

ANNEX

BACKGROUND NOTES ON EXPENDITURE DECENTRALIZATION AND POVERTY ALLEVIATION IN MEXICO

I. INTRODUCTION

These notes provide background information for a larger study of the impact of expenditure decentralization on poverty alleviation in Mexico. They identify some of the main problems and issues that need to be addressed to ensure that the expected positive impact on the poor is fully realized. The approach is eclectic, mixing historical and analytical observations. The notes need to be complemented with detailed studies that incorporate up-to-date information about programs and budgets in the different areas of interest. Further, more empirical evidence of the effects observed to date in each sector is needed before offering policy recommendations.

II. BACKGROUND

From December 1978, when the Fiscal Coordination Law was promulgated by president Lopez Portillo, up to December 1997, when major reforms to this Law were promulgated by president Zedillo, Mexico experienced almost twenty years of a fairly stable institutional understanding for revenue collection and expenditure sharing between the federal and state and municipal governments. The cornerstone of this understanding was the National System for Fiscal Coordination (*Sistema Nacional de Coordinación Fiscal*) created by the Fiscal Coordination Law. Under this arrangement, states and municipalities would forego the collection of an agreed set of federal taxes, levies, and contributions in their own jurisdictions, in exchange for a share of total revenues obtained from these sources (*Recaudación Federal Participable*). Although the Fiscal Coordination Law established that joining the National System was voluntary, in practice all states signed the corresponding agreements with the Ministry of Finance (*Secretaría de Hacienda y Crédito Público, SHCP*), establishing a single national unified system.¹

¹ Since the agreements were signed, no state has left the System, although occasionally there have been threats to do so. These threats are not very credible, however, because it would be extremely difficult for states to set-up their own tax collection mechanisms for what are currently federal taxes, aside from the political costs that it could imply for a state government. There are also unanswered questions if a state leaves the System: Would it have to pay for a share of the costs of the public debt? Would it profit from

Revenues shared through these agreements, labeled “*participaciones*,” were the main source of funding for states and municipalities, since local taxes or contributions played (and still play today) a minimal role as sub-national sources of income. *Participaciones* by Law “belong” to states and municipalities. Therefore, they cannot be earmarked for any purpose, neither by the Fiscal Coordination Law nor, evidently, by the Federal Government. Moreover, there is no federal supervision or audit as to their use. These tasks are performed by sub-national authorities (state legislatures and state auditing offices); in fact, after *participaciones* are disbursed from the federal budget to states and municipalities, legally they are no longer federal resources.

Each individual state or municipality’s share in the *Recaudación Federal Participable* is determined by various formulas contained in the Fiscal Coordination Law. These formulas are fully transparent, and allow almost no discretion to federal authorities (in particular, to SHCP, the ministry in charge of administering the Fiscal Coordination Law) to alter the amounts due to sub-national governments.² The little discretionary power in the hands of SHCP derives mainly from its ability to vary the calendar when *participaciones* are disbursed. In particular, through “advance payments” (so-called *adelantos*) SHCP can aid a particular state facing a transitory difficult situation. But the margin for doing this is, on the whole, small. By and large, the *Sistema Nacional de Coordinación Fiscal* worked reasonably well over these years as a mechanism to collect taxes and transfer resources to states and municipalities (without implying, evidently, that the tax structure or the revenue-sharing formulas were the most appropriate).

Participaciones were not the only resources received by sub-national governments from the federal budget during the 1979-1997 period. These were complemented with resources originally allocated by Congress to the budgets of federal ministries and agencies, but that could be transferred to sub-national governments through “*convenios*.” These are ad-hoc agreements signed between federal ministries/agencies and states and municipalities, by which the latter are entrusted to fully carry out tasks, or help in the execution of tasks, that are in principle a federal responsibility. *Convenios* share or delegate this responsibility, and transfer resources for that specific task. And though these resources are spent by a state or municipal ministry or agency, they are still federal, and are subject to supervision, audit, and sanction by federal authorities (the audit office of the federal ministry/agency in charge of oversight is the Ministry of the Comptroller and Congress’s own audit office).

Convenios are a very flexible mechanism by which, in principle, federal, state and municipal governments can work together to address specific needs. They can and are signed by various federal ministries/agencies in many areas: for road-building, public

positive oil shocks? The benefit-cost ratio of the current System has been positive for states, and it is becoming more so as the discussion below points out.

² Since some of the formulas depend on a state’s or municipal’s share of population in the national aggregate, disputes may arise at times, particularly since this information is up-dated only every five years. This and other technical issues are ignored in what follows.

security, justice administration, agricultural development, among others; as well as in areas associated with social protection and poverty alleviation like education, health, housing, and water sanitation.

The flexibility of *convenios* gives the Federal Government a strong tool to interact with state and municipal governments, particularly in tasks in which the latter have a clear comparative advantage. They are also a powerful instrument to nudge sub-national governments to follow and implement federal programs and policies, even though these policies and programs may not be contained in a Law (a new program for food distribution in poor communities, a subsidy for agricultural producers, etc.). This flexibility, however, comes at a cost: the rules for signing *convenios* are vague, so that—in contrast to *participaciones*—there is insufficient transparency and, one could argue, substantial discretionary power for the Federal Government who, at the end of the day, “owns” these resources (as opposed to *participaciones*, “owned” by sub-national governments).

Although *convenios* are signed continuously, there is no legal obligation for either party to do so. A particular federal ministry or agency might sign a *convenio* one year with a given state, but not the next. Yearly, the amount transferred might change from one year to the next with no obvious explanation; or the tasks delegated or required from the state government could be modified; or the conditions for the *convenio* to operate could be altered. The causes behind this instability, in turn, are many. For example, a federal administration comes to an end, and the new one is pursuing a different approach in, say, health policy, with the conditions imposed by the Ministry of Health (*Secretaría de Salud, SSA*) on state health authorities changing importantly. Or, Congress may substantially reduce the highway construction budget from one year to the next, thus the Transport Ministry (*Secretaría de Comunicaciones y Transportes, SCT*) signs *convenios* for a much smaller amount for *caminos rurales* with states, perhaps leaving some *caminos* unfinished. Another example might be a fall in aggregate tax revenues in one year, forcing SHCP to cut the federal budget. This in turn impedes the Ministry of Education (*Secretaría de Educación Pública, SEP*) from signing the *convenios* with states for building, say, technical secondary schools. Alternatively, political considerations could at times filter into decision-making, favoring a particular party/governor. Clearly, the flexibility of *convenios* was a positive element from the point of view of updating and adapting policies and budgetary allocations to changing needs and circumstances, but the process could also lend itself to rent-seeking or influence peddling principally by states and, sometimes, by powerful or important municipalities (e.g., Monterrey or Acapulco).³

³ In this context of insufficiently defined budget constraints, rent-seeking could also result from the activities of private groups. Thus, agricultural producers could, in the face of an unexpected drop in the world price of a particular commodity, or as a result of a larger than expected harvest, for instance, pressure the Ministry of Agriculture (*Secretaría de Agricultura, Ganadería, Desarrollo Rural, Pesca y Alimentación*,

Convenios are signed by executing ministries and agencies in the Federal Government, without the direct intervention of SHCP. With few exceptions, SHCP has no *ex-ante* knowledge of how many resources will be transferred, when, by what ministry/agency, and to which state. As a result, various ministries/agencies have both normative and budgetary responsibilities. Negotiations between federal ministries/agencies and state governments are at least yearly, and take place on many fronts (*convenios* for education, agriculture, health, school-breakfast programs, water, social development, financial “support”, etc.). In principle, attempts are made to unify these negotiations into a single instrument (the *Convenios Únicos de Desarrollo* later relabeled as *Convenios de Desarrollo Social*), but the coordination problem within the Federal Executive is too difficult to solve. *De facto*, each federal ministry/agency engages in bilateral negotiations with each governor.

