

## STRENGTHENING SUBNATIONAL PUBLIC FINANCE

### EXECUTIVE SUMMARY

**Message 1. Mexico’s intergovernmental transfer system needs to reduce vertical imbalances and discretionary federal transfers.** The dependence of Mexico’s states on federal transfers has increased dramatically and now amounts to about 90 percent of subnational public revenue. These vertical imbalances, combined with the rise in discretionary federal transfers, have lessened the states’ incentive to raise their own revenue. The fiscal federalism reform should focus on addressing these challenges.

**Message 2. Mexican states need to raise more of their own revenues and improve the transparency and efficiency of expenditures.** A salient characteristic of the Mexican fiscal federalism framework is the states’ low level of subnational tax effort (about 10 percent of GDP compared with 20 percent in Brazil). At the same time, subnational expenditures (half of the country’s total public expenditures) have been growing rapidly and now constitute two-thirds of total subnational public expenditures. The rise in state expenditures is partly explained by growing societal needs. But it is also the result of unfunded mandates that emerged from an incomplete fiscal decentralization process. This problem is compounded by limited budget flexibility, as most of the subnational revenues are earmarked federal transfers. In addition, there is a need to standardize subnational budgets and increase their transparency.

**Message 3. Mexico’s subnational borrowing framework could be strengthened to improve fiscal discipline.** The borrowing framework relies on market mechanisms, as reflected in the state credit risk premium charged by private lenders. While successful in keeping subnational debt at low levels (about 2.5 percent of GDP, compared with 10 percent in the United States), the framework has not prevented fiscal distress. Subnational debt has risen rapidly since 2008. The lack of fiscal discipline has led to unsustainable fiscal positions in some states. This calls for fiscal consolidation programs that combine financing (conditional on fiscal and service delivery targets) with technical assistance to mobilize the states’ own revenues and improve expenditure management. And it calls for a transparent crisis resolution mechanism for states that fall into fiscal distress.

### OBJECTIVE

**This note assesses Mexico’s pending subnational fiscal reform agenda.** Mexico is a federal country divided into 31 sovereign states and one federal district. Each state is composed of municipalities. The fiscal federalism framework in this three-tier government structure consists of the set of laws, rules, and institutions that allocate spending and tax responsibilities and of the transfers and institutional framework for the subnational debt. Mexico has made great progress in strengthening its fiscal federalism framework over the past 10 years, but there is room for improvement. The pending Mexican fiscal federalism reform should focus on decreasing the large vertical gaps that states face, increasing local revenue mobilization, increasing the transparency and effectiveness of local expenditures, and strengthening the subnational borrowing framework to improve states’ fiscal discipline.

