



WORLD BANK



DAVID ROCKEFELLER CENTER
FOR LATIN AMERICAN STUDIES

International Conference
Equity and Competition for High Growth in Mexico

MINUTES TO THE CONFERENCE

The Conference was held in Mexico City, on November 27-28, 2006. It was organized and sponsored by the World Bank Mexico Office and the David Rockefeller Center For Latin American Studies of Harvard University. Policymakers, market participants, and researchers attended the conference and contributed to the lively debate. Pamela Cox, Vice-President of the Latin America and the Caribbean Region at the World Bank, provided the closing remarks.

The conference was concerned with the relationship between unequal structures of power and influence and the design of economic institutions and policies in Mexico and was organized along eight sessions: The first one provided an overview of the relationship between unequal influences and economic growth. The second session focused on the mechanisms by which concentrated wealth and power in the business sector and corporatist groups such as unions—coupled with weak institutions—have distorted policy design and contributed to inefficient market functioning, which in turn has impacted negatively on economic growth. The next two sessions focused on the analysis of unequal institutional structures on the oil sector and the financial system. The fifth session analyzed institutions and competition, paying particular attention to why there had not been more significant reforms despite a change in the political regime. The sixth session presented an overview of the social security system and its negative impact on labor productivity and growth. The seventh session focused on the impact of monopolies and lack of competition in the telecommunications sector. The final session drew the implications of the analysis for the future design of public policies in Mexico.

Session 1

Saving Growth from Unequal Influence

Speaker: Guillermo Ortiz

Governor, Bank of Mexico

Mr Ortiz started out by saying that the subject matter of the conference was an important one. Equity is a key development concept which needs to be understood more broadly than in terms of the traditional focus on income distribution. It is also especially relevant as there is increasing evidence of a virtuous circle between equity and economic growth, as the absence of equal opportunities reduces productivity and inhibits competition, ultimately reducing economic growth. This is also a subject that is highly topical for the Latin America region as a whole, taking into account its economic performance in the last 40 years. In the 1960s Mexico had a per capita income level of about US\$4,000, measured in purchasing power parity (PPP) terms, while South Korea had a per capita of about US\$1,700 and Ireland a per capita of \$5,000. However, in 2005 Mexico had a per capita of about US\$9,000, South Korea a per capita of US\$18,000 and Ireland a per capita close to US\$30,000. In this time period Mexico had annual average per capita growth of 1.8 percent, South Korea and Singapore per capita growth of 5.5percent, whereas the Latin American region had per capita growth of 1.4percent.

There are two factors explaining the poor performance of the Latin American region. Firstly, it experienced a series of economic crises. In the case of Mexico, real average manufacturing salaries took 10 years to recover from the latest crisis of the mid 1990s. Simulations suggest that real GDP per capita in Mexico could have been 70 percent higher without these economic crises. Another important explanation for the poor performance of Latin America and Mexico vis-à-vis Asia is due to problems of competitiveness, which reflect low productivity growth and problems of comparative advantage. Simulations also show that if Mexico had adopted reform like those Chile implemented in the 1980s, its per capita income could be twice as high than what it is now. Economic stability in the last 11 years has allowed per capita growth to be higher than the average performance of the last 40 years, at 2.2 percent. The government has now been able to issue 30-year bonds, something unthinkable in the past. Mr Ortiz mentioned the recent study by Goldman Sachs on the BRIC economies—Brazil, Russia, India and China—which predicts that only two of the G6 countries will be the six largest economies in the future, namely Japan and US.¹ In a recent update of the study, Mexico appears as one of the countries capable of becoming as important globally as the original BRICs, despite not performing very well across a number of key indicators, including competitive indicators.² To end, Mr Ortiz stated that many of these topics would be discussed by other conference panelists.

¹ Goldman Sachs, “Dreaming with BRICs: The Path to 2050”, Global Economic Paper No.99, October 2003.

² Goldman Sachs, “How Solid are the BRICs?”, Global Economic Paper, Global Economic Paper No.134, December 2005.

Speaker: Francois Bourguignon

Senior Vice-President and Chief Economist, World Bank

Mr Bourguignon stated that it was a pleasure to discuss the subject of the conference, equity and growth, which is a crucial one. His presentation was based on recent World Bank studies which have found that inequity and poverty have a negative impact on economic growth. It also draws on the conclusions of the *World Development Report 2006: Equity and Development*, which as its title suggests looked at the link between inequality of opportunities and economic development. Mr Bourguignon stated that he wanted to focus on how to operationalize the ideas developed in these reports in order to make concrete economic policy recommendations, which could serve as basis in which to frame the discussions of the day, without focusing specifically on Mexico. His presentation focused on three ideas: the complementarity between equality and growth, the importance of political economy and its impact on economic reforms; and the relevance of access to information.

Recent research has provided evidence of a complementarity between equality and growth. There is a tendency to assimilate or to explain the low economic performance of the Latin American region to inequality of income. There is a clear statistical relationship between the two variables, although causality is more complicated. For this reason, causality has to start from a concept of inequality that differs from income inequality to one of inequality of opportunities, both for individuals and businesses. This inequality of opportunities is what is called lack of equity as opposed to inequality, which is a term associated with income inequality. Recent evidence shows that inequity is leading to lower productivity, lower economic growth and increased income inequality. If in an economy there are economic agents that do not have access to credit, education, infrastructure, justice and protection of property rights, then they cannot realize their full economic potential. Similarly, if certain economic sectors are protected, with barriers to entry, then in these sectors there also are unequal opportunities, leading to inefficiencies and reduced overall economic performance. The capture of certain economic sectors by an elite inhibits competition and has adverse consequences on the overall performance of the economy. The economic reforms needed to address these inequities are not limited to policies aimed at reducing income inequality and increasing social justice.

Turning to the issue of the political economy of a reform process, it appears evident that if a reform enhancing equity will generate an overall benefit for the economy as a whole, then such a reform should be implemented. However, if some economic agents win and other lose out, then making these reforms becomes much more complex. When this is the case, those who lose out will be those who have more opportunities and privileges in the existing system. This leads to the question of compensation, as in an ideal world the winners in the reform process would compensate the losers. The problem with this is that in practice it is difficult to guarantee that such compromises will hold in the future. As a result, policy reforms take place without such compensation mechanisms and largely depend on the political system. Implementing a reform agenda will be particularly difficult if those who have captured certain economic sectors also have the political power. In a democracy it should be possible to make such reforms, but in a more limited form of democracy, where elites and groups within the political elite are opposed to such reforms, it may be very difficult.

Ultimately, political institutions are responsible for the equity of a society and also how to change such inequities even if in practice it is difficult to change institutions. But what can be done is to ensure that all actors have the information they need to make the right decisions. Discussions on inequality tend to focus on social justice and not on issues of inequity that lead to economic inefficiencies and dynamic economic problems. There is a lot of work to be done in this respect and it would be significant progress if political actors had adequate information to address these issues. The suggestion here is that increasing the availability of information and transparency is a key component to ensure that economic reforms can be implemented.

To end, Mr Bourguignon gave two examples that apply the ideas he presented. In many countries the financial sector suffers from lack of competition and studies have shown that this translates into limited financial depth and low credit to GDP ratios, leading to underdevelopment of the sector. At the same studies show that there is a positive relationship between financial depth and economic growth, which is proof that lack of competition in the financial sector is contributing to lower economic growth. Moreover, in countries where the financial sector is limited growth tends not so much to benefit the poor, which implies that it is also having a negative impact on income distribution. The lack of a developed credit sector means that the less well off cannot carry out many projects that they would have otherwise, and this has both inefficiency and inequality implications. To change this situation there must be deregulation and increased competition in the financial sector. On the political economy side, it is necessary to understand that certain interests will lose out with the reform process. It is therefore important to provide information to explain that such reforms will not only change income distribution, but will also fundamentally transform the economy, making it more dynamic and capable of sustaining higher growth.

A second example focuses on education. In many countries there is a centralized educational system, which creates a situation of a bilateral monopoly, with one employer, the state, and with a supply monopoly, teachers' unions. This generates rents, which are reflected in higher salaries and lower levels of employment, and also have an adverse impact on the quality of education and absenteeism. This phenomenon is well documented across a range of countries. The decentralization of the education system offers an opportunity for parents of students to participate in the management of educational policies. This can lead to much greater efficiency and improvements in the quality of education. To end, Mr Bourguignon mentioned that he is currently writing a paper which will focus on the complementarity between equity and economic development, moving beyond the narrower question of income distribution.

Speaker: Raghuram Rajan

Economic Counsellor and Director, Research Department, IMF

Mr Rajan started by saying that he would first focus on some abstract ideas, before turning to concrete issues and suggesting some recommendations. He underscored the close relationship between inequality and lower economic growth and concurred with the earlier speakers that there were often third factors responsible for both. One of the reasons there is low growth in unequal societies is that the inequality generates social and political conflict. For example, policies may emerge that try to expropriate the poor. The problem with this analysis is that inequality, low growth, and poverty continues to persist. The persistence of inequality has led to the

development of a literature that emphasizes the importance of institutions for explaining low economic growth. However, Mr Rajan argued that there were problems in viewing political institutions as the sole reasons for explaining low growth and high inequality. The implementation of economic policies is intertwined with power structures, which does not in and of itself rule out the importance of political institutions. But it does explain why changes in political institutions have often not had a significant impact on inequity and underdevelopment. Political structures are an important part of the problem, but equally, political structures reflect internal problems in society and as a result are endogenous. In the case of the rapid economic development of South Korea in the past and that of China at present, both countries did not have Western style democracies. In the case of democracies such as Mexico, an important question is why the political transition has not led to changes in an equilibrium characterized by inequity and low economic growth.

Mr Rajan argued that the answer to this issue lies elsewhere. The view that the impediment to reform lies with the elites is only a partial view, because other sectors of society also have sources of rent. As a result, when an economic reform is being implemented there is internal division, because nobody wants to lose these rents, while getting on to a reform path that everyone wants is difficult. The crux of the problem is that economic agents see different opportunities and sources of rents that they want to protect, while reforms do not benefit all sectors. For example, increased foreign trade can bring new technology to an economy, but it is the more educated who have greater opportunities to take advantage of this. In a society divided between educated and uneducated, the opening of the economy will be perceived differently. There will be comparative rent preservation, with every segment of society trying to preserve its rents, making it more difficult to adopt reforms.

To illustrate this point, Mr Rajan gave the example of a society where there is a monopolist and an educated middle-class that has job opportunities that only it can obtain. If there is little competition and limited education outside of the middle-class, the monopolist clearly will have economic rents, but the educated-middle class also will. Less intuitively, the poor will also have rents, as the wages of the middle-class are lower than what they would be otherwise because of the monopolist, and this in turn can make certain services cheaper for the poor, for example, lower fees for consulting a doctor. In this situation if you increase competition, the poor will lose out, as the cost of middle-class services will rise, and they might not be interested in opening up to competition, unless there is increased provision of education. At the same time, the middle-class will not want poor people to have education, as this creates increased competition for jobs. The intuition behind this example is that societies are riddled with rents, and trying to reform while creating opportunities for only some segments of society will translate into the loss of rents by others. There are only a few circumstances where there is an unproblematic reform path.

A more concrete example to illustrate this is China, where the interior provinces are becoming more resistant to reforms in coastal areas, because they are not benefiting from the increased growth generated in the coastal areas as a result of the reforms. In interior provinces, the cost of medical services, for example, is rising as a result of migration. In the absence of policies aimed at reducing inequality or increasing spending on social services, it becomes difficult to move forward. Inequalities are often the basis for seeing a different value to reforms, and this suggests that it is necessary to change the underlying conditions of inequality in order to get consensus on

reform. Reforms need to be accompanied by a free access revolution, which means increasing access to endowments for the population at large.

In Mexico many tasks remain unfinished, even if the political reforms are in place. What needs to be done is to expand access to make society more open to equal opportunities in education, finance and health care. The Mexican education system requires a large change, as it is performing poorly. In the financial sector there is limited credit growth to the corporate sector, and there is a need to increase access to credit for small and medium enterprises and for firms in the informal sector. Such changes in the financial sector can be brought about by introducing increased competition and by strengthening supervisory institutions. It is critical to bring the middle-class into the reform process and to not develop separate services for different classes. To end, Mr Rajan argued that the reform effort in Mexico should focus on improving access for all sectors of society, and with this, further reforms will become easier to introduce.

Questions and comments

A conference participant raised the issue of why increased competition in the financial sector has led to increased access to credit for consumers, but not for businesses. This could perhaps be explained by banks' perception of risk, due to lack of transparency and tax evasion on the part of companies.

A participant commented that Mexico's political system is not doing anything to break barriers or improve access, questioning whether the system is working in the manner outlined by Mr Rajan.

A conference participant asked how reforms can be implemented in Mexico when unions are strongly opposed to change. With regard to the financial sector, the question is how competition can solve the problem of low credit to the corporate sector.

Another participant argued that a key point that had not been discussed was the ownership of capital. Between 1940 and 1982 Mexico grew at rapid rate and the debt crisis of 1982 was largely due to external factors. It would seem that the reason that growth was higher in this earlier period is because Mexico had a mixed economy that was capable of generating higher growth rates than what the economy can currently generate.

A conference participant stated that companies in Mexico pay very high costs for services as a result of banking commissions and fees, high interest rates, high electricity and telecommunications tariffs, amongst others. In relation to the banking sector, the question is what needs to be changed to make banks operate differently. High commissions and interest rates in the banking sector suggest that privatization of banks has benefited no one except for a small elite.

A participant commented that there have been important changes and progress to date in the financial sector that has not been reflected in the presentations. Competition has increased among private pension fund administrators, the Administradoras de Fondos para el Retiro (Afores), and there has been an expansion in *crédito popular*. Reforms undertaken in the financial sector are

starting to show positive results, which is different from what has occurred in the education and health sectors.

Mr Ortiz started his closing comments by noting that the fundamental issue that needs to be addressed is how to remove obstacles to competition in key sectors, such as education, finance, and telecommunications. Something that has not been mentioned relates to public expenditure. In the last 6 years there has been an extra margin of funds available for spending equivalent to about 2 percent of GDP, due to lower interest rates and higher oil prices. However, most of this has been used to finance current spending and not for investment in infrastructure or education. One of the key mechanisms for unleashing competition is related to the existence of information and its dissemination. In the financial sector, the Bank of Mexico has been working on this issue and since November 2006 information on the cost of credit, notably interest rates and commissions, charged by banks, has to be made public so that consumers can find out the real cost of the services they purchase. Something similar is being done for mortgages. The central bank is working with the Federal Competition Commission (CFC) in order make such information public. As a result of such policies to disseminate information, public opinion has become much more aware of the negative effects that public and private monopolies are having on Mexico's international competitiveness. This highlights that access and dissemination of information and public awareness are key factors in supporting the reform process.

Session 2 Competition, Equity and Economic Growth

Speaker: Michael Walton,

Lecturer in International Development, Kennedy School of Government, Harvard University

Mr Walton stated that his presentation, like that of Luis Felipe López-Calva, was based on a paper written with Isabel Guerrero. This paper finds evidence that Mexico's economy is characterized by a high cost structure and low competition, a situation arising from certain businesses and corporatist groups having unequal influence on power, distorting policy design and contributed to the inefficiency functioning of markets. In turn this has impacted adversely on the growth rate. Mexico is underperforming in relation to Chile and China and is suffering from low investment and low productivity. This is occurring despite NAFTA, pro-market reforms, macroeconomic stability and the consolidation of financial reforms since 1995. There has been an incomplete reform process, especially in non-tradable services, such as electricity, energy, telecommunications, financial sector, education and agriculture, all of which have high costs and low quality of services. The costs of electricity are high and rising, even when compared to Colombia and Brazil and there is significant electricity interruption. A similar picture emerges for the telecommunications sector, which is characterized by high costs and low levels of investment. There is also low access to credit, dualism between, weak property rights and a low tax take. The answer to the question of why this is the case is that the reforms of the 1990s were largely undertaken for the benefit of elites.

Mr Walton's central hypothesis is that unequal opportunities can be a source of low efficiency and growth and that unequal power is the root cause of inefficient and unequal institutions. Similar arguments were developed in the World Bank's *World Development Report 2006: Equity and Development*, which focused on the relationship between equity and economic development. During the reform process of the 1990s in Mexico, those groups holding unequal power used it to limit the effectiveness of reforms that were not in their interests as they would have reduced their overall power and economic rents. In other words, unequal structures create weak institutions, which in turn sustain the existence of inefficient markets and public institutions and distort the design of policies, with the end result of low and unequal economic growth. Two groups have benefited from the incomplete reform process: the wealthy and large firms on the one hand and unions in certain key sectors on the other. At the same time these groups are not held in check by effective political or regulatory institutions. Despite the advent of democracy in Mexico and the greater salience of outsiders, this situation has not been fundamentally altered.

Speaker: Luis Felipe López-Calva

Visiting Scholar, Stanford Center for International Development, Stanford University

Mr López Calva continued the presentation, focusing on concrete evidence of the income and wealth of the two groups with unequal power. Using data from Forbes, and assuming a return on net worth of 5 percent, the growth in income of Mexico's billionaires was 14,000 times higher than growth of average income in 1990-2006, suggesting monopoly rent capture. In 1995, the year of Mexico's most recent financial crisis, the 20 largest companies in the stock market were all controlled by families, as opposed to only 20 percent in the case of the US, suggesting a high concentration of capital. Evidence was then presented on the high salaries received by unionized workers in the protected oil, energy, telecom and education sectors. Workers in protected sectors are in the top quartile of salary distribution and their income growth in 2000-04 has been markedly higher than for workers in other sectors.

Turning to the role of regulatory agencies in ensuring that there are competitive markets, Mr López-Calva argued that these agencies have limited powers to promote conditions of competition and efficiency due to capture, weak statutory powers, overall lack of authority, and the annulment of decisions by other judicial mechanisms. Data from the Federal Competition Commission (CFC), there is evidence that large firms have a greater probability of using their power and to secure *amparos* that temporarily halt rulings against them. A similar situation occurs in the telecommunications sector, which is dominated by Teléfonos de México (Telmex), a company owned by Mexico's wealthiest billionaire. Calculations by the authors show that the probability that a CFC sanction is upheld is very low, as companies with access to power tend to protect themselves from unfavourable rulings. Meanwhile, despite the reconstitution of the political landscape after the demise of the corporatist state, certain unions have maintained their power to extract rents. By blocking reforms and offering poor quality services, they have had an overall impact on aggregate efficiency and ultimately economic growth.

