Introduction

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The main challenges facing the Mexican economy

It is now five years since the onset of the worst economic and financial crisis in decades, and the main scenario continues to be one of high risk – including the so-called fiscal cliff in the United States and unresolved financial, fiscal and institutional agendas in Europe. The majority of OECD countries are still facing the consequences of the crisis: high public debt, sluggish or even negative growth, record high unemployment, and fragile banking systems. The deterioration of confidence only adds to the downside in this scenario.

Although Mexico was among the countries hardest hit by the recession in 2008-09 because of its links with the US economy, its economy is now in a much better state than that of most other OECD countries. This is the result of the economic reforms carried out previously as a result of Mexico's own crises. Following a sustained recovery in 2010-11, the Mexican economy is expected to grow by around 4% in 2012 (compared to 1.4% on average in the OECD area) and to remain around 3.5% in 2013-14. The fiscal situation is sound and inflation remains under control despite some pick-up following increases in food prices. Capital inflows have been sustained at an adequate level, stimulated by the improvement in the business environment and by a network of free trade agreements with forty-four countries. In addition to its long-standing macroeconomic stability and international openness, the financial system, which fared relatively well during the global financial crisis, is another key strength of the Mexican economy.

Nevertheless, this is no time for complacency. Given its stage of development, its impressive market-based reforms in recent decades, the youth of its population and the opportunities to catch up with more advanced economies, Mexico could grow at a faster rate and establish itself on a par with the more dynamic economies if constraints to output potential can be lifted more rapidly and effectively. Although Mexico's GDP grew faster than the OECD average over the past ten years (2% a year on average compared to 1.6% in the OECD area), this growth was significantly lower than other middle-income OECD countries, such as Chile, Turkey and the countries in eastern Europe, and well below the trend of the other major emerging economies. GDP growth was also insufficient to make any substantial improvements in the living standards of the population, measured in terms of GDP per capita, which in 2011 was the lowest among OECD countries. According to OECD estimates, a growth rate close to 4% sustained over the next two decades is necessary to reduce the per capita income gap with the best performers in the OECD area from about 70% today to 50% by 2030. Even higher rates of growth would be necessary for Mexico to join the group of high-income countries. Nevertheless, it is certain that Mexico can achieve such higher rates.

This requires removing current obstacles to achieving a prolonged period of rapid economic expansion, and in particular to productivity growth. Not only has there been no improvement in productivity, but also in recent years its growth has been negative. Improvements have been uneven in a business environment that remains unfavourable for higher investment and innovation in many areas. In spite of clear progress in the competition framework, monopolistic practices still affect several markets in Mexico and increase the cost of doing business. There also continue to be high levels of informality in the labour market, and a lack of the necessary skills among the labour force for Mexico to move more quickly up the value chains. These weaknesses constitute bottlenecks and need to be addressed. Mexico has all of the elements and attributes to grow at much higher rates, and the main measures that are necessary to achieve that growth are already well-known.

A core element in building a more dynamic economy and a more inclusive society in Mexico is the effective functioning of the legal framework. The judicial system presently provides neither the certainty nor the necessary legal efficacy for economic activity to prosper at a faster pace. A malfunctioning legal system has a large impact on all areas of economic activity, and it can also become an obstacle for building a society that is more inclusive and based on solidarity. The costs are immense, as it affects economic structures as well as human and social capital. Tackling the problem must therefore be one of the main priorities of the new government, and reforms and reviews of the legal and judicial system need to include the different levels of government to ensure overall improvement. The new government, with the support of the main parties represented in Congress, has taken a very positive step forward by making the issue of security and justice central to the Pact for Mexico that was recently signed.

As is true of other OECD countries, Mexico can no longer just promote any type of growth: the challenge is to promote growth that is more inclusive and more respectful of the environment. As stated in the Pact for Mexico, policies to improve inclusion are particularly important in a country with the levels of inequality found of Mexico, where – despite having one of the most successful programmes for reducing poverty in the world, a model for other countries – around half of the population in 2010 was living in a situation of poverty (either moderate or extreme). In 2008 the average income of the 10% of the Mexican population with the most resources was twenty-seven times higher than that of the 10% with the least resources (in comparison with the OECD average, which is 9 to 1). The level of inequality in GDP per capita between states in Mexico is one of the highest among federal OECD countries, ranging from one and half times the national average in the *Distrito Federal* (Mexico City) to under 60% of the national average in Chiapas. Measures to achieve higher levels of growth will need to be combined with effective action to better distribute opportunity and income since, as in other Latin American countries, the effectiveness of the tax system in bringing about better redistribution is negligible. And Mexico must broaden its economic policy goals to achieve higher levels not just of income, but also of well-being. The country is not alone in this; there is a need in all OECD countries to redefine economic strategies. The end objective cannot simply be the unfettered accumulation of income and capital. It must target a real improvement in well-being that is inclusive and aware of the social sphere, environmental limits, and inter-generational commitments.