It is important to note that SHCP also had the ability to sign *convenios* with states to transfer resources in addition to *participaciones*, when states ran into “serious” financial difficulties. This possibility gave SHCP a strong hand with which to influence states’ policies. However, this practice created substantial problems of its own, since the discretionary nature of these transfers, political considerations aside, implied the usual incentive problems associated with non-credible defaults and soft budget constraints. Resources transferred by SHCP to states (and sometime to municipalities) were in principle for debt-relief and restructuring. But given the fungible nature of funds, they could end up paying for a state highway, an urban development project, a university, a hospital, or whatever project for which a state had borrowed previously.⁴

In some cases, states are required to contribute with their own resources to program funding (so-called *pari-passus*) with the purpose of expanding coverage faster, or modifying incentives to states by making them bare at least part of the cost of a given policy. And, although this may be a sensible policy in many circumstances, at times it could also impede full program execution (because states do not have or were unwilling

SAGARPA) for “emergency” resources, resulting in an addendum to the *convenios* previously signed by SAGARPA with the states experiencing the shock, or new *convenios*.

⁴ From 1995 to 1998 SHCP tried to use these *convenios* to restructure states’ debts, which had been affected by the 1995 economic crisis. In 1999 no resources were incorporated in the federal budget for this purpose, in an attempt to give credibility to the Federal Government’s intention to show states a harder budget constraint. This attempt worked partially. In the federal budget for 2000 Congress included a new program to transfer non-earmarked resources to states, aside from *participaciones* and the aportaciones of Ramo 33. There were three important differences, however: first, the state-distribution of funds was determined by Congress and not by SHCP, as was the case up to 1998, thus making it more transparent while reducing SHCP’s negotiating power with states; second, the amounts were fixed and could not be increased during the year (which was not the case with the previous *convenios*); and third, there was no conditionality of fiscal adjustment or reporting fiscal information to SHCP, as was the case with the 1995-98 agreements. Moreover, there is no transparency in the formula which has been changing every year. This program continues today in the federal budget, the *Programa de Apoyo para el Fortalecimiento Financiero de los Estados*, PAFEF, and its overall size is the object of yearly negotiations in Congress, as it is not contained in any Law, but incorporated in the yearly budget decree. PAFEF generates important considerations for fiscal decentralization, and some additional remarks are offered below.

to commit the required resources).⁵ In other cases, timing issues would also affect program execution. Given the yearly nature of the budget, and the fact that ministries/agencies could transfer resources late in the year, states were impeded from spending the full amount agreed to (because of calendar manipulation by SHCP, prolonged negotiations between a particular governor and a given federal ministry/agency, or simple bureaucratic inefficiency).

Lastly, it is important to point out that, under these circumstances, it was difficult for communities to fully understand how many resources would be spent on any given year by which level of government and for what purpose. A school breakfast program might be notably expanded, but communities may not know whether this is the municipal president's policy, the governor's policy, or the President's policy. The hospital might need repairs and new medical equipment, but it is not clear who is responsible for doing so; the same is true with a road that was severely damaged after the rainy season. With little transparency as to the source of funding, and substantial overlap in federal, state and municipal responsibilities (particularly in social programs), ordinary citizens find it hard to make a clear association between the taxes they pay, the subsidies they receive, and the level of government accountable for success or failure of key programs or policies. The same observation holds, *mutatis mutandis*, for programs and policies for poverty alleviation.

III. MOTIVATION FOR CHANGE

The institutional arrangement described above was subject to progressive pressures overtime. Population growth, migration, increased complexity of the services provided and a maturing democracy, among many factors, would make the decentralization formula [*participaciones + convenios*] progressively insufficient and inefficient.⁶ Direct federal management of very large and geographically disperse service-delivery organizations became increasingly difficult, and outcomes, at least in terms of quality, were deemed below expectations. Overtime, a consensus emerged centered on the need to involve state and municipal governments more directly in the day to day administration and provision of basic services, particularly in areas like education and health.

⁵ A related problem arises when federal ministries fail to notify state governments in a timely manner of the resources that they plan to spend in that state. If, as is often the case, state governments commit fully their own budgets at the beginning of the fiscal year, the lack of timely information may impede them from contributing with the *pari passu* requirements, even if they are willing to do so.

⁶ For example, provision of health services is gradually changing from simple vaccinations and treatment of contagious diseases to coverage of degenerative diseases like diabetes, hyper-tension, and cancer, requiring more complex equipment, more specialized personnel, and procurement of a larger number of medicines. All this is to be delivered in an increasing number of locations. In education constitutional reforms expanded basic education from six years of primary school to three additional years of secondary school.

A first step in this direction was the 1992 *Acuerdo Nacional para la Modernización de la Educación Básica*, signed by the Federal Government, the national teachers' union and state governors. (Note that this was a voluntary agreement among parties, not a Law. Initially Congress did not participate, although in 1993 the main elements of the *Acuerdo* were incorporated in the *Ley General de Educación*). A second step was the 1996 *Acuerdo Nacional para la Descentralización de los Servicios de Salud* (involving a similar set of actors). These two agreements in principle transferred to states (not municipalities) the physical infrastructure and day to day operational responsibilities in the provision of health and basic education services, with the Federal Government specializing in a more normative role. As part of these *acuerdos*, SEP and SSA transferred the financial resources previously earmarked in their budgets for these tasks to states. This implies that, at least initially, there were no additional resources; states would in principle receive, through a *convenio*, the same resources that these two ministries were spending previously. Thus, the pre-*acuerdo* distributions between states were maintained, although they were not derived from systematic equity considerations. This situation has generated substantial friction among those states that consider that they are not being treated equitably by the Federation.

In parallel with the technical and administrative considerations that called for a sharper division of labor among the various levels of government in the provision of social services, Mexico's maturing democracy introduced an equally important set of considerations. The decentralization formula [*participaciones + convenios*] was politically sustainable in a context where all (until 1989), or almost all, governors were members of the same party as the President, and when the President's party had a majority in both houses of Congress (up to 1997). Disputes over resources between federal ministries/agencies and state and municipal governments were in principle settled on technical terms. The President would always be the last resort arbiter in case a particular governor and a federal ministry did not settle on a mutually satisfactory understanding.

As more governors were elected from parties other than the PRI, this dispute settlement mechanism became more openly controversial (e.g., the dispute between the PAN governor of Baja California, on the one hand, and SEP and SHCP, on the other, over the state's basic education budget). At the same time, a larger number of non-PRI legislators in Congress and an increasingly free press also questioned the President's large discretionary powers over budgetary allocations, including the distribution of resources to states and municipalities. In some cases, questions were raised about the potential use of some social programs for electoral purposes (e.g., the criteria used by the Ministry of Social Development, SEDESOL, in the *Programa Nacional de Solidaridad*,

PRONASOL). By mid-1990's more and more voices called for "clearer budgetary rules," including those concerning the transfer of federal resources to states and municipalities.⁷

The mid-term federal elections of July 1997 mark an important turning point; for the first time in more than six decades no political party obtained a majority in the lower house of Congress. It is in the lower house that the spending side of the federal budget (*Presupuesto de Egresos*) is approved (as opposed to the *Ley de Ingresos*—the revenue side, which also requires approval by the Senate). Two factors came together at this time. On the one hand, the experience gained from the 1992 and 1996 agreements to decentralize basic education and health, and the 1996 precedent for distributing two-thirds of PRONASOL's budget through an explicit formula, aimed to improve quality in the delivery of basic education, health, and social infrastructure, respectively. On the other hand, there were calls by non-PRI governors and a majority of non-PRI deputies in the lower house of Congress, for more transparency and reduced discretion in the budgetary relationships between the federal and state and municipal governments.⁸

These two factors generated the conditions for a substantive change to the almost twenty year old [*participaciones + convenios*] decentralization formula. Consequently, at the end of 1997, president Zedillo proposed a reform of the Fiscal Coordination Law to Congress to create a new mechanism to transfer resources to states and municipalities, and to add a new *Ramo* (number 33) to the federal budget. This proposal was approved by Congress in December of that same year, adding a new chapter to the Fiscal Coordination Law and introducing the novel category, "*aportaciones*" which had five specific funds. Correspondingly, these funds integrated their budgetary allocations into the newly created *Ramo* 33 (labeled *Aportaciones Federales para Estados y Municipios*) of the 1998 federal budget.

