They are taken into account in the calculation of the broad debt of the public sector (under the central bank's definition).
5. The federal government, state and local governments and the social security system constitute the general government on a national-accounts basis. Consolidated government accounts are available for the period 1988-97 only.

Source: OECD.

Table A2. Structure of general government expenditure in OECD countries¹

		Per cent of GDP											
		Consumption		Transfers ²		Subsidies		Property income ³		Investment ⁴		Total expenditure	
		1993	1997	1993	1997	1993	1997	1993	1997	1993	1997	1993	1997
Mexico		11.0	9.9	1.9	3.4	0.9	0.5	2.9	3.8	3.0	3.4	19.7	21.0
United States		16.8	15.2	13.3	12.9	0.6	0.4	4.6	4.2	1.9	1.9	37.1	34.6
Japan		9.4	9.7	12.5	14.5	0.7	0.7	3.7	3.7	7.8	6.7	34.2	35.4
Germany		20.1	19.4	20.8	20.8	2.0	1.8	3.3	3.7	4.4	3.2	50.5	49.0
France		19.8	19.3	26.4	26.4	1.6	2.1	3.7	3.8	5.1	4.4	56.6	56.0
Italy	(1993-1996)	17.6	16.4	20.9	20.5	2.2	1.5	12.4	11.0	6.6	4.8	59.8	54.2
United Kingdom		20.5	18.4	26.6	23.9	0.8	0.6	3.8	4.2	5.2	2.3	56.9	49.4
Canada		23.9	20.0	15.0	13.0	1.5	1.0	9.3	8.9	2.6	2.2	52.2	45.0
Australia	(1993-1996)	17.7	16.7	13.4	13.3	1.5	1.4	3.7	3.4	2.6	2.5	39.0	37.2
Austria	(1993-1996)	19.1	18.5	22.2	22.6	3.2	2.7	4.3	4.4	3.2	2.8	52.1	50.9
Belgium		14.7	14.4	26.4	26.0	2.1	1.6	10.7	7.8	2.8	2.7	56.7	52.6
Czech Republic	(1993-1994)	22.1	22.2	12.7	13.0	3.3	3.6	1.8	1.4	33.0	11.8	73.0	52.2
Denmark	(1993-1995)	26.3	25.2	23.0	24.1	4.1	3.7	7.8	6.7	3.1	2.8	64.3	62.4
Finland	(1993-1996)	23.3	22.1	27.5	25.5	3.4	2.9	4.6	5.8	2.8	2.8	61.7	59.0
Greece	(1995-1997)	15.3	14.7	22.9	23.5	0.4	0.1	12.7	9.6	6.0	6.0	57.4	53.8
Iceland	(1993-1996)	20.6	20.7	8.0	7.6	2.6	2.1	3.7	3.7	6.3	5.0	41.1	39.0
Ireland	(1993-1996)	15.6	13.6	17.0	15.7	1.4	1.2	6.4	4.4	2.2	2.3	42.5	37.1
Korea	(1993-1996)	10.8	11.1	3.3	4.8	0.8	0.2	0.4	0.5	5.5	6.1	20.8	21.8
Netherlands	(1993-1996)	14.8	14.0	31.5	28.5	3.0	1.9	6.2	5.6	3.2	2.9	58.8	52.8
New Zealand		15.6	15.2	18.4	17.7	0.4	0.3	5.1	3.2	1.7	2.1	41.1	38.6
Norway		21.8	20.2	19.3	16.9	4.4	3.1	3.4	2.2	3.6	3.5	52.6	45.9
Poland	(1993-1996)	19.5	16.1	21.3	19.6	2.1	1.1	8.7	4.6	3.7	4.2	55.2	46.0
Portugal	(1993-1995)	17.9	17.7	15.9	16.0	1.3	1.1	6.2	6.3	6.8	6.2	48.1	47.3
Spain	(1993-1996)	17.6	16.4	18.7	17.6	2.1	1.8	5.2	5.3	6.0	5.1	49.6	46.3
Sweden	(1993-1996)	28.1	26.2	27.2	24.8	5.9	4.7	6.3	7.2	5.6	2.5	73.0	65.4
Switzerland		14.5	14.2	15.0	16.0	2.1	2.2	2.0	2.2	4.9	4.2	38.6	38.7
Total of above OECD countries ⁵		18.2	17.2	18.5	18.0	2.1	1.7	5.5	4.9	5.4	4.0	49.7	45.8
Total of above European countries ⁵		19.4	18.4	21.2	20.5	2.5	2.1	6.0	5.3	6.0	4.2	55.2	50.4

