Assessment and recommendations

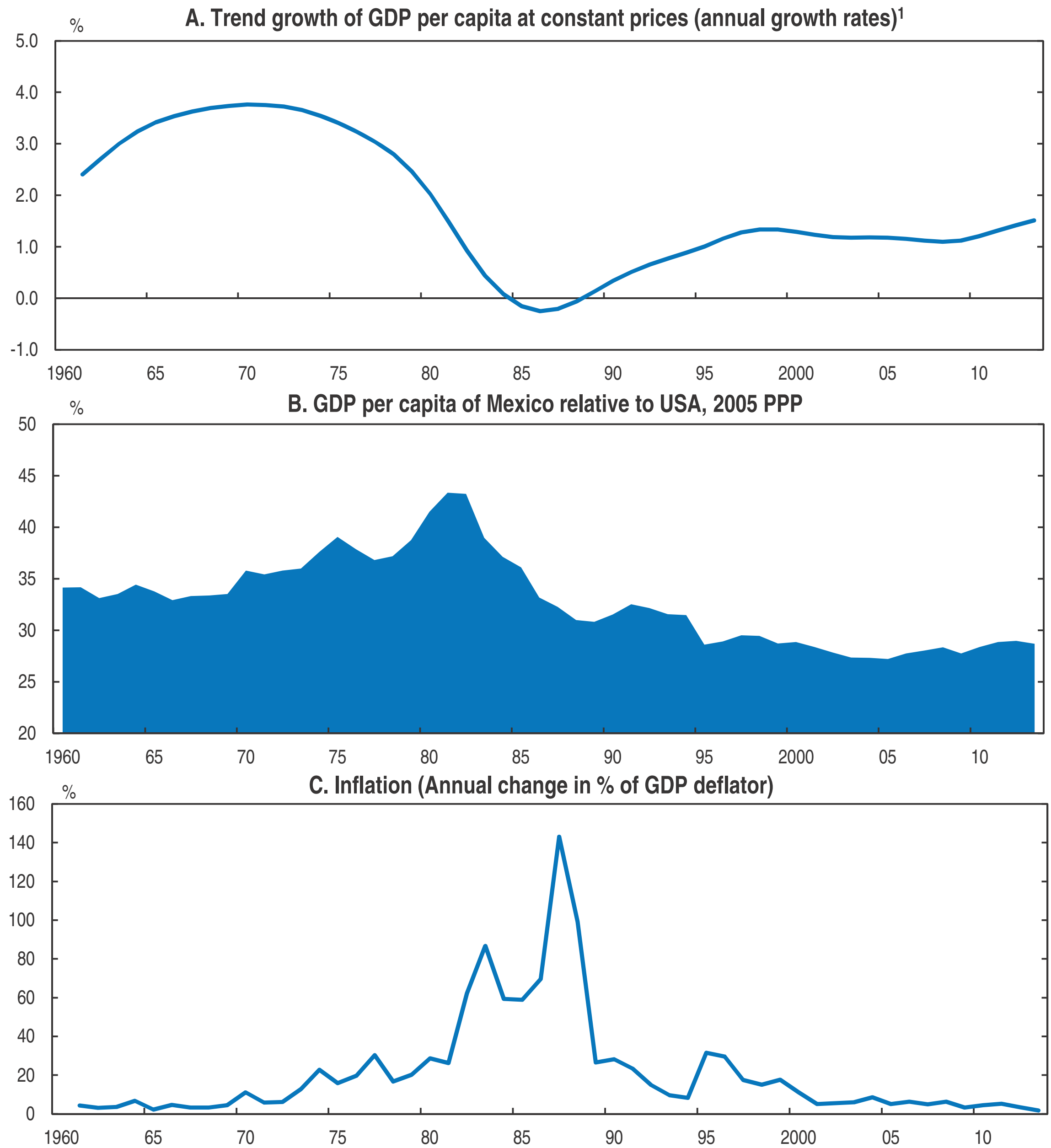
- *Stimulating macroeconomic recovery*
- *Structural reforms to boost growth and reduce informality*
- *Sharing the fruits of growth*

During the past three decades, the Mexican economy has experienced a prolonged growth slowdown, leaving it behind other OECD countries, and hurting the population's relative living standards as well as weakening their confidence in public institutions. After rapid, yet unsustainable convergence during the 1960s and 1970s, growth of income per capita slowed sharply in the wake of several macroeconomic crises (Figure 1), to an annual rate of 0.6% from 1980 to present, well behind performance in other emerging markets. While oil wealth and migrants' remittances brought in large revenues, the economy has been too hampered by multifaceted policy rigidities and weak institutions to yield sustained convergence and inclusive growth.

There have been, however, important changes that improved macroeconomic settings. Following its entry into NAFTA, Mexico tamed inflation, built a solid macroeconomic framework, and became very open to world markets. Many modern firms employ highly skilled and well-educated workers, notably in aerospace, automobiles, food and beverages. Yet, parts of the economy are still characterised by high informality, low-skilled work, weak productivity and out-of-date technologies. About 57% of workers have an informal employment relationship, and unregistered firms employ millions of workers who lack access to stable incomes, a good education, comprehensive health care and affordable financial services – hampering their accumulation of human capital. A third segment of the Mexican economy consists of companies that, for decades, have been protected from competition – notably dominant firms in energy and telecommunications. These firms have been able to extract large rents from consumers and faced weak incentives to invest and improve productivity. Previous governments from the 1980s onwards have sought to tackle these problems through a range of reform measures, but many of the earlier reforms were not completed, or were partially reversed during implementation – and thus did not produce the hoped-for results.

It is thus welcome that Mexico embarked on a bold package of structural reforms initially organised around the "*Pacto por México*". Not all of the reforms were new: many had been sought previously, and have been the focus of previous OECD Economic Surveys and reports (see OECD, 2011c, 2012b, 2013a). However, the *Pacto* was unique in that it broke the political gridlock by bringing the three largest parties together to agree on a single multifaceted package of specific reforms that they could all commit to. This was historic and helped to diffuse much of the opposition to individual reforms, allowing the government to advance legislation in key segments of the economy (Table 1). Each of these reforms is wide-ranging in scope, and addresses the main challenges in their respective sectors. They include: a labour reform that substantially increased the flexibility of hiring; a reform of "*amparos*" that made the legal system more efficient and fair; the introduction of a national code of criminal procedure; a wide-ranging educational reform that introduced clearer standards for teachers and schools; a fiscal reform that improved the efficiency of the tax system, raised the revenue ratio and strengthened the fiscal responsibility framework; an economy-wide competition reform; reforms to the financial,

Figure 1. **Growth has been weak**



1. Smoothed by a Hodrick-Prescott filter with a lambda of 100.

Source: OECD Long-term Growth Scenarios and OECD Analytical database.

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telecom and energy sectors that have opened long-closed sectors to competition and strengthened the powers of regulators; and a reform of the political system to allow politicians to be re-elected, giving them a longer-term perspective on policy.

This impressive policy effort, which makes Mexico the top reformer in the OECD over the past two years, deserves acclaim (Figure 2). From now on, the main challenge is to ensure full implementation of these reforms and progress further in areas that have not

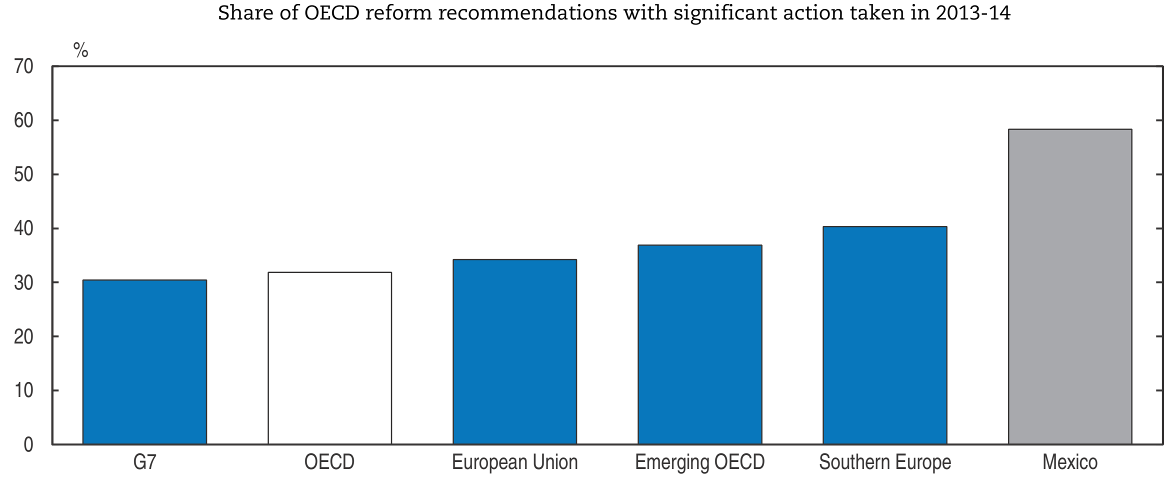
Table 1. **Progress on structural reforms**

Reform	Secondary legislation approved	Main provisions enacted?	Constitutional amendment (if required)	New or empowered regulator	Legislative approval	Remaining steps to be taken?
Reforms approved and being implemented						
Labour	Dec 2012	Yes	-	-	Federal	-
Amparos	April 2013	Yes	Yes	-	Federal/ States	-
Education	Sep 2013	Yes	Yes	Yes	Federal/States	Multiple stages
Tax/Fiscal	Oct 2013	Yes	-	-	Federal	-
Financial	Jan 2014	Yes	-	Yes	Federal	-
Transparency (access to public information)	Feb 2014	Yes	Yes	Yes	Federal/ some states	-
National Criminal Procedural Code	Mar 2014	Partial	-	-	*Federal/ some states*	States to use new code by 2016
Economic competition	May 2014	Yes	Yes	Yes	*Federal*	-
Political/Elections	May 2014	Partial	Yes	Yes	Federal/ *some states*	States to adopt by 2018
Telecoms	July 2014	Yes	Yes	Yes	Federal/ States	-
Energy	Aug 2014	Yes	Yes	Yes	*Federal/ States*	Issue new bidding rules
Reform of criminal justice	-	Partial	Yes	-	Federal/ some states	States should adopt by 2016
Reforms yet to be approved						
Anti-corruption and civil justice	-	No	Yes	Yes-	Pass bill	
Expenditure (Pensions and UI)	-	No	-	-		Pass bill
Health	-	No	-	-	-	Introduce bill
Agriculture	-	No	-	-	-	Draft bill

Source: OECD compilation.

Figure 2. **Mexico's reform activity is the highest in the OECD**

Share of OECD reform recommendations with significant action taken in 2013-14



Note: Emerging OECD countries include Chile, Estonia, Hungary, Mexico, Poland and Turkey. Southern Europe countries are Greece, Italy, Portugal and Spain.
Source: OECD (2015d), *Going for Growth* with interim estimates of 2014 reform implementation.

How to read this figure: Every two years, the OECD makes recommendations about the five most important reforms that should be undertaken. The figure shows that Mexico took significant policy actions in 2013 and 2014 on 58% of the reform recommendations on average in each year, more than any other OECD economy at the time of the interim estimates.

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yet been tackled, and that are key to ensure success of the current package. Against this background, the key messages of this *Economic Survey* are:

- The reforms will boost Mexico's living standards substantially over the next decade, if legislated reforms are fully implemented and followed through upon. Implementation includes improving administrative capacity at all levels of government, and reforming justice institutions.
- The implementation of the reforms should also focus on their impact on lower income groups. An inclusive growth approach will be necessary to address the very high inequality of incomes and opportunities among Mexicans, with the broadening of the main cash transfer programme and extended health care coverage to allow for investment in human capital.
- Further reforms, including of the judiciary, health sector and agriculture, will raise growth even more. For example, these reforms could increase GDP growth by an additional one percentage point (Table 2).
- While the tax reform created a new regime for small firms with positive preliminary results, incentives for businesses and workers to join the formal sector could be further strengthened by simplifying regulations, reducing corruption, improving justice and better enforcing laws.
- To reduce gender inequalities and promote female participation in the labour market, it is essential to extend early childhood education and build on the bold education reforms.