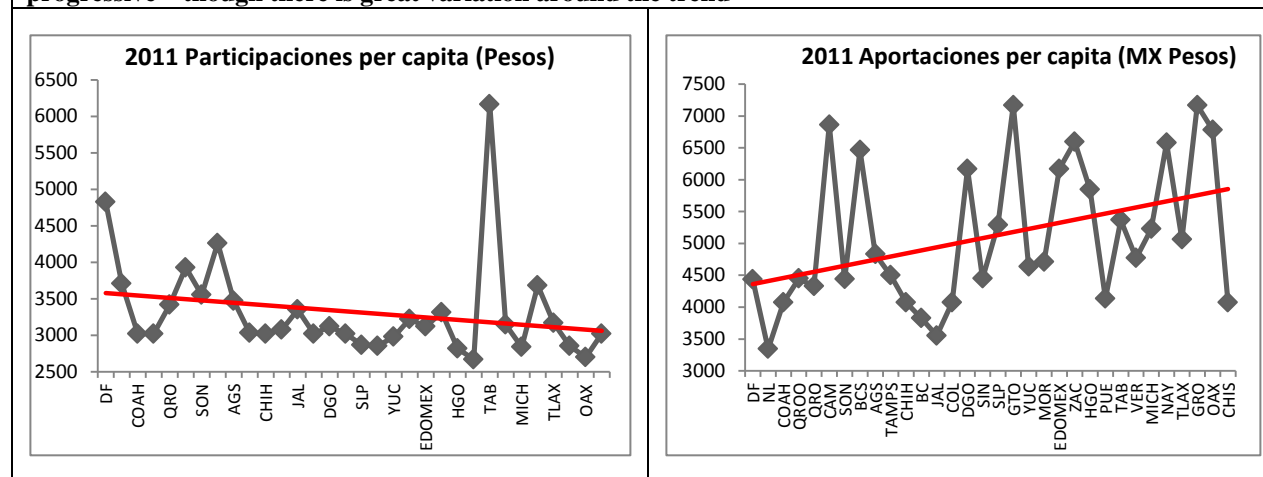
## KEY CHALLENGES

### *The federal transfer system faces vertical imbalances and a growing discretionary component*

The Mexican federal transfer system is affected by growing vertical imbalances. States depend heavily on federal transfers to cover their expenditure needs and debt obligations. Federal transfers account for about 90 percent of Mexican states’ revenues. There are three types of federal transfers: federal tax revenue shares (*participaciones*), which represent about 38 percent of states’ revenues; federal grants earmarked for mandated expenditures (*aportaciones*), amounting to about 40 percent of states’ revenues; and ad hoc federal transfers for sector-specific expenditure agreements (*convenios*), which make up about 10 percent of subnational revenues.

*Participaciones* were set up to “reimburse” tax revenues to states, whereas *aportaciones* emerged as a response to the Mexican expenditure decentralization process. Figure 1 shows the amount of transfers going to Mexican states.<sup>1</sup> Richer states tend to receive higher non-earmarked transfers. This is consistent with the reimbursement principle (*principio resarcitorio*), which assigns more resources to states that contribute a greater amount to the federal tax pool.<sup>2</sup> *Apertaciones* are more progressive, as suggested by the positive slope of the trend-line (though there is a lot of variability around the trend). A recent evaluation from CONEVAL suggests that the allocation of *aportaciones* could be improved (see Policy Note 5).

**Figure 1. Richer Mexican states tend to receive larger *participaciones*, whereas *aportaciones* tend to be more progressive—though there is great variation around the trend**

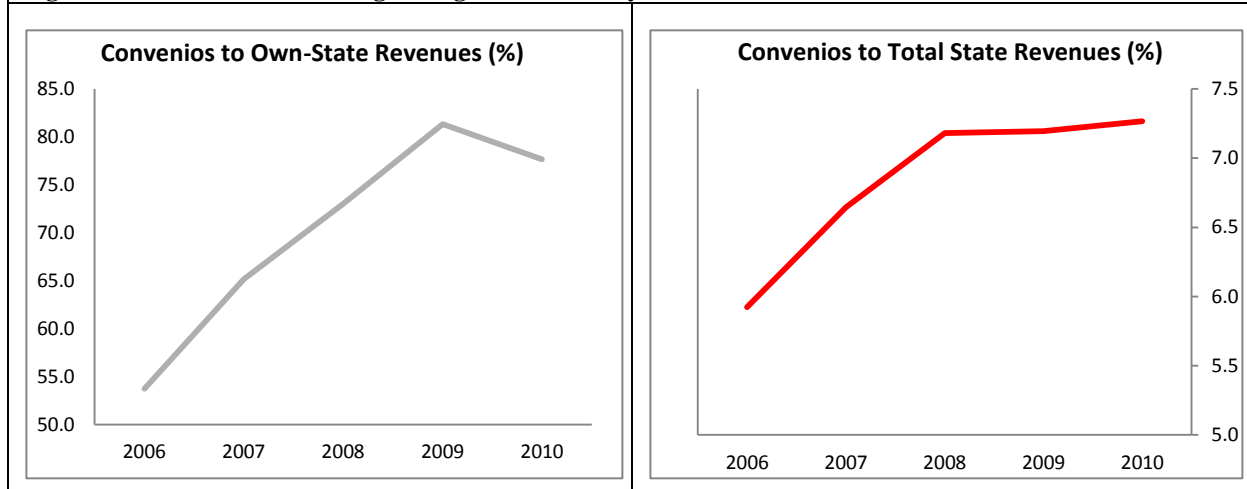


Source: Ministry of Finance and Public Credit (SHCP).