1. Based on SNA93 for Mexico, United Kingdom, Greece and Poland. SNA68 for other countries.

2. Social security and current transfers.

3. Including interest payments.

4. Gross fixed capital formation plus other capital outlays.

5. Unweighted average.

Source: OECD.

Table A3. **Public investment by sector**¹

	Breakdown, per cent of total			Annual percentage changes, in volume		
	1982-87	1988-93	1994-98	1982-87	1988-93	1994-98
Development	22.9	30.7	24.6	1.9	3.9	-11.4
Human capital	10.2	9.4	12.8	-5.1	4.3	3.0
Energy and industry	37.9	38.4	43.3	-3.3	-5.6	6.0
Communications and transport	23.0	15.4	12.7	6.7	-8.4	-4.1
Other	5.96	6.1	6.6	-31.9	8.0	-6.0
Total	100.0	100.0	100.0	-3.4	-1.4	-1.2

1. Including public enterprises

Source: Ministry of Finance.

Annex II

Poverty alleviation programmes

1. Poverty alleviation is an integral part of the development strategy of Mexico. Since the mid-1990s, the strategy for poverty alleviation has followed three main lines of action: *i*) investment in human capital; *ii*) creation of income opportunities, and *iii*) development of basic infrastructure. First, to enhance human capital, the government has promoted simultaneously programmes that strengthen supply and demand. This has been achieved through the development of CONAFE education and health programmes (IMSS-Solidaridad and PAC), on the supply side, and the implementation of PROGRESA on the demand side. PROGRESA, the Programme for Education, Health and Nutrition (*Programa de Educacion, Salud y alimentacion*, PROGRESA) started to operate in 1997.¹ It is targeted at families in rural and semi-urban areas, and integrates actions in the three complementary fields of basic education, health care and nutrition (*Box A1*). Second, to create employment opportunities, the main instruments have been the Temporary Employment Programme (PET) and the new productive programmes for low income producers. The Temporary Employment Programme has replaced emergency measures taken just after the peso crisis. Its aim is to reduce income instability in given regions where poverty is most acute by offering jobs, according to the farming season, for the construction of productive assets (irrigation systems and rural roads). The programme works by self-selection since the pay offered is below one minimum wage -- the poverty line is close to twice the minimum wage. The development of infrastructure, the third pillar of the strategy, is now mainly done by municipalities which receive transfers earmarked for that purpose that they can allocate according to their own priorities. Over the last five years, the resources channelled to combat extreme poverty have increased regularly. Transparency has improved; the operation rules for all these programmes are now published in a Federal Register of Rules. PROGRESA and PET are mainly targeted at the most disadvantaged population groups in marginalised rural areas, where most of the families in acute poverty are located -- which makes regional targeting effective. As noted in the main text, there are also a number of programmes to alleviate poverty in urban areas.

1. In the past specific programmes to fight extreme poverty had already been introduced to reach segments of the population which were too marginalised to benefit from broad social policies. In particular, the programme *Solidaridad*, PRONASOL, which was developed in the period 1988-94 probably had a favourable impact on living conditions for some population groups. However, in the opinion of several analysts, the *Solidaridad* programme suffered from shortcomings both in its design and implementation (OECD, *Economic Survey of Mexico*, 1995; G. Martinez, 1997, *Pobreza and politica social en México*, ITAM, Lecturas 85).

Box A1. An integral approach to poverty alleviation: PROGRESA

The Education, health and nutrition Programme, PROGRESA was established in 1997 to fight the main factors that cause extreme poverty. The rules of the programme are defined by the Federal Government, which transfers to states earmarked grants, the allocation being based on transparent and uniform criteria.¹ The states are responsible for operating the programme. The Ministry of social development (*Secretaria de Desarrollo Social, Sedesol*) is responsible for the co-ordination of the programme through an independent agency created in August 97.