The above analysis and empirical evidence motivates two fundamental questions that the conference will focus on. The first is analyzing the mechanisms by which unequal influence leads to inefficiency and lack of competition across a wide range of sectors. Although the conference will not touch upon all of the economic sectors characterized by inefficiency and lack

of competition, there will be sessions on the energy, telecommunications and financial sectors, as well as sessions that look in greater detail at institutions and the failure of policy reform and at the mixed results of social security reforms. The second question that the conference participants will attempt to answer is a critical one if there is going to be a change in the status quo, namely, how Mexico can transition to a different set of policies and institutions that will move the country from an unequal and inefficient equilibrium to one characterized by equity and economic dynamism.

Discussant: James Robinson

Professor of Government, University of Harvard

Mr Robinson noted that Mexican policymakers want to move the economy onto a path of more rapid economic growth, but that they are burdened with the inheritance of a legacy of inequality of assets and political power that emerged as an intrinsic part of the one-party rule of the Partido Revolucionario Institucional (PRI). This Discussant to the presentation made by Mr Walton and Mr López-Calva analyzes the political economy lessons that can be learned from US history which are relevant for thinking about how Mexico could move forward. This analysis will focus on two reforms, one successful and one not, in the late nineteenth and early twentieth century, that had important consequences for the US economy.

The first reform is one that failed and led to economic stagnation and persistent inequality in the post-bellum South. The slave economy of the South was relatively poor before the Civil War, but in the aftermath of losing this war, important institutional reforms took place, with slavery abolished and blacks given the power to vote. However, after the ending of Reconstruction in 1877 an economic system recreated itself that looked remarkably similar to that which had existed before the Civil War, based on labour repression, low wages, and limited labour mobility and investment in education. As a result, the South became even poorer and stayed that way for another 100 years. An important question is why the reforms did not radically transform the southern economy. The answer to this is that the victorious North did not change the underlying structure of power or the underlying inequalities of asset holdings. In other words, they left in power the ante-Bellum elite and while blacks were able to vote after 1865, the white elites were able to re-establish their control over the labor force and eventually over the political system. As a result, the elite offset the effects of the reforms implemented after 1865 and the South did not prosper. The lesson from this example is that that it is not enough to change political institutions and implement economic reforms, and that it is also necessary to change the underlying power structure to ensure that that there is no backtracking on reforms.

Mr Robinson then turned to a successful example of reform, industrial dynamism and falling inequality in the Progressive Era of the twentieth century. The period prior to the reforms is know as the period of the “Robber Barons”, with wealthy figures such as Cornelius Vanderbilt, Andrew Carnegie, who in 1901 controlled 60 percent of US steel production, John D. Rockefeller, who founded Standard Oil Company in 1872 and unscrupulously eliminated rivals, and J.P. Morgan. With time the reaction to such marked concentration of wealth and the existence of large monopolies was a political and social backlash that led to passage of progressive reforms. In 1887 the Interstate Commerce Act was passed and the creation of the Interstate Commerce Commission began the development of federal regulation of industry. The

Sherman Anti-Trust Act of 1890 began the attack on business monopolies and broke up Standard Oil in 1911. President Woodrow Wilson passed the Clayton Anti-Trust Act and the Federal Trade Commission Act in 1914. As a result of the implementation of these series of reforms, wealth inequality fell dramatically after 1900 while the economy grew rapidly and above trend.

The successful reforms of the Progressive Era were the result of decisive political reforms between 1882 and 1892 which introduced the Australian Ballot in elections, a confidential voting system, thereby reducing vote buying and clientelism, allowing a much less corrupt politics to emerge that was more focused on programmatic issues. In other words, success was due to decisive political reforms which increased the secrecy of voting, which in turn dramatically reduced corruption during elections. There was also a large mobilization of the farming coalition that had a vested interest in reform and controlled the legislative agenda. This was aided by the realignment of politics in the 1890s, when the political elite became distinct from the economic elite and the former feared the latter's power. There was thus a collective interest across party lines to discipline the economic elite. In contrast, the Reconstruction of the South failed because there was no coalition in favor of reform in the South, while the North was not prepared to finance the reforms of the South as it had little economic interest in doing so.

There are a number of lessons that Mexico can take from the examples of failed and successful reforms in the United States in the late 19th and early 20th century. Theory and evidence suggest that monopolies and concentrated industries are less innovative than competitive ones, which explains why US economic growth accelerated after the reform process began in 1900. In addition, both instances suggest that large concentrations of wealth can undermine democratic institutions. An important lesson from the reforms of the Progressive period is that there has to be a broad-based coalition in favor of reforms for such reforms to be successfully implemented. A key question is whether a progressive coalition can be formed in Mexico, which would take up the agenda of reform to reduce the influence of unequal structures of power on institutions and the economy. To end Mr Robinson argued that it was not always clear that multi-party systems are conducive to reform.

Questions and comments

A participant commented that the resistance to reforming public enterprises, especially in the energy sector, might be caused by the suspicion that such reforms will result in those groups who already wield unequal power capturing the rents. Or else there is the suspicion that if such companies are privatized, the rents will simply go abroad. A question that the analysis raises is why the existence of so many monopolies in the Mexican economy has not led to the development of a vigorous consumer protection movement fighting them.

A participant stated the issue of discrimination had not been touched upon, perhaps because it is difficult to measure. However, in Latin American countries this often acts as an obstacle to finding suitable job opportunities.

A participant asserted that about 60 percent of students are deserting secondary education, as they do not see the point of further education if there are no jobs available. Poverty programs that

focus on distinguishing between the rich and poor end up by stratifying society. There has to be a greater focus on the forces inside Mexico that are pushing for increased access to opportunities.

A participant mentioned that both Mr Bourguignon and Mr Rajan argued for the need to provide more opportunities to different sectors of society so that they can participate more equitably in the economy. Access to information was presented as a very important mechanism to fight entrenched inequalities. With regard to education Mr Rajan suggested that there is a need to increase public expenditure to increase the quality of education, whereas Mr Bourguignon suggested the need to decentralize education. A question this raises is whether successful countries like South Korea and Singapore left the issue of education to the deregulated market or not. A second question is whether increased competition in education should go hand in hand with fiscal reforms that will allow the state to become more effective in its interventions in the educational sector.

A participant stated that what had been discussed in relation to the labor market left untouched the issue of social security reform. However, this is an important precondition for successful labor market reforms, as there is a need to break the segmentation of the formal and informal sector, and within the formal sector, between those who benefit from increased protection and those who do not.

A participant mentioned that Telmex became a private company in 1990 and that this led to important improvements in the quality of services provided. Many other monopolies were not mentioned, whether it be in television or Walmart. It is also important to emphasize the positive role played by unions, which serve to regulate employer-employee relations.

A participant argued that an incentive for conducting wide-ranging reforms would be the large political benefits that could be obtained by parties supporting such reforms. However, it is not clear that in Mexico there is a constituency that wants such changes, in part because it is not clear that there will be clear benefits from the reform process.

A participant who followed the conference via the video link asked how much public expenditure is required to finance activities that will promote reform and increased competition.

Lastly, a participant who also following the conference via video link commented that the presentations had emphasized that incomplete information worked against reforms and economic development. However, Mexico grew much more quickly prior to the 1982 crisis and the participants wanted to know if economic and political actors had full information then.

Mr Walton commented on the interesting question of why there had not been a democratic rebellion to challenge the existing status quo in Mexico. The main explanation is that there are groups that benefit from the existing system who stand to lose from change and will therefore work to prevent a reform agenda shaping up. At the same time, unlike the US in the Progressive Era, there is no equivalent to a progressive coalition in the context of existing political groupings in Mexico. It is also politically easier for the government and congressmen to support increased social spending for certain groups, the *Oportunidades* program comes to mind, than to design and implement reforms which would hurt special interests and where there would be clear losers.

The new government in Mexico has to deal with these vested private interests in order to gain support for necessary reforms across a wide spectrum of political actors and interest groups.

Mr Rajan argued that to design and implement wide-ranging institutional and economic reforms, it is necessary to “unfreeze” the system. If economic agents are worried that they will lose their rents after the reform process and believe that they will get nothing in exchange, then they will not support reforms. In the case of Mexico, it could be the case that the majority does not want comprehensive reforms. They may be in favour of reforms that will not change their situation, and they may well support reforms that will not directly affect them. In this situation, a new economic and institutional equilibrium may be in the economic interests of the nation as a whole, but it will lack wide-ranging support. In other words, countries end up the equilibria that the political structure supports, based on a coalition of reform and the existing power structure. Mr Rajan suggested that reform of political institutions may go ahead of any changes to the power structures, but ultimately it is the power structures that are the basis for any kind of change. If these structures are not changed, then changing political institutions and economic policies becomes difficult.

Mr Bourguignon also commented on the question of why there is no democratic rebellion in Mexico. He believed that the democratic process will not by itself lead to the end of monopolies. Mr Rajan mentioned that an isolated reform in some cases does not lead to overall improvement nor does it lead to more efficient outcomes. This suggests that the sequencing of reforms is crucial. The lack of activism may also be linked to agents not knowing what the consequences of the reforms are. It is therefore important to make such information available in order to generate debate. In the presentations of Mr Robinson and Mr Rajan there is the idea that the structure of political decision-making can produce a positive impact on development. The examples of China and South Korea show that economic development occurred because the policies adopted were win-win strategies. At the same time, it is also possible to have a process of democratization without economic development, as there can be obstacles other than the type of political regime.

Mr Bourguignon agreed that education reform has to be seen in terms of equal access for all, but also taking into account the labor market. If there are no jobs for those graduating, then students will question the value of getting an education. In the case of South Korea, education reform was successful and the economy was growing, enabling students to find employment. This confirms the idea that one cannot look at reforms in isolation and that reforming the education system will not succeed unless at the same time there are other reforms that lead to higher job creation. In his presentation Mr Bourguignon did not want to say that the best educational system was a decentralized one, but rather, that there are cases when centralization creates inefficiencies as there are few incentives for efficiency in the delivery of services. Lastly, Mr Bourguignon affirmed that none of the speakers was suggesting that unions did not play a useful role in society, but that in some situations, unions can obtain rents that contribute to inefficiencies and a poor performance of the economy.

Mr López-Calva commented on the subject of how institutions can ensure that unions and firms function in a democratic system. It would be dangerous to believe that only a macroeconomic shock can lead to a realization that reforms are necessary and beneficial to the economy. Mr Robinson mentioned that it was important to empower voters, but in the case of Mexico this is

difficult because there is no reelection of senators, congressmen or the president, reducing the accountability of the political class.

Session 3 Policy Choice, Efficiency and Influence in PEMEX

Speaker: Adrián Lajous

President, Petrométrica

Mr Lajous focused his presentation on the role of the state in the oil sector, the different interests of the main actors in the oil industry in Mexico, before turning to the determinants of potential change and possible reform strategies. There have been significant changes in the oil industry in Mexico in the last 35 years, while there has been continuity with respect to its administration. The development of the oil sector occurred in the context of important structural changes in the Mexican economy and in the international oil industry. The greater opening of the economy in the context of NAFTA led to greater trade flows and foreign investment and reduced the role of the state, modifying key aspects of Mexico's economic policy. Meanwhile, the volatility of international oil prices have had an important impact on the economy, while at the same time oil production between 1970 and 2005 rose dramatically, from 429,000 barrels/day (b/d) to 3.3million b/d, with similar trends in the production of natural gas. Domestic demand for oil products grew annually on average by 4.4 percent. Perhaps the most important change relates to the trade balance, with oil exports as a share of total exports have fallen sharply since 1980, due to falls in the international oil prices and fast non-oil export growth since 1995.

The key strategic role of oil in the Mexican economy resides in its great importance for public finances. In the last 20 years, the oil sector has been critical for the management of the recurrent economic and financial crises that Mexico has experienced. However, more fundamentally, the great promise of higher economic growth and well-being has not materialized despite higher oil production. Instead, it has led to what is known in the literature as the natural resource curse, with oil income allowing the postponement of fundamental economic policy reforms, most notably fiscal reforms. The greatest challenge facing the Mexican oil industry today is the need establish adequate processes of administration and management that will permit the oil sector to improve its overall performance. This does not require privatization of the public monopoly, Petrolera Mexicana (PEMEX), but does require the introduction of greater competition in order to increase efficiency.

There are three basic functions of the state in relation to oil sector governance: the design of energy policy, the regulation of the industry and market, and the exercise of property rights in relation to hydrocarbon resources in the subsoil and those relating to public companies. The regulatory framework of the industry reflects general rules and norms application to the economy at large, but also those that are specific to the oil sector. Interactions between these four functions are intimately linked and tend to reinforce each other. The lack of a comprehensive energy policy has created a vacuum that has limited the capacity of the state to make viable and congruent policies. The institutional weakness of the Secretariat of Energy has been palpable. Various

agencies share responsibility over the management of state-owned energy companies, while the regulatory agencies lack autonomy and are in practice an extension of the Secretariat. In addition, the frequent changes in the middle and top cadres have had an adverse effect on policy continuity. On average, Secretaries of Energy have lasted for only 2.2 years since 1983. More recently, the government of Vicente Fox has had four different Secretaries of Energy, which in practice means that many decisions regarding energy policies are taken in other ministries or in the state-owned energy companies. The independence of government policy has been adversely affected by the close links between the government and business interests in Monterrey, which was the case for three out of four of Mr Fox's energy ministers.

In Mexico the regulatory framework can be characterized as one where there is overregulation, poor regulation, and in some instances a regulatory void. Part of this regulatory void has been filled by PEMEX, which has taken on the functions of both the operator and regulator. Notwithstanding the above, in a number of key dimensions PEMEX is subject to regulations similar to those for other public entities and this reduces its operational flexibility and weakens its capacity to compete. The development of the oil sector within a public monopolistic structure has been hindered by weak institutions and normative frameworks, as well as poor managerial staff. It has also sheltered PEMEX from competitive pressures that are necessary to improve its operational efficiency. At the same time, the general regulatory regime constitutes an insurmountable obstacle for the proper development of the company. An extensive list of rules and regulations drown PEMEX in a bureaucratic labyrinth. Moreover, the manner in which the state-owned companies contribute to fiscal outcomes in Mexico is unique among OECD countries and destroys economic value. There has also been limited progress to date with regard to internal regulated competition within the energy sector. The emergence of subsidies to consumers is also affecting the financial integrity of the pricing structure.

Recent Mexican experience in the natural gas sector reveals some of the main obstacles that arise from liberalizing energy markets. Over ten years ago the legal foundations for a new regulatory framework for the natural gas market were established. New functions were given to the regulatory agency, the Comisión Regularadora de Energía (CRE). Despite this, the government of Mr Fox did everything possible to dismantle regulated gas prices. The government's decisions revealed the lack of support on the part of the government for the new regulatory framework and for the new functions of CRE. It also highlighted the role of private interests in establishing energy policy, as these interest groups captured the decision making process. Once the regulated price mechanism was established, CRE refused to adjust prices to take into account changes in the energy sectors, which negatively impacted on the integrity of the price-setting mechanism and led to a growing gap between regulated prices and the cost of alternative energy supply. As result, this blocked the introduction of competition in the natural gas market.

Turning to the issue of subsoil rights, the government has left in the hands of PEMEX instruments for the administration of the oil and gas resources that are the property of the nation. At the same PEMEX has not been able to exercise its prerogatives adequately. It has been constrained by budgetary considerations, which negatively impacted on the handling of subsoil property rights. The main objective of the government has been the maximization of short-term revenues from the energy sector. The fiscal imperative has dominated energy policy in Mexico and as a result there has been little consideration of the long-term effect this has had on the energy sector. In line with these revenue objectives, PEMEX has paid taxes equivalent to more

than 60 percent of its sales and more than 110 percent of its gross returns, leading to significant decapitalization, something that is clearly not sustainable in the long-run. Mr Lajous expressed his pessimism about the possibility of reforming the current situation, because it is impossible to reform Mexico's energy policy without a concomitant fiscal reform that would substantially increase non-oil taxes.

The regulatory framework of the energy sector, the Reglamento de Trabajos Petroleros, dates from 1974 and is in conformity with Article 23 of the Constitution which regulates the granting of exploration and production permits. These permits can only be extended to PEMEX. A fundamental change in the regulation of subsoil rights is necessary, even if PEMEX continues to be the only company in this sector. In addition, if the government eventually wants to open up the hydrocarbon sector to private investors, it will need to demonstrate that it can effectively regulate PEMEX and adequately administer oil resources.

The last subject relating to the role of the state in the energy sector relates to the property of state-owned enterprises and the exercise of property rights over them. The federal government and the oil syndicate jointly make up the board of administration of PEMEX, and have failed the owners of PEMEX, the nation, in terms of their fiduciary responsibilities. At the same time the government's administrative interventions have been dysfunctional and the result of significant political pressure. The leadership of the oil union has not been able to reconcile its own interests with what is in the best interest of PEMEX. These factors help explain why the performance of PEMEX is poor in relation to its potential, even when compared to other state owned national oil companies. It is critical to differentiate the role of the state in the administration of PEMEX from its role as a government agent. The existing property rights regime can no longer be exclusively justified in terms of historical arguments, considerations of sovereignty or to the political impossibility of changing them. The effective exercise of property rights and improvement of PEMEX's administration requires real changes in corporate governance, as board meetings have a largely ceremonial character, without any effective discussions.