*Convenios* are sector-specific expenditure agreements that opened up the possibility of additional discretionary transfers from the federal government. *Convenios* play an increasingly important role in the Mexican intergovernmental transfer system (figure 2). They are determined according to agreements signed throughout the budget year between state governments and federal government agencies. This arrangement opens up the possibility of additional discretionary transfers from the federal government to the states. In addition, other, less transparent venues for providing additional financial assistance to states exist: taxes condoned, social security contributions (for federalized teachers insured with the federal ISSSTE), or payments of public services (such as electricity or water fees). The amount of annual discretionary transfers and financial assistance provided to states is increasing, though

exact information is difficult to obtain. These discretionary transfers soften the budget constraint that subnational governments ought to face to avoid excessive spending financed out of a common pool of resources. Rather than raise their own revenues, control expenditures, or even borrow from the markets, states have the incentive to lobby for more resources.

**Figure 2. *Convenios* have been growing fast in recent years**



Source: Ministry of Finance and Public Credit (SHCP) and National Institute of Statistics and Geography (INEGI).

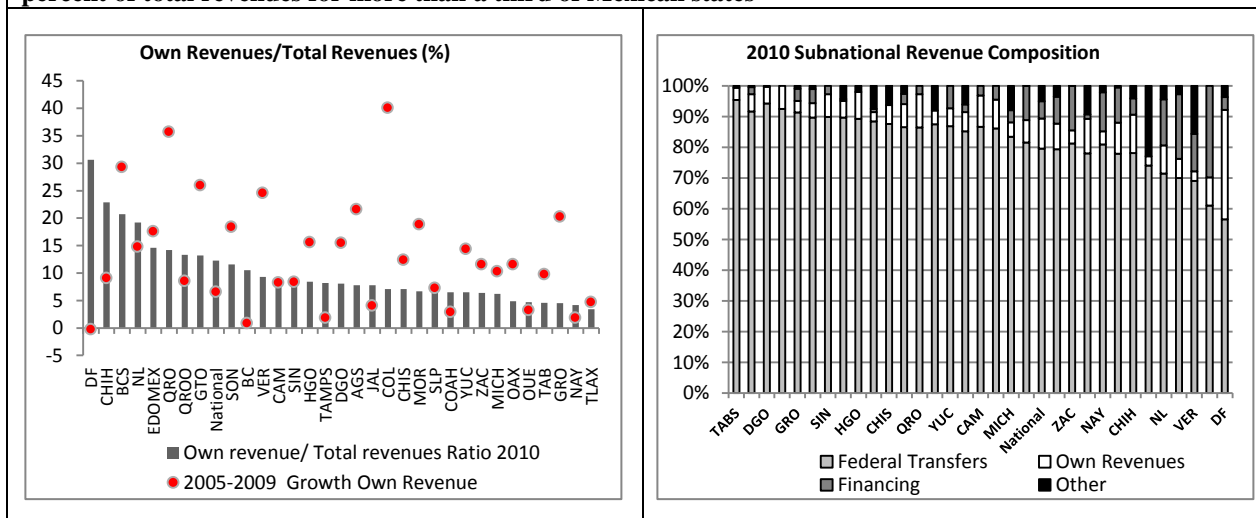
### *Low level of states' own-revenues*

**States' own-tax revenues have increased in recent years but are still low.** Own-tax revenues moderately increased over the past few years (the average growth rate over 2005–10 was about 6 percent). Their share in total revenues currently stands at about 12 percent, which is still lower than in other countries in the region such as Argentina (17 percent) or Colombia (30 percent). The increase in subnational revenues after 2000 was partly due to stronger economic activity and partly to an increase in the number of taxes collected by subnational governments (an increase in their tax base). For example, by 2000, 23 of 32 states collected the payroll tax; by 2009, all 32 states did.

**State-specific information reveals some degree of heterogeneity among Mexican states.** The Federal District and a few other states (Baja California Sur, Chihuahua, and Nuevo Leon) show a higher tax effort. But the share of own-revenues collected by other states is very low, representing less than 5 percent of total revenues in Guerrero, Nayarit, Oaxaca, Puebla, Tabasco, and Tlaxcala). The share of own-revenues is lower than 7 percent for more than a third of Mexican states (figure 3).

**Mexican states surrendered their most valuable taxing powers to the federal government in 1980.** The states gave up their ability to tax income and commercial activities and allowed the federal government to impose an income tax (ISR) and a value-added tax (VAT).<sup>3</sup> The aim of the reform was to improve tax collection efficiency, unify the tax authority, and reduce tax evasion. In exchange, the federal government agreed to share revenues with subnational governments. This was the origin of the current system of *participaciones* (non-earmarked transfers to subnational governments).