IV. PURPOSE AND NATURE OF APORTACIONES AND RAMO 33

Aportaciones are, from a legal point of view, an intermediate figure between *participaciones* and *convenios*. On the one hand, these resources in principle "belong" to the Federal Government, which allows targeting to specific uses, regardless of states and municipal governments' preferences. Furthermore, the Federal Government retains a last resort capability to supervise and audit their use. On the other hand, state and municipal governments have the legal right to receive these resources from the federal

⁷ Perhaps partly in response to these observations, in 1996, president Zedillo unilaterally announced to Congress that as of fiscal year 1997 SEDESOL would distribute 65% of the resources in *Ramo* 26 belonging to PRONASOL to municipalities by means of an explicit poverty-based formula.

⁸ Congress also negotiated other changes to the federal budget, concerning the spending rules in case there were unexpected additional revenues, and the allocation of a line-item to the Federal Executive not subject to auditing by Congress, among others. Put differently, decentralization of resources was at this point part of a broader concern associated with the distribution of power between Congress and the Executive over control of federal resources.

budget in the dates and amounts specified in the Fiscal Coordination Law as long as they use them for the stated purpose, independently of the will of the Federal Government.⁹ In principle, *aportaciones* are a vehicle to:

- transfer federal resources to states and municipalities for a specific purpose on the basis of clear and transparent formulas, independently of whether these formulas are the most appropriate ones for the given purpose;
- delineate more clearly federal and state responsibilities, allowing the Federal Government to, in principle, concentrate on normative issues, while state and municipal governments focus on operational ones;
- provide state and municipal governments with more stability, certainty and information as to the dates and magnitude of the resources they will receive from the federal budget in order to improve their own budgetary planning;¹⁰
- induce faster and in principle better program execution by eliminating one layer of bureaucratic control (the federal one), and promote efficiency as savings from programs that were not spent in the fiscal year could be transferred to the next;
- reduce the discretionary power of the Federal Executive to negotiate *convenios* with state governors;
- promote, in some cases, community participation in the decisions concerning the use of these funds; and,
- shift the principal responsibility with regards to supervision and auditing from the federal to the state level.

The “mixed” status of *aportaciones* is reflected in the legal provisions concerning supervision and auditing. In particular, the Fiscal Coordination Law contains a four-step procedure for this purpose: (i) the federal Ministry of the Comptroller supervises that SHCP budgets each fund in *Ramo 33* in accordance with the formulas contained in the LFC, and that the corresponding resources are delivered at the specified dates to states or municipalities; (ii) state or municipal level authorities, depending on the nature of each fund, supervise that the resources are spent properly; (iii) the auditing

⁹ An important consideration generated by *aportaciones* has to do with sharing macroeconomic risks between the three levels of government. If there is an unexpected negative shock during the fiscal year, SHCP cannot adjust *aportaciones* downwards, and all of the budget reduction must be borne by federal programs (assuming a constant deficit). This works conversely for a positive shock. The situation here differs from that of *participaciones*, where variations in the *Recaudación Federal Participable* (in any direction and coming from any source) are passed on to states. Further discussion is required to determine whether this is an adequate risk distribution, but the issue is not addressed here.

¹⁰ To contribute to this aim, as of 1998, the federal budget included the state breakdown of resources for all funds in *Ramo 33*. Equally important, it also made explicit the distribution of resources budgeted for wage increases during the year for all government employees, including those in health and basic education covered by *Ramo 33* resources. This reduced, but did not eliminate, uncertainty over a major component of states’ expenditure over the course of the fiscal year, as the discussion below points out. Further, the Fiscal Coordination Law also stated the date at which some of *Ramo 33* funds would be disbursed.

authorities of each state legislature then supervise that the executing ministries and agencies of states and municipalities applied the funds to the purposes stated in the Fiscal Coordination Law; and (iv) finally, the auditing authority of the Federal Congress in turn supervises that the Ministry of the Comptroller and SHCP each complied with the requirements of the Fiscal Coordination Law. To facilitate this four-step procedure, state and municipal supervising authorities are required to notify the Ministry of the Comptroller when they observe any deviations; similarly, states' legislatures auditing authorities are required to notify Congress's auditing authority when resources are not applied to the purposes stated in the Fiscal Coordination Law.

With the creation of *aportaciones*, states had new budgetary responsibilities: in their own use of *Ramo 33* resources, in the mechanics for transferring funds to their *municipios* and, very importantly, in matters of auditing and supervision. To fulfill them properly, state legislatures had to pass new legislation. Thus, the legal framework of the Fiscal Coordination Law for auditing and supervision is complemented by, in principle, 32 additional laws (31 states plus the Distrito Federal). This results in a large potential variance in the nature and depth of the auditing and supervision process across states (as well as in the conditions imposed by states to transfer resources to their *municipios*, as elaborated upon below).

The result of the 1997 reform to the Fiscal Coordination Law was a three-pronged [*participaciones* + *aportaciones* + *convenios*] decentralization formula (although, as explained below, other channels have been created since then). Three central results of this reform are: (i) the Federal Congress (Executive) has more (less) power than in the past; (ii) uncertainty has been reduced but not eliminated and transparency has increased; and (iii) the overlap between national and sub-national responsibilities in some areas has been reduced though, again, not eliminated.

It is important to emphasize that the reforms to the Fiscal Coordination Law did not substitute *aportaciones* for *convenios*. The reforms added the former, but the latter remained as a channel to transfer resources to states and municipalities, in addition to *aportaciones*. The relative magnitude of each is different, as the resources currently decentralized by *aportaciones* are substantially more significant than those operated through *convenios*. However, the persistence of *convenios* leaves open a parallel decentralization channel, with all the advantages and disadvantages mentioned before. Furthermore, in some sectors, federal transfers to states are still wholly operated through *convenios*. Indeed, for ministries like SAGARPA or the Ministry of the Environment (*Secretaría de Medio Ambiente y Recursos Naturales*, SEMARNAT) the mechanisms for transferring resources to states and municipalities are not very different in the recently approved federal budget for 2006, than what they were in 1996. The same could be said for the National Water Agency (*Comisión Nacional del Agua*, CNA).¹¹

¹¹ As a result of this, states still do not know the full amount of federal resources that they will receive in a given year from the federal budget.

Aportaciones have helped to increase transparency and signal a “harder” budget constraint in some sectors, not all.

It is noteworthy that, since the addition of two more *aportaciones* funds in reforms approved in December 1998 to the Fiscal Coordination Law, there have been no further legal initiatives to advance Mexico’s decentralization process. Instead, aside from continuing with the *convenios* as a transfer mechanism between the Federal Executive and state and municipal governments, a new *convenio*-type mechanism has *de facto* been created. This mechanism, the PAFEF has been voted into the budget decree by the House of Representatives over the last seven years (2000-2006). The novelty is that this is an agreement between Congress and state governments, without any formal intervention by the Federal Executive.¹²

It is clear from the above description that expenditure decentralization in Mexico has changed importantly over the last decade. Decentralization now occurs through many channels. Part of it takes place as a result of a legal mandate derived from the Fiscal Coordination Law (*participaciones* and *aportaciones*), with the corresponding attributes of transparency and stability. Part of it continues to take place through old channels (*convenios*), with the corresponding attributes of flexibility-cum-discretion. And part of it takes place through new channels (PAFEF and sharing of positive oil shocks) as a result of a yearly negotiation in which Congress plays a key role, with the corresponding attributes of uncertainty, and potentially asymmetric risk distribution. It is not very clear, however, that expenditure decentralization has advanced as part of an overall institutional arrangement that: assigns resources to the level of government best suited to perform a given task; provides incentives to all levels of government to enhance tax revenues; distributes macroeconomic risks appropriately; or ensures that key social services are delivered efficiently to all, including those living in poverty.