Mr Lajous turned to the issue of determinants of institutional changes. These often come about after external shocks or following extensive transformations in the international context. From this perspective it is necessary to understand what the reasons have been that have prevented genuine change in the governance of the energy sector. PEMEX is very far from an economic collapse, as it is one of the three largest oil producers in the world, and half of its production is exported. Oil receipts will reach US\$40bn this year, of which PEMEX will invest more than US\$13bn. Despite this, PEMEX has large debts, which have served not only to finance its capital, but to pay taxes. In an international context where there is increased concern about energy security, the predicted fall in Mexican energy exports will generate pressure from the US to reform the sector in order to increase production and export levels. However, the call for reforms is most likely to come from endogenous changes to the oil sector. In the last 25 years there have been few hydrocarbon discoveries, oil well productivity has fallen substantially and oil reserves are dangerously low. The life of Mexico's oil reserves has been put at 10 years, and probable reserves are concentrated in areas that are hard to develop and have much higher extraction costs. Increasing deep-seal oil exploration will be costly and will take a number of years. These upstream elements require changes of oil policy and will probably be the driving force behind changes in policy reform.

Mr Lajous then briefly described the main reform objectives of the oil sector in the short and medium-term. The first is to maximize the value of resources and to guarantee a predictable supply of energy. Secondly, there is a need to assume greater responsibility for the local and global environmental impact of the oil industry. Thirdly, Mexico needs to develop public energy companies that function on the basis of commercial objectives. There is a need to liberalize oil product markets and to open the sector to private sector investment. But before opening the oil sector to private investment it is necessary to reform the regulatory framework and regulatory agencies, both of which have performed poorly in the past. Lastly it is necessary to train specialized personnel in PEMEX.

There are a number of potential impediments to reforming the hydrocarbon sector. Firstly, as already mentioned, the institutional weakness and instability in the Secretariat of Energy and capture of the regulatory agency by private interests and the governments augurs ill for reform. Secondly, the oil union impedes improvements in operational productivity and greater public investment in PEMEX, as its objectives are to maximize employment and to control employment conditions. The organization of the union and its leadership respond to an authoritarian and patrimonial political culture. Thirdly, reform will be more difficult due to the ageing of technical and management staff and their replacement by less able staff, as PEMEX is unable to attract the most qualified employees. Lastly, Mexico's past experience with privatizations and deregulation in other sectors of the economy have not been satisfactory and the fear of a potential privatization may prevent more limited reforms from gaining support.

Discussant: Rashad Kaldany

Director, Oil, Gas, Mining and Chemicals Department, IFC

Mr Kaldany shared Mr Lajous's perspective on the need for reform in Mexico's petroleum sector and as result his comments highlighted a few of the arguments made by Mr Lajous, placing them an international perspective by showing the experience of other countries and suggesting a way forward to enable Mexico to proceed with reforms. As already mentioned, the contribution of PEMEX to the economy has declined in the last two decades despite a significant increase in oil production, largely reflecting the diversification of the economy. However, oil revenue still accounts for about 40 percent of the federal budget, and this has important implications for PEMEX: investment in PEMEX is subject to political decision making and delays in finding alternative sources of revenue for the state will affect the government's capacity to reform the oil sector, as a result of its excessive dependence on oil revenue.

The performance of the oil industry in recent years does not augur well for the future. There has been an actual decrease in oil production since 2004, when production peaked. Output in mature fields is declining, although there is no consensus yet as to what the rates of decline will be in the coming years. In addition, a growing share of PEMEX's income has been used by federal guarantees and consumer subsidies. At the same time the cost of producing oil is increasing worldwide and in Mexico the costs have risen from about US\$4/barrel to US\$12/barrel. Refining capacity has stagnated at about 1.5m barrels/day, while consumption has risen to 1.75m barrels/day. There is evidence showing that there is less high quality crude available for export and Mexico is importing large quantities of refined products. Although gas production has risen, so have gas imports. This has led to growing dependence on gas imports from the US, where

there is significant price volatility, and in turn this has motivated the introduction of gas price caps in Mexico; gas subsidies are now approaching US\$4bn.

As mentioned by Mr Lajous, the energy sector needs to do more to internalize its impact on the environment. It is expected that Mexico will be among the first developing countries to take on commitments to reduce greenhouse gas emissions. The benefits of adopting a policy to mitigate climate change can help Mexico increase its competitiveness, while allowing it to earn carbon credits and to take on a leadership role in relation to this agenda. Policies to limit environmental damage, such as adopting measures to reduce gas flaring, are not only good for the environment, but can also help Mexico meet its growing demand for gas. Mexican leadership on environmental issues could also be used to encourage the US to take a more active role in reducing its own greenhouse gas emissions. This suggests the need to rethink Mexico's energy policy in light of not only local environmental impact, but of their global impact.

A number of lessons can be learned from the experience of other countries. In general, there is evidence that competition in the energy sector leads to great efficiency. There is also a need for transparency with respect to subsidies. In addition, communities where the hydrocarbons are located need to benefit from projects, and this in turn requires a comprehensive approach that includes proper consultation with affected communities and rural development. As already touched upon, there is a need to reduce the adverse environmental impact of the sector. Mr Kaldany then turned to specific lessons that Mexico could learn from recent experiences in Pakistan, Indonesia, Russia and Norway. Pakistan has sold stakes in its state-run energy company, has made subsidies more transparent, and has targeted subsidies while liberalizing energy prices. As a result of recent reforms, there has been some increase in production and investment, but the largest impact has been on fiscal balances. Likewise, the government of Indonesia has recently decided to cap the country's oil price subsidy, as a combination of high international oil prices, growing domestic demand, increasing oil imports and declining domestic oil production have led to escalating expenditure on subsidies which threatened creating a fiscal crisis. Russia's privatization of the energy sector led to large increases in oil production, while recent increases in state participation have led to stagnating output. However, Russia is proceeding with price liberalization. Perhaps the most relevant example is Norway's oil sector, as its state-owned oil company has performed very well, in a framework characterized by transparency and open access to information.

Going forward, it will be difficult to reverse energy subsidies in Mexico. Generally, subsidies tend to benefit the middle class and the wealthy more than the poor, so there is a need to target subsidies. Improving governance, accountability and disclosure, together with benchmarking are central for improving the overall performance of PEMEX. Other reform options could be to allow private investors into the refining sector and to significantly expand the petrochemicals industry. To conclude, within a 5 to 10 year time horizon there is unlikely to be a major crisis in PEMEX, but without reforms the status quo in the long-run is not tenable. As the hydrocarbon industry is subject to long lead times, it is critical for Mexico to act now.

Questions and comments

A participant asked what the size of the fiscal reform would need to be, either in absolute terms or expressed as a percentage of GDP, if the objective is for the government to maintain the same levels of overall public expenditure as at present, while leaving sufficient funds for the proper functioning of PEMEX. An associated question was to ask what kind of reforms would be necessary so that PEMEX could receive the same kind of fiscal treatment as the Norwegian oil company.

A participant commented that one of the mechanisms for improving administration and governance in the energy sector would be the creation an oil stabilization fund. He asked if there were any experiences in the Latin American region of creating such funds.

A participant noted that one of the peculiarities of PEMEX is that it does not need to buy its own reserves, unlike many other oil companies and asked what the impact of buying oil reserves would be on PEMEX. A second question is what the challenges would be of deeper oil extraction.

Mr Noll commented that if he were the incoming president he would want to have a precise estimate of the financial dependence of the government on PEMEX, assuming oil and gas market prices. Then, it would be necessary to calculate the additional cost of the energy subsidies. Mr Noll suggested that relying on US markets for Mexico's oil exports left the country highly vulnerable if there was a change in US energy policy. Lastly, if Mexico does not attempt to reform the energy sector, it will be heading toward an energy crisis.

Mr Perry wanted to know of examples of oil exporting countries that have successfully reformed before an imminent crisis took place. In Latin America the examples of Colombia and Peru come to mind. He asked what the likelihood was that there could be an autonomous regulatory agency for PEMEX. Lastly, he inquired if PEMEX had the possibility of increasing oil production, and what the technological, cost and risk implications of this would be, and whether it would require strategic partnerships with other energy companies

Mr Lajous commented that PEMEX needs to be investing on a sustained basis about US\$20bn a year instead of the US\$13bn it currently is investing. A recent report from PEMEX provides calculations of the value of oil reserves, which are among the lowest in the sector, due to the confiscatory fiscal regime. Their valuation is significantly below those of Exxon, Shell or BP. PEMEX does not attach a value to subsoil reserves because of the confiscatory fiscal regime, which makes it difficult to assess the company's performance in exploration.

It appears clear that Mexico has reached an oil production peak, whether final or local and that in the coming years there will be a decline in production. The only thing that remains unclear is the pace at which oil production will decline, and much will depend on the drilling of new wells. Although technology for deeper wells can be bought, the main impediment is not technological but managerial, in order to know where best to buy technology and how to manage project risks.

Mr Lajous argued that a good example of oil sector reforms which can provide some lessons to Mexico is Spain. Mexico should learn from its experience of liberalizing the market and how it developed an integrated energy company, Repsol. In order to prepare its entry into the common market, the government took the right decisions to liberalize and privatize the Spanish energy sector.

With regard to stabilization funds Mr Lajous argued that Norway was not the only successful example, as there was also the case of Kuwait. Both countries have low populations and high GDP per capita which have facilitated the establishment of such funds.

The main risk endogenous to the energy sector is a sharp fall in the international price of oil, something that could occur if there is a world recession. However, if the world economy does not suffer a recession, then oil prices will remain high relative to those of the past. If there is a chance that oil prices will fall, contingency plans will need to be prepared as past price shocks have had pernicious effects on the Mexican economy.

A participant stated that in the last government administration it was not possible to introduce a comprehensive reform package in the energy sector. He then asked what would be the key to open the reform process in the next two administrations.

Mr Haber mentioned that in the 1920s Mexico was the world's second largest producer of oil and one third of total revenue came from oil taxes. However, within six years Mexico's oil production collapsed and did not regain the same production levels again until 1976. This change was mostly brought about by small changes in the taxation of the energy sector, suggesting that it does not take much for oil industries to collapse.

Mr Bourguignon mentioned that one way of measuring the cost of PEMEX on the overall economy would be to measure the company's debt and to add the funds that would be needed to take investment to levels required to make it function adequately. In his view, these costs do not appear to be so high, somewhere around US\$40bn, especially in relation to Mexico's GDP, unless there something is missing from these calculations.

A conference participant claimed that there appears to be increased convergence between the electricity and energy sectors and between the electricity and telecommunications sectors. Even though cogeneration is allowed by law, firms face an electricity monopoly, which forces PEMEX to sell energy to the Comisión Federal de Electricidad (CFE) for the thermal generation of electricity. It would appear that nothing would impede CFE from exploiting gas and PEMEX from producing electricity, but the question is whether this would permit the development of greater competition in the energy sector.

Mr Lajous commented that oil production will decrease within two to three years by 20 percent and if there is a general decline in international oil prices, then oil revenue from PEMEX could fall significantly, from 40 percent of the budget to say 30 percent, which could lead to a fiscal crisis. Despite high oil prices, Mexico has failed to save any of the oil windfall generated by high international oil prices the downside risk to production.

Mr Rashad recommended that Mexico take advantage of the fairly good environment at present to make adjustments. It is critical to disseminate greater information on the challenges facing the oil industry in order to develop a consensus on what policies to adopt. In the case of Norway it took 5 to 10 years of consultation to develop a national consensus on what to do with oil proceeds. Within the Latin American region, Chile is a country that has succeeded in saving the copper windfall of recent years in a special fund, and there may be lessons for Mexico to learn from this example.

Responding to Mr Haber's comment that Mexican oil production collapsed in the 1920s, Mr Lajous argued that the lessons from that experience are not along the lines he mentioned. Instead, the cause of the collapse in oil production was due mainly to the exhaustion of the resource in the oil-producing province. At the time, the technology was not available to extract oil located in other parts of the country. This episode is relevant today as Mexico's largest producing area, the Cantarell offshore oil field in the Gulf of Mexico, is facing a similar decline in production, although unlike the earlier experience the oil sector will not face an imminent crisis. The risk of dramatically lower production is something that a new government will have to face six years from now. There are about 10 years of proven oil reserves so the issue is not of an imminent crisis but of Mexico finding itself at a critical crossroad where reforms are necessary. There is a lack of consensus on what needs to be done, in part because the government and political parties have failed in explaining to the general public what the nature of the problems are. The problem is not so much one of informational deficiencies as the information is there, but of disseminating such information and discussing the challenges that lie ahead.

Session 4 Competition and Equity in the Financial Sector

Speaker: Stephen Haber

Professor in the School of Humanities and Science, Stanford University

Mr Haber started off by highlighting that by any comparative metric the Mexican banking system provides low levels of credit to firms and households, and that this in turn has a negative impact on economic growth and income distribution. Private credit as a percentage of GDP is low even by the standard of former Eastern Bloc countries that did not have private banking until the 1990s. The expansion of credit in recent years is from a low base, with Paraguay, Argentina and Venezuela having smaller banking sectors in the Latin American region. If you compare Mexico's ratio of private credit to GDP is about the same as what it was more than 50 years ago. Equally striking is the fact that the decline in credit to firms and households has not been uniform across all users of credit. Business enterprises have been hit harder than households. Even with a minor increase after 2003, the ratio of commercial credit to GDP at the end of 2005 was still one-third its level in 1997. At the same time, there has been an increase in credit granted to consumers and credit granted to Sofoles (non-bank intermediaries that specialize in the construction and financing of new housing, usually with federal government repurchase agreements that reduce default risk). While all of these ratios are stunningly low by any international comparative metric, any explanation of Mexico's credit contraction has to account

not only for the overall trend, but also account for the differences in trends between credit allocated to business enterprises and credit allocated to households.

Mr Haber then turned to an assessment of the underlying causes of Mexico's small financial system and to offer recommendations for policy makers. He assessed three hypotheses that explain Mexico's small banking system: the existence of alternative sources of finance, an oligopolistic banking system, and a weak property rights environment. According to Mr Haber, the evidence is consistent with the second and third hypothesis, and these are in turn jointly determined by Mexico's pre-2000 political economy. The lack of checks on the discretion of the PRI government created a thorny problem for Mexico's business class: there was nothing preventing the government from expropriating private assets once they had been deployed, which meant that the incentives to invest were weak. Weak incentives for investment created a problem for the PRI as the economy needed to generate jobs for its core constituencies in order to ensure the party's electoral dominance. The PRI solved this problem the way many authoritarian governments do: it awarded a select portion of the country's business class a set of special privileges, with the result that large companies could obtain loans through private deals. The political economy situation has changed and there have been important reforms to improve property rights which have helped to open the financial sector.

The first hypothesis, that the decline in bank credit in Mexico is an outcome of increases in other sources of finance, such as securities markets, foreign direct investment, and direct lending by international banks, is not substantiated by the evidence. There is no evidence of an expansion of the security markets: the ratio of private bonds to GDP has hovered at roughly 3 percent of GDP for the past decade. The stock market is somewhat larger, but by international standards it too is small and has been shrinking over the past decade. In the mid 1990s the ratio of the capitalization of the stock market to GDP stood at around 40 percent, but by 2005 it remained at only 23percent. Another alternative source of finance for business enterprises is foreign direct investment (FDI). Here again, the evidence points in the opposite direction, with a dramatic decline in the absolute level of FDI flows to Mexico since 2001. Lastly, a third alternative source of finance for business enterprises is direct loans by international banks. Indirect evidence provided by business surveys suggests that direct lending from foreign sources has not replaced lending by domestic banks.

The second hypothesis is that Mexico's banking system is oligopolized. The entire retail banking business is comprised of only 19 banks, with two of these banks, BBVA Bancomer and Banomex controlling just over 50percent of total bank assets. However, there is a difference between showing that a market has a structure consistent with oligopoly, and demonstrating that it practices oligopolistic pricing. Econometric results are consistent with the finding that the largest banks do extend less credit than the smaller banks, assume less risk, and have lower non-performing loans, suggesting that large banks choose the best borrowers and constrain credit volumes. However, they do not charge higher net interest margins, when controlling for risk, because they have lower administrative costs. Although there is no relation between the rates of return on equity and size of banks, regression results show that larger banks have higher rates of return because they make fewer commercial loans and earn more from commissions and fees. Taken together, the evidence indicates that larger banks appear to be able to exert market power, although they do not appear to use it to charge higher risk-adjusted net interest margins than their

smaller competitors. Rather, the evidence suggests that they use their market power to generate income from their control of the payments system. Mexico's largest bank, BBVA Bancomer, generates 17 percent of its income from commissions and fees, while Mexico's second largest bank, Banamex, generates 24 percent of its income from commissions and fees. Their behavior in the loan market suggests risk aversion, particularly toward commercial loans.

The third hypothesis is that weak property rights are behind the low levels of credit. Data reveals that higher ratios of commercial credit are strongly associated with lower net interest margins and lower rates of return on equity, even when controlling for the ratio of non-performing loans. These findings suggest that there is something peculiar about the commercial loan market relative to other segments of the credit market. The peculiar feature of commercial lending is that banks find it more difficult to assess risk and enforce contracts in the commercial credit market than in the market for consumer loans. This is not to argue that the property rights environment is good for consumer lending, but to argue that it is difficult to assess risks and enforce contracts broadly speaking in Mexico, and that the environment facing commercial lenders is particularly difficult. Historically, property rights have been weakly enforced, with limited investment in courts, police and property rights. In the 1990s there were a series of reforms to credit reporting, mandatory use of credit reporting and bankruptcy laws. These reforms have had less of an impact on the enforcement of commercial loan contracts where assets are more difficult to assign, where credit reporting is harder and where the court system is crucial.

To conclude, Mr Haber argued that the second and third hypothesis, that banks constrain credit in order to raise rates of return and because property rights are hard to enforce, are the key factors explaining the low levels of credit in the Mexican economy. Both are jointly determined by Mexico's pre-2000 political economy. Going forward, Mexico has two reform paths. It can continue to reform the property rights regimes, although this is costly and difficult as the government has limited fiscal resources available. An alternative possibility would be to open the banking system to more competition, which will also increase access to credit and create interests that will push for property rights reforms.

Discussant: Augusto de la Torre

Senior Regional Financial Sector Advisor, Latin America & the Caribbean, World Bank

Mr de la Torre commented that Mr Haber's arguments were relevant, balance and compelling. His paper asked the relevant question, which is why the Mexican financial system is so small by international comparison and provided careful data analysis. He also presented compelling arguments that the contractual environment is particularly relevant for enterprise finance. However, Mr de la Torre argued that while the analysis of the alternative hypotheses was excellent, he did not agree with the overall conclusion. Mr Haber's basic conclusion is that the small size of the financial system reflects oligopoly in the banking sector and weakness in contract rights, both of which are jointly caused by the 70 years of PRI-based hegemony, which led to privileges for incumbents, who had no interest in stronger, independent contract enforcement. The suggested policy cure was to facilitate market entry in the short-run and to embark in improvements in contractual environment in the long-run.