Targeting: The programme is targeted at population groups which cannot benefit from general public spending because of their geographic isolation or extreme level of poverty. The targeting mechanism, which represents a significant innovation in Mexico, selects programme beneficiaries through a transparent three-stage process:

- Poor communities are identified as “eligible” according to an index of “marginality” that establishes ranking on the basis of their level of poverty.
- A survey of all households in the “eligible” communities is carried out to select “eligible families” according to various socio-economic variables : income levels, availability of running water, dependency ratios, ownership of durable goods, of animals and land or the presence of disabled individuals.
- Finally, once households have been selected, an assembly is organised in the relevant communities and an agreement is reached to select beneficiaries in the community.

Operation: In the *education* area, monetary grants are provided to children so as to promote school attendance; the amounts increase with the year of schooling and are higher for girls than boys because drop out rates among them tend to be higher. In *health care*, the programme provides basic health services for all members of the beneficiary families with particular emphasis on preventive care. Services are provided by the Ministry of Health (at the federal and state levels) and by IMSS-Solidaridad.² The third pillar is *nutrition*: a fixed monetary transfer is provided to improve food consumption conditional on children’s school attendance and regular visits to health care facilities by all the family members. The target groups are children between the ages of four months and two years (five years if signs of malnutrition are detected), as well as pregnant and breast feeding women. At the end of 1999, a pilot programme was launched to widen PROGRESA’S scope in order to help hearing- and sight-impaired children to improve their school performance.

Achievements: By the end of 1999, the programme was covering almost 2.6 million families in some 53 000 localities from all states, a coverage approaching 100 per cent of families in extreme poverty in rural and semi-urban areas.³ For beneficiary families, the monthly benefits contribute to a significant increase in the income level: 22 per cent of the monthly income⁴, through monetary benefits; 26 per cent when considering also in-kind benefits. Monetary benefits include nutritional support and education grants, while in-kind benefits include medical visits (Basic Package of Health Services) and food supplements.⁵ Monetary benefits are given to women, through the services of the public telecommunications company (Telecomm) in offices and modules installed nearby the communities. School attendance and frequency of medical visits are verified through school and clinic records.

1. Funds are transferred through the general budget items for education, health and social development.
2. IMSS-Solidaridad is a branch of the Social Security Institute, IMSS, which provides health services to the uninsured rural population.
3. PROGRESA does not encompass quite the totality of extreme poverty, mainly because of geographic isolation of some communities that prevents access to services such as health and education.
4. In 1999 the average family was receiving monthly payments amounting to a cumulative \$US322 for the year. There is a cap on benefits so as to discourage families from having additional children.
5. Monetary benefits account for three-quarters of PROGRESA budget (most of it for education grants and nutritional support, but also purchases of school supplies). In-kind benefits account for about 14 per cent of PROGRESA budget (medical consultations and nutritional supplements). The cost of operation amounted to 5.4 per cent of the budget in 1999 and to 4.4 per cent in 2000.

*Annex III***The use of market-based mechanisms to improve the efficiency of public spending**

1. Market-based mechanisms have been used in several countries to introduce market behaviour in the provision of public goods or services. The experience of many OECD countries shows that, by increasing the role played by market principles in public spending decisions, these mechanisms have tended to enhance public sector performance. Often, their introduction has also led to better accountability of public agents, increasing their flexibility and responsiveness. Instruments used for that purpose have included vouchers, user charges, intra-governmental contracts and contracting-out (including public-private partnerships).

Vouchers

2. Vouchers are issued to beneficiaries, so that they can “purchase” a good or a service to which they are entitled.¹ Often, recipients have the possibility of going directly to the market, rather than having the good or service delivered by the public sector.² Voucher schemes work as an earmarked transfer, where the recipient is limited to spending funds on a certain category of goods or services. As a result, consumer choice is enhanced in comparison with benefits “in kind”, but not necessarily in comparison with non-earmarked cash transfers, such as those deriving from the negative income tax system in Mexico. For that reason, this type of scheme has generally been used to replace benefits “in kind”, which have not always reflected consumer choice and have often implied large administrative costs. As such, in most cases the introduction of vouchers has led to an improvement in the efficiency of government programmes, increasing the real benefits to the targeted population while lowering administrative cost. Moreover, voucher schemes have also stimulated supply-side improvements in the provision of goods and services.