**Figure 3. Subnational own-revenues increased recently but remain low. Own-revenues are less than 7 percent of total revenues for more than a third of Mexican states**



Source: Ministry of Finance and Public Credit (SHCP).

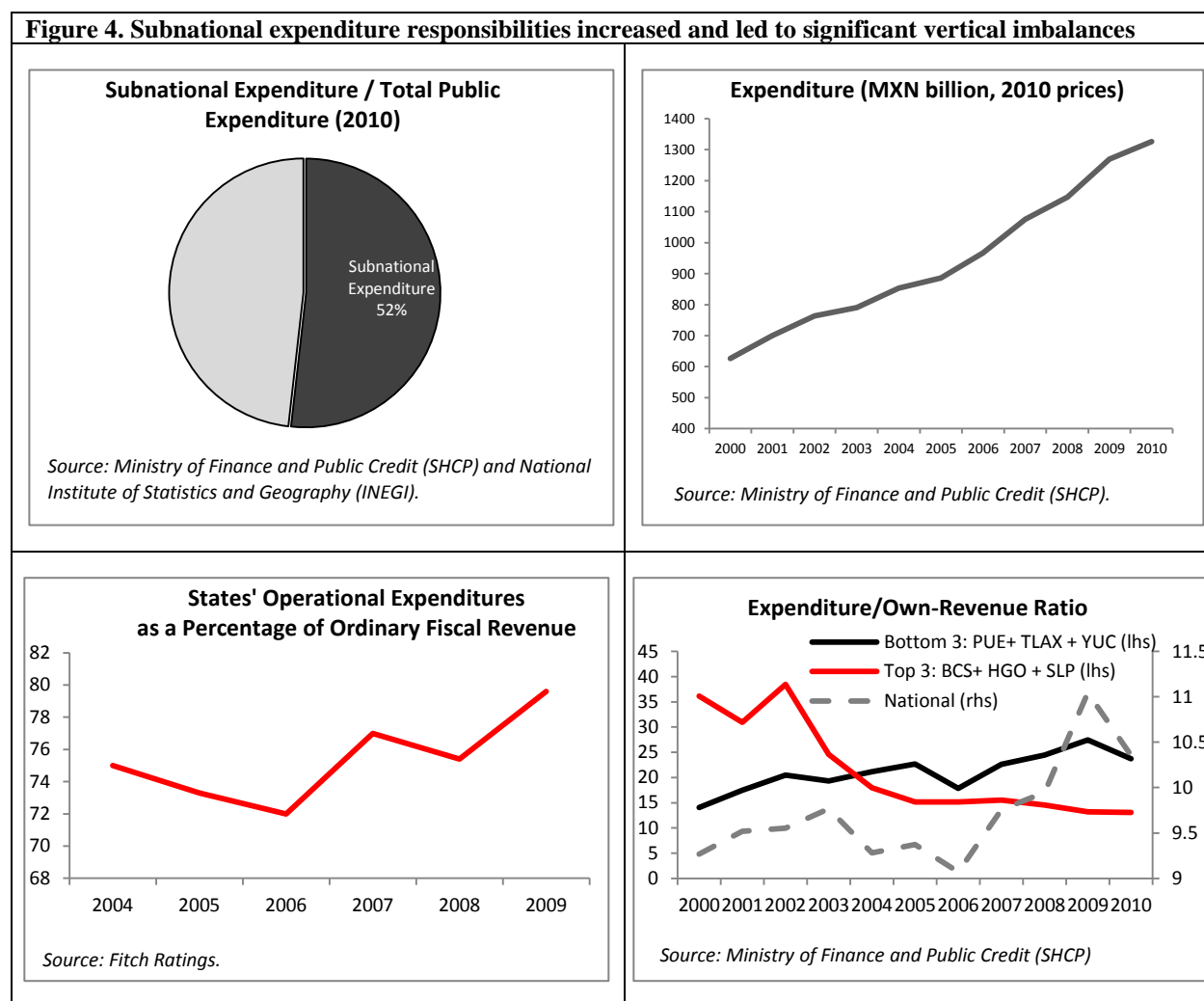
**Today, the largest tax handle for Mexican states is the payroll tax.** The payroll tax accounts for almost 80 percent of state tax revenues, and states are free to set the tax rate. But rates are rather homogeneous across the states, at around 2 percent; in Baja California Sur and the State of Mexico, the rate is higher, at 2.5 percent. The “local *tenencia*” (on cars older than 10 years) and the lodging tax are also relatively important (even if much less than the payroll tax). The “federal *tenencia*” (on car ownership and use) and the ISAN (on new cars) are “federally coordinated.” This means that tax rules (including the definition of the tax base and the determination of the tax rate) are set by the federal government, but states collect these taxes and keep the proceeds. The special tax on gasoline and diesel fuel (fixed fee per liter), which was introduced in 2008, has similar features. Its base and rate are determined by the federal government, but it is administered by the states, which keep all of the proceeds collected from this tax. Overall, the amount collected through “federally coordinated” taxes is similar to what is collected through the payroll tax and therefore constitutes a critical source of revenue for Mexican states.