In Mr de la Torre's "creditor rights story", weaknesses in registries and contract enforcement have disproportionately large adverse effects on firm finance. Unlike credit cards, collateral matters for small and medium-enterprise (SME) loan technology. Unlike mortgages and auto loans, non-real estate collateral that firms offer have limited value in a weak contractual environment, while credit bureaus boost credit to persons more than to firms. Finally, firms are better able than households to delay repossession, especially as repossession proceedings are weak in Mexico. These facts help explain the contrast in growth in different credit segments, with faster growth in consumer and mortgage lending and stagnation of commercial lending. It remains unclear how much of the low credit to firms is due to demand factors.

Working against Mr Haber's hypothesis of an oligopoly in the banking sector, or the "market power story", is the fact that large banks exploit economies of scale and pass on the cost savings to debtors via lower net interest margins. In addition, credit market competition appears vigorous in large corporate, mortgage and consumer segments, while non-price competition dominates consumer credit markets. However, the hypothesis of market power and collective action problems does characterize retail payments markets, leading to high fees in the payments system. Large fixed costs constitute a natural barrier to entry and given economies of scale, reliance on competition does not guarantee optimal outcomes. Moreover, there is evidence of insufficient cooperation on payment "highways" and undue competition on access to infrastructure.

Turning to Mr Haber's "PRI hegemony story", Mr de la Torre argued that past history is no longer a driver of oligopoly in credit markets. Contestability in credit markets appears strong, except for SMEs, while the existence of foreign banks, non-deposit taking credit institutions such as Sofoles and local bond markets are helping to increase competition in credit markets, while current licensing practices are not unduly restrictive, favouring prudent entry. Bank ownership is no longer intertwined with non-financial interests following the privatization of the banking sector. It does not make sense for foreign-owned banks to be interested in maintaining a weak property rights system. What can however be true is that large banks may not have incentives to cooperate towards common or interoperable retail payments infrastructure and this is contributing to low credit growth.

To conclude, Mr de la Torre noted that the policy reforms needed to address the low levels of credit should continue with current policy to facilitate prudent market entry and also focus on specific reforms to enhance the contractual environment, such as developing registries, improving contract enforcement, and using the regulatory and catalytic roles of the government to enhance efficiency in retail payments systems.

Discussant: José-Antonio González Anaya

Director General for Insurance and Securities, Secretariat of Finance and Public Credit

Whereas Mr de la Torre largely agreed with Mr Haber's analysis but disagreed with his conclusion regarding the causes of the low credit in Mexico, Mr González Anaya disagreed with part of analysis but agreed with Mr Haber's conclusions. Undoubtedly the contractual rights system has been poor in Mexico, but it has been that way for decades, and cannot explain why credit has fallen from 1994 onwards. Similarly Mr Haber's evidence that there has been an

improvement in the property rights regime from 1995 onwards cannot explain why credit has fallen from 1994.

What needs to be brought out more explicitly is that part of the reason for low bank credit growth after 1994 is that the financial crisis wiped out the capacity of bankrupted banks to extend credit until at least 1998. Meanwhile, bank credit has been rising in recent years, from 7.5 percent of GDP in 2000 to 11.4 percent of GDP in 2006. If this trend persists, then it will be difficult to argue that banks in Mexico do not lend. Some of the reforms mentioned in Mr Haber's presentation, such as the introduction of bankruptcy laws in 2003, have contributed to a steep rise in mortgage lending by non-bank institutions. As a result, non-bank mortgage has risen from a little over 1 percent of GDP in 2000 to over 2 percent of GDP in 2005.

In June 2001, the authorities introduced a new type of debt instrument: the *certificado bursátil* that basically combines the speed in issuance of medium-term notes with the flexibility in terms of amortization and covenants of the debentures. Until now, only one firm has issued a *certificado bursátil*. Whereas the bond market represented between 1 percent to 2 percent of GDP in the 1990s and until 2000, this has risen sharply to 5 percent. The number of issuers has increased, from 9 commercial bond issues in 2001 to 79 in 2006. The creation of this new debt instrument has allowed both national and foreign firms to obtain finance in the domestic bond market, and although this does not invalidate Mr Haber's conclusions, it does provide an alternative source of financing for firms.

Mr González Anaya then discussed some recent policies that have been adopted in Mexico that are in line with Mr Haber's recommendations. The first relates to the payments system. There appears to be evidence that banks are using their market power to generate income from their control of the payments system, as Mr Haber's data suggested. Only banks have access to the payments system, which means that all financial intermediation has to inevitably pass by banks. The problem is then not of credit concentration and of abuse of market power in the credit market but in the payment system. Under the administration of Vicente Fox, authorization for 16 new banks were issued, 13 of which were granted in 2006. In addition, a reform is under preparation that would grant banks "limited licenses", that would allow transaction banks to be created which would specialize exclusively on the provision of access to the payments system. This should spur competition in the payments system and reduce the high commissions banks currently obtain.

Mr González Anaya then turned to recent government reforms which deregulated the Sofoles, who are active mortgage lenders. The reform had three overarching objectives: the liberalization of financial intermediation so that any firm can obtain funds from the debt market or banks in order to then make loans; the liberalization of capital leasing and factoring activities so that any mercantile entity can do this without authorization from the financial authorities; and ensure that firms that focus on credit, capital leasing and factoring have the same fiscal and procedural advantages that they already had as financial entities. Such deregulation should lead to increased availability of credit.

Lastly, Mr González Anaya mentioned the new Securities Law, which defined for the first time the duties of company directors, combining an obligation to "take care of the business as if it

were your own” with a list of activities that violate that duty and is expected to raise Mexico’s corporate governance standards. The objective of this law is to increase the depth of the securities market, increase the list of companies listed in the market and demand for their shares. The new law introduces a new type of corporation, called a SAPI (*Sociedad Anónima Promotora de Inversión*) that gives much clearer rights for minority shareholders than other limited liability companies do. Companies can become SAPIs, but once they do, they have three years to list on an exchange. SAPIs will give minority shareholders more protection. For instance, investors will need fewer votes to call a meeting, and it will be easier to file a civil legal action or to oppose a resolution from a shareholders' meeting. SAPIs will also impose duties of care and loyalty on company directors, improve corporate financial reporting, and make clearer, harsher penalties for violations such as insider trading.

To end, Mr González Anaya stated that the basic diagnostic of the financial sector given by Mr Haber is correct, in the sense that the emphasis of future reforms should be on increasing competition in the payments system. Mexico has finished consolidating the financial sector, something that was necessary following the financial crisis of the mid 1990s, and has started to implement reforms to increase competition. There is evidence suggesting that growth in the financial sector is accelerating and the key to support this is to continue with measures to increase competition. In the banking sector this calls for the granting of new licenses and changes to the Credit Institutions Law, while in the non-banking sector deregulation of Sofoles and adjustments to the laws relating to trust, insurance and pension funds. In the bond market new debt instruments are making it easier to obtain financing by issuing domestic debt, while the new Securities Law is expected to lead to improvement in the functioning of the stock market.

Questions and comments

Mr Elizondo commented that banking credit grew strongly in the 1950s to 1970s, even with poor contractual rights, in part because of banking credit to the government. He also commented that Mexico’s elites had probably not done enough to promote improved property right. Secondly, he argued that as many companies do not file their tax returns correctly, this makes it difficult for banks to make an assessment of companies’ creditworthiness.

A conference panelist suggested an additional hypothesis for why bank credit is low. The average cost of raising capital is much lower for large banks, although this would need to be confirmed empirically, while at the same time they take on less risky loans. This is in line with Mr Haber’s analysis which showed that smaller banks specialize in commercial loans as they need to take on higher risks to get higher returns. Something that was not discussed is that firms obtain credit from their suppliers.

A conference panelist asked what the role the Federal Competition Commission (CFC) could play in the banking sector, given the high market shares of the top two banks. Given the high cost of turning to the courts in the case of a dispute between borrower and lender, a possible alternative is to commercial arbitration.

A panelist mentioned that ECLAC recently launched a study on competition in the banking sector. One of the facts that came to light in this study is that the international banks charge

much lower fees for services in their home country and overseas. Apart from appropriate regulation, a response to this phenomenon could be to develop a consumer groups that would gather greater information on bank services and would allow depositors to make more informed decisions.

A panelist commented that the public-private banking system, or “mixed” system, seemed to work well in Mexico in the past, but despite this there appears to be no debate regarding whether a purely private banking system is good for sustaining economic development, increasing employment and reducing inequality.

Mr Haber answered the comment made by Mr González Anaya, who argued that property rights cannot explain current low levels of lending, as they were badly enforced in the past and yet there was significant lending prior to 1982. However, Mr Haber argued that a large fraction of loans in that period were from bank directors to their own companies, in other words, insider loans, precisely because it was difficult to enforce property rights. Following reforms dating from 1997 it has becoming much more difficult to extend insider loans. In addition, the privatization of banks means that there are new bank directors who are foreigners and not Mexicans. Turning to the issue of the payments system, Mr Haber mentioned that there was evidence that this market was oligopolistic.

Session 5 Institutions: Competition and Failures of Policy Change in Mexico

Speaker: Carlos Elizondo

Researcher, Division of Political Studies, Center for Research and Teaching Economics (CIDE)

The central argument of Mr Elizondo’s presentation was that weak competition in Mexico is the result of excessive power that certain actors wield and an institutional framework designed for another political and economic environment. In turn, this has negative effects in terms of productivity and growth. As already mentioned, institutions affect the distribution of power and economic decisions, but what needs to be emphasized is that there is a close relationship between *de jure* and *de facto* power. There is a tendency to exclusively focus only on formal institutions, assuming that changing institutions will lead to significant changes in behaviour and practices. Mexico has gone through large institutional changes and nevertheless, given the *de facto* distribution of power, the institutional changes that have occurred in practice are much less deep. In other words, the power which certain key actors have in Mexico makes it difficult to successfully reform institutions, even where such reforms are carried through, to make them operational.

Mr Elizondo then compared Mexico’s GDP per capita between 1820 and 2000, expressed as a percentage of US GDP, alongside those of Argentina, Brazil and China. This exercise showed that Mexico’s GDP per capita has failed to catch up with that of the US. This is something that dates from several decades and is not unique in Latin America, with both Argentina and Brazil also failing to converge. A similar picture emerged if the performance of Mexico between 1970

and 2005 was compared to that of other OECD members, such as Turkey or South Korea. This long-term perspective provides evidence of the long-term difficulty Mexican institutions have had in adopting policies that promote productivity and economic growth. Reforms to reduce barriers to entry have been blocked by special interests. One of the central objectives of the reform agenda of the presidency of Carlos Salina de Gortari, who ruled Mexico from 1988 to 1994, was to reduce the size of the state in order to strengthen it. However, what happened in practice was that the size of the state fell and its power was weakened.

Turning to the issue of competition, there is ample evidence that increased competition stimulates technological developments and uptake, innovation and productivity. There is also empirical evidence which suggests that there is a relationship between high market power and lower levels of productivity. Mr Elizondo illustrated this point by looking at the case of the Mexican airline industry following reforms. After Mexicana and Aéromexico de-merged and two low-cost ventures have started operating, the price of tariffs have fallen significantly, confirming the well-known fact that increased competition raises productivity and tends to reduce prices.

Mr Elizondo then focused on the main argument of his presentation, which is that existing institutions in Mexico were useful for the development model adopted by the Partido Revolucionario Institucional (PRI) dominated regime, but that they are an obstacle for generating higher economic growth and not optimal from a governance perspective. Following the Revolution, Mexico was organized in such a way that the president was granted large discretionary powers, which allowed him to negotiate with different actors, whether large businesses or unions, within a corporatist framework that worked against competition. The underlying logic of this system was the existence of rents allocated to specific economic actors in order to secure political acceptance of the regime. Despite the reform process of recent years, the instincts to not compete remain strong. Within this corporatist system, states could act as mediators to solve governance problems. A concrete example is the number of the governors that were forced to resign when there were large problems in the states. This acted as a safety valve, although at present there is no such system, and this is reflected in recent political problems.

Mr Elizondo argued that Mexico's transition from the corporatist system is not yet complete. In this respect, it is worth comparing Mexico to Russia and China, which have all undergone significant institutional changes in order to reform their economic systems. In the case of Mexico and Russia which both undertook political reforms, the state has lost the capacity to successfully undertake reforms and administration. The Russian case is an extreme one, where privatizations were a brutal mechanism to transfer state assets into the hands of a small oligarchy which was not controlled or regulated by the state until the Russian president, Vladimir Putin, succeeded in disciplining this group. In contrast, China undertook economic reforms without significant political reforms. Its strong centralized state enabled competition to take hold in the economy, and this has helped spur higher economic growth. The Mexican state has not been able to make competition take hold in the market or among workers.

The transition to democracy has not been a solution to these problems, despite the optimistic view prior to 2000 that competition through votes would strengthen the majorities in the face of organized interests, something which in practice has not taken place. In reality, the opposite took place as the dispersion of power following the change in the political regime in 2000 has made it

much more difficult to control economic actors who have excessive power, such as large businesses or unions. An important question that needs to be asked is why democracy has not been able to control these specific economic interests. Mr Elizondo then presented recent legislation in terms of whether it benefited the general public or specific groups and this provided evidence that the greater part of the legislative agenda has helped specific groups rather than the population at large. An example was the approval by unanimity of modifications to the Federal Radio and Television law (Televisa Law) by Congress, who gave in to the pressure of media giants Televisa and TV Azteca, approving reforms to the country's broadcasting laws that strengthened the broadcasters' influence and were against consumer interests. This reflects the fact that in Mexico political parties need the support of large corporations and unions in order to survive politically. It is an oligopolistic market characterized by barriers to entry and high rents. Legislators and the executive are less accountable than in other political systems as there is no re-election and because they control large budgets. Political campaigns are markedly more expensive in Mexico than in Spain, which is a markedly richer country. About 510 million Mexican pesos were spent in the Spanish legislative campaign of 2004, while the figure for Mexico's legislative campaign in 2006 was 4.1 billion pesos.

Mr Elizondo emphasized that the rule of law is not merely the application of existing laws, but the need to reform laws so that no one is above the law and that everyone is protected by law. An example which reveals that this is not the case in Mexico relates to *amparos*, which represents 81 percent of the judicial cases in 2005 and has become the key instrument to protect companies against regulatory or fiscal powers. Although *amparos* were created to protect individuals and companies from expropriation it has now become the main instrument to protect the rights of corporations against the authority of the state, whether it be to avoid rulings of the Federal Competition Commission (CFC) or taxation. Large businesses and wealthy individuals have juridical protection with regard to taxation that does not exist in the US or Spain and which did not exist in Mexico prior to 1960, when the interpretation of Article 31 of the Constitution was changed. Article 31 states that Mexicans have to "contribute to the public expenditures of the Federation, and the State and Municipality in which they reside, in the proportional and equitable manner provided by law." This clause was interpreted between 1857 and 1960 by the Supreme Court as excluding taxpayers from *amparos* on taxation issues. However, from 1960 onwards it was interpreted differently and the right to *amparos* in relation to taxation issues was recognized by the Supreme Court. In the end, it is the Supreme Court which is defining Mexico's taxation policy and it does this in an inconsistent manner. *Amparos* disproportionately affect the competitiveness of small and medium-size, who incur large costs in relation to their size.

Mr Elizondo then briefly referred to the effects of the lack of competition in the education system on educational outcomes as measured by the OECD's Programme for International Student Assessments (PISAs), which assesses the extent to which students near the end of compulsory education have acquired some of the knowledge and skills that are essential for full participation in society. The OECD assessments show that Mexico performs particularly poorly when it comes to educational outcomes, but such a poor performance is egalitarian, with similar outcomes in both public and private education. Although students from private schools perform better on average, if one controls for socio-economic background, then students from public schools actually perform better. Mr Elizondo suggested that one possible explanation for this surprising outcome is that students from privileged backgrounds do not need to be well-

education but well-connected and part of a privileged circle of relations and networks, as this is what is necessary to succeed in life. In the past when education was limited to a small fraction of society, it was sufficient to have a degree, irrespective of the quality of education. However, at present there are no incentives to improve the performance of schools if this does not lead to improved opportunities.

To end, Mr Elizondo raised the issue of how to build a political coalition that breaks with this suboptimal equilibrium. A positive aspect of the recent presidential campaign is that defeated the candidate, Andrés Manuel López Obrador, brought to the center of political debate the issue of inequality, exclusion, and the dominance of monopolies. As these issues are in the public eye, the incoming administration should take advantage of this in order to carry out legislative reforms.

Discussant: Eduardo Perez-Motta

President, Federal Competition Commission (CFC)

Mr Perez-Motta commented that the subject matter of the presentation reminded him of an article by Luis Rubio, a Mexican journalist, some months prior to the elections in 2006. In this article it was argued that when most Mexicans think of Carlos Slim [Mexico's richest man and the third richest billionaire in the world] what they do not want is for him to become poorer, but for themselves to become part of that system of privileges. Mr Perez-Motta agreed with most of what Mr Elizondo stated in his presentation: concern for falling competitiveness was not new. Rather, it was a gradual crisis that reflected the underlying economic structure of the country. However, this kind of crisis does not create a consensus or collective understanding regarding the need for change as happens when there is a sharp and violent macroeconomic crisis.

Mexico is losing the capacity to attract foreign investment into the country. One of the strengths of Mr Elizondo's presentation was that he provides empirical evidence that one of the principal causes of this systematic fall in competitiveness is the lack of competition, something touched upon by other conference panelists. This lack of competitiveness was also due to the poor performance of the education sector, which has a long-term impact on productivity and economic growth. Most people agree with this diagnosis, and there appears to be a consensus. The problem of lack of competition is a broad one and includes the private sector, unions, political parties and public administration. The virtue of Mr Elizondo's presentation is to bring to light the underlying institutional bases for rent-seeking and capture. The state has been captured by a group of large companies, both private and public, and unions. The best remedy to this problem is to increase competition.