3. Voucher schemes can be particularly useful in circumstances where governments want to guide transfer recipients’ spending towards the consumption of “socially desirable” goods or services, such as housing, food and education. On the other hand, some governments have encountered difficulties with voucher schemes, related either to the lack of adequate consumer information or to issues of co-ordination between service providers, which have led to increased administrative costs. The success of voucher-type schemes hinges in part on the level of effective competition between service providers. Success also depends on the possibility of circumvention and the extent of information problems. Mexico does not have voucher schemes in operation at present, but this type of scheme deserves to be considered, especially in the case of education and training, where the problems encountered in other countries can be more easily minimised.

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1. See “voucher programmes and their role in distributing public services”, PUMA/SBO(98)7/FINAL for conceptual issues and more details of the experience of OECD countries with voucher schemes.
 2. Occasionally, recipients’ choice falls exclusively within the private sector, since the public sector does not directly provide the good or service in question.

User charges

4. User charges for the provision of public services have also been used by many OECD countries, including Mexico, with the objective of reducing excess demand and improving services through the introduction of market signals. Although privatisation is in many cases a better way to achieve these goals, user fees are justifiable where market failures exist or when it is socially desirable to keep the provision of a good or service in the public sector. The closer user charges are to the full cost of providing the service (including depreciation and the cost of capital), the more they serve to reduce distortions and improve resource allocation economy-wide. In Mexico, user charges apply especially in the health sector, where services provided in Ministry of Health (SSA) facilities and in State hospitals draw fees. Revenue from those charges have been increasing rapidly and, by 1994, they accounted for about 10 per cent of total SSA spending (need update). Some user fees also exist in the education sector, but these are generally insignificant.

5. The OECD Public Management Committee has published “Best practice guidelines for user charging for government services”, a summary of which is included in *Box A2*.³ Among these guidelines is the need for equity considerations to be recognised before the introduction of user charges. When cost recovery represents an excessive financial burden on individual users, it is important to establish compensatory mechanisms. Preferably, these would consist of measures through the tax and benefit system. In Mexico however, where a large number of the poor are not reached by the tax and benefit system, reduced (or zero) charges, would be appropriate. The user fees that exist in parts of the Mexican health sector seem well designed in this regard; to the extent that in principle, fees are proportional to patients’ payment capacity. User charges, with built-in compensatory mechanisms, can also be useful in augmenting the progressivity of public spending. In Mexico, as in many other OECD countries, subsidies to higher education and certain types of cultural events are regressive in nature, since they tend to benefit the wealthy, who consume relatively more than the poor. As a result, the establishment of means-tested user fees would serve to enhance both equity and efficiency.

Box A2. Best practice guidelines for user charging for government services

1. *A clear legal authority should be defined.* It is important that the legal authority for the organisation to charge for its services be clearly defined. This should be done through a general framework and not by setting the precise amount of the charges to be applied.
2. *Users should be consulted about the best manner to implement charges.* Consultation should serve to communicate to the users the rationale for charges. The views of users can be useful in designing and implementing an effective charging system.
3. *Full costs should be determined.* The degree of subsidy involved in providing the service should be transparent, even in cases where there is no intention to recover the full cost of services. Full costs should include indirect costs, including depreciation and the cost of capital.
4. *An effective and efficient collection system should be established.* Responsibility for collection should rest with the organisation levying the charge, even if the collection itself is contracted out. Efforts should be made to minimise collection costs, while enforcement mechanisms should be in place.

3. For details of the guidelines as well as for a series of case studies on the introduction of user charging, please refer to *Public Management Occasional Paper No. 22*, OECD, 1998.