**The low level of subnational tax effort is one of the main vulnerabilities of the fiscal federalism framework in Mexico.** States’ dependence on federal transfers constitutes a severe vulnerability, as confirmed by the Lehman crisis. The slowdown of economic activity and the drop in oil prices led to a dramatic reduction in the amount of federal revenues shared with subnational governments. While federal public finances were partly protected from exogenous shocks because of the government fiscal risk management strategy (for example, the oil hedging program), Mexican states were defenseless and subnational public finances were hit hard.<sup>4</sup>

*Subnational expenditures have been on the rise and should be more transparent and efficient*

**Subnational expenditures have been growing in recent years.** They currently constitute more than half of total public expenditures (figure 4). During the 1990s spending powers were largely transferred from the federal government to states and municipalities. In 1992 Mexico’s federal government decentralized primary education, effectively transferring to the states the responsibility to finance basic education. This implied also transferring the teachers’ large wage bill. In 1996 health services were decentralized to the states, too. Expenditure pressures kept

increasing in recent years (up 100 percent during the last decade). The rising cost of state retirement plans will create additional pressures. They currently represent 2.3 percent of total retirement accounts in the country but are projected to increase during the next decade.



**Greater expenditure management efficiency is needed to gradually reduce the burden of current expenditures as well as budget rigidity.** States' current expenditures have been increasing in recent years. According to Fitch data, operational expenditures (defined as current expenditures and transfers) increased from MXN 300 billion in 2007 to MXN 370 billion in 2010. On top of that, some recurrent expenditures (such as social transfer programs) have been classified as part of the state investment program. The large and increasing amount of operational expenditures limits states' budget flexibility. To address this issue, the increasing trend of current expenditures needs to be reversed by increasing the efficiency of expenditures (for example, in education).

*Subnational debt is also on the rise and some states are in fiscal distress*

**The global financial crisis severely affected the amount of federal transfers to subnational governments.** The decrease in oil prices meant significantly lower oil revenues, which are

shared between levels of government. In addition, the subdued level of economic activity implied a significant reduction in federal tax revenues,<sup>5</sup> which are also shared. Overall, the combined impact of these shocks implied significantly reduced transfers for subnational entities and created an aggregate gap in their balances of about 70 billion pesos (three times the amount accumulated in the FEIEF, the “rainy day” fund created through annual federal surplus revenues).

**To fill the gap created by high expenditures and lower revenues, subnational governments borrowed resources from commercial banks and debt levels increased.** Subnational debt showed a particularly strong increase in the period following the Lehman crisis. Subnational debt registered by SHCP amounted to MXN 390.8 billion (\$30.0 billion) by the end of 2011 after increasing at an annual rate of nearly 20 percent in real terms since 2008. Over 2001–08 subnational debt had expanded at a much more moderate average annual pace of 6 percent in real terms.