The aspect of social well-being is crucial, because such persistent widespread poverty and inequalities inhibit social cohesion as well as growth. For example, to the extent that inequality affects the results and outcomes of education and the provision of health services, it tends to limit the development of the human potential that all Mexicans deserve and that Mexico needs in order to achieve higher growth. The fact that pro-growth public policies do not succeed in reducing inequality could also lead to resistance to these policies.

With regard to the environment, the impact that economic activity has had on the country's natural resources is evident and decisive action is needed to limit the impact of growth policies on the environment. Economic and demographic growth has led to considerable environmental degradation, the depletion of natural resources and a rapid increase in greenhouse gas emissions. The level of particulate air pollution is among the highest in the OECD countries. There are also high levels of soil and surface water pollution. It is essential for the commitments undertaken in the Section 2.4 of the Pact for Mexico regarding these matters to be decisively implemented so that sustainable development can be encouraged.

The interconnected nature of the challenges of economic growth, inclusiveness and environmental impact also underscores the need for a multidisciplinary solution. The agenda must progress simultaneously on various fronts in order to benefit from the effects of the different measures. For example, new labour legislation would have a greater impact on productivity and equity if improvements were made to the business environment, competition and educational achievement, and if a better transition to the labour market can be ensured. With a simpler and fairer tax system, the positive effects would be even greater. Environmental policies that are well designed can create new markets, investment opportunities and employment.

Achieving higher, more inclusive and greener growth therefore calls for a strategic agenda to convert Mexico's assets into actual strengths, and to overcome the obstacles that stand in the way of a more dynamic development.

The design of such a strategic agenda is essential, but not sufficient. Mexico also needs to improve the implementation of public policies. Excellent decision making by the Mexican government in many areas has failed to give the desired results due to poor implementation, poor monitoring and follow-up, and poor assessment and evaluation. Institutional capacity is uneven even at the federal level, and still below the level necessary in a competitive and rapidly changing world. Progress in building and investment in institutions, agencies and public officials who are capable, ethical and efficient is therefore an absolute priority. These elements are essential for improving not just the rule of law, the judicial system and a framework of integrity, but also the management capabilities of public administration at all levels. This would make the business environment more stable and conducive to higher growth, and facilitate the effective implementation of the most important reforms. It is also key to reducing disparities between states, which stem largely from the high divergence in management and governance capability in the different regions.

Special mention needs to be made of the fight against one of the main problems confronting Mexican society. Corruption causes not just a loss of confidence in institutions, but also a drain on resources due to distortions in decision making and misappropriation. It is also harmful to the social fabric. The establishment of an anti-corruption agency is a good proposal as it sends out a clear sign regarding the commitment to this fight, although it is not enough. In order for it to be effective, the agency will need to have its capabilities, powers and instruments appropriately defined; it will need to have the necessary financial and human resources in addition to resources for action (including the establishment of penalties); and its independence and necessary autonomy will need to be preserved. Mexico has everything it needs to embark on a path of dynamic and sustained economic growth in the coming years, although there are bottlenecks that will need to be eliminated in different areas, which are identified in this report.

With the right decisions, Mexico can again be a real success story. The thirteen presidential decisions announced by President Enrique Peña Nieto on taking office, and the ninety-five commitments contained in the Pact for Mexico that was subsequently signed by the leaders of the main political parties, are essential steps in addressing these challenges. The OECD has signed a Strategic Alliance with President Peña Nieto's government to accompany it in defining a more competitive and inclusive agenda, and the Organisation will be supporting the current government in making progress in the implementation of the various commitments that have been announced. This report analyses the main aspects of this strategic agenda, on the basis of Mexico's strengths and the obstacles that need to be overcome. The analysis is further enhanced with information from international comparisons. The following section deals with the specific areas that are analysed in the different sections of this report.

A strategy to support growth and well-being

Going structural to accelerate convergence toward higher living standards

In order to tap Mexico's enormous potential for growth and to decisively raise the living standards of the Mexican population, sustained and comprehensive structural reforms are necessary.