Table 2. **Impact of reform on the level of GDP in the medium term**

OECD estimates of legislated and envisioned reforms[1]

Impact after 5 years, assuming immediate implementation

	via productivity growth (%)	via capital deepening (%)	via employment growth (%)	GDP growth (%)
A. Pacto por Mexico Reforms:	**0.41**	**0.51**	**0.03**	**1.0**
1. Product market regulation				
a) Telecoms	0.06			0.06
b) Electricity & gas	0.32			0.32
c) Petroleum		0.45		0.45
2. Labour market reform				
Employment protection			0.03	0.03
3. Tax structure		0.07		0.07
4. Legal reform	0.03			0.03
B. Additional Reforms:	**0.91**	**0.00**	**0.10**	**1.0**
5. Judicial reform	0.50			0.50
6. Labour market reform				
a) Pro-formality reforms	0.42			0.42
b) Female participation			0.10	0.10
Total	**1.82**	**0.51**	**0.13**	**2.0**

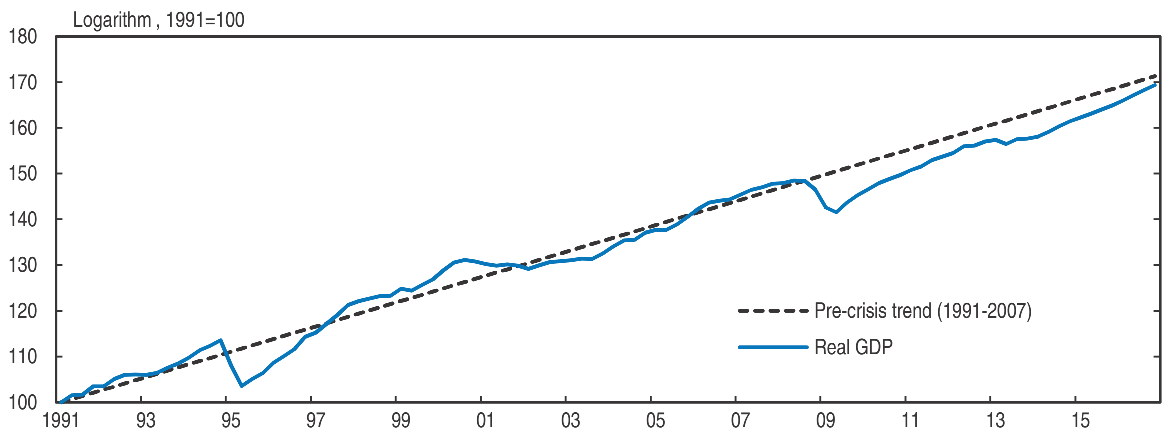
1. The financial reform and the educational reform are also likely to have a significant impact in growth (the later mainly in the long term), but have not been included in the table because of difficulties quantifying the impact.

Source: Bourlès et al. (2010); USEIA (2014); Bassanini et al. (2009); Dougherty and Escobar (2014); Thévenon et al. (2012); Johansson et al. (2011); IMF-OECD-World Bank (2014); Dougherty (2014).

Stimulating macroeconomic recovery

In the past decade, Mexico made little progress in catching up towards the upper-income OECD countries, in contrast with a number of other OECD middle-income member countries. In addition, over the past five years, strong headwinds have hindered the economic recovery, leaving output below its pre-crisis trend (Figure 3). This downturn was magnified by financial problems in the construction sector in 2013 and a bout of weather-related shocks.

Figure 3. **Output is returning to trend**



Source: OECD, Economic Outlook database.

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Fortunately, the cycle has started to turn around and a rebound is now underway, fuelled primarily by stronger import demand from the United States, as well as a gradual recovery in domestic demand, and supported by expansionary fiscal policy and an accommodative monetary stance (Table 3). The policy interest rate remains at an all-time low of 3%, and the exchange rate has been stable. A marked rebound in GDP growth is projected, with growth to reach nearly 4% in 2015. As external demand strengthens with the US recovery and the fiscal stimulus (0.5% of GDP in 2014), investor confidence should return. The ongoing boost to government spending is welcome, in particular the national infrastructure investment plan over 2014-18. As conditions begin to normalise, monetary accommodation and stimulus spending can be scaled back. The tax reform has resulted in a significant increase of tax revenues, which have grown by 6.1% in the first three quarters of 2014 and are expected to increase by 7.5% in 2015. On the other hand, the significant decline in oil prices, while helping to lower business costs and improve consumers' real incomes, could reduce fiscal revenues significantly, thus calling for vigilance regarding the state of public finances. Indeed, Mexico has a comprehensive framework to insulate the budget from temporary falls in oil-related revenues. First, when the price of oil falls, usually it is accompanied by exchange rate depreciation, thus cushioning the impact on oil revenues. Second, with a lower oil price, there is an increase in gasoline tax revenues – given the administered price. Third, Mexico has a financial hedge on oil prices (i.e. a put option) which places a floor in the oil price at which Mexico sells. For 2015, the Government has fully covered the oil price at the budgeted level of USD 79 per barrel. Finally, these hedges are complemented with an oil stabilization fund that alone could compensate for up to a USD 13 drop in oil prices. Thanks to these various mechanisms, a significant drop in oil prices in 2015 would not increase the deficit (in terms of PSBR) by more than 0.05% of GDP (Figure 4, Panels A and B).

Table 3. **Macroeconomic projections**

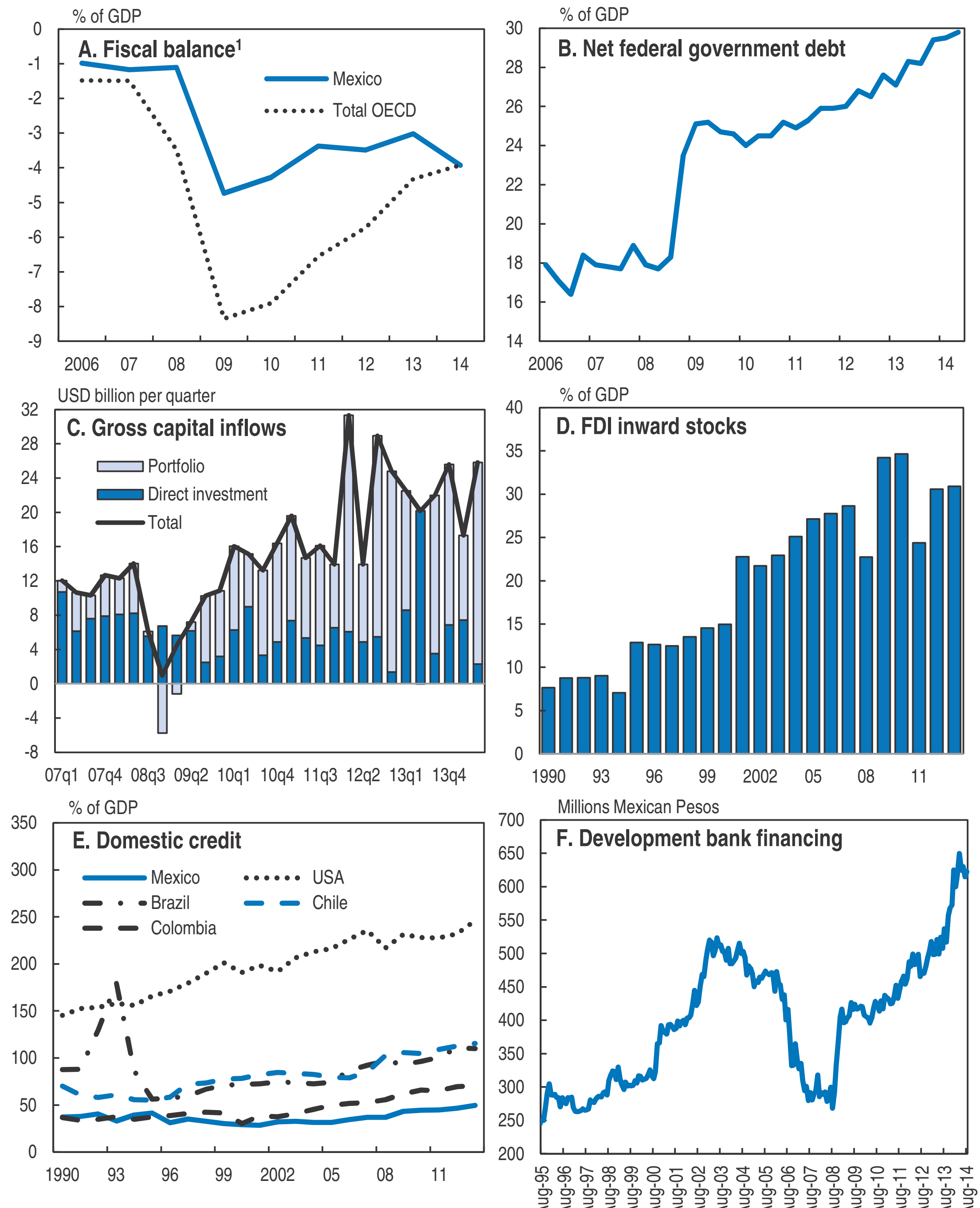
	2011	2013	2014	2015	2016
	Current prices MXN billion				
GDP	14 544.1	1.3	2.6	3.9	4.2
Private consumption	9 658.2	2.9	2.2	3.5	3.6
Government consumption	1 683.2	1.4	2.1	3.7	2.4
Gross fixed capital formation	3 156.7	-1.7	1.8	4.1	4.8
Final domestic demand	14 498.2	1.7	2.1	3.6	3.7
Stockbuilding[1, 2]	224.4	-0.1	0.3	-0.1	0.0
Total domestic demand	14722.5	1.6	2.4	3.6	3.7
Exports of goods and services	4 543.8	1.1	7.0	6.2	7.0
Imports of goods and services	4 722.2	1.8	5.0	4.2	5.5
Net exports[1]	-178.5	-0.3	0.6	0.6	0.5
Memorandum items					
GDP deflator	_	1.8	4.0	3.5	3.0
Output gap	_	-0.9	-1.3	-0.5	0.4
Potential GDP	_	2.8	2.9	3.1	3.3
Core inflation	_	2.7	3.2	3.1	3.0
Consumer price index	_	3.8	4.0	3.5	3.1
Private consumption deflator	_	2.7	3.9	3.1	3.0
Unemployment rate[2]	_	4.9	4.9	4.7	4.7
Public sector borrowing requirement[3, 4]	_	-3.8	-4.2	-4.1	-3.6
Narrow budget balance[5]		-1.3	-1.7	-1.6	-1.1
Gross debt[6]	_	36.9	40.5	..	..
Current account balance[4]	_	-2.1	-1.9	-1.7	-1.8

1. Contributions to changes in real GDP, actual amount in the first column.
2. Based on National Employment Survey.
3. Central government and public enterprises. The PSBR differs from the government's definition of the deficit in that it excludes non-recurrent revenues and pure financing operations, such as withdrawals from the oil revenue stabilisation fund.
4. As a percentage of GDP.
5. Based on the PSBR not including investment in public enterprises (PEMEX and CFE).
6. Official gross debt figures as of Dec 2013 and Sep 2014.

Source: OECD Economic Outlook 96 database.

One main risk for this outlook comes from the pace of withdrawal of US monetary policy accommodation, which could trigger market instability that would affect Mexico. In view of high levels of portfolio capital inflows in recent years, along with other emerging market economies – increasing long-term interest rates and asset price volatility as happened in May 2013 after the Fed initiated discussion of "tapering" (Olaberria, 2014a). However, Mexico's financial markets showed more resilience in 2013 than did many other emerging markets (Figure 4, Panels C and D), suggesting that its sound macroeconomic framework can absorb external shocks. Moreover, it is backed by a high level of international reserves and a recently renewed Flexible Credit Line with the IMF, which altogether provide financial buffers of about USD 265 billion in funding, if needed. Another risk comes from a possible further decline in oil prices. As mentioned, Mexico's federal budget is well protected in the short term from such decline through various hedging mechanisms. While there are also upside risks, notably a stronger US recovery, the balance of risks remains slightly tilted to the downside. This underlines the need to further strengthen macroeconomic fundamentals and maintain financial buffers to better face possible periods of financial volatility. In the medium term, however, persistently low oil prices would reduce the payoff from energy return given the budget's high reliance in oil-related revenues.

Figure 4. **Macroeconomic indicators**



1. For Mexico, the fiscal balance is based on the borrowing requirements of the central government and public enterprises.

Source: OECD Analytical database and IMF Direct Investment database; Banco of Mexico; The World Bank; Datastream.

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Macroeconomic policies

Although fiscal stimulus and the economic slowdown widened the budget deficit in 2014, Mexico remains committed to sustainable budgetary trends, and last year's wide-ranging tax reform boosted revenues substantially. The reform will raise the revenue ratio by 2.5% of GDP by 2018 through a broadening and extension of the tax base. Major reforms were made to most types of taxes, including personal, corporate, consumption and energy taxes. In personal taxation, the top marginal rate was raised to 35%, and limits were imposed on deductions. A capital gains and dividend tax of 10% was also introduced. In terms of corporate taxation, limits on depreciation allowances were imposed and an alternative tax regime (*IETU*) was eliminated. A number of loopholes and exemptions that allowed for accelerated deduction of investment expenses have been removed or reformed. The preferential tax treatment of *maquiladoras* has been revised to make it more neutral. Consumption taxation was broadened by abolishing the reduced rates on the border regions, and special exemptions for *maquiladoras* were removed. New excise taxes have been imposed on fossil fuels (except natural gas). Finally, a carbon tax and taxes on high-caloric foods and sweetened beverages were introduced.

The approved changes to the Fiscal Responsibility Law are a key element of Mexico´s medium term fiscal strategy. This framework: i) seeks to reduce the budget deficit in the medium term and put the debt-GDP ratio on a downward path; ii) allows fiscal policy to play a more counter-cyclical role; iii) limits annual increases of current public expenditure; iv) enhances transparency by establishing the public sector borrowing requirement (PSBR) as the main target for the conduct of fiscal policy; and v) requires to set aside excess fiscal revenue in a financial buffer so as to deal with macroeconomic shocks that could affect Mexican public finances. The government has defined a path to cut the PSBR in the next three years and contain the growth of public debt over the medium term. The government plans to return to a neutral fiscal stance in 2015, begin fiscal consolidation in 2016, and eliminate the deficit – as defined by the narrow ("traditional") balance – by 2018, in accordance with the fiscal rule. This will stop the growth of the public debt in relation to GDP and start to bring it down (Figure 4, Panel B).

The reform of the Fiscal Responsibility Law establishes a mechanism to save the additional receipts expected to stem from the energy-sector reform, the Mexican Oil Fund for Stabilization and Development, which will receive, administer and distribute income derived from oil assignments and contracts. The Fund can invest domestically and internationally, and its contribution to the budget is limited to 4.7% of GDP. The fund is located in the Central Bank and four of the seven board members are independent. As the fund accumulates assets, it will be important to ensure separation of its activities from other institutions' mandates (Della Croce et al., 2011).