Aportaciones and *Ramo 33* must therefore be seen in a broader framework, since they are only part of the decentralization process. Even if all the objectives posed when *Ramo 33* was created were fully achieved (which probably is not yet the case), states would continue to face budgetary uncertainty as to the transfers that they would receive from the federal budget. Further, to the extent that the federal and state governments can still sign *convenios*, clear budget constraints have yet to be established. Moreover, to the extent that state governments can still extract additional resources from the federal budget through yearly negotiations with Congress, incentives may not be fully aligned

¹² There have been other changes that also affect the distribution of federal resources between the three levels of government. Perhaps the most important one has to do with the formulas contained in the budget decree for sharing non-budgeted revenues derived from a world oil price higher than the one assumed in the Federal Revenue Law, with states now receiving some of the additional benefits. In the end, the persistence of PAFEF and the sharing of unexpected oil revenues is just the budgetary reflection of a continuing change in the balance of power between the Federal Executive and Congress and, indirectly, between the federal and state governments (given the more active participation of the latter in budget discussions in Congress).

in the direction of tax efficiency. In addition, to the extent that the Federal Government continues to introduce new programs in basic education or health, for example, a clear division of tasks between the three levels of government has yet to be achieved, and a clear message to citizens as to who is responsible for what is yet to be delivered. Lastly, to the extent that national trade unions continue to operate in their current form, it will be difficult to make providers of services fully accountable to sub-national levels of government; this has evident implications for monitoring and incentives (as the discussion below will point out). *Aportaciones* and *Ramo 33* have probably helped to advance Mexico's decentralization process, but they are not the substitute for an overall strategy for fiscal federalism, trade-union modernization, or poverty alleviation.

V. PRINCIPAL APORTACIONES FUNDS

Congress initially approved five different funds in *Ramo 33* in December of 1997. As commented, a year later, two more funds were added via an additional reform to the Fiscal Coordination Law. Of these seven funds, five are explicitly associated with social programs, with some transferring resources to states, and some to municipalities.¹³ The main characteristics of the five funds associated with social programs are discussed next; although, it should be stated at the outset that not all of these funds are directly associated with poverty alleviation.

Fondo de Aportaciones para la Educación Básica, FAEB

As mentioned, in 1992 the Federal Government signed an *Acuerdo* with the national teachers' union and state governments to transfer direct responsibility for basic education to the latter, with resources directly transferred to each state by SEP. Five years later, FAEB served as a mechanism to formalize the budgetary aspects of this *Acuerdo* without, as expanded below, immediately changing the relationship between the teachers' union and the Federal Government, or having an important quantitative effect on the federal resources available to states for basic education.¹⁴ Given the budgetary and political constraints under which FAEB was born, the Fiscal Coordination Law stated that federal resources decentralized to states would be based on an inertial formula derived mainly from the number of teachers and schools in each state (*Registro Común de Escuelas y de Plantilla de Personal*). The formula allows for a yearly update based on the number of schools built or teachers hired in each state

¹³ The other two funds are for public security (to states), and for financial strengthening (to municipalities). The fact that *Ramo 33* contains resources for such diverse purposes helps to reinforce the idea that it is, in essence, just a legal vehicle to transfer (decentralize?) federal resources to sub-national governments earmarked for a particular purpose. The specific details of each fund, therefore, are essential to determine to what extent effective decentralization is achieved.

¹⁴ Federal resources for basic education increased importantly after the signing of the 1992 *Acuerdo*, particularly for teachers' salaries during 1993/94. FAEB did not bring any additional increases after 1998, although it reflected the inertia derived from the salary provisions of the *Acuerdo*, particularly the *carrera magisterial*.

during the previous year, and salary and other pay raises granted during the year. The formula, however, does not contain any elements associated with states' performance, the number of actually enrolled or school-aged (potentially enrolled) students, or incentives for quality improvements in the delivery of basic educational services.¹⁵ Further, there is nothing in FAEB directly associated with poverty alleviation. (Of course, to the extent that the poor rely almost completely on public education, they should in principle also benefit from this change; however, the point here is only that FAEB was not specifically targeted to them, nor that any special mechanisms were incorporated into it for these purposes.)

FAEB mirrors the principles established in the *Ley General de Educación* in the sense that basic education is a shared responsibility between the Federal and states' governments. This implies that formally there is no role assigned to municipalities, nor are any FAEB resources shared with this level of government. This does not preclude states from, in turn, decentralizing some resources further, or making arrangements with their *municipios* to participate in the delivery of basic educational services. The Fiscal Coordination Law does not prohibit them, although it does not promote this practice either. If further decentralization occurs this is a state-level decision, and it takes place at the pace and with the scope that the state governor and legislature determine.

Though FAEB brings more certainty to states, it does not do so fully. This is because resources for pay raises and related salary measures (particularly end of year bonuses and *carrera magisterial*) are initially (i.e., at the beginning of the fiscal year) kept by SEP in *Ramo 25*. These are budgeted for the purposes of covering the results of a single centralized negotiation between the Federal Government (formally represented by SEP, but sometimes with a behind-the-scenes participation from SHCP) and the teachers' union. Once the outcome of this negotiation is known (usually in mid-May), resources are then transferred from *Ramo 25* to FAEB in *Ramo 33* and distributed to states on the basis of the national registry of teachers and schools.

Pay raises are thus in principle covered by the Federal Government. But since states had some teachers on their own budgets prior to the 1992 *Acuerdo* and the creation of FAEB, they must extend any pay increases to these teachers with their own resources, meaning by and large their *participaciones*. As a result, *de facto* basic education is paid for by a mix of *participaciones* and *aportaciones*, with the proportions varying from state to state in accordance with the share of "*maestros federalizados*" (i.e., covered by FAEB) to the total number of teachers in each state (which varies widely). Furthermore, in some states there may be a further round of negotiations between the teachers' union and the state government. These negotiations may result in additional pay raises or other implicit wage increases, which must also be covered with state resources (i.e.,

¹⁵ Moreover, since the formula reproduces the pre-1992 *Acuerdo* distributions, it is not equitable among states.

participaciones). Thus, at the beginning of the fiscal year, states know how many resources they will receive initially from the federal budget for basic education, but they do not know what will be its end-year cost, nor the resources that they will have to contribute from their own budgets.

Uncertainty over the outcome of the first negotiation (i.e., between the Federal Government and the national teachers' union) is not complete, however. Starting in 1998 resources budgeted for teachers' pay increases have been made explicit in the federal budget, so that state governments have an approximate, though not exact, knowledge of what the results of the centralized bargaining will be. It is difficult to make an overall assessment of the above; but two points can be made. First, it is clear that decentralization is not complete and that states do not have full control over their budgets for basic education; as it stands, the largest component of costs -personnel remuneration- is in large measure not state determined.¹⁶ And second, the importance of this budgetary uncertainty varies significantly from state to state (since, as mentioned, neither the 1992 *Acuerdo* nor FAEB corrected the historical imbalances in the distribution of resources between states).

The *de facto* division of basic education financing by states, partly with their *participaciones* and partly with their *aportaciones*, along with the double negotiations between federal (first) and state (second) authorities over teachers' salaries, has two corollaries. One is that this process may not be fully known to the citizens of a state. The context described makes it difficult for parents to make a clear association between the taxes they pay, and the quantity and quality of the educational services that their children receive. A second corollary is that states' attitudes and incentives with regards to the teachers' union in matters related to remunerations may vary; states with no or proportionately very few "*maestros no federalizados*" may not offer strong resistance to large pay raises. Indeed, there could be some elements of free riding or opportunistic behavior in that the costs of politically attractive pay raises is borne by the Federation. Conversely, in states where a large share of the costs of basic education is covered by their own budget, attitudes may be different.

These two corollaries underscore that FAEB is an intermediate point in a decentralization process, but clearly not its end point. This is particularly true if the objectives of decentralization are to improve accountability, quality, and performance. FAEB brings benefits in terms of transparency and stability; it is most likely better than the *convenio* arrangement that preceded it. Nevertheless, FAEB does not address a fundamental issue: how to motivate teachers to improve quality and be accountable to local authorities in the context of a national (and powerful) teachers' union.