The unequal application of the *amparo* law is problematic, but at the same time it is important for economic agents to be able to appeal if the public administration has applied the law correctly or not. Judicial reforms could help to greatly speed the decision-making process. For example, the specialization of courts of appeal, *tribunales de segunda instancia*, could substantially improve the functioning and accelerate the speed in which decisions are made. An example of the slow pace of the judicial process in Mexico relates to a case involving the Federal Competition Commission (CFC). In 1997 the CFC issued a market dominance ruling against Telmex, and it

took nine years for the judge in the court to take a decision, dismissing the ruling two months ago. This suggests that there is a lot of scope for improvement.

More generally, there are three principles which CFC has tried to apply to break up the vicious circle of inefficient institutions, lack of competition and capture. Firstly, by concentrating on regulated sectors that have artificial entry barriers and that have a large economic impact on the rest of the economy: transport, telecommunications, energy, and finance. Secondly, by exposing to public scrutiny companies that defend their narrow interests, the example of Coca-Cola is illustrative. An investigation by the CFC found that Coca-Cola was guilty of widespread use of exclusivity contracts in its dealings with the nation's mom-and-pop variety stores. But by filing an endless string of legal appeals, Coke and its distributors blocked any action in the case and the company has not paid the US\$70m fine that the CFC imposed on it. However, a correspondent from an important international news agency took up the story which gained coverage in BBC and CNN and significantly affected the brand image of Coca Cola. The negative impact on the image of the company by far exceeded the fine that it refused to pay. Another important example is the discussion in the Congress over the Competition Bill. There was no debate on economic principles or in relation to the content of the bill, but instead was focused on interests, with Mr Slim wanting to defend Telmex from competition. Lastly, Mr Perez-Motta mentioned the reforms in the airline industry. It was not easy to convince the government to break up Aeromexico and Mexicana and to open routes to low cost competitors, but the results have been very positive to date, with significant falls in tariffs and an increase in the size of the market.

There was a need for institutional change, including the need for independent regulatory agencies, which should be independent from the line ministries, but at the same time they need to be more accountable to the legislative, executive and to the general public. More generally there was a need to eliminate capture of the state by companies and unions. To end, Mr Perez-Motta stated that Mexico was faced with two options. The first was to continue without major changes, which will lead to continued losses of competitiveness, and to adopt policies which address symptoms and not underlying causes. The second option was to introduce competition policy to destroy monopoly power. Australia faced a similar situation some years ago, but the government took the decisive step to increase competition and OECD data shows that as a result economic growth rose by 2.5 percentage points above what it would have been without the implementation of these reforms.

Discussant: Guillermo Perry

Chief Economist, Latin America and the Caribbean Region, World Bank

Mr Perry framed the discussion by asking which of the problems that Mexico faced were common to other Latin American countries and which were specific to Mexico. The findings of a recent World Bank publication, *Poverty Reduction and Growth: Virtuous and Vicious Circles*, is that while growth is key for poverty reduction, poverty itself is hampering the achievement of high and sustained growth rates in Latin America, which remains one of the most unequal regions in the world. The origins of these problems lie in the exclusionary policies of colonial times in most of Latin America and the south of United States. Independence did not radically change these exclusionary policies and institutions as the same elites remained in power. However, there are also important divergences within the Latin American region in the 20th

century. An important question that needs to be asked is why Mexico developed as a corporatist state, something which only occurred briefly in Argentina, and the answer is that it was probably an unintended consequence of the Mexican Revolution.

The sectors in which Mexico diverges most widely from the rest of Latin American are the energy and telecommunications sector. The persistence in Mexico of the oil monopoly reflects the historical capture of PEMEX by the PRI and unions. Given its hydrocarbon wealth, it is hard to understand why Mexico imports gas or why there is not more active oil exploration. This has had enormous implications for the performance of the oil sector and its impact on the economy more generally. Likewise, Mexico has among the highest electricity tariffs of the region, reflecting high costs caused by low productivity. It is not that reforms have always succeeded in other countries, but there has been more progress in terms of increased production and lower tariffs. Turning to telecommunications, Mexico is the only country in the region where the privatization process led to the creation of a private telecommunications monopoly.

The question that this raises is why the transition from a corporatist system to a competitive democratic regime has not led to fundamental change in the energy and telecommunications sector. One explanation is that the transition was not complete and in some respects the power of the state was weakened. However, it could be a question of time before genuine reforms are adopted, especially in the context of growing competition as a result of globalization. There is a clear need for the transformation of political parties, as parties remain clientilistic, without clear programs and are beholden to monopoly and union interests.

Turning to education, union and political party capture in the education sector is common in the region. Public universities in Mexico have the largest research budgets among developing countries, but they produce very little in terms of patents, technology and research. A similar picture emerges in relation to the problems of the social security system. As more than half the population is not covered by social security, there has been increase demand for other social programs which create large incentive problems in the labor market. The only country in Latin America that is in the process of addressing this issue is Chile, with a new proposal for second generation pension reforms. The financial sector was excluded from NAFTA and appeared to be a sector as beholden to the corporatist inheritance as the other sectors mentioned. However, the pressures of globalization and the financial crisis of 1994 created a window of opportunity for reform. It took years for the banking sector to recover from the crisis, which explains in part the low levels of banking credit.

To conclude, Mr Perry raised two questions. When the PRI monopoly ended, there was a rapid process of decentralization. Future research needs to take account of the impact decentralization has had on equity and competition. In the case of Colombia, the evidence is mixed, with increased rent capture in some instances by municipalities and state administrations, and in other cases there has been increased competition. A second question is to what extent drug trafficking has increased corruption, strengthened capture, increased inequality, and weakened institutions. This occurred in Colombia, and future institutional analysis in Mexico should look into this issue to see what impact this has had.

Questions and comments

A participant asked what characteristics social actors and institutions should have in order to help government to solve conflicts, such as those currently occurring in Mexico, which reflect inequality.

A participant commented that several panelists had mentioned the importance of information. However there is more and more information available in the public domain, but this maybe makes people analyzing such information. At the same time, there is a selective use of information, and individuals only turn to information that supports their arguments. Contrary to what Mr Elizondo argued that the agenda of Andrés Manuel López Obrador was not so much about inequality but about poverty. Many Mexicans have unequal access to services such as health care and education without being poor and so his agenda was much narrower than the inequality agenda. The participant asked what proposals the panelists had for dismantling existing monopoly and union interests, which are closely connected with political parties, so that a consensus develops around the need for reform, even if there will be losers in the process. Finally, the participant wanted to know what can be done so that public policies are adopted that take a long-term horizon.

A participant commented that unions have a strong veto power on reforms in general and not only labour reforms and wanted to know if this reflected Mexico's historical corporatist legacy.

A participant stated that decentralization had taken off since the 1990s, but that the criteria for decentralising were based on "centralist" principles, with this being discussed at length in a recent World Bank publication on decentralization. An interesting new development has been the emergence of the national governors conference, the Conferencia Nacional de Gobernadores (CONAGO), as a state-level institutional counterweight to federal powers. What also needs to be looked at is decentralization at the municipal level and how it can sometimes impede regional development, as each municipality wants to build sections of a highway, but none is prepared to spend on the highway that connects the various parts.

Mr Noll commented that the choice is not between no judicial review or the existing *amparo* system. Business policy in Mexico should have as one of its highest priorities judicial review, so that it moves away from formalism towards substance. Mr Elizondo's explanation of the legal origins of this problem was correct: at that time of the Revolution the prospects for a stable democracy depended upon the wealthier class having some assurance that they would not be expropriated. The *amparos* at that time served that function, but the reality at present is that it has gone so much beyond that due to judicial formalism. What is necessary is to articulate the functions that judicial review performs and create a legal definition of what expropriation actually is. Expropriation needs to be understood as forcing firms to earn less than the competitive rate of return, as opposed to protecting monopoly rents. Judicial reviews also need to protect an entity against random decisions and against all the organized interests and regulators getting together and making decisions that work against the unorganized interests. This would provide the baseline for a reform of judicial review that would move in the direction of protecting the interests that judicial reviews ought to protect and doing so in a substantive manner and not in a legalistic-formal manner.

A participant commented that the energy sector in the past was used for economic development and not for crude oil exports, as took place since the 1970s. The oil rent was supposed to be used for promoting economic development and to industrialize the economy. However, what has happened under the neoliberal regimes is to use the oil rents for financing current spending and not for economic development.

Mr Walton asked under what conditions there could be a successful transition. Examples of institutional breaks in Mexico include the decision to make the central bank independent and post-1997 financial sector reforms. In both cases, there was a generalized recognition on the part of the political elite that past policies had failed and the economic elite also believed that the reforms were in their interests. The question then is how the recent polarization and close election can show the economic elite that it is in their interests to accept reforms and thus lead to a realignment of interests that will bring about reforms and a move to a virtuous circle of growth.

With regard to *amparos*, Mr Elizondo stated that there is an obvious a need for judicial review, but not in the manner that it exists at present in Mexico. An important difference between Mexico and Spain or US is that in Mexico there is a continuous debate about the constitutionality of laws rather than asking if judicial decisions are right or wrong. For example, on taxation issues, the main difference between Mexico and the US is that American courts will not debate the constitutionality of a tax rule, but whether it is being applied in the right manner. There is therefore a clear need to move to a judicial review system so that is reasonable, without that margin of excessive protection that currently exists.

The specificity of Mexico relates to energy, both in the oil and electricity sector. Luz y Fuerza del Centro produces low quality electricity, which is subsidized and expensive. These subsidies exceed the total budget of Mexico's two largest public universities. The reasons behind this lie in the history of unionization, the fragility of the government in the face of union mobilization in the energy sector and to the legitimacy of working in a sector with high historical resonance as a result of the past nationalization of oil assets. As a result, the mere thought of privatization prevents any attempt at even partial reforms. The fact that energy assets are publicly-owned is akin to the position of the queen in the United Kingdom, where it is not clear what the function is, but she remains a powerful symbol, making it difficult to reform the institution of monarchy.

The education sector in Brazil performs worse than in Mexico. However, what is striking about Mexico is that it performs poorly across all social strata, as education in Mexico is about networks and social circles of influence. There is also a serious difficulty in Mexico for companies and universities to establish successful partnerships, perhaps because of the limited need for this given alternative sources of funding.

The party system is extremely difficult to reform, given the high rents that can be captured once a politician gets into power. One possible reform would be to limit expenditure on electoral campaigns. This would not require a legal reform, but simply for the electoral commission, the Instituto Federal Electoral (IFE), to define differently campaign finance contributions. It has not been able to do so to date due to political pressures from the parties.

One of the fundamental reasons why it was possible to reform the financial system was because there was no clear loser. The problem with the other reforms is that there is a clear loser, which makes it much harder to get a consensus for reform. The recent polarized elections open up a window of opportunity and could make the privileged elites realize that to protect their own class interests, there is no need for specific groups within the elite to have special protection. This would be the only way to break the existing equilibrium.

Mr Perry commented on the subject of state-owned assets. Although theoretically state-owned companies are the collective property of the nation and should take these interests into account, in practice this has not been the case in Latin America. An example that comes to mind is the banking sector, as publicly owned banks have been the first to crash during financial crises. This does not mean that public development banks do not have a role to play in economic development. Mexico's development banks are now much more focused on growth and have adopted a new set of practices which means that they are likely to play a more positive role than in the past.

Session 6 Social Security Reforms in Mexico

Speaker: Santiago Levy

Economist

The subject which Mr Levy discussed was Mexico's social security system, within the analytical framework discussed by Michael Walton and Luis Felipe López-Calva in their presentation, where a connection was made between rent-seeking behavior and the impact of such behavior on productivity and economic growth. The topic is thus not only about income distribution, but also about the concomitant negative impact of such rent-seeking behavior on productivity and economic growth. In the case of social security, Mr Levy wanted to show how a social security system that doesn't work well has an impact on labor productivity, on company behavior, and depending on how such a system is financed, can also affect public investment and economic growth. The second part of the presentation looked at the relationship between rent-seeking behavior and the poor functioning of the social security system, focusing on the impact of such behavior on retirement savings and the Administradoras de Fondos para el Retiro (Afores) or the retirement funds administrators, which are private companies authorized by the Secretariat of Finance to manage individual retirement accounts.

Mr Levy then briefly presented a simplified theoretical model to identify the equity and efficiency effects of social security. Let us assume that a company operating in the formal sector needs to hire workers for wages w_f and pays social security contributions T_f , which include health insurance, work-risk pension, disability pension and life insurance, retirement pension, day care and sports and cultural services and housing. On the other hand, the utility that the worker derives can be less than what the company pays. A worker's utility can be expressed as $U_f = W_f + \beta_f T_f$, where β_f can take a value between zero and one and captures the valuation coefficient a

worker attaches to social security benefits. If this coefficient has a value of less than one, this means that the worker does not fully value the benefits of social security and there will be a wedge between what the formal firm pays and what the worker receives. If β_f is less than one, then a wedge, equal to $(1-\beta_f)T_f$, develops between what the employer pays to hire a worker in the formal sector and what the worker receives. This is equivalent to a tax on formal employment, and can be interpreted as an indicator that the social security system is not fully valued. The value put on such services by formal sector workers will depend on the quality of health services provided by the Instituto Mexicano del Seguro Social (IMSS), the retirement pension associated with Afores, housing provided by Infonavit, among other social security benefits.

The coefficient β_f is a complex number, because it represents the valuation of all social security benefits, as these are bundled together and a worker cannot choose to forego a particular benefit. For a worker earning two minimum wages, the cost of social security contributions is equal to about 30 percent of the salary. This implies that the productivity of the worker must be 30 percent higher than his wage if he is to be hired by a firm operating in the formal sector. In an economy which has both formal and informal sector employment and the social security system does not work efficiently, then if β_f is equal to one the labor market equilibrium is such that the labor productivity of workers with similar characteristics is the same in both the formal and informal sector. However, when β_f is less than one, the informal sector expands, formal sector employment falls, the average productivity of workers falls and the gap between productivity of formal and informal sector workers increases. It is important to highlight that what happens in the formal sector will have an impact on the informal sector, as workers can move from one sector to another.

Apart from the impact on employment, the poor functioning of the social security system means that there is an incentive for firms and workers to evade social security contributions. There are only 13 million workers affiliated to IMSS, while the number of workers who evade the system are 8 million. Likewise, there are over 1.5 million firms that do not pay IMSS contributions. But because the probability of such evasion being detected and fined increases with the number of workers that are not registered, evasion is mostly concentrated in small and micro firms. Therefore, aside from reducing coverage of social security, evasion also affects firms' size, with some firms finding it profitable to keep small in the informal sector, while reducing the possibility of exploiting economies of scale, improving access to formal credit, and more generally, to innovate and invest in training their workers. These are some of the dynamic productivity costs associated with evasion. This has dynamic productivity costs, and it is easier to evade if one is a small company, which creates a marginal tax based on company size.

Mr Levy then presented two reforms to the Mexican social security system, which have had as their objective to raise the coefficient β_f to one. The main feature of the new Social Security Law of 1995 was the replacement of a defined benefit pay-as-you-go retirement pension regime by a defined contribution pre-funded regime for all workers affiliated to IMSS. An important operational characteristic of the new regime was that workers' retirement savings would be deposited in individual accounts administered by private financial intermediaries, Afores. Due to lack of competition, the Afores have generated significant income from commissions, so much so that in the last eight years Afores' income from commissions has exceeded government subsidies for workers. These subsidies were supposed to ensure that final pensions would be

higher for workers than what would have the case with only their contributions. However, since the start of the reforms the full amount of government subsidies to workers' retirement savings have been absorbed by Afores commissions. Mr Levy then turned to calculations of the real annualized net rate of return on savings in the Afores over 1997-2005. These have been very low, under 2.1 percent, which is significantly below the return of alternative saving instruments. Over the last few years legal reforms and regulatory measures by the regulatory agency, the Comisión Nacional del Sistema de Ahorro para El Retiro (CONSAR), have sought to increase competition and reduce Afores' commissions. As competition intensifies lower commissions will probably imply lower monopoly rents to the Afores in the years ahead, although little can be done about the monopoly profits realized over the last eight years. This example shows how rent-seeking behavior, lack of competition in a transition process and high income from the Afores led to suboptimal outcomes.

Before turning to the pension reform of 2004, Mr Levy provided an overview of IMSS as an institution. IMSS is not only the social security agency, but also acts as the main provider of medical and other social security services. For its own workers, IMSS has a separate pension regime, labeled Régimen de Jubilaciones y Pensiones (RJP), negotiated by SNTSS (IMSS union) and IMSS directors with no need for approval by Congress or even IMSS's board of directors. This institutional arrangement generates profound incentives or moral hazard problems as IMSS is a public agency whose liabilities have an implicit guarantee from the federal government, implying that bankruptcy does not occur when the organization's net worth is negative. The bargaining process takes place under a legal framework that assumes symmetry between parties, but as IMSS is a health service provider to around 40 percent of the population, making a strike a potentially catastrophic event, and that there is no creditable bankruptcy threat, this generates an asymmetric bargaining situation with negative effects on the outcome. The pension of IMSS workers and IMSS affiliates are markedly different, with the former having much lower years of service, lower retirement age, and with a large part of pension income not financed by worker's contribution. This means that IMSS workers benefit from a large RJP-rent. As a result of these generous pension benefits, IMSS has a negative net worth, although even this information was only made public in 2002. The liabilities associated with the pension benefits for IMSS workers have had far ranging implications. For example, there has been sharp decline in the provision of medical infrastructure—measured in terms of medical centers and number of hospital beds—as more and more of its funds are going to paying the pensions of IMSS workers.

At the initiative of Congress, the Social Security Law was reformed with the objective of making IMSS fully fund the RJP obligations of new entrants and to do so without using IMSS resources. The implication of the 2004 reform is that IMSS can no longer hire a new worker without renegotiating the labor contract with the SNTSS; and at the time of such renegotiation it could not longer sign that contract unless the RJP costs of new workers are fully borne by these workers. The reform was important because it was the first reform that affected public sector workers, as the 1995 reform was for private sector workers. However, it is important to note that the reform allowed IMSS to continue to use its resources to pay for RJP obligations of existing IMSS workers, leaving their rights untouched. In the renegotiation of the labor contract in 2005, a pay-as-you in reverse was created, in which existing IMSS workers will subsidize the pensions for those who are just entering as new IMSS workers, and not those who are retiring. As a result, even the reformed system is clearly unsustainable financially.