Given that inflation expectations have been well anchored, monetary policy has been able to provide support to the economic recovery. The central bank's policy rate is currently at a record low of 3%, and the structure of the yield curve and measures of inflation expectations suggest that markets anticipate it will stay there until the second quarter of 2015. The exchange rate has remained roughly stable despite bouts of turmoil in other emerging market economies. Mexico has sufficient policy credibility to maintain a supportive monetary stance until the economy recovers, without compromising the 3% inflation target.

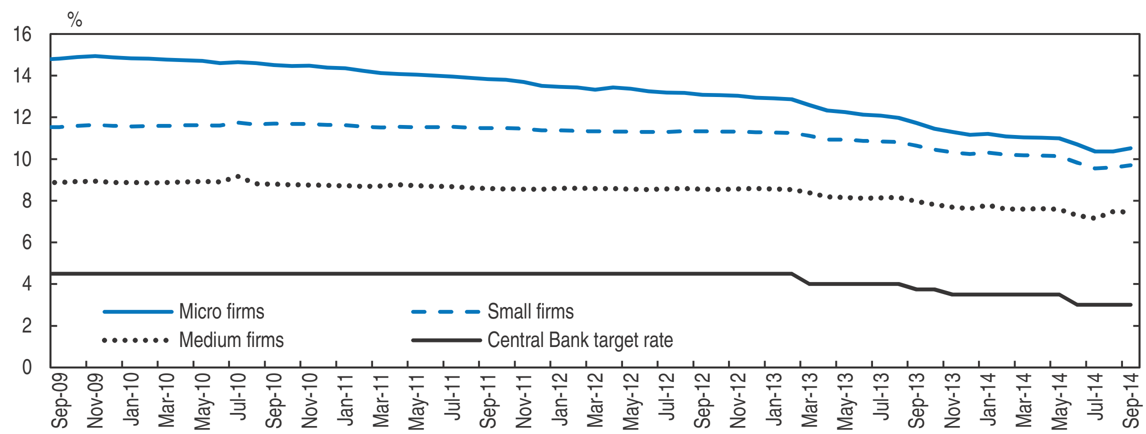
The financial sector

Mexico is underbanked compared to other OECD economies (Figure 4, Panel E). Large segments of the population do not use formal banking services, and much progress needs to be made to promote financial inclusion and to increase the use of banking services. Concerns about the high cost of credit and lack of competition in the banking sector have motivated a major financial reform. Legislation passed in January 2014 strengthens regulation, increases competition and lowers the cost of borrowing. These changes should allow for more robust and sustainable private credit deepening.

Three sets of measures stand out in the financial reform: more effective property-rights protection for creditors; more formal legal authority for the regulator to manage the resolution of banks; and the promotion of competition among financial intermediaries. The reform reduces obstacles in the judicial process to recover collateral, following longstanding difficulties in enforcing creditors' property rights. More immediately, government development banks have been given more scope for lending to small and medium-size businesses (SMEs), which often lack access to credit (Figure 4, Panel F). This measure already appears to have borne fruit in driving down interest rates for SMEs (Figure 5).

Figure 5. **The cost of credit for small firms has been reduced**

Lending interest rates



Note: For micro, small and medium firms, market interest rates for various types of borrowers without support.
Source: Comisión Nacional Bancaria y de Valores (CNBV).

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Structural reforms to boost growth and reduce informality

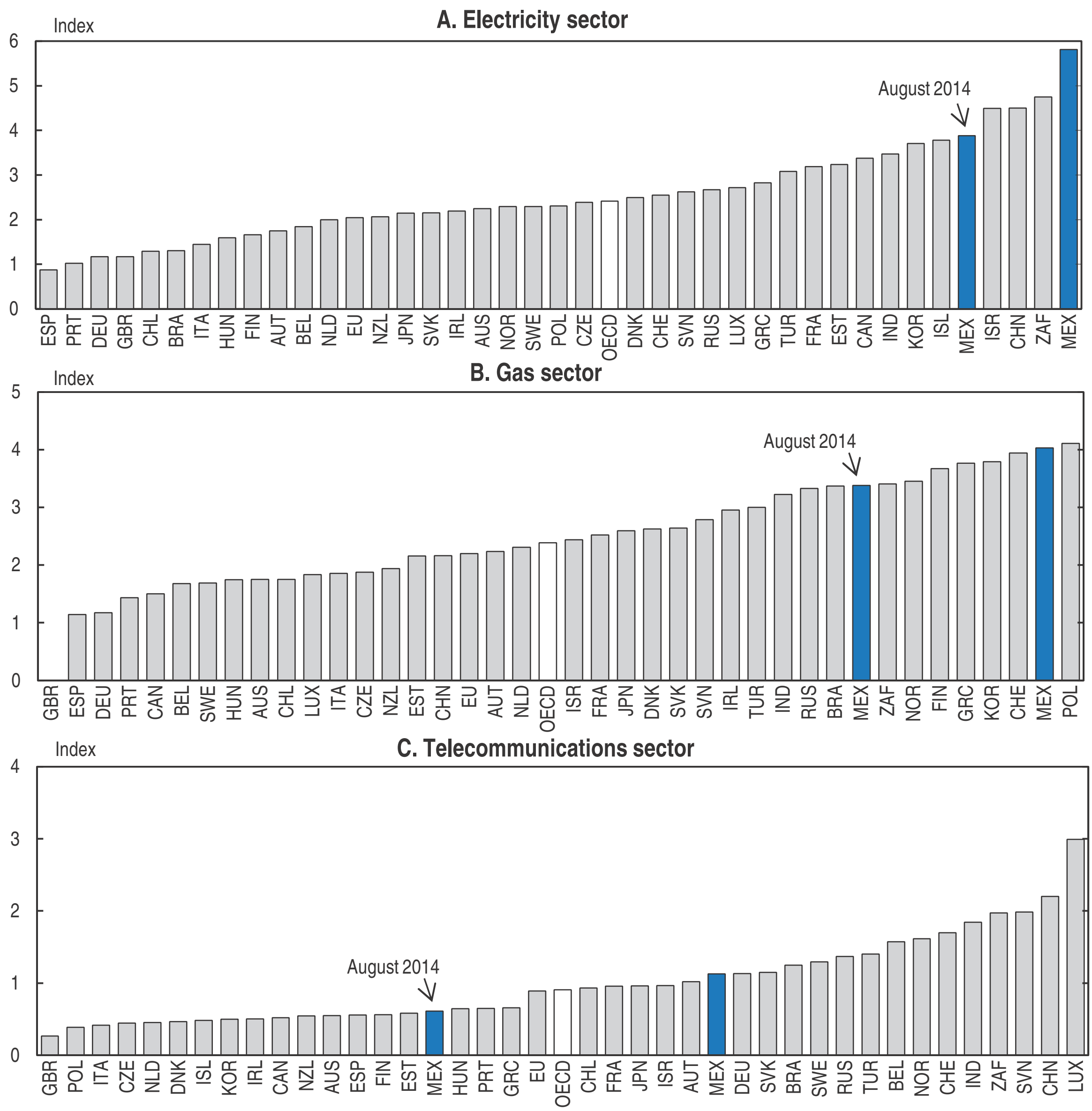
Competition law

For decades, Mexico's economy has been hindered by weak competition, and large firms have become dominant players in several markets and thus have earned monopoly rents. To restore dynamism in these markets, the general competition agency COFECE has been strengthened and transformed into a constitutionally-autonomous body, with the power to regulate access to "essential facilities" and remove "barriers to competition", through broad market investigation powers similar to the UK competition authority. Criminal penalties for extreme bid-rigging have also been increased. In addition, the new competition law gives Congress one year from July 2014 to harmonise Mexico's legal framework with free competition principles. These changes should help to intensify competition in the substantial number of markets that have high concentration of incumbent operators. However, the agency has only a small budget, which could limit its impact.

The energy and telecom sectors have already been opened to greater competition, with sufficient progress having been made to have economy-wide effects. These reforms can be observed through changes in the stringency of product-market regulation in these key sectors (Figure 6). An interim update of indicators for these sectors through August 2014 shows that Mexico has eased its regulatory stance from one of the most stringent levels. In a key sector where reform has focused, telecommunications, regulatory stringency will move from worse to better than the OECD average. Two-thirds of these indicators' value reflects legislative changes in regulation, but *de facto* contestability of the market is also measured through the market share of either the incumbent or new entrants, and by this measure, it will take some time for the reforms to have their full impact on competition.

Figure 6. **The stringency of sectoral product market regulation has been reduced**

Index scale of 0-6 from least to most restrictive (January 2013)



Source: OECD, Product Market Regulation database, 2014 and interim estimates prepared in co-operation with Mexican authorities.

How to read this figure: Mexico's regulation in the three network sectors mentioned above became substantially less restrictive from January 2013 to August 2014, moving towards the OECD average, or below it in the case of telecoms.

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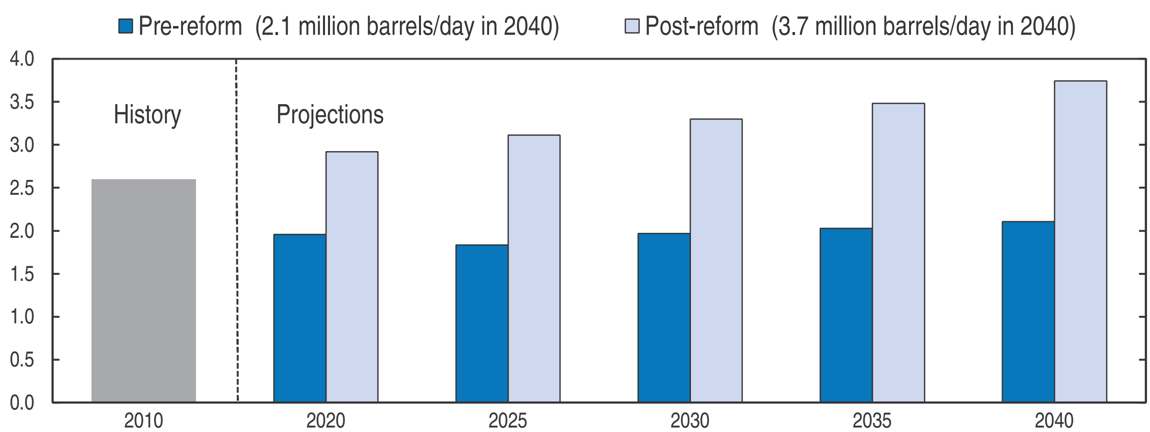
Energy

Mexico has launched a major reform of the oil and gas sectors, following years of declining oil production by the state-owned company PEMEX, high energy costs for the business sector, and a lack of funding and technology to exploit new energy resources. Congress passed secondary legislation in August 2014 to implement a constitutional reform approved in late 2013. These laws established largely autonomous, independently-funded regulators for licensing, safety and environmental protection in the sector. These new regulators will help supervise the opening of the sector to greater competition and more efficient use of national resource wealth. The governance of PEMEX is also being reformed, with a Board that, for the first time, will comprise independent directors responsible for establishing the company´s strategic vision of the company supported by committees and it will no longer play the role of "gate-keeper" to the energy sector. Mexico now allows the entry of both domestic and foreign investors in the exploration, production and transportation of oil and gas, as well as the refining and marketing of hydrocarbons, potentially attracting considerable new investment. These changes are estimated by market observers to boost long-term petroleum output by 75% annually relative to the baseline (Figure 7).

Figure 7. **Petroleum production is set to expand substantially**

Million barrels per day



Source: US Energy Information Administration, International Energy Outlook 2014.

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The energy reform follows recommendations made in previous OECD *Economic Surveys* (OECD, 2013a), and allow for several types of private sector involvement, including profit-sharing, production-sharing and licensing arrangements. Contracts will be awarded through public tenders to the bidder who offers the largest payment to the government, under contractual terms determined by the Ministry of Finance and the Ministry of Energy, while the upstream regulator (CNH) will award and administer the contracts. Revenues from oil and gas production will be managed by a new autonomous entity, the Mexican Oil Fund for Stabilization and Development. A national content requirement will begin at 25% in 2015 and rise to a share of 35% by 2025, which is comparable to a number of other emerging markets. It will be important to ensure that the new contracting rules, including on local content for oil and gas investment, are carefully designed in order to ensure they are sufficiently attractive, and also create a competitive market for large-scale private sector participation. Downstream activities – including midstream, refining and distribution activities – will be open to full private sector competition, including for imports of oil and natural gas, supervised by a dedicated and strengthened regulator (CRE) and the Ministry of Energy.

The electricity sector has also been liberalised by ending the monopoly of the state-run power utility CFE and by promoting competition from new entrants. A transition to a different energy mix will contribute to improving the sector's environmental performance. Improved access to US shale gas resources thanks to new pipelines and Mexico's own resources are expected to narrow the substantial gap with the United States and thus making industry more competitive. Establishing a robust system for monitoring would help to identify any drawbacks or limitations of specific regulations.