In most other emerging countries that compete with Mexico, growth over the past ten years has been driven by constant gains in labour productivity. This has not been the case in Mexico, where the growth in labour productivity has been lower than the average for OECD countries over the same period. This has been due to an insufficient capital deepening and, more importantly, negative total factor productivity (Chapter 1). There are many interrelated causes for this negative productivity. Firstly, it is a reflection of the enormous size of the informal sector (Chapter 10). It also results from resource allocation to sectors with a relatively low productivity growth – such as the wholesale and retail trade and construction and building, which in the past twenty years have seen a rise in their share of total employment.

Productivity growth in Mexico is also limited by institutional rigidities in the labour market and insufficient innovation, education and physical infrastructure. All of these shortcomings point to bottlenecks that limit competition, the diffusion of technology, and investment in the sectors of highest productivity and in human capital. These bottlenecks are numerous and they mutually reinforce each other.

In order to restart the convergence process and generate a sustained high level of growth, Mexico needs to eliminate these bottlenecks which have prevented the important reforms carried out to open up the economy to translate into higher productivity. Similarly, internal sources of growth need to be better harnessed and aimed at products and services that are internationally competitive and deliver more value-added. Mexico should also continue in its efforts to diversify its trade and investment relations and make use of the advantages offered by its proximity and access to the US market.

Firstly, in order to boost productivity, Mexico needs to modify the structure of economic incentives, with a view to promoting competition and openness (Chapter 1). This means that institutional weaknesses need to be corrected, the rule of law strengthened, monopolies undone, further investment made in physical and technological infrastructure and in the skills of the labour force, incentives set up for sufficient capital accumulation in both physical assets and human resources, and for innovation to spread across the country. In particular, there is still a great deal of scope to reduce the cost of business transactions. Companies face high costs due to the lack of investment in infrastructure, notably in transportation, as well as the lack of competition in network industries, especially the telecommunications sector. Important foreign direct investment (FDI) restrictions continue to exist in these sectors. As a result, even though Mexico is the second largest recipient of FDI in Latin America after Brazil, foreign investment is not on the level that it should be, and it is not always allocated to the most dynamic sectors or those where it would have the greatest impact.

According to Chapter 2 of the Pact for Mexico, in order to strengthen its competitiveness and integration into the world economy, it is essential for Mexico to ease the regulatory barriers to services, foreign investment and competition in network services (see Chapter 8). The telecommunications sector is a case in point, where recent progress needs to be consolidated (see Chapter 9). For example, the commitment to "Guarantee equitable access to world-class telecommunications", included in the Pact for Mexico, is a highly important decision that calls for immediate and effective implementation. Improvements in the business environment need to be complemented by specific measures that support small enterprises, increase their productivity, stimulate innovation and encourage them to join the formal sector (see Chapter 10). Additional efforts to combat corruption and resolve security-related issues would reduce these costs and increase the attractiveness of the country for both foreign and Mexican investors (see Chapter 4).

Secondly, Mexico needs to upgrade its human capital and the availability of skills in the population, in order to reap the full benefits of its young and growing labour force and to successfully integrate better into global supply chains (Chapter 8). The education system has undergone substantial reforms in recent years (Chapter 6). One major achievement has been to expand educational coverage, especially in early childhood education and education up to the age of 14. Allocating additional resources and the setting in place of efficient evaluation systems are positive steps. Nevertheless, the various measures all need to be adopted in a coherent way to improve management of the system and to ensure that decision making produces the expected results through efficient implementation – something that still does not always occur. Section 1.3 of the Pact for Mexico admits that, in spite of the important achievements that have been made in educational coverage on all levels, more efforts are indeed required to prevent children dropping out of school and to ensure universal education up to the level of higher education. Improvements also need to be made to quality in education: reforms to make education more relevant and to better prepare students for the labour market have yet to produce specific results. The decisions concerning education made by President Peña Nieto during the start of his term of office are truly encouraging. In order to deliver results, they will require effective implementation and close monitoring.

Education is a major issue, considering the demographic profile of Mexico and the fact that the largest population cohorts are currently in education. Their imminent entry into the labour market over the next twenty years represents a historic opportunity. Mexico therefore needs to upgrade the skills of the labour force by providing more and better education, thereby enabling enterprises and the economy to move up the value chains.

Thirdly, weaknesses in education are compounded by the malfunctioning of the labour market, as a large number of workers are in the informal sector with no access to on-the-job training or human capital development opportunities. The underrepresentation of certain sectors of the population in the labour market (for example, the participation rate of women is very low compared to the average for the OECD) is another obstacle preventing the full benefit of the assets and potential that exist in Mexico. In addition to implementing labour policies that facilitate the harmonising of family and work life, Mexico needs to adopt a skills strategy that addresses the needs and strengthen the provision of skills at all levels. In order to fully tap the potential of better skills, increase the capacity of enterprises to create products with higher value-added and adapt to technological change and international competition, it is important to reduce the formalities involved in starting and running a business, excessive protection for formal employment, and the high non-wage labour costs that prevail in the formal labour market. Substantial progress has been made in recent years in improving the regulatory framework through reductions in unnecessary burdens. This effort, launched at the national and regional level, needs to be continued in order to reap the rewards. The recent labour reform should help address the problems of inclusion and informality by making formal employment more attractive to both employers and employees (Chapter 5).