The rents associated with the behavior of the Afores and SNTSS reduce the value of social security benefits for formal sector workers, as the return on forced savings are low and IMSS channels increasing amount of contributions to finance pension liabilities. The 1995 and 2004 reforms are an improvement when compared to the earlier the pay-as-you-go retirement pension system which was clearly unsustainable. However, transitional rents were created during the process of reform and the question that needs to be asked is why this occurred. The answer to this question is mainly institutional. For one thing, both Congress and the executive have not followed a clear agenda aimed at improving the social security system. Secondly the social pressure to improve the system has not been strong, especially as there are alternatives to in-depth reforms that appear to be lower cost policy option. In addition, informal sector workers benefit from social protection programs, such as pensions, health insurance, day-care, at no cost to them. So in addition to the tax on formal sector work mentioned earlier, there is an implicit subsidy to the informal sector that increases the attractiveness of the informal sector, and will widen the productivity gap between the formal and informal sector, lowering productivity and encouraging work in the informal sector. Since 2003, there is more public expenditure on social protection than on social security programs. The expansion of social programs has been by financed by using the oil rent instead at the expense of public investment, which is another channel that reduces productivity and growth. As a result of these trends, there is an increasing divorce between labor productivity and their quality of life.

Echoing the institutional analysis presented by other panelists, Mr Levy interpreted what has occurred in Mexico using Albert O. Hirschman's ideas of exit and voice. The basic idea is that members of an organization, whether a business, a nation or any other human grouping, have two possible responses when they perceive that the organization is demonstrating a decrease in quality or benefit to the member: they can exit (withdraw from the relationship); or, they can voice (attempt to repair or improve the relationship through communication of the complaint, grievance or proposal for change). If voice is weak, that is to say if workers and firms have imperfect information over the causal factors behind β_f being less than one, rent seeking behavior is likely to continue. This is accentuated if exit, understood as a move to the informal sector, is made easier or is subsidized. This is a bad equilibrium, with high inequality and low productivity as outcomes. To move to a good equilibrium characterized by low inequality and high productivity, two things need to happen. Voice needs to be strengthened and exit needs to be made more expensive. This would require extending the social security system to everyone, reducing the commissions of Afores, reforming RJP pensions, and creating more transparency, information, accountability and representation in Congress. It appears that the only way to make exit more costly is for the Executive and Congress to raise the cost of exit by internalizing the costs of the oil rent.

Discussant: William Maloney

Lead Economist, Office of the Chief Economist for Latin America and the Caribbean, World Bank

Mr Maloney argued that Mr Levy's presentation made two broad sets of ideas. Firstly, the cost of social security in Mexico is high, as a result of Afores' commissions and union power. In addition, the social security system is being financed by lower worker welfare and by borrowing from future generations as a result of lower public investment and use of the petroleum rent. The second is the issue of exit through informality, and how social protection policies provide a subsidy to informal sector employment and blunt demands for reform. Although both issues are distinct, they are closely linked. A forthcoming World Bank study shows that Afores's costs, expressed as equivalent fees over assets, are falling but remain high in relation to other countries in Latin America. If left unreformed, by 2025 the resources for IMSS health expenditure will fall to zero, as all of IMSS's income is used to finance RJP obligations.

Mr Maloney first comment to Mr Levy's presentation was whether the correct labor model was used when discussing exit. In the traditional model of a segmented labor force, rigidities in the formal sector, such as a minimum wage or a union induced wage premium, lead to workers being rationed out of the formal sector. In this case, social protection to help rationed out workers is positive, as this is offsetting some of the distortions coming out of the rigidities, and does not affect the movement from workers from the formal to the informal sector. But if instead workers choose between sectors in a more integrated labor force market, then informality becomes an exit option. Evidence suggests that 26 percent of unskilled workers and 9 percent of skilled workers quit, of which 85 percent are quits. In addition, about 70 percent enter self-employment voluntarily from the formal sector, suggesting that the labor market in Mexico is more integrated than segmented and somewhat similar to US labor market. This is in line with a number of studies which suggest that Mexican informal workers choose to avoid social security contributions, and there is evidence of this for the Chilean and Brazilian labor markets. Voluntarily exit to informality still implies two dimensions of exclusion. For one thing, the logic is most applicable to poorly educated workers, who have unattractive options in the formal sector, who have high turnover which means the coefficient β_f is less than one with respect to pensions. In addition, voluntary abandonment of benefit packages leaves workers vulnerable, as there are no adequate substitutes to health care coverage in the formal sector.

Mr Maloney then turned to his second comment, which is concerned with gauging the importance of the exit option. Exit option is not only the result of a poorly designed social security system, but can reflect poorly designed labor legislation. It may be impossible to get β_f to equal one for a number of reasons. For example, in Chile only 7 percent of self-employed are enrolled with the Administradoras de Fondos de Pensión (AFP), the private pension managers, suggesting that workers are myopic and can undervalue social security benefits. In countries where there is an absence of strong reciprocity due to low levels of social capital, workers will try to free-ride on others to finance the provision of public goods. These examples suggest that it may be necessary to separate social security benefits from taxation from labor markets. As mentioned by Mr Levy, there are additional productivity costs associated with the social security system, with less firms acceding to the formal sector, particularly for smaller companies. There is also less training in the formal sector, as the training is lost to a firm if the worker quits. In addition, companies may pay efficiency wages to prevent workers from exiting, which cause

additional distortions on the economy. Simulations suggest that a 30 percent pure tax on formal worker can lead to up 9percent of workers moving into the informal sector, which is a large effect. Simulations on the impact of replacing labor tax on the first minimum wage with value-added tax (VAT), providing investment is excluded from VAT, suggest that there can be a 1.5 percent decline in informality and reductions in income inequality as measured by the Gini coefficient.

Mr Maloney then presented his final thoughts, addressing the issue of how to reduce rent-seeking behavior in Mexico's social security system. The information issue is a key factor to get unions to see that reforms are in their own interest. If the government says that there will not be adequate financing of health care because of rising expenditure on IMSS pensions, this could make workers realize that there is a large cost to existing rules and regulations. Hardening the budget constraint is significant, and this has already happened with the reform to the funding of IMSS worker pensions. It may take a Margaret Thatcher like figure to take a firm stand to not give in to special interests when attempting to reform the social security system. There is also an important need to emphasize that such monopolistic behavior in Mexico is not limited to unions, and that changes are necessary across a wide range of economic actors. Privatizations have had bad press because in the past the government transferred monopoly rents to the private sector. This makes the case for privatizing the social security system less feasible politically. To end, Mr Maloney echoed the view of the recent Mexico survey in *The Economist* magazine, which had as its title 'Time to Wake Up'. There seems to be a lack of urgency in Mexico to implement far reaching reforms, which is dangerous, especially as China is looking at all the markets that Mexico is in, making it even more necessary to undertake far reaching reforms across a wide range of sectors.

Questions and comments

A conference participant raised the question of what can be done to reduce the commissions charged by the Afores and thereby increase the returns on savings accounts, without adversely affecting the financial viability of Afores. The issue appears not to be one relating to the number of firms in the market, as there are already twenty-one Afores.

A conference participant agreed with Mr Levy's argument that it is necessary that the government internalize the opportunity cost of using oil rents for social security expenditure, as well as the use of the oil rent to finance other public expenditure. The participant asked how this could be achieved in practice.

A conference participant commented that it would be interesting to include in the concept of exit not only the workers who leave the formal sector to join the informal sector, but also the large number of Mexicans who leave the Mexican labor market and migrate to the United States.

A conference participant asked both Mr Levy and Mr Maloney a question relating to voluntary exit. Social protection or any policy that reduces β_f will stimulate voluntary exits from the formal sector, and this will have unintended adverse effects on the informal sectors, as higher supply of informal sector labor reduces informal sector wages. It is clear that the level of productivity and

human capital of informal sector workers will remain low, so the question is why unproductive results occur in a dynamic labor framework.

Mr Bourguignon commented that the issue of social security reforms was a central one and that he wanted to make two observations. Firstly, although Mr Levy stated that there are free social security services offered to workers in the informal sector, Mr Bourguignon clarified that this is indeed the case, but only for poor informal sector workers. The positive aspect of this is that it represents a transfer to the poor, but the negative side is that it can generate additional disincentive effects that can be large. For a worker the choice is not only between choosing between the formal and the informal sector, but also of making sure that any job in the informal sector does not exclude one as recipient of free social services. Mr Bourguignon's second observation was that the natural conclusion of Mr Levy's analysis is that the only way to reduce the differences between formal and informal sector work is to offer the same package of benefits to all, financed by a value-added tax (VAT). This would reduce formal sector labor costs and would increase the overall efficiency of the labor market and hence the economy. It is important to have this as a long-term objective for Mexico.

Mr Perry commented that the data used by Mr Levy revealed that the net worth of IMSS is negative when pension obligations are included in the analysis. Excluding pension obligations, IMSS's net worth is positive but is declining over time. The question is what is driving this process. Mr Perry commented that the solution to the problems in Mexico's labor market is to have universal social security coverage financed from general taxes. For this to be financially viable, one has to define a minimum social security package, be it for health care or pensions. The second observation related to Mr Levy's observation that negotiations between public firms and unions are biased in favor of unions because public sector firms cannot become bankrupted. However, Mr Perry argued that there is no reason for this to be the case and that ultimately the decision to allow a public sector entity to go bankrupt depended on a government decision. As an example he cited the case of Colombia, where the agrarian bank, the public telecommunications company, and the pension institute have been liquidated. This does not mean that the government does not assume the pension liabilities of the liquidated institute, but it does mean that workers which received excessive rents lost jobs. If Colombia could do this, then this suggests that this possibility cannot be excluded for Mexico.

Mr Elizondo commented that he was rather discouraged by the fact that the reform of IMSS, which was easier to do, had not worked as initially planned, and this despite it having an excellent director at the time and despite the incentives of the different actors to create a space for innovation and change. However, private sector workers lost out to IMSS workers, as they have to work to partly finance public sector worker pensions and ended up accepting a reform that was contrary to their real interests. In other words, in the end it was the smaller and better organized group that benefited the most from the reforms. Mr Elizondo stated that he shared Mr Levy's final thoughts and suggested that he could propose mechanisms to facilitate the implementation of reforms. With regard to the evidence that Mr Levy presented on federal subsidies to social protection and social security programs, Mr Elizondo mentioned that research by John Scott confirmed that government expenditure on social security was more regressive than expenditure on social protection. He argued that it was inconceivable that in the last 50 years a significant fraction of the population did not have a minimum of health benefits. This

raises the question of how you reconcile the provision of a minimum package of benefits without creating the disincentives that Mr Levy explored in detail in his presentation.

Mr Perez-Motta commented that he agreed with Mr Levy's analysis with respect to the Afores. Last week the Federal Competition Commission (CFC) brought out a recommendation on the subject, and as a result it had been widely criticized by those groups who benefit from the existing system, who have accused the commission of not knowing how to make the calculations used in support of the recommendation. However, Mr Levy does know how to do the calculations and has shown in his presentation that there is indeed a problem of excessive Afores commissions, that workers in the last ten years have not benefiting from the existing system, and that the Afores have had extraordinary profits. An important question is whether the trend of falling commissions will continue in the future, and if this is not the case, whether short-term actions should be taken now in order to change the incentive structure to make sure that competition in this sector will lead to greater benefits for workers in the short-term.

Mr Levy thanked the discussants and panelists for their observations. He agreed with the conference participant who mentioned that there is no formal model of the dynamic productivity costs of the existing social security system, but if one takes into account that the movement of workers from the formal to informal sector and vice-versa, caused by the social security system and also by labor legislation, this will reduce investment and innovation on the part of firms, so that the loss in productivity exceeds the negative impact on labor productivity. A fundamental question which needs to be asked is why there are so many people working in the streets, selling contraband goods instead of working in export assembly plants. A related question is what there productivity will be in five years if they continue working in the streets selling contraband.

In relation to Mr Bourguignon's comments that health care is not free for all workers in the informal sector, Mr Levy argued that in the model of the labor market presented, the main point is not that health care is 100percent free for workers in the informal sector, but that there has to be a difference between social security and social protection benefits that are not internalized by firms. The key factor driving the labor market model is the difference between wages and labor costs. With regard to Mr Bourguignon's policy proposal of universalizing social security benefits and not financing this through the labor market, Mr Levy agreed that this was undoubtedly the reform that Mexico should carry out in the future. As Mr Perry mentioned, there is the need to answer a fundamental question: if Mexicans want workers to have benefits which are not tied to their labor status, is the country willing to finance such reforms without touching the oil rent? Mr Levy stipulated three conditions necessary for any successful transition away from the existing social security system: social benefits should not be finance with the oil rent, they should not be made at the expense of public investment, nor should they encourage workers to turn to the informal sector. With these restrictions, it should be possible to develop a transition trajectory that will ensure that no one's utility declines and that labor productivity rises. However, the reform path adopted to date by Mexico has been a costly one, because it is depressed labor productivity. On the other hand, if one waits to have enough funds to finance the extension of social benefits to the whole population, then one would have spent 10 or 11 years of reduced labor productivity, something which has large, negative dynamic costs. As a first step, Mr Levy suggested that it is necessary to start by increasing subsidies to social security benefits in order to encourage workers and firms from joining the formal sector.

Turning to an issue raised by Mr Bourguignon, Mr Levy clarified that in his presentation he excluded the costs of funding existing pensions. The most regressive aspect of social security spending has to do with pensions. In his calculations funds that affect workers who are currently in the labor market were included, but what was excluded was the payment of pension obligations and ISSTE. An important question is the amount of funds the government uses to encourage the formal and informal sectors. Turning to the distributive impact of social protection spending, Mr Levy argued that the redistributive impact was more optical than real. Although such spending goes disproportionately to the lower income deciles, if it is not funded by taxes but by the oil rent, then there is an intergenerational element of redistribution.

Mr Levy then touched upon Mr Elizondo's comment that he was discouraged by the recent social security reforms in Mexico. Exit, as understood by Hirschman, is an easy option and is closely related to the comment about migration to the US, which Mr Levy did not discuss, in part because it reflects differences in labor productivity between the two countries. Undoubtedly emigration is an exit response. To lose about 300,000 Mexicans a year is a national tragedy, especially as many of these are qualified. As the system has these safety valves this generates a poor equilibrium which is not contested and nobody pays directly for this, it persists. Mr Levy then made what he qualified as an absurd recommendation: there should be an article in the Constitution stating that the oil rent should be used exclusively for productive investments. He made this point to emphasize that something needs to be done to internalize the costs of the existing social security system. This is the debate that needs to take place in Mexico. Continuing with the existing policy of increasing the social protection benefits is clearly unsustainable. In addition, as Mr Lajous mentioned yesterday, there is uncertainty regarding future oil production, which means that a system of social benefits has been created on a very fragile foundation.

Finally, Mr Levy addressed the question posed by a conference participant about the Afores rates of return. Depending on the methodology used, the rates of returns in the last eight years can even be slightly lower than what he calculated. An important distinction must be made between what has already happened and what will happen in the future. Given lower commission charges, the rates of the return at present are higher than in the past. For workers who have already been savings for the last ten years, there is a significant loss given the low rates of return. The regulating agency, CONSAR, has done good work, but it is necessary to deal with the underlying problem, which is not limited to the issue of competition. One can conceptualize the retirement savings market as one where there is supply and demand under appropriate and efficient regulation, but Mr Levy argued that it was not clear if this was an accurate description of the market. There is a need for policies aimed at encouraging competition and the provision of more information. It is also important to ensure that commissions do not exceed the marginal costs of providing retirement savings accounts.

Session 7

Equity and Competition in the Telecommunications Sector

Speaker: Rafael del Villar

Research economist, Bank of Mexico

Mr del Villar argued that there is a close relationship between equity and competition, as equity factors play an important role in underpinning institutions that support greater competition. When there are low levels of competition and rent-seeking behavior in economic sectors that are key inputs to the rest of the economy, this imposes high costs on the overall performance of the economy. At heart, the issue that is being debated and discussed in this conference is how to change the structure of incentives in order to reduce rent-seeking behavior and increase innovation. Household expenditure on telecommunications has been increasing in the last decade, accounting for about 2percent of expenditure among the lowest decline. It is important to keep in mind that the telecom sector is no longer a luxury and that household expenditure on internet services occurs across all income deciles.

The manner in which Teléfonos de México (Telmex) was privatized in 1990 is intimately linked to the current structure of the telecom sector. The government's main objective at the time was to maximize the income from privatization and to ensure that the privatization of other firms proceeded as rapidly as possible. However, there was not at the same time an adequate development of regulatory institutions. To maximize the privatization proceeds, the government sold to one group of investors a package which included the two state-owned fixed-line telecom companies, Telmex and Telnor, the only mobile phone concession with a national reach, the federal microwave network, as well as a number of frequency bands. The buyer was allowed to offer all telecommunications services, with the exception of radio and television. The government significantly reduced the tax burden of the newly privatized company by reducing the effective tax rate from 29percent to 10percent.

Prior to the privatization, there was a large rise in tariffs, so that annual revenue per line increased from US\$440 in 1989 to US\$710 in 1990, an increase of 61 percent. At the same time, the government negotiated an increase in labor flexibility and limited for a period of six years competition for long distance national and international calls. The evolution of tariffs shows a significant real rise of 50.3percent between 1998 and 1994, a slight fall of 0.3 percent between 1995 and 1997, and a significant reduction of 29.6 percent between the end of 1997 and 2005. However, these reductions in tariffs have been dwarfed by very steep declines in Telmex's input costs, with, for example, a fall in the number of employees per telephone line of 74 percent for the period 1990-2005. In addition, Telmex's investment as a percentage of total income has been significantly lower than for the telecom sector in other emerging economies. These numbers reveal how the telecom sector in Mexico suffers from lack of competition, as productivity gains are only partly passed on to consumers as lower tariffs.