¹⁶ Note also that states do not fully internalize the costs of their teachers even if they cover their social security contributions, given that their pension plan with ISSSTE (the social security institute for government workers) is not fully funded by the state. ISSSTE's deficit is completely covered by the Federal Government.

FAEB also does not have any explicit mechanisms to promote community participation or parental involvement in basic education, although in principle it should facilitate both. These mechanisms are in the 1992 *Acuerdo* and in the *Ley General de Educación*. It may be useful to observe, nonetheless, that decentralizing resources to states should not be interpreted as releasing the Federal Government from its responsibilities in basic education. Indeed, decentralization of operations to states may require a strengthening of the Federal Government's involvement in tasks that are complementary to this decentralization including: establishing mechanisms to promote effective parental participation and community involvement; supervising results; and disseminating performance comparisons across states (amongst other possible tasks). Auditing and supervision should not be thought of as only involving financial resources; this is a task which, under FAEB, mostly concerns states. It should also encompass impact and performance results, and SEP could ensure the inclusion of such accountability measures according to the 1992 *Acuerdo* and the *Ley General de Educación*. In a decentralization context it is essential that this task is performed by the central government. Communities and parents should, at the least, have ready access to credible information about what is happening in their schools (and in other schools). This allows them to effectively participate in their children's education, even if they are hardly empowered to do anything else, given their almost complete lack of control over spending decisions, or the hiring and firing of personnel.

As stated, FAEB does not explicitly have any redistributive objective, though it should according to the General Education Law. From the perspective of poverty alleviation, however, it is essential to understand that the overall institutional arrangement for funding, administering, and operating basic education goes beyond FAEB. First, there are additional resources for basic education in *Ramo 33* (in the *Fondo de Aportaciones Múltiples*, see below). And second, and more importantly from the point of view of the educational needs of the poor, there are other resources for basic education in the budget of SEP in *Ramo 11*. Through these *federal* programs, the Federal Government maintains an explicit responsibility in enhancing poor peoples' basic education. This responsibility is in practice reflected in programs to subsidize the demand for education, basically through the educational component of *Oportunidades*, and programs to improve the supply of educational services (quality and quantity), basically through CONAFE.

As is illustrated above, delivering high-quality basic education to the poor requires significant coordination between the federal and state educational authorities in order to yield desired results. It is in principle up to state authorities to ensure that teachers lecture from Monday to Friday in the schools where poor parents send their children, and that they correct their children's homework. But federal authorities should also, beyond setting the curriculum and drafting the national textbooks in Mexico City, assume other responsibilities. For example, it should ensure that poor children, particularly in remote rural areas but also in the urban poverty belts, attend school instead of working on the field or begging in the street; it should channel

additional resources to improve the educational infrastructure in very poor communities; and it should provide systematic impact and operational evaluations to judge how the poor are faring vis-à-vis the rest of the population. In the Mexican context, decentralization is not a panacea for improving basic education for the poor. It may be part of the answer if it delivers what it is supposed to, but it must be complemented by strong Federal participation. However, decentralization may also hurt the quality of basic education that the poor receive. This is particularly true in the absence of the right incentives to state and municipal authorities, to the teachers' union, and to individual teachers. And it should be clear that FAEB, by itself, does not provide these incentives.

Lastly, FAEB does not include the Distrito Federal. This is because in 1992 this jurisdiction had no independent legal status from the Mexican Federation (the Mayor was appointed by the President). Since then, however, major constitutional reforms have given substantial autonomy to the Distrito Federal.¹⁷ Decentralization of basic education to the Distrito Federal and its inclusion in FAEB is pending until the agreement is signed which would bring this into fruition.¹⁸ Therefore, those who live in the Distrito Federal still depend directly on the Federal Government for the provision of basic education, and have not seen any effects (positive or negative) of the 1992 *Acuerdo* or FAEB. It should be noted, however, that there has not been strong political pressure by the Distrito Federal to be included in FAEB. One can speculate whether this is because they perceive few benefits from this inclusion, or whether there are other motivations.

Fondo de Aportaciones para los Servicios de Salud, FASSA

As with basic education, FASSA builds on a decentralization agreement between the states and the Federal Government, this one signed in 1996. This *Acuerdo*, among other things, set the administrative basis for the transfer of operational responsibilities in health by inducing states to form specialized units for this purpose (*Organismos Públicos Descentralizados*, OPDs), that manage FASSA funds together with state resources for health delivery in their jurisdictions. FASSA transfers resources to states, not municipalities, thus leaving the state-municipality relationship in health services delivery to state-level legislation.

The formula used by FASSA to distribute resources to states is very similar to the one used by FAEB, the only difference being the addition of a so-far quantitatively small component of resources not tied to personnel expenses that try to explicitly compensate

¹⁷ Though note that while there are now elections for a *Jefe de Gobierno* (no longer a Mayor), and there is a local legislature (the *Asamblea General*), the Distrito Federal is legally not akin to a state.

¹⁸ Since the constitutional reforms came into effect, the Distrito Federal has been governed by a party different from the one to which either presidents Zedillo or Fox belong. This, together with the sheer administrative and political complexity of any measure of this nature in the nation's capital, may explain the delay.

states with below-mean health indicators. Despite FASSA, a national union of health workers remains, and the Federal Government is its main counterpart for wage and salary negotiations. This generates a similar set of issues, *mutatis mutandis*, regarding budget uncertainty; mix of *aportaciones* and *participaciones* in funding; accountability; and incentives for community participation to improve the quality of services.

From the point of view of poverty, and again parallel to the case of basic education, the Federal Government runs programs to improve health delivery to the poor, notably the health component of *Oportunidades*, the IMSS-*Oportunidades* Program, and (at least until very recently) the *Programa de Ampliación de Cobertura*, PAC. These compensatory programs are run directly by federal ministries or agencies with federal resources. Thus, strong coordination and cooperation between federal and state authorities, along with strong federal supervision, is required to obtain quality health services. The rules and regulations to promote this cooperation, however, are not in the Fiscal Coordination Law. As with FAEB, FASSA is just a budgetary vehicle that may facilitate, but does not ensure, an effective decentralization process, particularly from the point of view of poor households.

It would be wrong, however, to think that decentralization in health faces the same challenges and problems as with basic education. This is not the case, and in fact the budgetary arrangements and institutional set-up is even more complex. To understand this, it is essential to point out that in Mexico the responsibility of the State to deliver health services derives from two separate constitutional mandates, and therefore operates through two separate channels. On the one hand, health protection is a constitutional right of all Mexicans regardless of their work status. On the other hand, health protection is also a constitutional right derived from social security legislation, given that social security in Mexico encompasses not only pensions but also health. And to deliver health services to beneficiaries of social security (formal sector workers and their families), Mexico has two large federally-run institutions that directly provide these services, IMSS and ISSSTE, working independently of the states' OPDs. Moreover, IMSS delivers health services in some rural communities to families that are not beneficiaries of social security through a special program named IMSS-*Oportunidades*.¹⁹ And while this program is funded with fiscal revenues and not social security contributions, like the federal resources that are transferred to states through FASSA, the funds are spent by IMSS, hiring personnel belonging to the IMSS national union, with no interference by states.

Thus, there is a three-pronged segmentation of public health delivery: social security institutions for workers in the formal sector (IMSS and ISSSTE), federal

¹⁹ IMSS-*Oportunidades* operates in 17 out of the 31 states, and covers approximately two million families, or around 10 million people. As a result of a truncated decentralization effort during the administration of president de la Madrid, it is present in some very important states from the point of view of poverty alleviation (Chiapas, Oaxaca, Veracruz, Michoacán, Yucatán and San Luis Potosí, to name a few), but not all (notably Guerrero, Guanajuato and Estado de México).

programs run by social security institutions for non social security beneficiaries (IMSS-*Oportunidades*), and state level organizations (OPDs) also for non social security beneficiaries. In turn, public health delivery is funded by social security contributions (IMSS and ISSSTE), federal resources for federal programs run by social security institutions (IMSS-*Oportunidades*), federal resources for *aportaciones* through FASSA for states OPDs, and state level *participaciones* to complement OPD funding.