Mexico has strengthened its political commitment to reduce greenhouse gas emissions by 30% in 2020 (with respect to the business as usual scenario) provided adequate financial and technological support from developed countries is sufficient. For this purpose Mexico aims at more intensive use of renewables (currently subject to a target of 35% by 2014), a carbon tax on fossil fuels has been introduced in 2014. In addition, the retail price of gasoline and diesel will be raised, until 2017, in line with overall inflation. Based on current oil prices, this is expected to eliminate the fossil fuel subsidy that has prevailed at a high level in recent years, and resulted in gasoline and diesel products being effectively taxed; further action would be needed if oil prices were to rise significantly from current levels. Beginning in 2018, gasoline prices will be liberalised and determined by market conditions. Despite these initiatives and targets, reducing greenhouse gas emissions remains a major challenge for Mexico. Although carbon emissions per capita are low, the energy and carbon-intensity of the economy is high compared to other OECD countries. Therefore, establishing adequate prices, removing inefficient subsidies (and providing better targeted support to the poor), and improving energy efficiency will all be needed if Mexico is to meet its greenhouse gas emissions target. The new effective carbon tax should be evaluated, and raised if deemed inadequate.

Telecoms

A new regulatory and competition agency (IFT) focused on telecommunications and broadcasting was formed in 2013 and following the passage of the secondary legislation in May 2014 it is now fully operational. The IFT has exclusive authority for regulation and competition enforcement in the telecommunications and media industries, and has a range of new regulatory capabilities to promote competition, such as imposing obligations on dominant operators. The dominant operator in the fixed-line market, Telmex, has an 80% market share, while the mobile company Telcel has a 70% market share. OECD studies have suggested that data prices are relatively high (OECD, 2012a). An initial decision requiring these companies' owner, América Móvil, to provide free interconnection to other operators, triggered its announcement of a plan to sell assets to reduce its market share below the 50% regulatory threshold to avoid the application of asymmetric regulations. The response suggests that the new framework is having an impact, though attention will need to be paid to whether a smaller market share still ensures adequate market competition. A full-fledged competition assessment may still be required to ensure that individual market segments do not face market dominance. In addition, given the rapid technological developments in the telecommunications sector, close monitoring of the technological evolution and boundaries of the sector will also be required. There is also an outstanding international compliance issue regarding the conditionality of market access rules to FDI in the telecoms – which appears to be contrary to OECD instruments and other international conventions that prohibit reciprocity. These will need to be addressed to avoid legal complications.

Other regulatory reform

Dynamism is still hampered by stringent regulations in many markets. The government aims to lighten the regulatory burden with constitutional reforms and secondary legislation. There is still a large stock of administrative regulations in many domains, notably in business entry and operation at the state and local levels. New federal regulations are already subject to a regulatory impact analysis by the regulatory assessment agency (COFEMER) prior to promulgation that assesses the costs of regulations against their potential benefits, including consultation with the competition agency when required.

However, efforts to roll back regulation at the state and local levels have encountered substantial difficulties and setbacks (see OECD, 2014a). A draft Presidential Decree would require a full review of the entire existing stock of regulation and require removal or revision of regulations that cannot be justified. This effort, and an analogous one at the sub-national level that includes incentives for local governments, should be followed through with urgency.

Beyond making reforms to regulations, the administrative capacity of many agencies and local governments is still wanting. Extensive improvements in the capacity of the laggard governments to carry out policy in a neutral manner are essential (see OECD, 2014c). This will require an intensive focus on training and boosting the quality of officials in these localities through clear incentives that reward good governance and punish corruption and mis-governance, with certainty. Greater transparency will also help.

Strengthening innovation

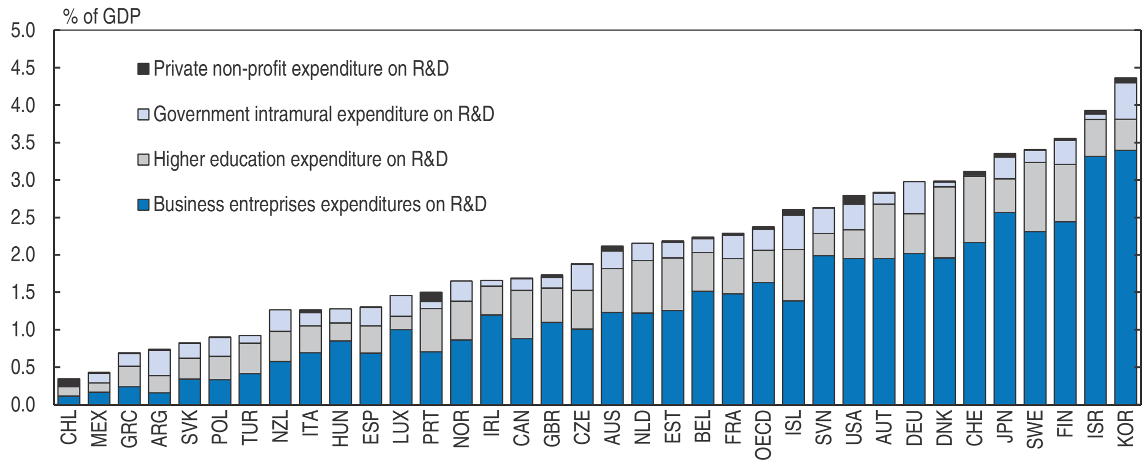
Innovation is essential to raise productivity, and here Mexico's performance has been weak. Both private and public sector R&D investment (under 0.5% of GDP in 2012) is well below that of nearly all OECD and BRICS countries (Figure 8). This is partly a result of Mexico's industrial structure, as over one-third of manufacturing R&D is carried out in low and medium-technology sectors. However, obstacles to boosting the country's innovative potential include a weak domestic research and skills base, an underdeveloped knowledge-based start-up environment and institutional challenges.

Regional high-technology clusters, such as the aerospace cluster of Queretaro, have grown considerably and case studies suggest that they have been able to find strong regional synergies between companies and research and training institutions. One important question is how the government can facilitate networks among businesses and between business and academic institutions.

Reviews of experiences with clusters in other OECD countries emphasise the potential importance of the government encouraging new firm creation, stimulating innovation, co-ordinating policies, strengthening human capital, facilitating access to finance and addressing congestion (OECD, 2009a). Recent empirical evidence suggests that, after controlling for convergence in start-up activity at the region-industry level, industries located in regions with strong clusters can experience higher new business formation and start-up employment (see Delgado et al., 2014). Industries participating in strong regional clusters also have higher patenting rates, and can even enhance growth and trade opportunities in related industries and neighbouring clusters. Overall, these findings

Figure 8. **R&D intensity is especially low**

Expenditure on R&D by sector of performance, 2012



Source: OECD, Main Science and Technology Indicators Database.

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highlight the potential positive role of cluster-based agglomeration in regional economic performance. However, policies to promote clusters should avoid "picking winners" and focus instead on building on existing industry networks, enhancing infrastructure and promoting linkages with universities (Warwick, 2013).

Access to credit, especially in the seed and start-up phases, is a major barrier to start-ups in Mexico (OECD, 2013b, 2013c). Private equity and venture capital are only 0.02% of GDP, one of the lowest figures in the region. A National Institute of the Entrepreneur was created in 2013 to refine and implement schemes to address entrepreneurs' needs, including forming a seed capital "fund of funds". Further strengthening of the start-up environment through enhancement and expansion of these programmes to support angel and venture capital financing would be especially helpful. Pacific Alliance members have been working jointly to boost SME financing, and one promising step was Mexico's joining of the Latin American Integrated Market (MILA) in 2014, making it the largest stock market in the region.

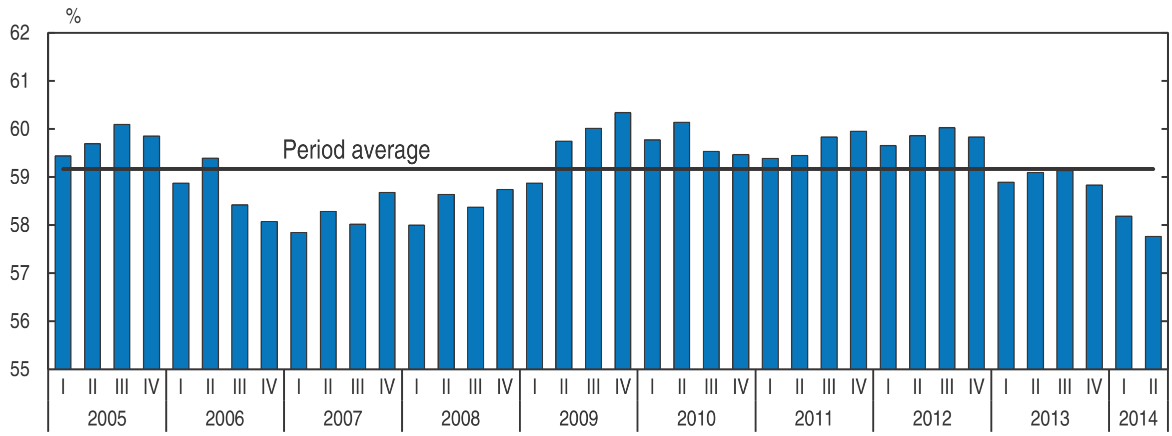
As a central part of the Programme to Democratise Productivity, the new National Productivity Commission (NPC) has been established to improve co-ordination and identify policy reforms. Early signs suggest that the NPC is working well, helping to analyse problems and building consensus for reform, notably in the area of public sector management. In order to increase its impact, it would benefit from a more robust legal framework and more systematic processes related to the legislative process. Legislation was proposed to Congress in September 2014 that provides such a framework, including a clarification of the Commission's mandate and the establishment of a requirement that the federal government respond to its policy recommendations; the new law should be passed.

Reducing informality

Although many parts of the economy are quite advanced, informality is pervasive in many sectors. Fifty-seven percent of workers have an informal employment relationship and a majority of small businesses still operate in the informal sector (Figure 9). The government has started to address the problem through the creation of a new tax regime for micro and small enterprises, which seeks to promote formalisation of the workforce,

Figure 9. **The share of workers in the informal sector has been reduced**

Percentage of informal labour force



Source: INEGI, *Encuesta Nacional de Ocupación y Empleo* and *Instituto Mexicano del Seguro Social*.

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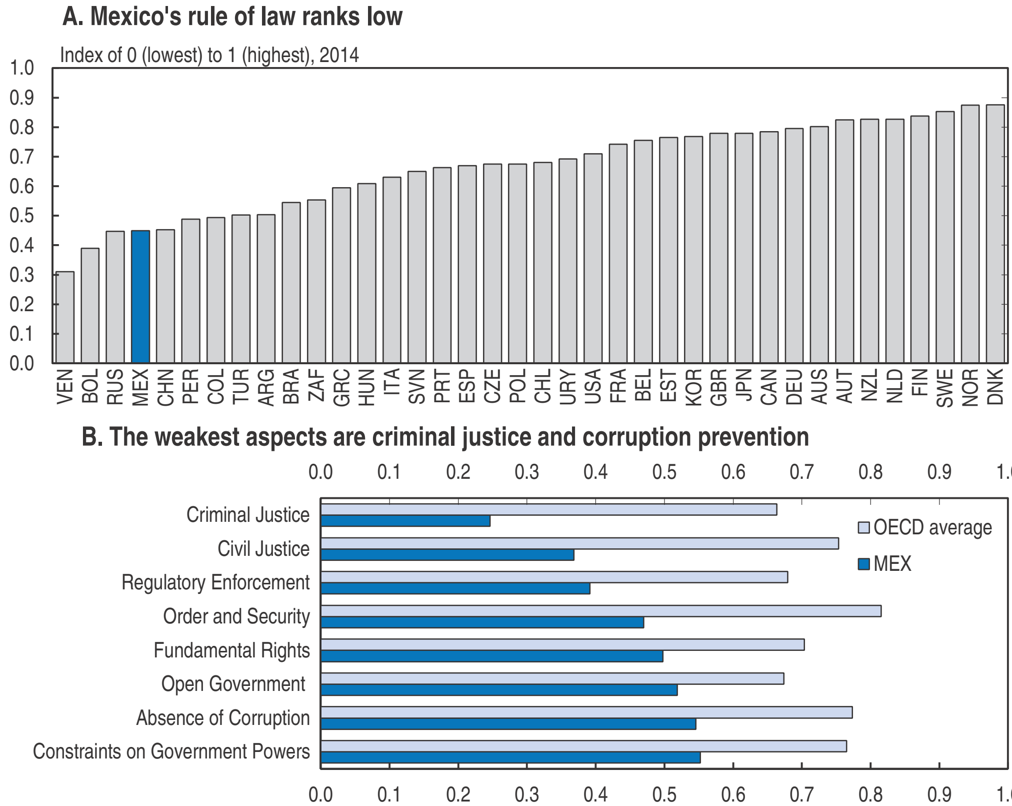
and through a comprehensive strategy launched in 2014 to "Go Formal", which pools the benefits and resources of different programs. These measures resemble those Brazil followed to reduce its informality rates (OECD, 2013f). Mexico's new fiscal regime for small firms (*RIF*), which started to operate in January 2014 and replaced an earlier small-taxpayer regime (*REPECOS*), includes substantially reduced personal, social security and value added and excise tax obligations in the initial decade of operation, to induce informal firms to regularise their status and start paying taxes (see Annex). Tax reductions will decrease gradually over time, until the firms are incorporated in the general regime after ten years. Importantly, the scheme includes special incentives to help new firms expand, including through access to special government-backed financing and training, as well as a series of electronic tools that simplify tax compliance. Already, 4.3 million firms have registered under the new scheme, as compared to 3.5 million under its predecessor.