Fourthly, a major effort must be put into promoting innovation. The country has one of the lowest levels of research, development and innovation (RD&I) among OECD countries. Innovation is essential for promoting productivity, creating new sources of growth, and optimising the benefits of Mexico's integration into the world economy. As the Section 2.3 of the Pact admits, in particular, Mexico needs to increase the capacity of the business sector, including small businesses, to assimilate and adapt foreign-developed technologies, and thereby increase its international competitiveness (Chapter 10). It also needs to promote investment in knowledge-based assets to foster innovation in Mexican enterprises, consolidate their participation in global networks, and above all to diversify into value chains in the services sector. There is evidence of failings in the governance of the innovation system that must be addressed, although confronting this difficulty reinforces the need for continued investment and improvements in education, and for a framework with appropriate general conditions (including competition, infrastructure and legal certainty).

Going social to reduce poverty and tackle inequalities between individuals and regions

Reducing poverty and inequalities is an urgent task. Mexico (together with Chile) continues to be the most unequal OECD country; with more than half of the population still living in poverty at the start of the 21st century, it needs to ensure greater equity in the distribution of the benefits of growth. Poverty and inequality are caused by ineffective public policies, and they are also factors that prevent higher levels of growth from being attained.

Poverty and inequality stem largely from the vast informal sector of low-paid, low-productivity jobs and a labour market that lacks access to training and has very limited social safety nets. They also reflect the wide geographical dispersion of the population in remote areas where it is difficult to provide services, together with a high concentration in urban areas where there is huge pressure in terms of infrastructure and public services.

Pro-growth policies need to be aimed at reducing poverty and inequality in Mexico. They can be particularly effective if higher growth is spurred by infrastructure investment, which also benefits the population in all regions, and all the more so by investment in human capital. A highly skilled workforce is an essential driver of productivity and long-term growth, but it is also key to preventing poverty from reproducing itself from one generation to the next. It is particularly necessary to strengthen the capacity of education systems to engender social mobility (Chapter 6). Mexico is one of the countries in the OECD where socio-economic background affects outcomes in education, and the educational system has not managed to effectively break this vicious circle.

That, however, is not sufficient. Poverty reduction requires a continuous broadening and strengthening of social safety nets; this is one of the most important commitments of the Pact for Mexico. Despite major progress, social spending (excluding on education) still represents less than a third of the average level in OECD countries, and is also low in relation to per capita GDP. Mexico is also the only OECD country without a system of unemployment benefits, and this contributes to informality, inequality and insecurity. In addition, while progress has been made in health access and coverage, quality and efficiency still need to be addressed, particularly in certain parts of the country. In this regard, a reform of the system's structure is necessary to consolidate both the number and the operational framework of institutions that supply these services, which on certain occasions duplicate coverage and on others hinder expansion. The administrative expense stemming from this ineffective structure is three times the OECD average.

Poverty reduction programmes are very successful although they need to be strengthened and increased, and better-targeted social spending (Chapter 2) is necessary, including on health (Chapter 7). The commitment to ensure universal access to health services, also included in the Pact for Mexico, is an overarching challenge. This will necessitate increasingly stable fiscal revenues (Chapter 3). Mexico's public finances are sound, although they are highly dependent on oil revenues, they do not provide a sufficient buffer to output volatility and the resulting social impact, and they do not provide sufficient resources to finance growth-enhancing investments in physical and human capital, or in social policies.

A broad fiscal reform is therefore necessary to allow the accumulation of fiscal buffers, increase tax revenue, and increase the efficiency of public spending. Efforts to reduce informality would reduce poverty both directly and indirectly by broadening the tax base and thereby allowing for higher financing of poverty reduction and social programmes, as well as productivity-enhancing policies.

As more people overcome poverty, the development of the middle class with the capacity to consume and save will be an important basis for higher growth and contribute to the consolidation of tax revenues.