Mr del Villar then turned to the tariff regulatory mechanism, that formed an integral part of Telmex's concession, which consisted of two components. Firstly, the telecommunications regulatory agency, the Comisión Federal de Telecomunicaciones (Cofetel), sets the level of price

caps for basic services, that is to say, local, national and international long distance residential and business originator calls. Secondly, every quarter Cofetel applies an adjustment factor to the index of controlled services tariffs, to take into account productivity gains. However, there is a fundamental problem to this price adjustment mechanism, as Telmex cost studies, which serve as a basis for calculating the adjustment factor, are confidential. In other words, it is not possible to conduct an independent evaluation of this regulatory mechanism, as only Telmex and Cofetel have such information. This situation is one of a bilateral monopoly, where only the regulator and the firm being regulated have access to confidential information, so that consumers cannot complain about tariffs, as they do not know the underlying costs of service provision. As a result, there is a serious informational problem due to lack of transparency. Economic theory shows that the outcome of negotiations between two monopolists is indeterminate, and in this case it ultimately depends on the negotiation skills of the regulator. With the limited public information available, Mr de Villar calculated that price caps should have fallen by 33 percent in 1999-2003 and by 13.1 percent between 2003 and 06. As a result, annual real tariffs should have fallen by 5.3 percent in 2003-06. As Telmex's tariffs are 9.5 percent below the actual price cap, a 33 percent reduction in the price cap would have forced Telmex to reduce the prices on the basket of controlled telecom services by 24 percent.

Likewise, it has been difficult for the Federal Competition Commission (CFC) to have its resolutions upheld by the justice system. Of the nine formal complaints that CFC has brought against Telmex for monopolistic practices, the commission has been unable to apply any of its resolutions, either because the tribunals have taken a long-time to come to a decision or because Telmex has succeeded in obtaining *amparos*, judicial reviews, which lengthen procedures and even prevent resolving the disputes. The most important case where CFC and Cofetel have lost is in relation to Article 63 of the Federal Telecommunications Law, which states that it is possible to impose special obligations to telecom operators that have substantial market power. Only in 2006 did a district judge decide to dismiss the original resolution made by the CFC in December 1997, arguing that the data used by the commission was out of date.

A related subject is that of consumer protection. Federal consumer protection laws were reformed in 2004, allowing for the first time class action lawsuits. Article 26 of the Federal Consumer Protection Law, which has yet to be applied, states that the federal consumer protection agency, the Procuraduría Federal del Consumidor (PROFECO), can take class action lawsuits on behalf of adversely affected consumer groups. However, PROFECO's role is limited to ensuring that adversely affected groups accredit their status as prejudiced, which in some cases make these class action lawsuits unviable.

Turning to the issue of interconnection between telecommunications operators, Mr del Villar presented evidence of slow fixed-line traffic growth in Mexico. Between 1999 and 2006 fixed-line traffic increased by only 14 percent, with the number of fixed-lines almost doubling, while mobile telephony traffic increased fourteen fold and the number of mobile lines increased seven fold. In the calling party pays system introduced in Mexico in the late 1990s, the call originator pays a fixed fee for calling from a fixed-line to a mobile number, while the call receiver does not pay a fee. Using panel data published by Merrill Lynch from over 45 countries to uncover the determinants of mobile telephony development, Mr del Villar found evidence that the calling party pays system is associated with an increase in tariffs, a reduction in minutes used, and an

increase in mobile penetration. In addition, the number of firms in the telecom sector is statistically significant in relation to income per minute and mobile phone penetration, implying that greater competition leads to lower tariffs and greater usage of mobile phones. The main conclusion of the regressions is that the calling party pays scheme reduces the use of mobile phones in relation to the called party pays scheme. The intuition behind these empirical results is that in the calling party pays scheme there is an agreed interconnection fee paid by the fixed network to the mobile network. There is also an interconnection fee between different mobile operators that is mutually agreed. Evidence seems to suggest that these interconnection fees are not set in a competitive fashion. In contrast, in the called party pays scheme, there no interconnection fees or they are close to zeros as companies compete to push them down.

Mr del Villar then discussed broadband, which is increasingly becoming important and may become the most important infrastructure of this century. It permits the introduction of a wide range of services that have a positive impact on economic growth. There is also complementarity between broadband and internet content provision, so that competition over broadband provision positively impacts on the provision of internet content and vice versa. To the extent that competition reduces the price of broadband, this in turn makes it more attractive to place contents online. If there is monopolistic provision of internet content, then it is in the interest of the broadband provider to make an exclusive agreement in order to prevent content providers from selling content to competitor broadband providers. The same situation can arise if the monopolistic provider of internet content tries to obtain preferential treatment from content providers. This is normal practice, but becomes worrying if both the broadband and content markets are highly concentrated, then these exclusive deals or preferential arrangements can negative impact on the development of the market. In addition, it is not always in the interest of broadband providers to allow unrestrictive access to applications and contents, especially if these compete with their own services, as the case with Voice over Internet Protocol (VoIP). In the case of the US, the Federal Competition Commission (FCC) has prohibited any restriction of access to internet content, but no such ruling has been made in Mexico. What is at stake is not limited to the development of the internet market, but goes beyond this to the significant effect this can have on the productivity and overall competitiveness of the economy.

Discussant: Roger Noll

Professor of Economics, Stanford University

Mr Noll's comments focused on strategic planning in the public sector, using a framework that is similar to a benefit-cost analysis, where one looks at the probability that a reform is going to succeed multiplied by the benefits to society that will arise from reforms, including distributive as well as strict efficiency benefits, and from that you subtract the economic and political costs. Without being an expert on political issues, Mr Noll argued that the objective of the incoming administration should be to make it in the interests of opposition parties to support reforms, because it will aid these parties in their re-election rather than hinder them. Political analysis in Mexico does not give enough attention to this phenomenon and the country is behind in thinking of ways to engage in multi-party, multi-partisan negotiations to come up with reforms. This explains why structural reforms, that is to say the microeconomic side of policy making, is more symbolic than real, is incomplete and produces an infrastructure sector which is among the worst in the world given Mexico's per capita income. Both the energy and telecommunications sectors

are particularly important because they have major linkages to the rest of the economy, determining the structure of industrial investment. High tariffs for electricity and telecoms services have resulted in many industries choosing not to locate in Mexico and to relocate to China, despite the advantages of NAFTA and propinquity. As a result, Mexico is consigning itself to low economic growth and being overtaken by better performing countries.

Turning to Mr del Villar's presentation on the telecommunications paper and how it fits into the strategic planning model, Mr Noll argued that it was of medium level importance because it is doing better than energy and electricity. The threat to the Mexican economy from excessive dependence on oil for exports and public finance, particularly as much of the oil revenue is used to finance consumption instead of investment, is much more significant and oil sector reforms should therefore be of high priority. Likewise, reforming the electricity sector, which charges very high prices, is also of high priority. The robber baron version of social security system that Mexico has is highly negative in terms of what it does to productivity, but also from an equity standpoint. In Mr Noll's prognosis, the oil and electricity sector and social security system should be at the top of the reform agenda. Nevertheless, telecommunications reforms would not be costly and would generate significant benefits and should therefore be undertaken.

Mr Noll argued that the privatization of Telmex was a positive process, as it is better to have an efficient private monopoly than an efficient public one. Since privatization, Telmex has sharply reduced the cost of its inputs, but there has been no concomitant reduction in its tariffs. Such high tariffs make Telmex the most profitable telecom company in the world, measured in terms of profits per line. Telmex is well managed and efficient and as a result costs have dropped sharply, but there is still low usage of telephony given per capita levels, and this is attributable to high usage prices. However, telecommunications technology in the last twenty years, namely digitization, which has led to large productivity gains, means that it is no longer economically rational to price usage per person, as the actual marginal cost of usage is lower than the cost of metering and billing for it. Given these changes, the optimal pricing structure should be one where the marginal cost is zero, which is what major telecommunications carriers are doing in the US and the world are increasingly doing.

An important question is whether legislative reform is needed to address the problems in the telecommunications sector. Mr Noll stated that any attempt at legislative reform is going to be difficult, given what has happened in the legislature in the last 15 years, due to the existence of a three-party system where no one party has a majority. As it is difficult to get a durable coherent majority to make structural reforms, Mr Noll reform proposals for the telecoms sector focused on changes that could be made which don't need legislative reform and will not be stopped by *amparos* (judicial reviews). But before addressing those reforms, Mr Noll argued that there was a great need of creating a judicial review system that actually can cope with problems. *Amparos* are supposed to stop agencies from expropriating capital, and they have done this for Telmex, although not for its competitors who as a result have often had negative returns on investment. A second issue is whether *amparos* prevents regulatory agencies from doing their work. The answer to that is unclear, as there is no information to know whether Cofatel issued an appropriate ruling or regulation, whether it did what Telmex wanted it to do, as it is not allowed to make public the basis for its actions due to confidentiality rules. Such rules mean that Cofitel is forced by virtue of the system it operates in to make its decisions behind closed doors as this is

the only way it access information. The implication of the above is that Mexico's judicial review system needs to be reformed for Cofitel to function properly, but this in turn requires legislative reform.

Mr Noll then suggested four reforms to the telecommunications sector that do not require legislative reform and which would not be likely to lead to an *amparo*. The first is price cap reforms, as price caps are the appropriate mechanism for controlling monopoly prices. There are two problems with the existing price cap mechanism enforced by Cofitel. Firstly, the revision of the price cap formula has been slow and incomplete. Secondly, the price cap no longer acts as a significant binding constraint on Telmex's ability to earn excess profits. In the long-run a price cap is supposed to fall more or less in line with the rate of productivity advances. However, this has not been the case in the Mexico, so that a first step in the right direction would be to ensure that the price cap does move in line with improvements in productivity. In addition, there is a need for the price cap formula to be unbundled by services, so that it is organized according to the degree of competition in the different sectors in order to prevent price increases in monopoly services from cross subsidizing below competitive prices in competitive services aimed at driving competitors out of business.

A second reform would seek to take advantage of a provision in the telecommunications law which envisions extensive resale. In other words, there is a permit as opposed to a licensing system for resale of telecom services in Mexico. For example, if a firm does not want to pay high telecom rates, then it can create its own network or buy its own network. Permission of resale implies that this firm can in turn sell access to this network to other firms. Shared private lines and networks are currently illegal in Mexico, but if allowed they would be a highly effective way of eliminating price discrimination in a telecommunications system that produces more competitive prices for large companies who build their own networks, and charges high prices for small companies which do not have the resources to build or buy their own networks. This is the most important mechanism for making prices for small businesses and residential customers fall significantly. There is nothing to stop Cofitel from issuing such resale permits, but only two have ever been approved.

With regard to the call party versus called party pays problem mentioned by Mr del Villar, Mr Noll argued that the termination fee that a carrier imposes on the calling party but not on the called party means that there is no need to compete on termination fees, but only on origination fees. If one separates the financial cost of the call, with the originator pays for the origination component and the consumer pays for the termination component, then incentives are aligned with pricing and persons will make carrier choices based on both origination and termination prices. This is the way of introducing competition and of reducing prices.

A related issue is the nature of what telecommunications laws requires for concessions. In concessions, telecommunications companies are supposed to list the services they will provide. However, in the last twenty years most of the distinctions made between services is becoming unnecessary. Separating services carried by digital networks does not make sense, as the system is a series of digital signals, and it does not matter whether it is voice, text, or video as these are just bits. Separating out the industry into those who can provide some services and not others is purely a mechanism for price discrimination to benefit the carriers, and has no basis in technical

or economic reality. Instead, the list of services in the concession should be malleable, so that it would be possible for any telecom company to enter into a different segment of the market. Although this was originally envisioned at the time the concession law was implemented, it has not turned out in this way and has acted as an important constraint on competition. A convergence proposal, that is to say, the elimination of concession restrictions, has been discussed in Mexico but it has yet to happen. With regard to the related issue of wireless spectrum, it should not matter whether a wireless carrier provides internet or telephone services via this medium. But if a distinction is to be made between the type of services provided, then it is better to have a spectrum auction which offers multiple bands of spectrum, each of which has to be purchased by a different entity. Wireless technology is substantially lower cost than fixed-line telephony and is the technology of the future, so it makes sense for Mexico to develop it.

There are two important lessons to learn from telecommunications privatizations in the last two decades in developing countries, which is also what came out of Mr del Villar's regression. Firstly, the way to have a low cost, high penetration telecommunications sector is to make it competitive and to make it as unregulated as possible once it has been made competitive. Secondly, in practice no country has succeeded in making the fixed-line segment competitive, because incumbent monopolists always have an advantage. The best that can be hoped for is the existence of a dominant firm operating in a competitive environment. However, the future of telecommunications lies in wireless technology, which with the next generation of technology that is being rolled out, will become the dominant and cheapest technology by 2010. As wireless has virtually no economies of scale, the main issue for regulators is to allocate sufficient spectrum and guarantee that there is a competitive market structure. With wireless becoming the dominant technology, it will not matter if Telmex is a monopoly or not, as its market power will become eroded by its wireless competitors.

Questions and comments

Ms Guerrero commented that Mr Noll had argued that the future was wireless, but asked whether Telmex could capture the wireless market. A second related question is whether there are any lessons from the break-up of AT&T for Mexico.

A conference participant made two comments to complement Mr del Villar's presentation. Firstly, mobile phone operators who have used the calling party pays scheme have made their income highly dependent on interconnection fees. This is clearly a distortion, but the problem is not the calling party pays scheme or the interconnection fees as such, but the charging of abusive interconnection fees. Secondly, Mr del Villar mentioned in his presentation that there are examples of countries where there is no calling party pays scheme and yet there is competition. But there is an example in Mexico itself, as Nextel which is subject to sui generis regulation and does not have a caller pays or called pays scheme and does not charge interconnection fees, yet despite this has become the second largest mobile operator if measured by income. In other words, there is competition at the level of customers, without the need to charge or speculate with interconnection fees. The participant wanted to know if Mr del Villar had studied cases where telecom operators were operating under unequal competition and under different regulatory conditions and nevertheless managed to compete successfully.

Mr Perez-Motta commented that he agreed with Mr del Villar's view that part of the problem of the telecom sector in Mexico originated with the privatization of Telmex. Although tariffs have declined, large productivity gains in recent years have not been passed on to consumers, and an important question that needs to be asked is how much these tariffs would have fallen if there had been competition in the market. To date, all importing CFC rulings against Telmex have ended up in the courts, and the commission has lost a number of litigations. The one event that gives some hope for the future is the unanimous approval of important amendments to the Federal Law of Economic Competition in 2006. With regard to content and given expected convergence in the future, CFC will be issuing a ruling that will seek to avoid the displacement of downstream players by content providers. This is an important issue, as the television network Televisa, is a large content provider and distributor, and has incentives to displace competitors.

With regard to the four proposals made by Mr Noll, Mr Perez-Motta wanted to comment on the one relating to the wireless market. In 2005 the Secretariat for Communications and Transport made an unfortunate decision which went against an earlier decision made by Cofetel aimed at encouraging competition for the distribution of spectrum frequency. The Secretariat decided to reserve a significant fraction of frequencies for the state and to probably make a not very transparent usage of such frequency. After months of discussions, this rule was changed and mechanisms favoring competition in spectrum distribution. If the right policies were adopted in Mexico, something which is not that likely, then it could be possible to operate a significant turnaround of the telecommunications sector, as technological changes are moving in the right direction. In the coming years, it would be possible to see a sector where four networks are competing actively: the electric network, the cable network, Telmex and wireless. If Telmex does not buy the electric, cable and wireless networks, a more competitive system could be in place that would benefit consumers.

A conference participant wanted the panelists to comment on the possible spillover effects of technological changes, which could be used to leapfrog the development process and to break up the monopolistic power of energy and telecom companies.

A conference participant mentioned the issue of tax collection in relation to the high earnings generating by the telecommunications sector. Telecom conglomerates consolidate their earnings, so that loss-making firms do not pay taxes. However, important information is lost in the process which could be of significant value. Likewise, personal income tax could provide information of relevance to the tax authorities and CFC.

A conference participant argued that Mr Noll hit the nail on the head when he stated that there was a lack of political analysis over the subject of creating pro-reform coalitions. No analysis had been made that attempts to link the existence of legislative coalitions and presidential leadership to key reform issues in Mexico. This would require studying what it would take to develop winning congress coalitions and a pro-active president that goes public with the reform agenda and openly criticizes the opposition for delaying reforms.

Mr del Villar commented that his analysis did not focus on Nextel, which is the operator that has the largest income per subscriber in the Mexican market and is also the second largest mobile company. Referring to Mr Noll's comment on the opportunities generated by new technologies,

he argued that indeed this could lead to important changes in the structure of the telecoms market, even if in the past radio spectrum auctions did not open the market to increased competition. Spectrum that was initially allocated to different operators was later consolidated, with adverse effects on competition, and the same could occur in the future with respect to WiMax, the standards-based wireless technology that provides high-throughput broadband connections over long distances and is a newer standard of wireless networking designed to provide the last mile of high speed internet access to the end user. However, with the open access Wi-Fi standard, there could be an interesting opportunity to open up the market.

Turning to the question of whether power line communication, a term used to describe several different systems for using power distribution wires for simultaneous distribution of data will be used in a competitive fashion by operators is an important topic. It remains unclear in Mexico whether the main electricity operators, the Federal Electricity Commission (CFE) and Luz y Fuerza del Centro (LFC), will make use of such telecommunications technologies. This is a decision that has not been made to date, but if and when such a decision is taken, it will be necessary to think of how these business units will be administered, whether as separate or parallel entities.

With regard to the role of the treasury, it is clear that it plays a central role in the definition of the telecommunications market. For instance, there have been inconsistencies in bandwidth charges for radio spectrum. Bandwidth tendered in the 1990s was exempted from the payment of such charges, and as a result there has been arbitrage, with operators who have frequencies which do not pay charges using the bandwidth exempt from such additional costs. This has also led to a hoarding of frequencies in order to prevent competitors from entering the market, and here the government could step in order to encourage the use of these bandwidth frequencies.