5. *The performance of organisations implementing user charges needs to be improved and monitored.* Specific financial, service quality and other performance targets should be set. The views of service users need to be regularly solicited. Organisations should be given sufficient time to plan for the introduction of user charges, including for the adaptation of human resources and information technology.
6. *Receipts should be retained by the organisation.* This should reinforce the notion that users are paying a charge in return for a specific service and that responsibility for revenue management rests with the organisation itself. Budgetary arrangements should be flexible to allow organisations to respond to increase volume by permitting commensurate increase in expenditures and user charging receipts.
7. *Appropriate pricing strategies should be in place.* Charges should be based on competitive market prices and on full cost recovery to enhance the efficient allocation of resources in the economy. Fee structures should be simple and transparent. Consideration should be given to charging for substitute services.
8. *Equity considerations should be recognised.* Consideration should be given to reduced charges for users where full cost recovery would represent an excessive financial burden on individual users, even though measures through the tax and benefit system may be a more efficient means of ensuring equity. The criteria for applying reduced charges should be clear and explicit and the degree of subsidy should be transparent to those providing and monitoring the service.
9. *Competitive neutrality should be ensured.* If an organisation is supplying a commercial service in competition with the private sector while retaining a monopoly provision of another service, care should be taken to ensure that there is no cross-subsidisation. When pricing those services, costing should be accurate and should incorporate all items faced by the private sector competitor.

Internal markets

6. Other reforms aimed at improving the performance of the public sector in the provision of services have included the introduction of intra-governmental contracts, also known as internal markets. This generally involves giving budgetary appropriations to the “consumer” ministry or agency, which can then determine the type and amount of service they require. As with contracting out, supplies can then be open for competition, including the private sector, and the “consumer” agency can keep the savings arising from lower bids. To ensure fair competition with the private sector, public sector suppliers are often subject to financial and other performance targets. Some of the guidelines described in *Box A3* for contracting out also apply to internal markets, including the need to specify well the service requirements and to ensure valid comparisons and foster competitive markets.

7. Several OECD countries have experience with these schemes for the provision of internal services, such as printing, automobile fleet operations and real estate management, as well as consulting and legal services. The creation of internal markets becomes more feasible within the context of the devolution which is taking place in Mexico. In other countries, it has led to productivity increases as well as to more efficient resource allocation within the public sector.

8. Based on member countries’ experiences, the OECD Public Management Committee has published “best practice guidelines for contracting out government services”, a summary of which is included in *Box A3*.⁴ Guidelines include the recommendation that service requirements are specified in

4. For details of the guidelines as well as for a series of case studies on the introduction of contracting out, please refer to *Public Management Occasional Paper No. 20*, OECD, 1997. For a more detailed assessment of public-private partnership arrangements for the provision of infrastructure, please see *Public Management Occasional Paper No. 6*, OECD, 1994.

terms of outcomes and outputs and that internal skills are developed to deal with contracting out requirements. The failure of many contracting out schemes has often derived from the escalating administrative costs associated with the process itself. This suggests that in principle, the activities best suited to contracting out are those for which the transactions costs of outsourcing are low. This tends to be the case for services with clearly definable outputs, such as waste collection, road maintenance, street cleaning and computer services.