The reluctance of workers and firms to operate formally reflects a variety of factors, notably stringent regulation, but also perceptions of corruption and weak enforcement of legal rights (Dougherty and Escobar, 2013). Promoting formal employment is essential both to improve inclusion and increase productivity: formality enables workers to have access to social rights – such as unemployment insurance, health care and pensions – and allows businesses to expand, modernise, innovate and become more productive. If formality increases, the vulnerability of social institutions will recede, fiscal revenues will increase and long-term sustainability of social entitlements will be strengthened (OECD, 2009b). The comprehensive labour reform law of 2012 contained initiatives to stimulate formal employment by adding new types of contracts that give access to social benefits. Since its adoption, formal employment has been more rapid than both overall employment and GDP growth, but further efforts are needed to improve formal employment prospects, especially for women and young people.

The judicial system

Boosting productivity and achieving the range of the structural reforms done by the government will require stronger judicial institutions to enforce laws and regulations as well as to adjudicate disputes (Figure 10). Essential in this effort is the efficiency and quality of the court system, including the training of its personnel, their performance

Figure 10. **Adherence to the rule of law is relatively weak**



Note: The WJP Rule of Law index is a quantitative assessment tool designed to offer a picture of the extent to which countries adhere to the rule of law in practice.
Source: The World Justice Project (2014), *www.worldjusticeproject.org*.

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management system and the soundness of administrative procedures. Empirical estimates carried out in the context of the last *Economic Survey* (OECD, 2013a) suggested that there was considerable scope to boost the quality of the judiciary, since a low-quality judiciary makes contract enforcement and insolvency procedures problematic in Mexico, lowering the average size of firms and their capital intensity, thus reducing aggregate productivity substantially (see Palumbo et al., 2013; Dougherty, 2014).

Improving criminal justice is not only important for the economy, but is also crucial to improve personal safety, which is a major challenge for well-being in Mexico. Some progress has been made in reforming the criminal judicial system, which is shifting from a written system that was slow and lacked credibility to an oral "adversarial" one that allows for cross-examination. Data from SETEC suggests that trial times have been cut from 343 days using the old system to 132 days using the new one. The new system is fully operational for state-level offenses (for all cases) in only four states, while it is partially operational (in some districts) in 24 more as of the end of 2014. More rapid progress will be needed in order to meet the target of June 2016 in the 2008 Constitutional Amendment for full implementation. A new monitoring and evaluation body for the reform was set up in July 2014 and a unified national code of criminal procedure was published in March 2014, which represents important steps to support the transition to the new system. For federal offenses, the operation of the new criminal justice system began with two states in 2014 (Durango and Puebla).

Extension of the judicial reforms to the civil and commercial domains, which only started recently, has gathered speed. Now 26 states use oral trials in commercial trials, while four states use them in civil cases. These new procedures need to be fully rolled out and followed in practice. Reforms of judicial procedures have also helped considerably. Most notable is the 2013 reform to Mexico's *amparo* or "habeas corpus" petitions, which now prevents firms from readily blocking regulators' legitimate actions while decisions are under appeal. Judges will now have to give more consideration to the legitimacy of a complaint and the negative effects of a suspension of government decisions. These are important breakthroughs; however, their effectiveness will be determined by jurisprudence in practice. Helpfully, in the competition policy domain, specialised judges with relevant training and knowledge are now adjudicating cases in dedicated courts that have national (Federal) jurisdiction.

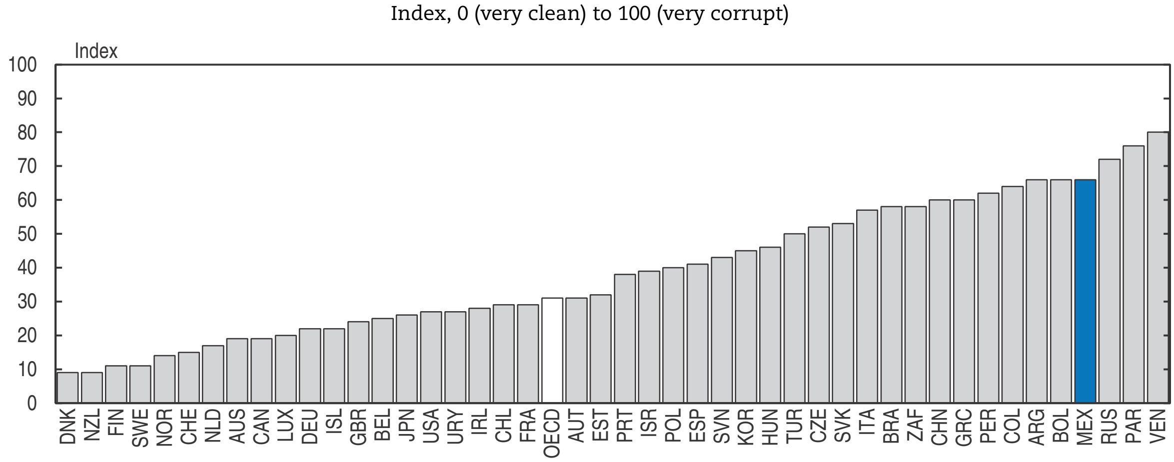
Corruption

The traditionally weak criminal justice system has helped to promote a public sector that is perceived as being highly corrupt (Figure 11). While this is partly because of the inefficiency of a legal system that prosecutes few crimes, it also results from other institutional weaknesses such as the structure of the police force and corruption within the system (see Figure 10, Panel B). Corruption fosters a variety of illegal activities, including non-compliance with tax laws and regulatory obligations. Recent OECD evidence shows that the degree of public sector corruption in Mexican states is causally linked to the size of the informal sector, which in turn has a strongly negative effect on productivity, particularly in more productive sectors (Dougherty and Escobar, 2014). Making it easier for informal firms to join the formal sector is an important way to deter corrupt behaviour, such as what is done in the new programmes in the recent fiscal reform (see the Annex for more details).

Given high crime rates in many states, which directly reduce well-being and deter investment, an important priority of the government has been to improve security. Further professionalisation of police forces at all levels has been needed for some time, along with better co-ordination amongst them (OECD-IMCO, 2013; OECD, 2013a). The administration initially focused on augmenting these forces by recruiting and training a rapid-reaction

Figure 11. **Mexico's public sector is perceived as corrupt**

Index, 0 (very clean) to 100 (very corrupt)



Note: The Corruption Perceptions Index ranks countries and territories based on how corrupt their public sector is perceived to be.
Source: Transparency International (2014).

StatLink http://dx.doi.org/10.1787/888933174875

"Gendarmerie" force of highly trained Federal police, similar to those in France, Spain, Chile and elsewhere. It will start with 5 000 members, expanding to 16 000 by 2018. This compares to the existing 36 000 member federal police force. Security co-ordination and training is now being improved amongst federal, state and local governments, though the scale and pervasiveness of organised crime is a major challenge. The military still plays an important backup role in addressing security challenges in problem areas.

To promote clean government, a new anti-corruption authority is being set up that will be responsible for preventing, investigating and handing down administrative sanctions for graft-related offenses. However, the Senate still needs to pass the enabling legislation. Branches of the watchdog will be set up in all of Mexico's states. The administrative sanctions that can be handed down against corrupt officials include removal and disqualification from office and fines. The authority will also work closely with prosecutors in the event of criminal offenses and can recommend precautionary measures such as pre-trial detention and the freezing of assets.

More broadly, a new Federal law – which States are required to implement by 2018 – will allow senators, deputies, mayors and local lawmakers to serve consecutive terms (the President is not included). These new rules should strengthen the incentives of local governments to provide higher quality services, and are complemented by laws requiring greater transparency of government finances. These rules should be adopted by states in order to promote stronger incentives for good governance.

Land reform

Agriculture remains an area in need of fundamental reform. Although it employs over 13% of the workforce, it accounts for only 3% of GDP. An important part of boosting productivity is for Mexico to further promote labour reallocation from low to high productivity sectors. Barriers to reallocation have meant that labour resources are misallocated, reducing productivity growth (Padilla-Pérez and Villarreal, 2014). Complexities in transferring land titles for communal land plots, called *ejidos*, which cover half of Mexican territory, have been a major obstacle. The property rights arrangements for this land promote small scale farming, limiting economies of scale. Evidence suggests that the transfer of land to private hands can alter the incentives for investment and thus boost agricultural productivity substantially (Castañeda Dower and Pfutze, 2013). While a constitutional amendment in 1992 allowed these plots to be transferred, only 2.5% of the land entered into the private domain over two decades (Dell, 2012). Political factors and administrative complexity have tended to limit administrations from pursuing such land transfers more aggressively. A significant simplification of the land certification and transfer process is now needed to ensure more productive use.

More broadly, agricultural subsidies need to be reconsidered. While the overall level of producer support is low in Mexico, it is heavily skewed towards input and production-linked support, and tends to benefit the richest farmers, thus being regressive. The announcement in late 2013 to move from subsidies to "productive" incentives is welcome, as is the intention to differentiate subsistence and commercial agriculture. Programmes to offer collective financing for smaller famers could also be further strengthened. At the same time, it will be important to phase out subsidies for water pumping and fuel and consider direct rural income support, if needed, as an alternative.

Recommendations to boost growth and reduce informality

Main recommendations

- Focus on fully implementing the reform package with close monitoring at a high political level, and strengthen administrative capacity and governance quality at all levels of government.
- Reform justice institutions, strengthen the rule of law, address security issues and reduce widespread corruption with reforms centred on the efficiency of judicial resolution of civil, commercial and criminal matters, and a strengthening of the transparency of public procurement.
- Improve and simplify the existing stock and quality of regulation at the local, state and national levels.
- Phase out restrictions on agricultural land ownership and transfer, while strengthening rural income support and access to finance.

Additional recommendations

- Promote high-tech industrial clusters with linkages to universities and early-stage investment vehicles.
- Address conditionality rules in the telecom reform that makes market access conditional on reciprocity.

Environment

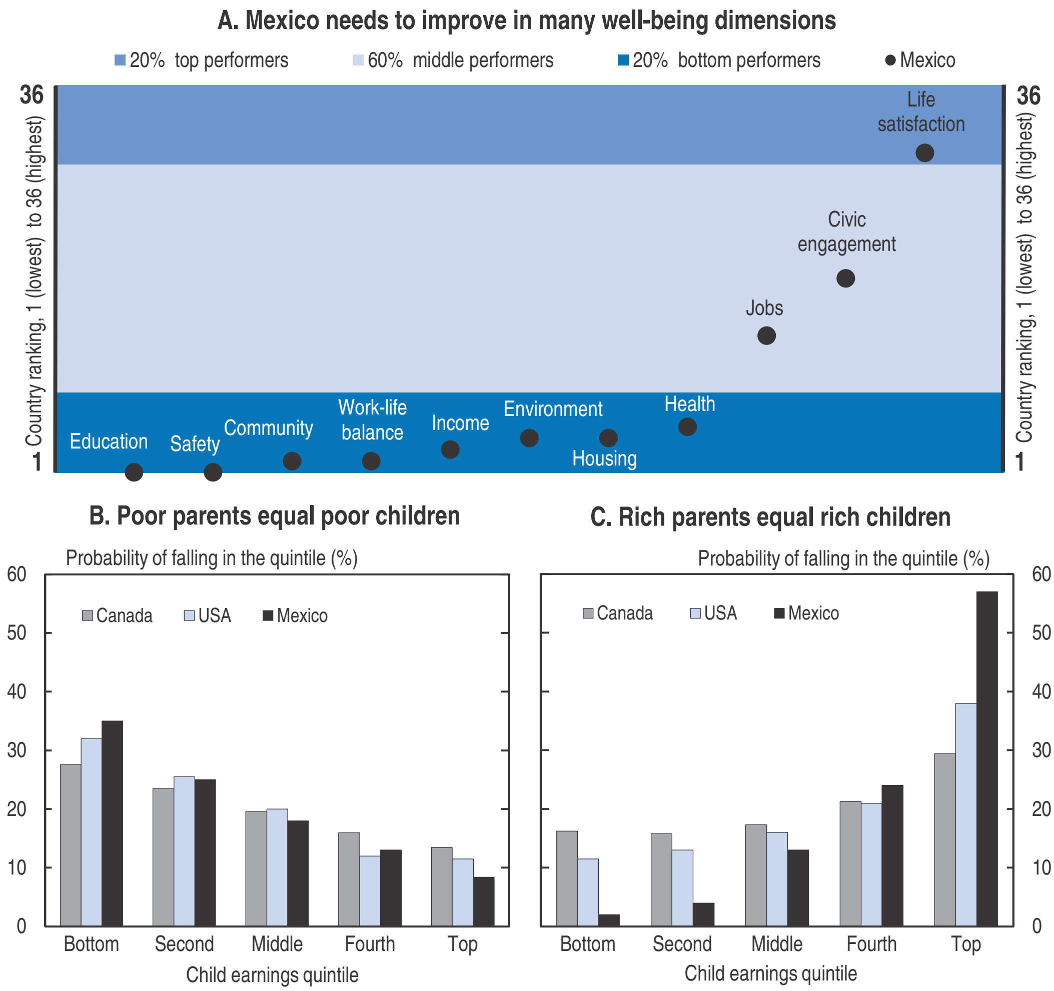
- The new carbon tax should be evaluated given to determine the effective tax rate, and raised if deemed insufficient.
- Pass the pending renewables energy bill, and take further steps to fully implement the renewables target of 35% by 2024.
- Stay on track in the phase-out of the gasoline subsidy, such that gasoline prices are fully liberalised by 2018.