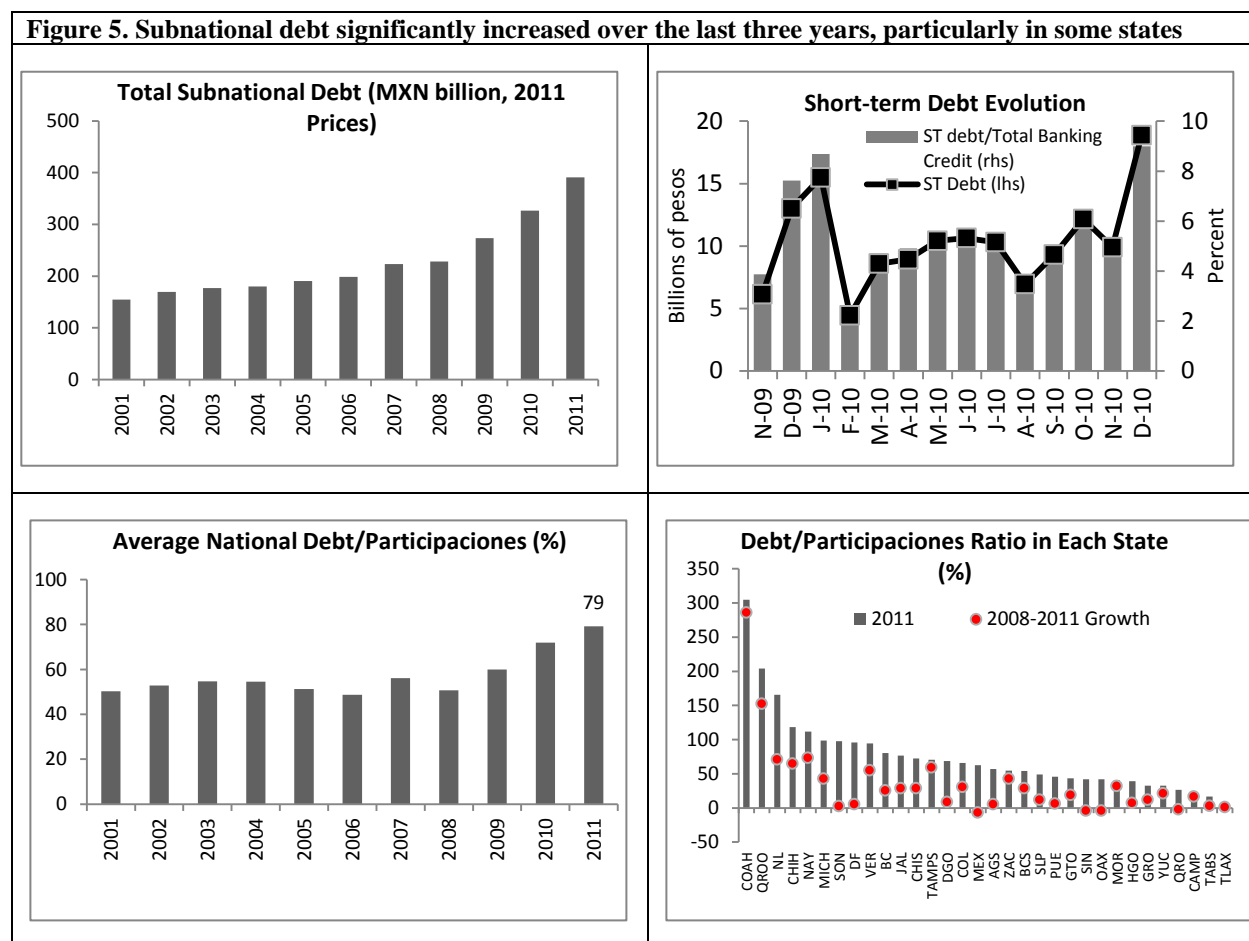
**Subnational borrowing capacity has shrunk since the global crisis.** Compared with GDP, aggregate subnational debt in Mexico appears low relative to international standards since it accounts for about 3 percent of GDP, well below its share in countries such as Argentina, Brazil, and the United States (7, 12, and 19 percent of GDP, respectively). However, in view of the limited ability of subnational governments to impose taxes, the debt-to-GDP statistic can be misleading, and subnational borrowing capacity is probably better measured by comparing subnational debt with the percentage of subnational revenues that can be used or pledged for debt service payment. With this aim, shared federal tax revenues (*participaciones*) have often been used as the denominator, because these resources are not earmarked for the use of specific expenditures or in predetermined sectors. According to SHCP, the average level of subnational debt as a percentage of *participaciones* increased to 79 percent in 2011 after hovering around 50 to 55 percent over the past decade.<sup>6</sup>

**Subnational debt is high and has been growing rapidly in some Mexican states.** To assess subnational indebtedness levels, it is essential to go beyond national aggregate figures (which are still relatively low) and consider state-specific situations. Figure 5 shows that heterogeneity is high and has increased since the Lehman crisis (the coefficient of variation is equal to 80 percent, up from 64 percent in 2008). In some states the debt to *participaciones* ratio is very low (such as Campeche or Tabasco) and/or has decreased during the last three years (Estado de Mexico, Oaxaca, and Sinaloa). But there are states where debt exploded after the Lehman crisis (such as Coahuila and Quintana Roo) and became a significant source of vulnerability.