Box A3. Best practice guidelines for contracting out government services

1. *Secure top management involvement and encourage re-engineering.* Contracting out should be integrated with the overall corporate strategy of the organisation. It requires the active leadership of top management if it is to achieve its full potential. The ownership and oversight of the contracting out exercise should therefore rest with the very top of the organisation. Contracting out should be used as an opportunity to re-evaluate both the rationale for tasks and the processes used to carry them out.
2. *Focus on staff issues.* It should be recognised that contracting out is not only a financial and performance issue; it is also a people issue. It is essential to demonstrate a high degree of sensitivity in this area, consulting staff and trade unions and acting with transparency. While the process requires proper analysis, it must proceed rapidly in order to minimise any period of uncertainty for staff.
3. *Specify service requirements in terms of outcomes and outputs.* This means specifying what the activity is, not how the activity is to be performed. Operational flexibility is essential for the contractor to be innovative in performing the activity, and thereby securing efficiency gains. These outcomes or outputs should be specified as fully as possible, and include appropriate service quality measures.
4. *Monitor performance and foster co-operative relationships.* The organisation contracting out should regularly and formally monitor the performance of the contractor to ensure that the performance standards stated in the contract are fulfilled. When performance information originates from the contractor, it should be audited to ensure its accuracy. A co-operative relationship should be developed and contracts should incorporate provisions regarding contractor non-performance, dispute resolution mechanisms, and the smooth hand-over of the activity to another contractor.
5. *Ensure valid comparisons.* It is important when considering proposals for contracting out that all alternatives, which may include in-house provision, be comprehensively evaluated. This involves considering both the costs and outcomes or outputs, including comparative quality. All risks should also be systematically assessed. This includes the risk of dismantling in-house capabilities and possible dependence on a single supplier.
6. *Give consideration to in-house bids.* An in-house bid occurs when the staff presently performing an activity bids against an outside contractor for an activity being considered for contracting out. These bids should in all respects be treated the same as outside bids. Special care needs to be taken to ensure that the costing of the bid is complete, *i.e.* that it incorporates all items of cost faced by private sector contractors. A winning in-house bid should be awarded to the staff on the basis of a formal document that obligates the staff to meet the terms of the bid. The performance of in-house staff should be monitored using the same processes and criteria used for outside contractors.
7. *Foster competitive markets.* Competitive supplier markets are key to achieving the benefits of contracting out. The government should foster competitive markets by recognising that its contracting out practices can play a major role in the development of markets for the relevant services. This relates especially to the scope and duration of the contracts. Contracts should not be so small and short that they do not stimulate interest, neither so large and lengthy that only the largest suppliers can participate. The bidding process should be simplified and shortened, so a greater number of valid bidders participate.
8. *Develop and maintain the necessary skills.* Recruitment and staff training need to take account of contracting out requirements. Organisations that contract out activities need to maintain their knowledge of the market and their technical knowledge of the activity to be able to communicate with the contractor on equal terms, and to be in a position to effectively tender the activity again.

Contracting out and private-public partnerships

9. Contracting out is generally used as a means of reducing costs and increasing efficiency, although it can also be useful when limited resources prevent the public sector from expanding the supply

of a service. In many OECD countries contracting out has led to substantial savings to the public purse -- in the order of 15 to 25 per cent of related spending -- with a concomitant improvement in the quality of services provided. In Mexico, contracting out of cleaning and security services is widespread in government offices, but more complex functions are not generally contracted out, in part because the contract process involves a considerable amount of red tape and significant administrative costs.

10. Concerning private-public partnerships, Mexico has had one of the broadest experiences of any OECD country. In such partnerships, the private sector shares the risk of providing infrastructure and its involvement extends through the entire life of capital projects, such as design, financing, construction and operation. These schemes are now often used to accelerate capital investment programmes in the context of tight budgets. In Mexico, this has included “build, operate, transfer” (BOT) and “build, lease, transfer” (BLT) schemes in power generating plants, substations, transmission lines, petrochemical processes and oil refineries.⁵ More recently, a hybrid scheme for financing infrastructure building, known as PIDIREGAS, has been widely used. Under that scheme, the private sector finances and builds infrastructure, with no payment due by the public sector until completion (see *Box 7* in the main text).

11. The private sector has played a prominent role in the large-scale highway building programme of 1989-1994, although that experience met with mixed success. Abstracting from the unforeseen circumstances of the 1995 economic crisis, it is now clear that this contracting out process contained flaws (see *Box 6* in the main text). First, specifications should have corresponded better to economic needs. For instance, the quality of the highways constructed was higher than actually required: high building costs led to relatively high toll rates, which in turn were an important cause of lower-than-expected traffic. Second, commercial or operating guarantees should have been better designed, so the investment risk would have been clearly shared with the private sector. In that context, the financial structure of bids should have been better scrutinised to avoid high leverage.⁶ A longer term for the concessions (in the case of toll roads, the maximum term stipulated by law was 30 years) would also have helped ensure the financial viability of projects. Finally, competition should have been introduced separately at each stage of the process, including construction, operation, exploration, and maintenance. This would have allowed a better spreading of financial risk and would have led to a reduction in overall costs.

5. The total value of public works tenders amount to several billion dollars annually. In the 1996-97 period, tenders by PEMEX and CFE, the oil and electricity companies, averaged US\$2 billion a year.

6. In the case of toll roads, construction was financed mostly with short-term resources, so that the average bank loan term was six years, against an average concession of twenty years.

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