It would also be wrong, moreover, to think that from the point of view of poverty alleviation, health delivery by social security institutions is not relevant (particularly by IMSS). This is because access to social security is defined by work status and not by income level. In particular, any person with a boss-to-worker relationship (*relación obrero-patronal*) is, according to Mexico's labor legislation, obligated to belong to IMSS. And there is a large (and growing) number of poor workers in both the rural and urban areas that belong to this category and are in IMSS, despite large-scale evasion. Construction workers in urban areas and agricultural workers (*jornaleros agrícolas*) in rural areas are two important examples. Thus, for better or worse, the impact of health decentralization on the poor through FASSA is more limited than the impact of basic education through FAEB. There are a large number of poor people whose health services were unaffected either by the 1996 *Acuerdo* or FASSA. This is because even though they are poor, they have a formal sector job and they receive services from IMSS, or because they live in a state where IMSS-*Oportunidades* operates.

The above segmentation should also be seen in a dynamic context, given that high turnover in the labor market and internal migration generate a large set of outcomes. A poor *campesino* might live in Oaxaca and obtain a living part of the year working on his own two or three hectares, but then migrate the rest of the year to Sinaloa to work as a *jornalero agrícola* under a *relación obrero-patronal*. He then gets health services part of the year (in Oaxaca) through IMSS-*Oportunidades*, and part of the year (in Sinaloa) through IMSS. But another *campesino* from the contiguous state of Guerrero with the same migration pattern will receive health services during part of the year in Guerrero from his local OPD (because IMSS-*Oportunidades* does not operate there), although for the rest of the year, while in Sinaloa, he will also get health services from IMSS. A poor urban *trabajadora* from Tabasco who migrates temporarily to a *maquiladora* plant in Chihuahua will get health services from IMSS while in the north, but from the Tabasco OPD if and when she returns home. It is difficult, under this set up, for the *campesinos* of Oaxaca and Guerrero and for the *trabajadora* of Tabasco, all probably poor, to understand what level of government is responsible for the quality of the health services that they receive. It is more difficult still to hold anybody accountable for possible shortcomings.

These problems were not addressed in the 1996 *Acuerdo*, or in the Fiscal Coordination Law when FASSA was created. FASSA was an improvement over the previous situation, and despite the shortcomings that it shares with FAEB, it most likely has helped states to deliver better services. There are, nonetheless, deeper issues that

must be discussed to ensure that Mexico has an efficient and stable institutional set-up to deliver health services to the poor. Decentralization is part of this discussion, but only one component. Complex incentive problems, derived from the link between health and social security and from the link between social security and labor markets, need to be solved. The issues are conceptually more complex than in the case of basic education, because the financing of social security has a direct effect on the labor market, which is not the situation in the case of basic education. And politically, they are at least as complicated as in the case of basic education, because there are two large national unions involved in the delivery of public health services.²⁰ These issues need to be sorted out, independently of the improvements that can be made in the day-to-day operation of FASSA, to improve quality health care for the poor.

Fondo de Aportaciones para Infraestructura Social, FAIS

The *Programa Nacional de Solidaridad*, PRONASOL, started by president Salinas in 1988, was by the mid-1990s, the main budgetary initiative of the Federal Government directed towards social infrastructure projects for the poor. It was also the predecessor of FAIS.

PRONASOL emphasized strong community participation. For this purpose, SEDESOL established direct contact with poor communities, through local *Comités de Solidaridad*, to agree on priorities, before transferring the agreed-upon resources to state or municipal governments via *convenios*. Thus, a distinctive element of PRONASOL was a direct relationship between the Federal Executive and communities, with sub-national governments playing a secondary role. PRONASOL principally financed public goods in the form of physical infrastructure projects including rural roads, water sanitation, urban development, educational and health facilities, and the like. However, some resources were also devoted to programs targeted to developing the human capital of the poor, or towards subsidizing private productive projects.²¹ In the federal budget a special line-item was assigned to it (*Ramo 26*), with very flexible disbursement rules in terms of the types of projects, or the geographical distribution of funds.

The absence of explicit rules to distribute resources to states and municipalities was partly remedied in 1996, when president Zedillo unilaterally decided to distribute 65 per cent of *Ramo 26* resources to municipalities through a poverty-based formula. This generated more transparency, although resources were still spent by SEDESOL.

²⁰ In addition to the political complications, there are also important legal differences. The IMSS union belongs to *apartado "A"* of article 123 of the Constitution, while the Health Workers Union belongs to "B". These differences affect workers' pension regimes, wage bargaining mechanisms, and health delivery costs.

²¹ *Niños de Solidaridad* and *Crédito a la Palabra* are an example of each. *Niños de Solidaridad* granted an in-kind consumption subsidy (a food basket), and a scholarship to children of poor families who attended primary school. The program was an important precedent of *Progresá* (now *Oportunidades*), and its resources were eventually absorbed by it. *Crédito a la Palabra* gave small credits to poor agricultural producers with no collateral.

Two years later, with the 1998 reforms to the Fiscal Coordination Law and the creation of FAIS, three additional steps were taken to further decentralization. First, transfers were tied to the *Recaudación Federal Participable*, generating more stability. Second, SEDESOL's participation in the choice and execution of projects was ended; under *Ramo 33* these decisions were taken by states and municipalities. And third, a specific calendar for disbursing funds was written into the Fiscal Coordination Law, giving states and municipalities the certainty that budgeted resources would reach them in equal amounts during the first ten months of each fiscal year.

Two characteristics make FAIS substantially different from FAEB or FASSA. First, FAIS was not preceded by any decentralization-type *Acuerdo* with states or municipalities. PRONASOL was created by a presidential decision in 1988; later a large share of its funds was distributed with an explicit formula to sub-national governments by another presidential decision in 1996. It was then converted into FAIS by Congress in 1998 with the reforms to the Fiscal Coordination Law, in a process where there was no intervention by any national trade union, and hardly any participation by state governors. Second, FAIS resources are not tied to a wage bill, as is the case with practically all of FAEB or, to a lesser extent, FASSA.

These two characteristics implied a very different political process, with substantially less constraints on the depth of decentralization achieved. First, it permitted an explicit statement in the Fiscal Coordination Law targeting these resources directly towards poverty alleviation. And secondly, it allowed for transferring most of the funds to municipalities, not states.²² The Fiscal Coordination Law indicates, moreover, that FAIS funds are not intended for services aimed at the general population (like basic education or health), but for physical investments on a broad range of items directed towards the poor, thus giving states and municipalities considerable flexibility in their spending decisions.²³

Thus, without diminishing the importance of basic education or health, the possibilities that decentralization will benefit the poor proportionately more than the rest of the population is greater in the case of FAIS than in FAEB or FASSA. These possibilities are, in principle, enhanced by another distinctive feature of FAIS vis-à-vis FAEB or FASSA. In this case, the Fiscal Coordination Law mandates municipal and state governments to: (i) inform the inhabitants of the respective jurisdictions of the

²² The Fiscal Coordination Law mandates that FAIS be budgeted at 2.5 per cent of the *Recaudación Federal Participable* approved by Congress in the *Ley de Ingresos*, regardless of the latter's fluctuations during the year, or its end-of-year value. Of the total FAIS budget, 2.197 per cent is distributed to municipalities, and 0.303 per cent to states.

²³ Funds transferred to municipalities can be used for "*agua potable, alcantarillado, drenaje y letrinas, urbanización municipal, electrificación rural y de colonias pobres, infraestructura básica de salud, infraestructura básica educativa, mejoramiento de vivienda, caminos rurales e infraestructura productiva rural*". Those transferred to states are for "*obras y acciones de alcance o ámbito regional o intermunicipal*" (Fiscal Coordination Law, Article 33).

scope, costs and potential beneficiaries of each individual project financed by FAIS; (ii) promote community participation in the *ex ante* choice of projects, in their execution, and in their *ex-post* evaluation; and (iii) inform the population at the end of the fiscal year as to the results obtained.²⁴

The extent to which FAIS funds effectively contribute to poverty alleviation depends importantly on two considerations, notwithstanding the above said. The first derives from the interaction between state and municipal governments. The Federation legally cannot have direct budgetary relationships with *municipios*; in particular, it cannot disburse funds directly to them. FAIS resources must be transferred from the federal budget to states' budgets, and subsequently from states to municipal budgets under the conditions and terms mandated by state legislatures.²⁵ Thus, in addition to federal preferences on the use of FAIS resources as contained in the Fiscal Coordination Law, state-laws matter importantly, generating a potentially large variance across states in poverty alleviation outcomes. Some states simply transfer FAIS funds to municipalities with few or no constraints; but some impose substantive conditions on their *municipios* before funds are disbursed.