**In several states, the growth of subnational debt was driven by the increase of short-term debt.** In Mexico, state legislatures have the right to define what constitutes debt. Most states do not consider liabilities whose maturity is less than a year to be debt. This has had important consequences. If the state definition of debt does not include short-term debt, the contracting of debt does not need to be approved by the local congress. If short-term debt is not officially considered as debt, it can be used to finance current expenditures. In addition, the 2009 modification of bank prudential regulations exempted short-term debt from a higher risk rating and the need to establish prudential reserves.<sup>7</sup> Consequently, short-term debt increased significantly during the past two years (figure 5) and the rapid accumulation of short-term



liabilities resulted in unsustainable debt levels and fiscal problems in some states (such as Coahuila).



Source: Ministry of Finance and Public Credit (SHCP).

**Nonregistered short-term debt led to growing discrepancies between debt included in the federal debt registry and actual subnational debt.** This issue became particularly relevant for states such as Chihuahua, Coahuila, Michoacán, Tabasco, and Zacatecas. In Coahuila the actual amount of debt turned out to be four times higher than the amount registered in SHCP. As a result, in 2011 its financial distress took the authorities and market participants by surprise, partly because there was misreporting and underreporting of the state’s debt and partly because these loans were not considered when monitoring loan concentration.

**The lack of complete and reliable information on subnational entities’ liability position raised questions regarding the borrowing framework.** Credit ratings were used by bank regulators to assign capital risk weightings and prudential reserves for bank loans to subnational governments. But the overdependence on rating agencies, and decreased regulation of short-term debt, reduced due diligence by some financial institutions and led to fast debt growth and high lending concentrations. The borrowing framework was recently improved. In September 2011 the government modified banking regulation, linking prudential reserve requirements for lending to subnational entities with a comprehensive set of indicators. However, additional reforms are still needed.

### POLICY OPTIONS

#### *Raise subnational own-tax effort*

**Subnational governments in Mexico should raise more taxes.** Higher subnational tax efforts would have several advantages, including: improving the resilience of Mexican states to exogenous shocks; reducing the dependence on oil-related revenues, which are projected to decline; preparing states to face the growing burden of retirement benefits; and increasing subnational states' capacity to repay their debt (thus lowering the borrowing costs).

**Several strategies could be considered to achieve this objective.** Improving tax administration would offer states an opportunity to raise more revenues. In addition, states could levy surcharges on a tax defined and administered by the federal government. Another option is to improve property tax collection. Property taxes are the ideal tax at the subnational level of government, as the tax base cannot be shifted easily from one jurisdiction to another. The collection of property tax (which is levied at the municipal level) is very low (0.2 percent of GDP compared with an average for OECD countries of almost 10 times as much). Mexican states could be involved in strengthening property tax collection for their municipalities.

**Political economy factors complicate states' incentives to increase tax collections.** For political reasons, it is difficult for states to raise or even maintain tax collection levels (especially when taxes are closer to the voters). The recent experience with *tenencia* offers a clear example of these political limitations. In 2007 the federal government proposed to transform the federal *tenencia* and gave states five years to enact local *tenencia* laws. Notwithstanding the importance of this tax, many states decided to repeal it, particularly those having elections. Political disincentives could be managed through the imposition of “federally coordinated taxes.” But beyond political reasons, states' incentives to raise more taxes are also limited by the possibility of receiving discretionary transfers, which soften the budget constraints that states should face. A hard budget constraint is essential to promoting fiscal consolidation at the state level.

#### *Improve the transparency and efficiency of subnational expenditures*

**Fiscal transparency would promote accountability and efficiency of subnational expenditures.** The importance of state expenditure responsibilities requires the standardization of the classification of states' budgetary expenditures. Currently, subnational budgetary reporting is not homogenized. Teacher payrolls are a clear example. According to the National Institute of Statistics and Geography, state teachers' payroll may be filed under “Personal Services” or “Transfers” in official public finance statistics. States report spending less than 20 percent of their budget on payroll. In reality, a large part of the payroll is filed under transfers. The Mexican Institute for Competitiveness estimates that, due to the lack of transparency, hidden payroll costs amount to 4 percent of GDP. It is critical to make expenditure reporting more transparent to verify the actual destination of earmarked transfers and promote accountability and efficiency of expenditures. Classifying all payrolls under Personal Services (Chapter 1000) would constitute a step in the right direction.