Sharing the fruits of growth

The administration introduced major structural reforms that go beyond macroeconomic variables and seek to improve the quality of life of the Mexican people. This is a key step forward, as during recent years, and despite increasing efforts on poverty alleviation through social programs such as *Oportunidades*, weak growth, pervasive informality and high income inequality have held back well-being in Mexico (Figure 12, Panel A). In particular, Mexico needs to enhance efforts to improve in areas such as education, safety, housing, work-life balance and health, as well as reduce gender gaps. Poor quality education and health have a negative impact on people's productivity, affecting their employability. In turn, this induces informality, which means poor job quality – affecting work-life balance and the time parents can spend nurturing their children, with a negative effect on their future prospects – and lower fiscal revenues, which affects the state's capacity to provide high-quality public goods like health and education. These factors help explain why intergenerational mobility is relatively low in Mexico, causing large inequalities to persist in time (Figure 12, Panels B and C).

The tax reform passed in 2013 is expected by the administration to increase general government revenues from 21.6% in 2013 to 24% of GDP in 2018. This should make headway in reducing inequality, as more than half of the revenue increase will come from

Figure 12. **Well-being and social mobility are low in Mexico**



Note: Data for panel A include Brazil, Russia and the 34 OECD countries. Panel B shows the distribution of earnings of children whose parents' earnings are in the bottom income distribution. Panel C shows the distribution of earnings of children whose parents' earnings are in the top income distribution.

Source: OECD, *How's Life? Measuring Well-being* (2014); and Olaberria (2014b).

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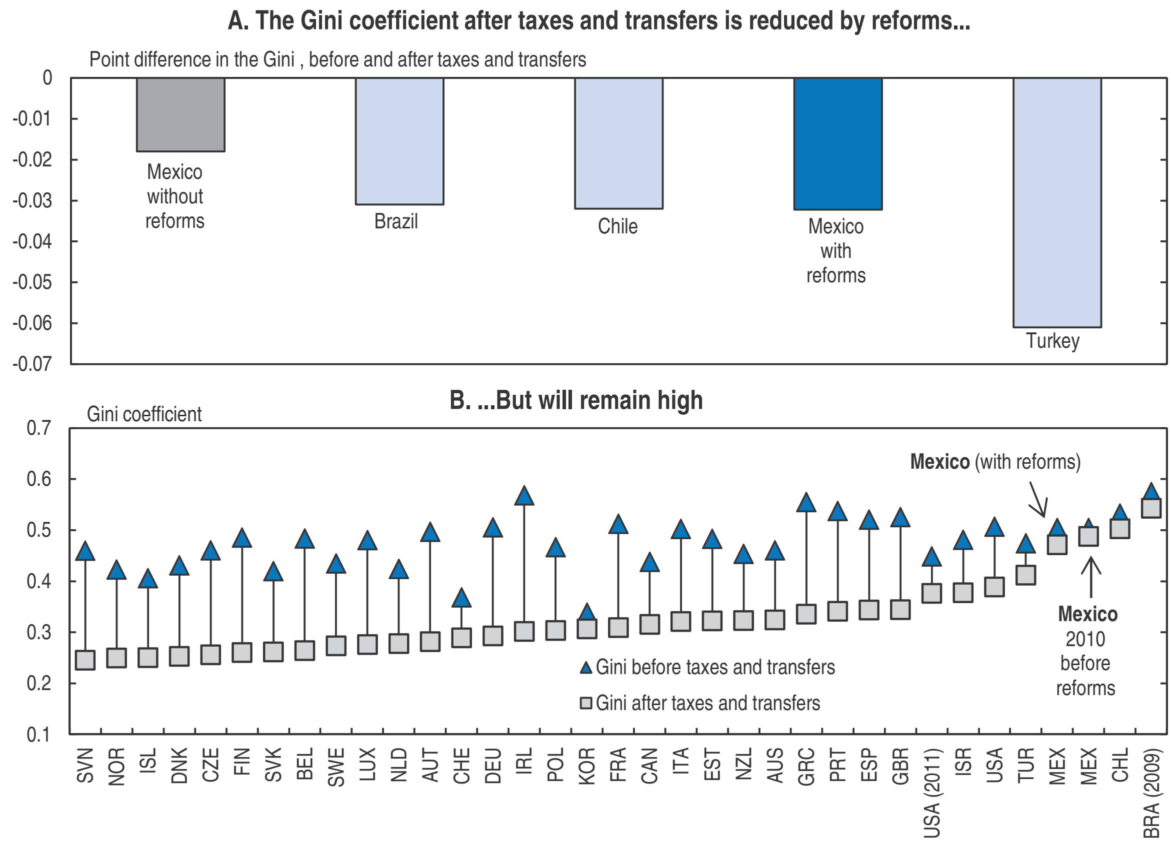
higher taxes on the richest 10% of the population. Before this reform, Mexico was the OECD country where the tax and transfer system was doing the least to reduce income inequality: the Gini coefficient before and after taxes and transfers was almost identical. With this reform, the Gini coefficient after taxes and transfers is moving in the right direction (Figure 13, Panel A); however, income inequality will remain above OECD averages (Panel B), and further reforms will be needed in the future. Part of the issue is continuing to strengthen tax rules to avoid evasion and non-compliance, combined with stricter enforcement measures.

The large inequalities in terms of income, as well as in terms of access to education, hinder growth (Causa et al., 2014) and translate into differences in life satisfaction across socioeconomic groups. In Mexico, the perception of life satisfaction is associated with the level of income and level of education (Figure 14).

Figure 13. **Tax policy should do more to reduce inequality and poverty**



Note: Data refer to 2011. For panel B, 2012 for Australia, Finland, Hungary, Korea, Mexico, the Netherlands and the United States. 2010 for Belgium.

Source: OECD, Income and Poverty Database; Mexico Ministry of Finance (SHPC); *Commitment to Equity* (for Mexico and Brazil).

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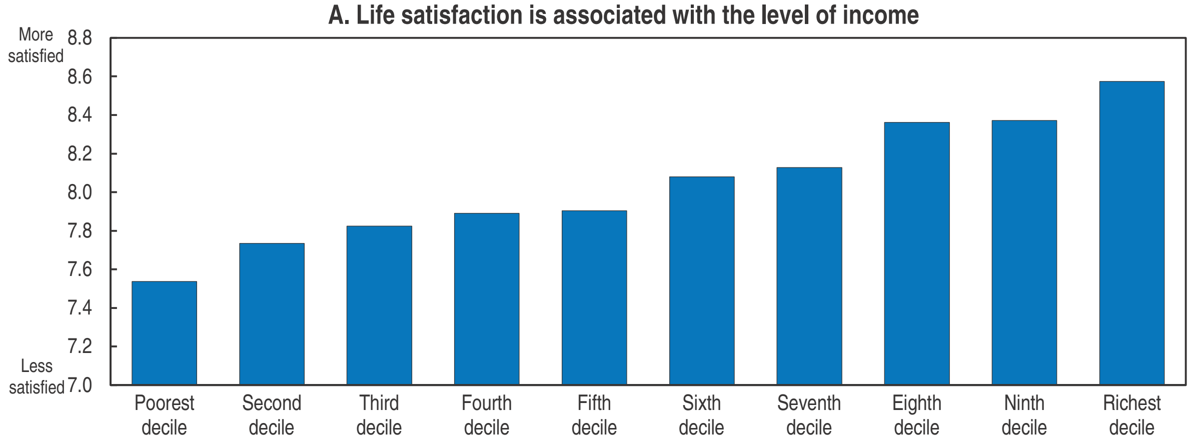
Income protection

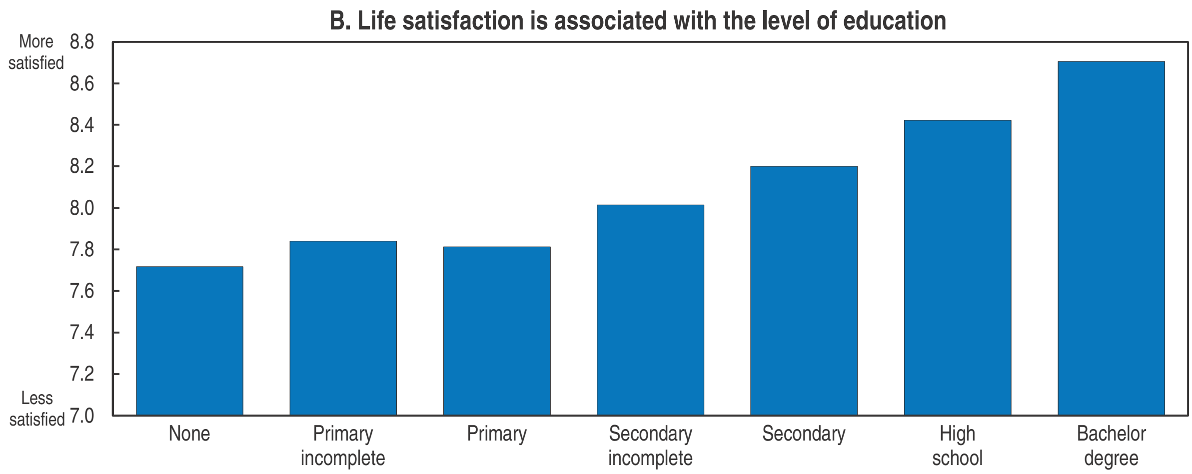
Mexican households, in particular families living in poverty, have only limited protection from economic adversity. Hence, income and consumption at the lowest levels of the income distribution are more volatile and follow closely overall macroeconomic trends, increasing in good times and decreasing in bad ones (Figure 15). For example, in the four years 2007-10, real household disposable income fell by more than 5%, one of the largest declines among OECD countries. Although mean and median household disposable income have risen since 2010, average household disposable income per capita, including in-kind transfers (USD 12 850 a year at PPP) remains the lowest among OECD countries, and there are wide disparities across the population.

Increasing income protection is therefore an important priority. For this purpose, the government has started to overhaul several social programmes. Among these is the “National Crusade Against Hunger” (*Cruzada Nacional Contra el Hambre*), which seeks to help 7 million people in hunger by pooling human and financial resources from various programs at the federal, state and municipal levels. Although severe undernourishment is not a major problem in Mexico, this programme could lift people out of poverty, reduce infant mortality and improve inclusion.

Figure 14. **Inequality affects life satisfaction**

Life satisfaction level ranges from 0 (No satisfaction) to 10 (Totally satisfied)





Source: INEGI, *Módulo de Bienestar Autorreportado* (BIARE), 2012.

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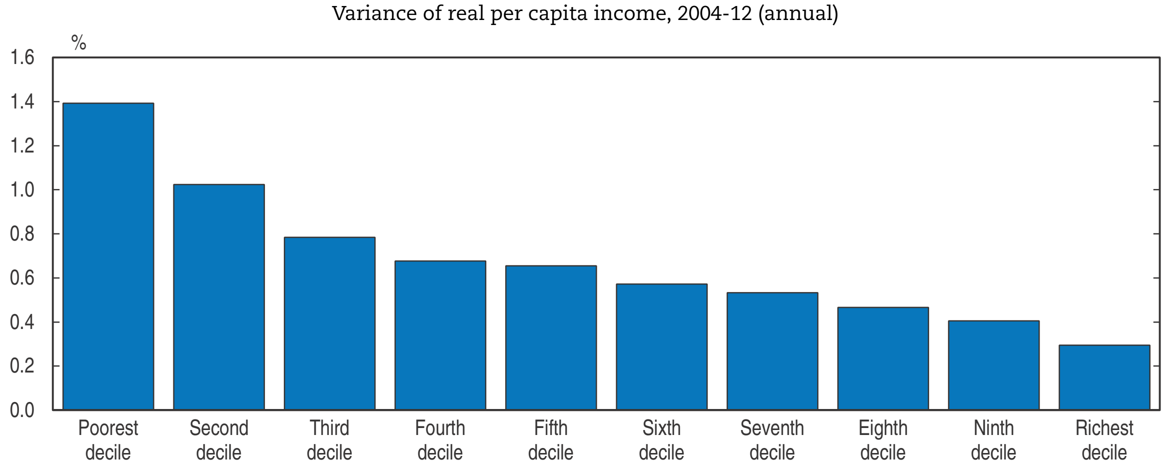
Figure 15. **The poor have very volatile income**

Variance of real per capita income, 2004-12 (annual)



Note: Real per capita income is per capita income in current prices deflated by CPI.
Source: OECD, Income Distribution Database; CEDLAS and the World Bank.

How to read this figure: The figure shows that the variance of real per capita income is higher for households with low average real per capita incomes than for households with high average real per capita incomes.

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Mexico has one of the highest old-age poverty rates in the OECD. Approximately 66% of those more than 65 years old (8.6 million Mexicans) do not have access to a pension and 4 million live in poverty. To provide income protection to the elderly, the administration has recently proposed the Universal Pension Act. This programme will ensure that all Mexicans over 65 years old not entitled to receive a pension benefit will be eligible for a minimum pension from the federal government.

To help workers who lose their job in the formal sector to smooth consumption and support their job search, the administration has proposed unemployment insurance. This will guarantee a 6 months benefit to all workers who lose their job in the formal sector, and who have contributed in at least 24 out of the last 36 months. The worker will have an account that can be used for housing, pension or unemployment insurance. To complement this, there will be a Solidarity Fund, funded with a federal government contribution of 0.5% of the workers basic wage that will guarantee a minimum wage for 6 months.