These conditions, in turn, may be fully justified in economic terms. Thus, state laws may give governors the right to request municipalities to have a community participation process and some minimal cost-benefit analysis in order to improve the quality of their projects, prior to fund disbursement. States may also try to solve a coordination problem between contiguous *municipios*, say, with regards to a health clinic (so that with joint funds perhaps only one is built, which may be better equipped). Alternatively, states might want to achieve economies of scale in building, say, a rural road (so that with joint funds a longer one is constructed and not two unconnected segments). Or, finally, the state might want to induce a single municipio into developing a larger project, say sewage facilities, providing incentives to do so with *pari-passu* state funds. But governors, however, can potentially also impose conditions on *presidentes municipales* that *de facto* translate into obstacles for disbursing funds for other reasons. For example, the governor and the municipal president could be from two different political parties. Or, they might even belong to the same party, but they may lean differently in the selection of potential candidates for, say, the up-coming election for state governor.

²⁴ The Fiscal Coordination Law, however, does not specify how these three objectives should be reached, how their achievement (or lack thereof), will be monitored, nor the type of sanctions to be applied in case there is no compliance with these provisions.

²⁵ When FAIS began there was an important controversy between the Federal Government and some states as to how far state's legislation could either alter the distribution formulas to *municipios* contained in the Fiscal Coordination Law, or impose some conditionality. The controversy did not reach the courts, and was settled by a compromise where LFC formulas would be observed, along with states' rights to legislate conditions on their *municipios*.

The second consideration is internal to the *municipio*, as there is nothing in the Fiscal Coordination Law concerning the distribution of funds inside each municipality. This is an important consideration if one recalls that while there are approximately 2,500 municipalities in Mexico, there are almost 200,000 localities inside these municipalities, the majority of them poor and small (with between 500 to 2,500 inhabitants). Funds may effectively reach a poor municipality, but distribution between the *cabecera* municipal and remaining localities will depend importantly on the incentives, preferences and relationships between the *presidente municipal*, the *cabildo* and the other powers-that-be. There is also the question concerning the extent projects respond to the needs of the poor, not all those who live in a poor *municipio* are necessarily poor. Effectiveness also depends on the capabilities of municipal authorities in terms of project design, execution, and supervision.

These issues are not easily solved by federal legislation, although they may matter importantly for the effectiveness in the use of federal resources. The issues, in fact, are inherent to the purpose of decentralization: in the end, the outcomes are very much up to local authorities. FAIS is a good candidate for efficient decentralization: by and large the externalities associated with the type of projects that it funds are fully internalized at the municipal level. Moreover, if information is available to all, direct participation by beneficiaries should lead to better project selection and execution. But there is no guarantee that this will be the case, or that decentralization will be pro-poor, despite the targeting formulas. Political issues associated with state-municipal and within-municipal relations also play a critical role.

These observations may help identify an important role for the Federal Government in FAIS. While SEDESOL clearly no longer controls the process by which funds are allocated or spent, it can still influence this process in the direction of efficient and poverty-oriented outcomes by providing clear, timely, and abundant information. This could complement the information that, under the Fiscal Coordination Law, states, and *municipios* should provide to their constituencies. It can also perform a useful role comparing outcomes across municipalities, both within a state and across states. It can help identify what type of state legislation is successful in insuring a better use of FAIS funds, or what other legal, administrative or political considerations lead to better outcomes in some situations vis-à-vis others. The role suggested here for the Federal Government is, *mutatis mutandis*, similar to the one mentioned before in the case of FAEB. Decentralization changed the role of the Federal Government in the provision of basic education but, at least for some years, it did not make it redundant. In Mexico's very varied landscape of states and municipalities, particularly with regards to the functioning of local democracy, the same can be said for basic social infrastructure.

Fondo de Aportaciones Múltiples, FAM

FAM serves as a vehicle to transfer resources to states for two tasks previously carried out by two separate federal agencies: the various food and school-breakfast

programs run by the *Sistema Nacional para el Desarrollo Integral de la Familia*, DIF, and the school construction program run by the *Comité Administrador del Programa Federal de Construcción de Escuelas*, CAPFCE. Like FAIS, resources are budgeted as a share of the *Recaudación Federal Participable* approved in the Revenue Law. In another parallel to FAIS, resources are not tied to a wage bill. Yet, in contrast to FAIS, resources are not distributed among states with an explicit formula, nor is there a fixed disbursement calendar. Rather, resources are by-and-large distributed following an inertial formula based on the pre-*Ramo 33* spending patterns of DIF and CAPFCE in each state, in a manner similar, though not identical, to FAEB or FASSA.²⁶ Further, the Fiscal Coordination Law states that resources intended for food programs and school breakfasts (i.e., the DIF component), should be specifically targeted on the poor, although no such targeting is expressly pointed out for the school construction funds (i.e., the CAPFCE component). FAM is thus a mixed fund in three senses: it has two distinct purposes; its logic is partly based on FAEB and FASSA, and partly on FAIS; and it is partially intended for poverty alleviation.

Decentralizing CAPFCE began before the 1997 reforms to the Fiscal Coordination Law. The reforms only formalized a process, and helped to signal the detachment of the Federal Government from that task. However, the Fiscal Coordination Law also allows these funds to be used for higher education infrastructure (i.e., universities); hence, this component of FAM should not necessarily be considered as the “bricks, blackboards and desks” complement to FAEB. Decisions as to the division of funds between basic and higher education belong to the states.

Decentralizing DIF followed a different logic. At the time *Ramo 33* was created, the Federal Government was also revamping its food subsidy programs. A new integrated food-health-education program, *Progresa* (now *Oportunidades*), started in July of 1997, replacing generalized food subsidies and other isolated food programs run by various federal ministries and agencies. In this context, transferring resources to states previously used by DIF for food and school-breakfast programs would allow the Federal Government to focus on a single national program, with states complementing *Progresa* with locally designed and operated food programs in poor communities with DIF funds via FAM.²⁷

Fondo de Aportaciones para la Educación Técnica y de Adultos, FAETA

FAETA transfers funds to states to cover two different programs previously under direct SEP control: adult education programs run by the *Instituto Nacional de Educación para Adultos*, INEA; and technological education delivered through

²⁶ The Fiscal Coordination Law states that the state distribution of FAM, fixed at 0.814 per cent of the *Recaudación Federal Participable* approved in the Revenue Law, shall be specified annually in the budget decree, with no further criteria. In practice allocations are approximately carried out on an inertial basis.

²⁷ These programs could take the form of school-breakfasts, community-based kitchens, or some other formulas.

CONALEP. Resources are used mostly for personnel services, and hence the mechanics of FAETA are very similar to FAEB. Nonetheless, the Fiscal Coordination Law explicitly mandates that the resources for the adult education component of FAETA be distributed between states using formulas based on the relative performance in literacy, basic education, and labor training indicators.²⁸ Thus, there is a partial focus on poverty alleviation, as with FAM.