Mr Noll answered the question about whether there is a risk that Telmex will capture the wireless market. It has already done so under the current regulatory regime. The solution to this problem would require the adoption of an unbundled price cap mechanism, where all the various forms of interconnection are in a separate price cap bundle that are priced based on productivity gains. This would undermine Telmex's ability to use increased interconnection prices to eliminate competition. Telmex could also capture wireless by capturing the content market, if it struck deals with video content suppliers and thus developed a shared internet monopoly. The CFC would need to step in to prevent this from happening.

The lessons of the break up of AT&T for Mexico are probably not relevant any more. The reformation of AT&T that is now occurring is nowhere near as significant as it would have been twenty years ago because there are many more competitors in the sector. It also does not compare with the market power of Telmex and its mobile subsidiary, Telcel.

Focusing on new technologies in the last mile should be thought as the coming method of access for a variety of services. Wireless is the dominant technology for access and what is necessary is to prevent Telmex and Telcel combined from controlling wireless, then there can be a competitive last mile market.

The minimum legislative package that the new administration could go for would start with a reform of Cofitel so that it has power to gather information and make such information public. This would also require making it a statutory agency with standard powers in line with those of regulatory agencies in other countries. A key second reform would be to change the *amparo* system.

Session 8 Implications for Policy Design in Mexico

Speaker: Danny Leipziger

Vice President and Head of Poverty Reduction and Economic Management Network, World Bank

Mr Leipziger attempted to link the topics discussed in the conference, equity and competition, with the objective of the independent high-level Commission on Growth and Development. Established in April 2006 with the support of World Bank President Paul Wolfowitz, the Commission will, over a two-year period, deepen the understanding of economic growth for development and poverty reduction. The Commission will be chaired by Nobel laureate Michael Spence, former Dean of the Stanford Graduate Business School, with Mr Leipziger acting as the Commission's Vice-Chair. The Commission is looking at how to sustain economic growth and to accelerate it is a main driver of poverty reduction.

A recent study by the World Bank has compared per capita income levels of three groups of countries between 1900 and 2000—the eight largest Latin American countries that have reached middle-income levels (Brazil, Mexico, Argentina, Colombia, Peru, Uruguay, Venezuela, and Chile), five East Asian economies that have reached high-income levels (Japan, Singapore, Hong Kong [China], Taiwan [China], and South Korea), and the five middle-income countries in East Asia (China, Indonesia, Thailand, Malaysia, and the Philippines).³ There have been two noteworthy developments that these regional per capita comparisons bring to light. The first is that by the mid-1960s, while the range of incomes differed considerably between the two groups, the average per capita income of the “Latin America Eight” was roughly the same as that of the “East Asian High Income Five”—an average of about \$5,000. The second is that by 2000, the “East Asian Developing Five” had caught up with the Latin America Eight, whose average per capita income had not changed much since the 1970s.

It is logical for policy makers to ask what the five Asian leaders did to successfully transit through middle-income stages of development, and what the Latin American countries did wrong. Clearly, there has to be the desire to implement economic reforms to accelerate the pace of growth as this acceleration in growth did not happen casually. Secondly, there is a need to produce for the world market, with exports playing a crucial role in accelerating economic growth. Thirdly, the import of new technologies is critical to raise total factor productivity (TFP) growth, whether this be through foreign direct investment or joint ventures. Fourthly, successful

³ World Bank, *An East Asian Renaissance: Ideas for Economic Growth*, September 2006.

economies have been able to evaluate their policies and have been able to make quick adjustments to the policy framework along the way. Fifthly, the Asian experience shows that there is broad support for policy reforms if benefits from high growth are perceived to be widely shared and not limited to benefiting only one particular group. Lastly, these economies have used competition in a variety of ways to sustain innovation and competitiveness.

Research undertaken by the Commission on Growth suggests the importance of leadership and vision on the part of governments successfully implementing reforms. It also finds evidence of the importance of churning, that is to say, the need for entry and exit from markets, which is a Schumpeterian vision of markets which presupposes significant levels of competition. Thirdly, there is a need for policy coherence, as developing and sustaining a coherent policy framework is not about getting only one policy reform right. Lastly, research highlights the importance of national consensus around economic goals, which is important for political economy reasons, in order to ensure that reforms are politically viable and for intergenerational distributional reasons.

Turning to Mexico, the early benefits of NAFTA have worn off and China's share in US imports overtook Mexico's share in 2000 and since then China's share has continued to rise while that of Mexico has continued on a downward trend. Moreover, this loss of market share in the US has occurred in nearly all product categories. This is a worrying trend as 87percent of Mexico's exports are destined to the US market. Productivity in export- oriented assembly plants, *maquiladoras*, has stagnated in the last decade, and this in any case is a low-value added, low productivity export sector. The fastest growing markets are in Asia and Mr Leipziger argued that it makes sense for Mexico to diversify its trade flows to take advantage of global production changes and opportunities. Secondly, service prices are high in Mexico and energy will be a growing problem in the future, while expenditure on research and development as a percentage of GDP is low. Some of these problems require improved regulation, while others require greater public spending. Although increased public expenditure in infrastructure and human capital is necessary, adopting policies aimed at increasing competition may be the first signal required to show that there is a genuine commitment to change the status quo.

To conclude, NAFTA was not the silver bullet that Mexico expected it would be, with most of the benefits of the trade block exhausted in less than six years. Countries that have achieved high TFP growth, and hence high economic growth, such as Ireland, Finland and South Korea, did this by spurring competition. In whatever form it shows up, competition is a driver of higher economic growth. There is therefore a need for concerted action across a wide range of policies to change the current situation in Mexico which is characterized by low growth. Although the Latin American region has solved its macroeconomic problems, it has not solved microeconomic issues that have acted as binding constraints to economic growth. Convergence with the US is possible, if TFP growth accelerates and if economic growth rises above 3percent . TFP growth in the 1980s and 1990s was negative and currently stands at only 1percent. If it continues with its current pace, Mexico will not catch up with the US and in 2030 the gap in the per capita income will be almost as large as at present. However, if Mexico implements far ranging reforms it could double TFP growth to 2 percent, like South Korea's TFP growth rates in the 1990s, and it will then be able to keep up with emerging economies like China. Finally, if TGP growth accelerated to 3percent, which is what Finland achieved, then Mexico could narrow the gap between its per capita expressed as a share of the US per capita, from about 24 percent to 40 percent. But unless

economic growth accelerates beyond 3 percent, there will not be much convergence with the US, nor will income distribution change significantly.

Speaker: Isabel Guerrero

Country Director Mexico and Colombia, World Bank

Ms Guerrero stated that the conference had been a very interesting one to participate in, especially as the same problems seemed to affect sector after sector. Turning to what one could take away from the conference, Ms Guerrero mentioned that Mr Ragan's opening remarks confirmed that countries that are more unequal grow more slowly. In the oil session, Mr Lajous presented evidence that the crisis that PEMEX will face in the future is much worse than what she was aware of. Although it remains unclear whether the banking sector is oligopolistic or not in Mexico, there is evidence of recent progress which suggests the sector is moving in the right direction. In the session on institutions Mr Elizondo mentioned that the institutions created in the past in Mexico were built for a PRI dominated corporatist state, and that these institutions do not work in the context of a changed political landscape. Dispersion of power after the end of the PRI reign has made it more difficult to control interest groups and institutions and rent-seeking groups have worked to protect the benefits derived from the corporatist era. The session on the social security system revealed that IMSS spends more on its pension obligations than it does on providing services. Mr Maloney mentioned that these social security costs are having adverse effects on public investment, as more public expenditure is used to meet current spending.

The sectors covered in the conference were not exhaustive, and there is the need to extend this type of analysis to other sectors. Sectors that come to mind are agriculture, where subsidies disproportionately benefit wealthier farmers, the judicial system, where there is clear need for reform, particularly with regard to *amparos*. Similarly, education and decentralization are also areas that need to be studied within this framework of equity and competition. Given the poverty rates in Mexico and the need to create good jobs, the country cannot afford to grow at US rates, but needs to grow at a faster pace. Although in recent years rural poverty rates have fallen because of increased social spending, remittances, and rural job creation, urban poverty rates are not changing. Reducing urban poverty rates will require the creation of high quality jobs which needs to be underpinned by an acceleration in productivity growth. The conference also highlights the need for spending more on infrastructure, but also that this requires a competitive environment and not merely more public expenditure. As Mr Noll argued, many reforms can be undertaken which do not require legislative changes. Lastly, telecommunications technology is moving in the right direction and might facilitate needed change to enhance competition. As Mr Maloney mentioned in his comments, echoing the views of a recent The Economist survey, the current situation cannot go on and it is time for Mexico to wake up.

Speaker: Santiago Levy

Economist

Mr Levy decided to structure his comments around five issues. Firstly, it is difficult to understand the current situation if one does not understand that Mexico is a democracy in transition, in which past institutional arrangements helped the country function until the late 1990s. Mexico is now in the process of creating a new institutional framework and this is taking

time, while other countries are quickly moving ahead. If these changes continue to take more time, then there is a serious risk that Mexico will continue to lose its competitiveness. The existing institutional arrangements of political parties, legislators, and the relationship between legislative and executive are far from ideal. However, current practices cannot be understood without realizing that existing institutions sustain the institutional and economic status quo. The lack of institutional support to align incentives for change is a key challenge faced by the country.

A second and related issue is that the reform agenda lacks coherence. There are important unanswered questions, such as what the sequence of reforms should be, how the various reforms are interrelated, and more importantly, what is the systemic logic of the reforms. Answering these questions requires the development of a vision that gives global coherence to a reform framework. The danger with analyzing and proposing piecemeal reforms is that it may make it difficult to justify a proposed path of policy reform sequencing. In addition, the reform process needs to be intertemporally coherent.

A third point raised by Mr Levy is the need to distinguish between the different roles of the state. For historical reasons, in Mexico the state was involved in production, but at present it has a central role in defining competition and as a regulator. The answer to the question of whether the state has an incentive to do a good job as a regulator is no. The Federal Competition Commission (CFC) does not work properly because it faces large constraints. In turn, the systemic failures of the regulatory framework are the result of incentive problems. The institutions built in the 1990s did not address these problems, which is why these problems have not gone away and are now an important part of the reform agenda for Mexico. More broadly, the efficiency in the functioning of the state and the need to strengthen both the state and public administration will be critical for Mexico's future.

Fourthly, Mr Levy stated that substantive progress in reducing poverty has occurred thanks to anti-poverty programs, the principal one being the conditional cash transfer program *Oportunidades*. However, further poverty reduction will not take place as a result of an expansion of these anti-poverty programs. Instead, future reductions in poverty will require increases in productivity, which in turn will require significant changes in the labor market. Transfers are not a long-term solution to high rates of poverty, and it is important to emphasize that poverty reduction policies have to ultimately be connected with production. Despite the above arguments, Mr Levy argued that there is good news. The message from the conference is suggesting that the current equilibrium in Mexico, in terms of institutions and economic outcomes is poor both because it is inefficient and because there are better equilibria which are both more efficient and less unequal. In other words, equity and efficiency go hand in hand in a virtuous circle of increasing equal opportunities and promoting efficiency.

Speaker: Raghuram Rajan

Economic Counsellor and Director, Research Department, IMF

Without being an expert in the topics covered by the conference, Mr Rajan wanted to suggest that not everything is negative in terms of Mexico's economic performance in recent years. The country has maintained macroeconomic stability which is a necessary foundation for economic

growth, and despite dependence on oil for tax revenue, there is also fiscal stability. There appears to be a consensus and strong awareness of the problems that Mexico is currently facing, and the recognition of these problems is the first step required to address them. These structural problems should not hide significant achievements made in years. Health indicators are good, life expectancy is high and close to that of the US, there has been increased public expenditure on education, which is necessary to develop Mexico's human capital. Likewise, anti-poverty programs such as *Oportunidades* have been a success and are now being emulated in other countries. Despite problems with recent social security reforms, the fact that first steps have already been taken in the right direction is good news. Even if there is widespread acceptance that Mexico's economic growth rate is low, it must be recognized that many reforms in the past have not been fully carried out and that more generally, reforms do not always work out at the first attempt. It is important to continue experimentation with reforms, and to not be discouraged by past difficulties.

Mr Rajan was skeptical that rapid political and institutional change can substantially change the Mexican situation. Political and institutional changes are widely seen as magical solutions to existing problems, but the reform gridlock reflects different and underlying structures of power that cannot be destroyed by simply altering legislation. Like Mexico, India has had substantial interests blocking the reform process and the answer to this obstacle has been to step away from a grand vision of where the country is going to, as this generates fierce opposition to that vision. Instead, what has taken place is reform by stealth. An example of this in India was the manner in which the government addressed the issue of excessively high rate of return on provident funds that subsidized public-sector employees. The government made a small reform, reducing the rate by half a percentage point, which in practice did not make a large difference, but it did establish the principle that the rate of return could be changed and made more flexible. Over time, the rate of return was brought down more seriously, taking it much closer to the market rate, which was the original objective. In other words, the opportunity of limited change can create acceptance of the underlying principle of reform. Another example is China's path to reform, which has been called crossing the river feeding the stones. A few reform experiments are established, then if successful, they are generalized to the rest of the country. The argument here is that small opportunities and a number of experiments have merit, but also that each country has to find its own path. Mr Rajan said that he was convinced that Mexico would find its own path, but that it will not be an easy process.

Speaker: Yeidckol Polevnsky

Senator

Ms Polevnsky thanked the World Bank for organizing the conference, especially as its recommendations are often taken more seriously than the views expressed by national actors. The main problem facing Mexico is that of inequity, social injustice and polarization. The solution to this problem lies in generating wealth and jobs, but this in turn requires better regulation and real competition across a number of sectors. It is necessary to increase competition across key sectors which impact on competitiveness; all economic sectors need to participate in this effort, as do firms and unions. The senator then enumerated a series of problems, including the fact that unions are not always democratic in their decision making, that companies often dodge taxes, that government buys services from companies which do not pay

taxes, and political parties have access to too much money. Addressing these issues requires greater competition, transparency and accountability.

Speaking of regulatory agencies such as Cofitel, Ms Polevnsky argued that one needed to ask if the government was interested in making it work properly, given that it was starved of resources. However, a single reform cannot generate a win-win situation globally. The country needs a vision for change, as isolated reforms do not seem to work, and in addition a reform of the state is necessary. Civil society needs to participate more in the reform process, while Congress also has an obvious role to play. In Mexico there is a tendency to think that the government can do everything or nothing, whereas other countries competing with Mexico have a more balanced view of the role of the state. The invisible hand of the market needs to be complemented by the visible hand of the state.

Speaker: Francois Bourguignon

Senior Vice-President and Chief Economist, World Bank

Mr Bourguignon started by saying that much of what he originally wanted to say had been said already and that he would instead try to say the same things differently. Thanking the panelists for the high quality of the discussions, he stated that it was a good sign for the future that the issue equity, a subject which was at the heart of all the presentations, has so much resonance in Mexico. A long list of problems was mentioned during the conference, and this list is by no means exhaustive, as many sectors were not covered. Nevertheless, the optimistic message from the conference is that much needs to be improved in Mexico and that important progress can be made as there is consciousness of the need for such change.

However, the policy debate has to move beyond the diagnosis and intuition of the underlying problems in order to develop a real reform strategy for reform. This is closely related to the issue of what the transition path will be to allow Mexico to achieve its long-term goals. As it is difficult to make reforms when some actors lose out, there is a need to ensure that there will not be big losers. For example, in the case of social security reform, the long-term perspective would require separating the financing of the social security system from labor contributions. What has not been answered is how this is to be done. When there already is an agenda of reform, it is therefore critical to make that agenda known to the public; transparency thus becomes a key tool for shaping the reform process.

A related issue is that of the need to choose reform priorities as one cannot undertake reforms across all sectors at the same time. A firefighters strategy, which is one of acting only when there is a fire, is not a good strategy, even if Mexico may be facing such fires in the not too distant future. In order to think of priorities, there is a need to focus on the problem of economic growth and competitiveness, that is to say, what can be done to increase the competitiveness of the productive system in Mexico as quickly as possible. Such an analysis suggests that a reform of *amparos* and the social security system are key priorities. A roadmap for the future is necessary in order to take full advantage of the discussion and thoughts generated by the conference. There is extensive evidence of a vicious circle between income inequality, low productivity and low growth. Reforms are harder in an environment where there is low growth, as this increases the risk that actors some will lose out, making it harder to undertake such reforms. Getting out of

this vicious circle has become an absolute necessity for Mexico. To end on an optimistic note, the *Oportunidades* program has shown many countries how to fight poverty in an efficient manner. A country that can create and innovate in one area is also one which can find solutions to other pressing issues.

Final remarks

Speaker: Pamela Cox

Vice President for the Latin American and Caribbean Region, World Bank

Ms Cox congratulated the panelists and the participants to the conference for the high level of the discussions and thanked Roby Senderowitsch in particular for the successful organization of the event. It was clear from media coverage that the conference had made a good contribution to debate in Mexico, but also more broadly to the debate on inequality, growth and competition in the Latin American region as a whole. The twin problems bedeviling Latin America are the low levels of economic growth and high poverty and inequality in what are for the most part middle-income countries; Latin America is the most unequal region in the world after Sub-Saharan Africa. The World Bank has been studying closely the economic basis for such inequality, and a recent flagship report explored the issues of poverty reduction and economic growth, and found that poverty and inequality negatively impact on economic growth in the region. An important question discussed in this report is how growth can reduce poverty and how much emphasis should be put on growth as opposed to income redistribution as a means of reducing poverty and inequality.

A conclusion from this report suggests that investing in the poor is good business for Latin America, because inequality of opportunities has a negative impact on many sectors of the economy. In addition, there appears to be a clear relationship between the existence of power structures and unequal opportunities, and this in turn adversely shapes institutions and ultimately policies coming from these institutions. One of the messages from the conference is that strong and solid institutions can counteract such concentrations of power. For a country like Mexico, which is a democracy in transition, a key question then becomes how to reform and develop such institutions. This agenda is also highly topical for other Latin American countries, which might benefit from having a conference similar to the one that Mexico has hosted. The issues of poverty and inequality have helped shape political outcomes in the region in the last year, reflecting growing political divisions and polarization. Ms Cox ended by stating that she looked forward to seeing the next steps the incoming government would take in order to address this important reform agenda.