With the introduction of the Unemployment Insurance and the Universal Pension System, Mexico will move towards a universal social security system, independent of employment status. These reforms are key priorities to reduce poverty and inequalities; they should be approved by Congress and implemented with urgency.

Oportunidades – the conditional cash transfer programme that began in 2002 – has decreased poverty, encouraged educational attainment and helped to cushion income during economic downturns (CONEVAL, 2012). Despite a budget increase of 126% in real terms between 2006 and 2012, the poverty rate rose from 42.9% to 52.3% over the same period, reflecting mainly the social effects of the recession. The administration has announced that it will be replaced by a new programme, *Prospera*. Under this new programme, all beneficiaries will continue to receive the support they have had so far, but this will be complemented by new tools to help them improve their productive potential. Specifically, children can now receive scholarships for college or technical college; and those looking for a job have priority in the National Employment Service. Furthermore, *Prospera* will facilitate access to financial education, savings, insurance and credit; it will also allow families to strengthen their own income by having priority access to 15 productive programmes. The fact that *Prospera* will complement the conditional transfers of *Oportunidades* with active labour market-policies is also a positive step forward.

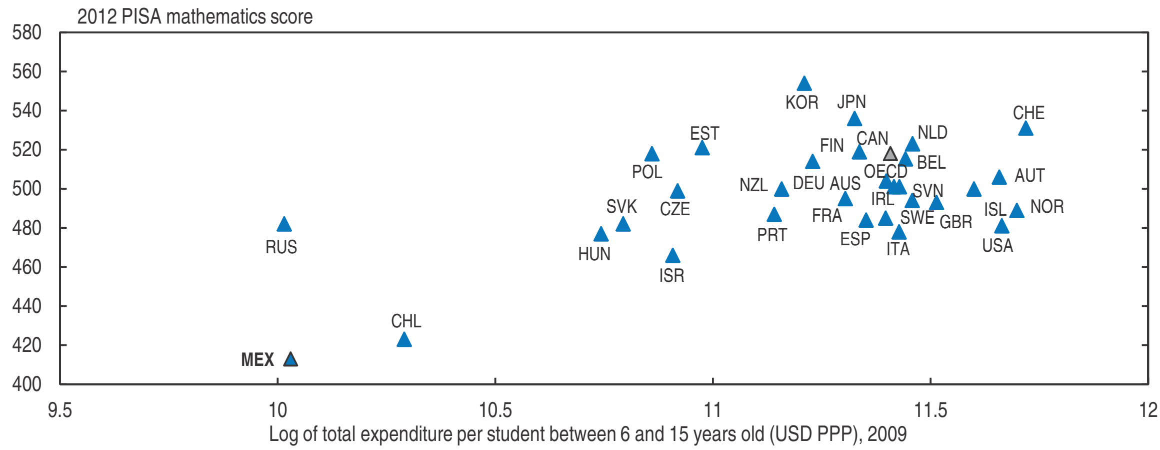
Mexico's social reforms are estimated to increase public spending by a limited amount, which will be funded. The pension reform will increase annual federal expenditure by 0.3% of GDP during the period 2014-18 and remain below 1% of GDP over the longer term, while the unemployment insurance scheme will have a more limited impact of 0.05% of GDP. Other steps such as the redesign of the conditional cash transfer, anti-hunger measures, and enhanced education efficiency do not imply significant costs under current plans. Additional spending is expected to be met by the proceeds of the tax reform.

Education

Improving educational outcomes of all Mexicans would be the most powerful tool to promote inclusive growth. Despite important improvements during the last decade, educational spending efficiency and academic achievement in Mexico are the lowest among OECD countries (Figure 16). Furthermore, access to a good education is linked to socio-economic status of the family. To address this challenge the administration has

Figure 16. **PISA mathematics score and spending per student**

In equivalent USD converted using PPPs for GDP, by level of education



Source: OECD, *Education at a Glance* (2013); *PISA 2012 Results: What Students Know and Can Do, Volume I* (2013).

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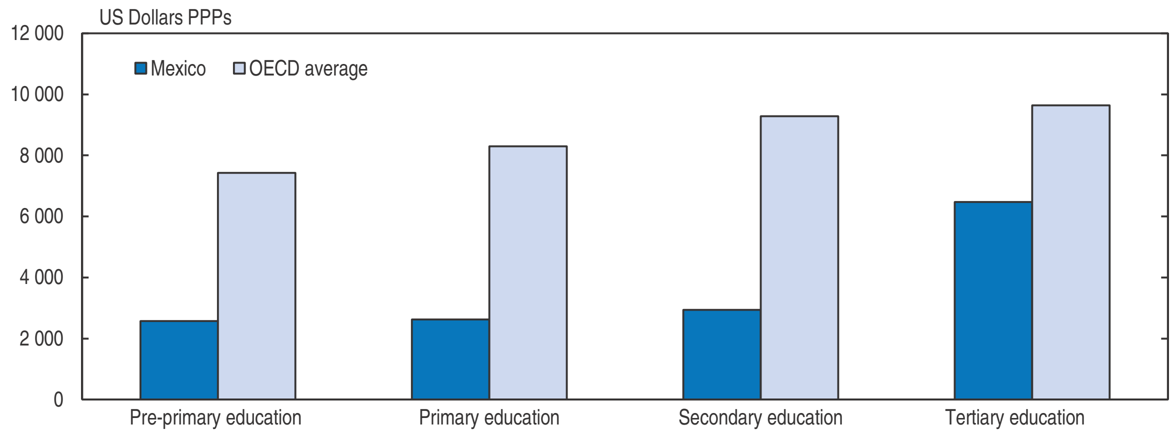
introduced important reforms. The amendments to the Mexican Constitution in 2013 established commitments that materialised in a series of legislative reforms: the General Education Act, a new professional teaching service law, and the Law of the National Institute for Educational Evaluation that will improve the quality of the teaching profession. For instance, these reforms tackle one of the most challenging factors to help improve educational outcomes: that Mexico's teaching profession needed to be stronger and better managed, and the best teachers should teach in the most difficult environments. In the short term, the education reform will allow the central government to better control the teachers' payroll which until now had been opaquely handled by state governments. The objective is that the central government verifies the identity and occupation of each individual that is included in the payroll, to reduce the amount of expenditure devoted to union or other administrative personnel that do not directly contribute to the education of the next generation. Moreover, this exercise will serve to reduce possible risks of corruption. These reforms are only the beginning of a broader and deeper transformation of the educational system, which will require expanded support for pre-primary, primary and secondary education and improving the returns of investing education, motivating kids to remain in school.

As a share of GDP, public spending on education is around the OECD average, but spending per student is only onethird of OECD average at all levels; most of the spending goes to the salaries of teachers, without a performance element, and not enough to infrastructure. Moreover, Mexico spends four times as much on university students (Scott, 2009), than on pre-primary, primary and secondary students (Figure 17). This is not only regressive, but also inefficient since returns to education are significantly higher at early pre-primary and primary levels, which therefore deserved increased focus (Heckman, 2006).

Mexico has one of the highest secondary school dropout rates (almost 50%) in Latin America. Secondary school graduation rates are relatively low, especially for low-income groups (Figure 18). If students are not motivated to stay in school, it is unlikely that they will benefit from the better standards achieved by the educational reform. The reasons behind high drop-out rates are numerous and complex, but it is striking that the majority of students who drop out express a lack of interest in schooling. Participation

Figure 17. **Spending per student in pre-primary, primary and secondary education is low relative to the OECD average**

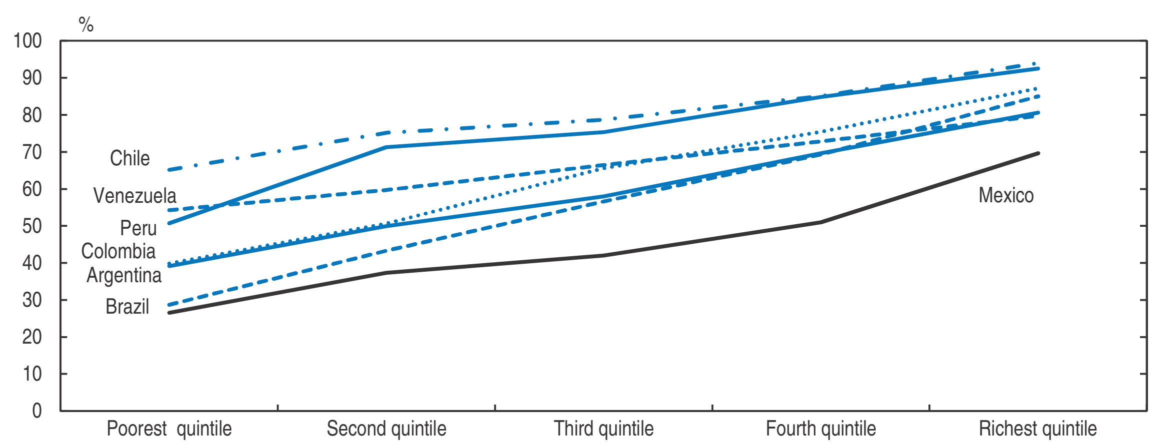


Note: Spending in tertiary education excludes spending on R&D.
Source: OECD, Education at a Glance (2014).

How to read this figure: The graph shows that expenditure on education per student is low in Mexico relative to the OECD average at every level of education, but particularly in pre-primary, primary and secondary levels.

StatLink http://dx.doi.org/10.1787/888933174938

Figure 18. **High-school graduation rates in Latin America by quintile of income distribution**



Source: Inter-American Development Bank.

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rates of disadvantaged students could be raised through better career guidance and counselling services and by the provision of education opportunities that are more relevant to the labour market.

For instance, to make upper secondary education more appealing to students, the transition from school to work should be a priority. One way to prepare students for the labour market is through vocational education and training (VET) and work-based programmes (OECD, 2010). In Mexico, the VET system provides learning opportunities in remote regions and support for students at risk. To improve the system, Mexico reformed the technological baccalaureate and created trainee grants. Vocational education and training (VET) has a key economic function in up-skilling and integrating young people into the labour market and in providing high-quality technical skills. But Mexico should enhance efforts to expand the VET sector as it remains among the smallest in the OECD area. There are different possible pathways for Mexico to improve the VET sector. For example, the government could establish a formal consultation framework between employers, unions and the VET system, adopting quality standards and apprenticeships to support and expand workplace training as an integral part of vocational programmes. It could also provide pedagogical training to VET teachers before they start teaching and develop the capacity to analyse and use data on labour market needs to guide the design of policies and improve decision making.

Empirical evidence shows that early childhood care support can also help reduce secondary school dropout rates, improve student performance and reduce gaps in learning achievement generated by different social backgrounds (Heckman, 2013; OECD, 2011a). Students in Mexico who had attended pre-primary school scored about 40 points higher in PISA 2012 (almost equivalent to a school year) than those who did not. Yet, although Mexico has one of the highest rates of school enrolment among four-year-olds, only 25% of children under the age of three receive care outside the home, which places the country in the bottom of OECD countries in care coverage and services for this population group. More should be done to improve access to quality early childhood education and care. This will not only provide a stronger head start to children from disadvantage families, but also help their mothers in joining the labour force.

Health care

Mexico needs to improve its health outcomes, which affect well-being, educational outcomes, and productivity (Mayer-Foulkes, 2008). The introduction of *Seguro Popular,* a publically-funded universal health insurance programme ten years ago helped improve some measures of health performance, but most health indicators remain worryingly poor, and the system is highly fragmented and inefficient. For instance, life expectancy at 74 years is still six years below the OECD average; infant mortality rates are among the highest in Latin America; mortality from coronary heart disease is increasing even as it is falling in almost every other OECD country; the obesity rate is the second highest in the OECD; and almost one in six adults are diabetic (OECD, 2015b).

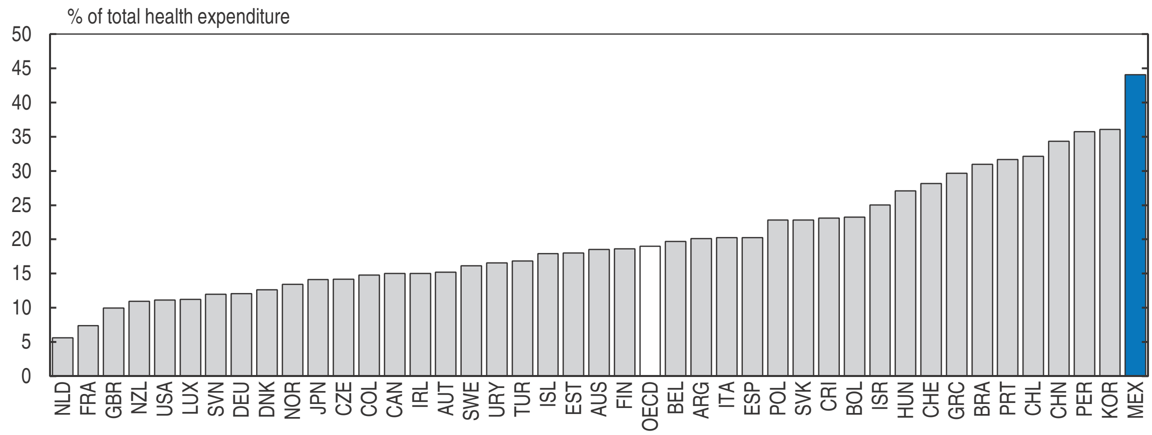
Improving health care calls for more efficiency in health spending. Currently, Mexico's public spending on health is 6.2% of GDP, significantly less than the OECD average of 9.3%. Administrative costs, at 9.2% of total health spending, are the highest in the OECD and have not declined over the past decade. Likewise, out-of-pocket spending is nearly 50% of total health spending – the highest in the OECD (Figure 19). High out-of-pocket spending drives families into poverty, offsetting the beneficial effects of social programs like *Oportunidades* (Lustig, 2007).