We close this section with a general remark on decentralization, *Ramo 33* and poverty. In the mid-1990's, and in parallel to the political and administrative motivations mentioned for the creation of *Ramo 33*, the Federal Government was also redesigning its poverty alleviation strategy. Programs, projects, and budgets were organized under a three-pronged approach: (i) investments in human capital, (ii) development of physical infrastructure, and (iii) promotion of income opportunities. From the perspective of decentralization, the strategy gave the Federal Government the leading role in component (i), state and municipal governments the leading role in component (ii), with federal and state governments jointly responsible for component (iii). A set of federal programs would subsidize the demand (*Progresa*) and supply (CONAFE, IMSS-*Oportunidades*, PAC) of human capital formation. And a set of state and municipal programs (FAIS, the CAPFCE component of FAM) would subsidize physical capital investments.²⁹

Thus, one should be able to identify an underlying logic linking decentralization with poverty alleviation. However, this is only partly so. Inertia, design shortcomings, administrative expediency, political constraints, and bureaucratic resistances have also affected the division of functions between levels of government, and mixed the purposes of various funds. States receive federal resources to subsidize food programs (the DIF component of FAM); compensatory programs for basic education are federally run, but are state run for adult education (the INEA component of FAETA). FAIS resources can be used for school construction, but the same is true for the CAPFCE component of FAM; health clinics can be built with FAIS but also with FASSA. Sometimes formulas are used to distribute resources, but this is not always the case. Sometimes the formulas are in the Fiscal Coordination Law, although on occasions they are left to the discretion of federal ministries. Responsibilities and functions are not fully delineated, independently of operational issues that produce low quality services. There certainly have been advances in decentralization to the benefit of the poor, but it is probably fair

²⁸ These formulas are not contained in the Fiscal Coordination Law. Rather, the Fiscal Coordination Law mandates SEP to publish them in the Federal Register, but gives little indication as to what elements should be considered, or how often they should be updated.

²⁹ Income generating opportunities for the poor would come from rural development and temporary employment programs (together with economic growth). These were to be implemented by different levels of government, depending on the nature of each program. However, as mentioned above, SAGARPA and SEMARNAP continue to decentralize their resources through *convenios*, so the discussion of the third component is not pursued here.

to say that the design of a coherent institutional framework for decentralization and poverty alleviation is very much work in progress.

VI. FINAL CONSIDERATIONS

In less than a decade Mexico's expenditure decentralization changed substantially. There is a large difference between the 1997 [*participaciones + convenios*] and the 2006 [*participaciones + aportaciones + convenios + PAFEF + a share in positive oil shocks*] formulas. Undoubtedly, the expenditure powers of the Federal Government have been reduced to the benefit of sub-national governments. Additionally, many more authorities now participate actively in the budgeting, spending and auditing of federal resources. Today, Congress, governors, state legislatures, municipal presidents and *cabildos* all have a greater responsibility to tax-payers and citizens in general, as do the auditing authorities at the federal and state level. There is more balance and more diversity.

Expenditure decentralization has been a process fueled by two parallel trends. On the one hand, there is a broad desire for increased efficiency in the use of public resources, with poverty alleviation being only one of many objectives. On the other hand, there is a desire to reduce the President's control over the federal budget. This process has taken place in the context of Mexico's evolving democracy, and in turn has affected and contributed to define the shape of this democracy. Expenditure decentralization thus matters on equity and efficiency grounds, but also on political grounds. A successful decentralization process would yield improvements in both these areas; an unsuccessful one would be harmful.

The decentralization process experienced over the last decade has been conditioned by three key factors. First, there is the continued presence of the national trade unions in education and health. Second, there is an absence of clear and stable definitions regarding the responsibilities of each level of government in the provision of services. And third, the decentralization process has been primarily centered on the expenditure side of the federal budget. These three factors—very much a reflection of Mexico's current political context—have shaped and molded the nature of the outcomes, both at the macro and microeconomic levels. They have also introduced important distortions along the way. Until the political process comes to terms with these three factors, they will continue to do so.

From a macroeconomic perspective, while, to date, decentralization has been consistent with overall stability, important issues need to be addressed to ensure continuity in this respect. Such central issues include the appropriate distribution of macroeconomic risks derived from unexpected shocks; the incentives of sub-national governments to achieve tax efficiency in their jurisdictions; and the moral hazard of debt contracting by state governments when defaults are not credible. More generally, incentives have yet to be aligned at the sub-national level, changing the relative rates of

return to rent-seeking from the federal budget (either in the annual discussions with Congress or in their year-round negotiations with federal ministries), vis-à-vis own efforts at tax collection. Decentralization should not be a continuing raid on the federal budget by state and municipal governments. Who is going to finance the large public infrastructure projects that are required to foster the country's competitiveness, particularly given the increasing liabilities of the public pension system? And how will stability be preserved if the world price of oil drops?

From a microeconomic perspective there are also important challenges ahead. First, the problems associated with national unions and decentralized delivery of services need to be solved. This is, of course, easier said than done, and the fact that many years have elapsed since the respective basic education and health *Acuerdos* were signed without significant changes signals the large difficulties in doing so. Nonetheless, it is essential to do so if quality, performance, and accountability are to be enhanced. And second, the roles and responsibilities of each level of government need to be clearly defined. After the 1997 reforms to the Fiscal Coordination Law, the Federal Government initiated new programs, or continued with old ones, in areas that clearly are sub-national responsibilities. This generates duplication of administrative costs, and sends a confusing signal to citizens as to the level of government responsible for given services. It can also generate perverse incentives to sub-national governments, inducing them to shirk from some of their responsibilities and shift costs to the Federal Government while reaping political benefits. This, like the trade union issue, remains difficult. Mexico has a long tradition of assuming and expecting that problems should be solved by the President. Conversely, presidents have at times also sought legitimacy and popularity by intervening in areas of public policy that in principle belong to sub-national governments. Old habits die hard, but program proliferation and duplication may not be the most efficient and effective way of using resources, holding sub-national governments to their responsibilities, or inducing them to progressively develop the administrative and technical skills required for these tasks.³⁰

These considerations matter for the poor in Mexico. Another episode of macroeconomic instability would have large negative effects on them, as always. But even if that is not the case, the poor desperately need a growing economy to create jobs and raise incomes faster than what has been observed in the past few years. Since large public infrastructure projects play a key role in promoting competitiveness and growth, it is clear that over the medium term the poor do not benefit from a division of the federal budget that progressively nullifies the Federal Government's possibilities to carry out such investments. Similar effects are observed when one considers the microeconomic distortions that currently characterize Mexico's decentralization, as the

³⁰ The foregoing should not be interpreted in the sense of a complete disengagement by federal authorities. As argued in the case of FAEB and FAIS, for example, there are still important tasks for SEP and SEDESOL in these areas. The point is to find the right balance between constructive collaboration and free-riding.

poor are most likely the ones that suffer the most from low-quality basic education or health care.

The remarks made above should be put into perspective, however. The process of decentralization has advanced over the last years. Compared to the 1997 situation, there is more transparency, increased budgetary stability and certainty for state and municipal governments, less discretion at the federal level and, as remarked, greater balance and diversity. These are important achievements for a country that was very centralized less than a decade ago. Moreover, at least for some states and *municipios*, decentralization should have helped to enhance the quality of services and augment the social infrastructure, which includes benefits for poor communities.³¹ The point, nonetheless, is to recognize that the process is far from complete, and that it needs to continue, perhaps with more speed and depth than that observed over the last few years and, hopefully, with a coherent vision of where it is headed.

While this occurs, there are immediate tasks for federal ministries and agencies, that can be carried out within the existing legal framework: increasing performance monitoring and supervision; divulging information; fostering the adoption of state or municipal best practices; comparing and disseminating results among states and *municipios*; containing federal program proliferation; paying more attention to incentives; and inducing states to legislate laws that require more transparency and accountability in their own auditing procedures, among others.

There are, however, more difficult design and political issues that in today's Mexico cannot be solved by the Federal Government alone: (i) a political understanding for a tax-cum-spending federalism that is sustainable and efficient from a macro and a microeconomic point of view, respectively; (ii) a clearer definition of responsibilities in key areas, like health; and (iii) a political agreement on the nature and role of national trade unions. In furthering a decentralization process that can improve services for all, and particularly for the poor, Mexican democracy faces a daunting challenge indeed.

³¹ The results of the sector studies mentioned at the beginning of these notes will hopefully provide empirical evidence to assess this.