**A clearer distinction between federal and state expenditure responsibilities, especially in the basic education sector, could improve service delivery.** Education is the main area that presents an issue of overlapping responsibilities. The decentralization of expenditures for this



sector, and in particular for basic education, is often criticized. Even though states continue to have limited responsibilities in implementation or actual delivery (as norms and financing are determined centrally), they perceive significant expenditure pressures generated by this decentralization. An example is provided by increases in teacher salaries. Negotiations on wages take place at the federal level, but the additional fiscal burden is borne by the states. Limited control of spending negatively affects expenditure efficiency.

### *Improve subnational fiscal discipline*

**The intergovernmental federal system requires better defined procedures for crisis resolution as an alternative to the ad hoc federal transfers.** A framework for state insolvency could be developed to provide incentives to good practices in exchange for federal assistance. This may take the form of federally supported subnational fiscal adjustment plans, in which fiscal and service delivery targets are set on measures to expand revenue, rationalize expenditures, or restructure public debt. Fiscal adjustment plans would be accompanied by transfers or loans from the federal government conditioned on the implementation of the program. The main differences with the current practice of ad hoc federal additional transfers may include the conditioning of the financial support and the transparency with which the program is implemented.

**A more transparent debt reporting is also needed to strengthen subnational fiscal discipline.** Strengthening debt data accuracy and particularly, the automatic inclusion of short-term debt in the definition of state debt would be a relevant policy reform. The establishment of a common budget classification system in parallel with the harmonization of accounting across government levels is also required to enhance transparency and fiscal discipline (see Mexico Policy Note on Public Sector Modernization).

### **Matrix of short- and medium-term policy reform options\***

Reform area	Short-term options (1 year)	Medium-term options (2–3 years)
Improve subnational fiscal discipline	<ul style="list-style-type: none"> <li>• Reduce discretionary transfers to subnational states (LR)</li> <li>• Include short-term debt in the definition of debt for all states (LR)</li> </ul>	<ul style="list-style-type: none"> <li>• Review the subnational borrowing framework to include a crisis resolution mechanism in case of state’s fiscal insolvency (LR)</li> </ul>
Raise subnational own-revenues	<ul style="list-style-type: none"> <li>• Impose federally coordinated taxes (such as ISAN) to promote state own-revenues (LR)</li> </ul>	<ul style="list-style-type: none"> <li>• Strengthen tax administration at the subnational level (AR)</li> <li>• Strengthen property tax collection efforts by states (LR).</li> </ul>
Improve transparency and efficiency of expenditures	<ul style="list-style-type: none"> <li>• Harmonize accounting of state payroll expenditures (LR)</li> </ul>	<ul style="list-style-type: none"> <li>• Standardize subnational budgetary reporting (LR).</li> <li>• Distinguish clearly between state and federal expenditure responsibilities (LR).</li> </ul>

\*LR=Legal Reform; AR= Administrative Reform. Preliminary classification.

### NOTES

<sup>1</sup> The income ranking for these charts is based on non-oil mining GDP per capita. Standard state's GDP figures carry a distortion due to the fact that a large share of the offshore oil production is assigned to Campeche. When GDP except oil mining is used, Campeche moves from the first to the fifth position.

<sup>2</sup> This trend is gradually evolving. In recent years, the “regressivity” of *participaciones* was gradually diluted, as shown by the decreasing steepness of the *participaciones* trend-line (see the red line in figure 1).

<sup>3</sup> In 2009 these two taxes represented about 80 percent of Mexican public sector tax revenues.

<sup>4</sup> This example underlines the importance of having a fiscal risk management strategy in place. States could consider designing a fiscal risk management strategy to smooth the flow of federal transfers.

<sup>5</sup> Federal non-oil tax revenues during 2009 decreased 10.5 percent in real terms.

<sup>6</sup> More recently, SHCP has started to integrate a series which broadens the definition of subnational resources that can be used and pledged for debt service payment, including state and local government own-revenues (local taxes and fees) and part of federal transfers for basic infrastructure. Using such a broader denominator, subnational debt increased to an average of 61 percent of subnational governments' available revenue in 2011 from 41 percent in 2007, according to SHCP data.

<sup>7</sup> The 2011 reform of banking regulations addressed this specific issue.