Health care is currently provided by segmented networks, each employing its own staff, with no synergies and high duplication and entitlements are determined by employment status. The largest providers are *Instituto Mexicano de Seguridad Social* (IMSS), for people in formal employment, and *Instituto de Seguridad y Servicios Sociales de los Trabajadores del Estado* (ISSSTE), for civil service employees. *Seguro Popular* covers remaining families, thus helping to achieve complete coverage of the population.

However, full coverage does not translate into equality of access. For instance, the number of specialist out-patient consultations per 1 000 enrolees is 47 for *Seguro Popular*, compared to 101 for IMSS; and the number of prescriptions that cannot be dispensed by a

Figure 19. **Out-of-pocket payments are the highest in the OECD**

As a percentage of total health expenditure, 2012



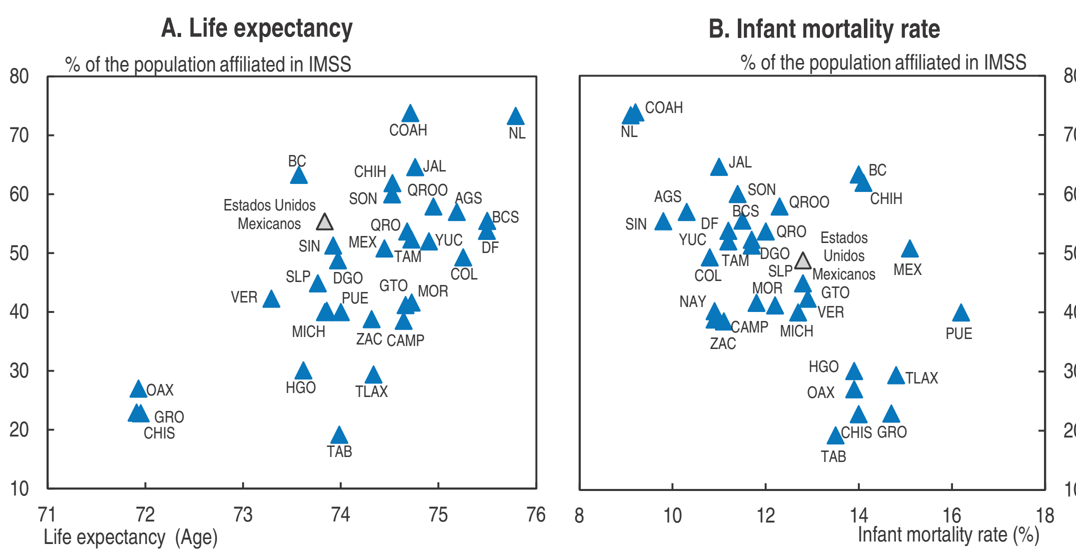
Note: The figure shows data that is comparable across countries. However, according to IMSS, these figures underestimate Mexico's health expenditure as a share of GDP (which should be 8.6% according to IMSS), and over-estimates the out-of-pocket payments as a share of total health expenditure (which should be 37% according to IMSS). This is because public institutions, such as IMSS, can buy medicines at lower prices. Once the prices paid by the private sector are considered, public health expenditure increases and therefore, out-of-pocket spending, as a share of total health expenditure, is lower.

Source: WHO Global Health Expenditure database.

StatLink http://dx.doi.org/10.1787/888933174958

pharmacist due to lack of stock is 33% for *Seguro Popular*, compared to only 3.6% for IMSS. As a result, there are large differences in health outcomes between IMSS affiliates and the rest (Figure 20). Furthermore, since treatment for some common and devastating illnesses are excluded from *Seguro Popular,* its affiliates' out-of-pocket spending on medications and diagnostics is 456 Mexican pesos per consultation, compared to 114 pesos within IMSS. That the poor spend a much higher proportion of their income on health care than the rich highlights the urgent need for reform.

Figure 20. **Health outcomes and affiliation to IMSS**



Source: IMSS and INEGI, Censos de Población y Vivienda, 2010.

StatLink http://dx.doi.org/10.1787/888933174962

Building a "National Universal Health System" to ensure effective access to high quality health care to all people regardless of employment status should be a top priority. The *Pacto por México* recognised this and committed to a system where quality and access are equal across all providers and where individuals can choose freely between them. However, effective action has been delayed by differences of opinions on how to effectively increase access to health. While a comprehensive reform of the Mexican health system should involve the full co-ordination of the existing sub-systems, such a reform would likely face resistance due to concerns about the perverse effects that it could create between institutions. Therefore, it is important first to identify reforms that, without involving the elimination or merger of the institutions in place, have desirable features such as encouraging all people to have health insurance, providing equity of access to quality health care, and facilitating portability.

A good place to start given the current configuration of the system is through standardisation of procedures, improved quality and reduced costs of services across all institutions and having institutions interchange these services to increase effective access. Moreover, Mexico should move away from the current configuration of disconnected insurer/provider conglomerates, which cover distinct groups and offer different levels of care for different costs and different outcomes, towards a system where access is determined by need, not by employment status, and individuals have some degree of choice over insurer and provider, driving efficiency and continuously improving quality.

Such reforms should help to reduce administrative costs, making the system more financially sustainable. However, other measures could also contribute to improved revenues:

- Make enrolment in social security mandatory for all self-employed workers, which may require a change in the legal framework. So far, enrolment in IMSS is voluntary for these workers, and as a result many self-employed workers choose to affiliate only once they need insurance, imposing high costs in the system.
- Strengthen enforcement mechanisms, notably through better coordination with the tax collection agency. Registered firms under-report wages to the social security administration to evade payroll taxes (Kumler et al., 2013), and over-report wages to the tax authorities to obtain deductions. Current legislation allows firms to do this as the Social Security Act (the law that defines payroll taxes) and the income tax law allows the basis for wage compensations to be different. A bill that has been approved by the House of Deputies and is currently waiting to be voted on in the Senate amalgamates the basis for wage compensations in both of these laws, which would solve this problem and pave the way for the social security and the tax collection agencies to share information and enforce compliance.
- Redesign *Seguro Popular* to improve efficiency and fiscal sustainability. Allocation of funds to health care services should be determined according to price, quality or optimal distribution of service provision, not by rigid institutional relations as it is today. Financial allocations to State Health Service (*Servicios Estatales de Salud*) from federal revenues should be determined according to need, and not on historical precedents, and give more flexibility to the states to determine their own mechanisms to ensure that funds are spent to best meet local health care needs, promoting productivity and quality. Furthermore, for the high cost diseases, resources should go directly to providers avoiding state intermediation as is currently the case.

- To boost health service delivery and reduce administrative costs, Mexico should consider converting government hospitals into corporate entities, while meeting certain standards determined by the central administration. The majority of public hospitals, owned and operated by the states, have little autonomy, usually limited to the purchase of supplies. Evidence for Latin American countries (including Mexico) suggests that hospitals with corporate status tend to have better facility and equipment maintenance, more availability of medicines and auxiliary services, greater administrative and labour efficiency, and superior clinical quality, including at the level of nursing training (Bogue et al., 2007).

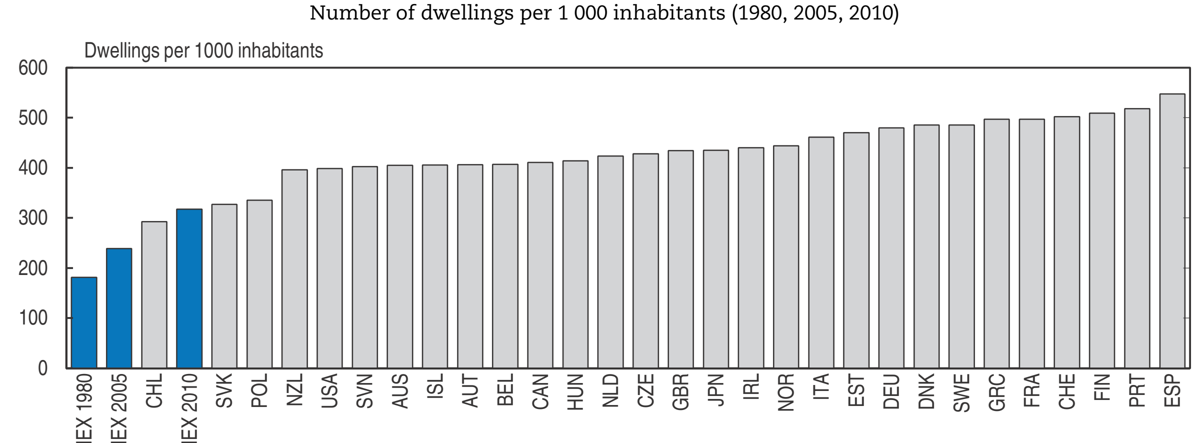
Housing and urban policies

Given that neighbourhoods have a major impact on the socio-economic outcomes of their residents, housing and urban policies should be thought jointly and as an integral part of the national plan to boost productivity and improve inclusiveness. Despite the country's rapid urbanisation – one of the fastest in the OECD (OECD, 2015c) – Mexico has until very recently lacked public policies to guide urban development, focusing instead on housing policy and, specifically, the expansion of housing finance. This approach has been relatively successful in facilitating housing access to an increasing share of the population (Figure 21).

However, this has come with high qualitative costs for urban development, contributing to rapidly sprawling cities, with housing located far from jobs and urban centres, and lacking basic infrastructure (e.g. water) and transport connections. The quantitative focus of housing development is one of several factors that has contributed to Mexico having one of the highest vacancy rates across the OECD (14%), a problem that persists in both inner-city and peripheral neighbourhoods. At the same time, these housing policies have contributed to increasing geographical segregation by socioeconomic status (Sánchez Peña, 2012), which can have negative effects on the well-being of the disadvantaged by affecting their health, educational achievements, work-life balance and personal security (Leigh and Wolfers, 2001).

Figure 21. **Mexico has been effective in facilitating access to housing**

Number of dwellings per 1 000 inhabitants (1980, 2005, 2010)



1. 1981 for Australia and Greece; 1982 for France; 1986 for Germany; 1988 for Finland; 1989 for Portugal and 1990 for Italy; 1982 for Chile.
2. 2001 for Belgium, Czech Republic and Greece; 2002 for the Russian Federation; 2003 for Australia and Italy; 2004 for France and Switzerland; 2002 for Chile; 2005 and 2010 for Mexico.

Source: INEGI (1980), Censo General de Población y Vivienda; INEGI (2005) Conteo de Poblacion y Vivienda.

StatLink http://dx.doi.org/10.1787/888933174972

In 2013, the federal government proposed a new vision for housing and urban policy, seeking to reduce the needs for adequate housing that still affects many Mexican households and to address the inefficient development patterns of recent decades. This new approach to housing and urban policy differs from those of the recent past in shifting from quantitative objectives for housing to a more explicit qualitative focus on housing and the urban environment. The creation, in 2013, of a single ministry tasked with housing and urban policy (the Ministry of Agrarian, Territorial and Urban Development, SEDATU) was an important step toward more a co-ordinated response to the country's urban challenges. These proposed reforms are a step in the right direction, but the consistency of housing policies needs to be reviewed.

Housing policies have mainly relied on the provision of subsidies and mortgages at below-market-rates to meet the needs of low-income households. In fact, Mexico has been one of the few OECD countries, along Italy and Spain, where social housing policy has relied exclusively on offering assistance for home ownership, rather than renting. Heavy reliance on home ownership is inefficient because, in many states, it is financially more advantageous to rent than purchase a home (OECD, 2015a). Moreover, rental housing may be the most efficient and cost-effective way to reduce the curb urban sprawl, because rental residences are often more densely developed and located in city centres (Blanco et al., 2014).

Priorities for housing and urban policy should include reforms to housing finance, co-ordination of housing and infrastructure investments, diversification of the housing stock (tenure and type) and tools to address the large share of vacant and abandoned homes. Moreover, there is a need to create new tools – beyond subsidies and subsidised mortgages – in order to generate different urban outcomes. Fiscal, legislative and institutional reforms to bolster the capacity of municipalities to manage urban development are needed.

Recommendations to share the fruits of growth

Main recommendations

- Improve the equity and efficiency of education spending by refocusing such spending on pre-primary, primary and secondary education. Concentrate on improving the quality of teaching.
- Encourage more women to join the formal labour force by improving access to quality child-care for children under three years of age and extending active labour market policies.
- Promote access to quality health care through improved coordination across health institutions to reduce redundancies; in particular, promote exchange of services between health care networks.
- Approve draft legislation for unemployment insurance and universal pensions to protect job seekers and elderly people against the risk of income losses, and reduce inequality.
- Fully roll-out the new *Prospera* cash transfer programme to help beneficiaries expand their capabilities, complete their education, join the formal sector and obtain well-paid jobs.

Recommendations to share the fruits of growth *(cont.)*

Additional recommendations

- Enhance investment in dual education and vocational education and training programmes.
- To improve quality and reduce costs of services across all health care providers, standardise procedures and make health insurance mandatory.
- Allocate financial resources to state health services according to need and give more flexibility to the states to determine how to spend them.
- Consider converting government hospitals into corporate entities.
- Develop a coherent national urban policy that takes into account the broader impacts of housing development on the urban environment and people's well-being.

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