The disparities in the levels of development among the states that have continued to increase pose yet another challenge for social cohesion. There has been no evident sign over the past ten years that the poorer regions have caught up. This divergence reflects the varying ability of the states to benefit from trade liberalisation, and points to major differences in their capacity to carry out reforms and meet the needs of the population – which further accentuates pre-existing geographical disparities. In order to address regional disparities and capacities, a more effective federal fiscal system is needed to ensure that resources go where they are most needed, that there is accountability, and that there is better infrastructure to incorporate regions lagging behind into business networks. It also calls for better institutions, improved administrative capacities, and the implementation of reforms to improve the business environment and human capital in states that lag behind. There is an enormous potential in all of these areas to learn from the success that has been achieved in the leading states.

Going green to reduce the pressure on the environment

Growth should not come at the expense of the environment. In order for growth to be sustainable, it must preserve the environment while simultaneously making best use of available natural resources. Increasing energy and resource efficiency is essential to prevent the current pressure on the environment from creating further strains on growth and the quality of life in Mexico in the medium term.

With its abundant natural resources, Mexico is a country with enormous energy and agricultural potential (Chapters 12 and 13). The full-scale development of this potential will require significant reforms to increase competitiveness and also to limit the impact of development on the environment. The challenge of combining social, economic and environmental goals and implementing them in a vast federal country like Mexico is particularly well illustrated by the case of water management (Chapter 14). These environmental priorities, which are clearly defined in the Section 2.4 of the Pact for Mexico, need to be incorporated into the strategies of the different government bodies involved in promoting the economic development of the country.

A better balance between Mexico's social and environmental goals could be achieved by reducing subsidies to energy and agriculture and by relying more on direct social transfers to help the poor (Chapters 12 and 13). Subsidies for fossil fuels totalled around MXN 169 billion in 2011. These subsidies are harmful for the environment, and they also represent a heavy burden on the government's budget. Moreover, they poorly target the vulnerable groups in society that they are supposed to protect. The new administration has shown its commitment to reviewing and reducing these subsidies, which is a very welcome measure.

The framework for environmental policy is another area in which Mexico has made important progress, especially the legal framework. This needs to be coupled with effective implementation and competent institutions.

Going institutional to support implementation of reforms

Mexico needs not only the financial means to reduce poverty and support growth-enhancing policies, but also the public institutions, skills and capability to design and implement these policies across a vast country of contrasts and in a complicated federal system (Chapter 4).

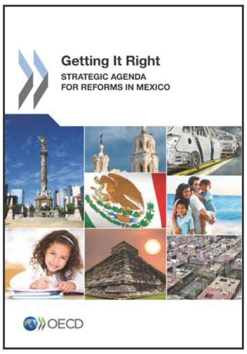
In all the areas where structural and social reforms are needed, the issues have been clearly identified. Progress in fundamental reform has often been hindered by power and interest groups, however, in for example the areas of competition, education and the network industries. Many opportunities have consequently been missed. Given the interconnection between the reforms, the fact that it has been impossible to achieve progress on several fronts simultaneously has limited the benefits of progress in some areas, for instance the opening up of the Mexican economy. The adoption of the long-awaited labour reform is a sign that things may be changing.

While the passing of laws is a major step, it is only a first step. The ultimate objective will only be achieved when these reforms are implemented effectively, with effective monitoring and follow-up, and evaluation of the outcomes. This is particularly the case with education, where quality improvement and enhancement still needs to be transformed into better learning outcomes for students. The implementation of reforms has also often been very uneven across states, which has fuelled regional disparities. This would suggest that institutional capacities are a core reason for the divergence of paths between states. In areas where reforms have been enacted (*e.g.* education, competition, labour), efforts should be made to achieve effective nationwide implementation.

While implementation of reforms is a major challenge in many OECD countries, it is even more difficult in Mexico, where the capabilities of public officials to implement, track and assess outcomes vary greatly in the federal administration and particularly across state governments. The implementation of reforms and the assurance that they will produce the anticipated results require better governance and institutional capacity across the country. This is a necessary condition for any growth strategy to succeed.

As many OECD countries, Mexico therefore needs to pay close attention to the political economy of reforms and to prevent power groups that benefit from the existing state of affairs from blocking progress in various spheres. Mexico needs to fight the powerful groups that have become established in strategic sectors; otherwise, it will be impossible to fully implement reforms and policies and they will not yield the anticipated results.

Mexico finds itself with an excellent opportunity – not just because of a relatively better situation than that of its main partners following the crisis, but also because of its young population and many assets, as well as the fact that there is a new federal government administration in office that has sent out a clear message that it intends to promote the necessary changes. Now is the time for vigorous efforts to move forward a strategic agenda that improves productivity, competitiveness and well-being. The Pact for Mexico, signed by President Enrique Peña Nieto with the leaders of the main political parties, provides solid ground to promote structural reforms in this respect. Mexico needs to place trust in its assets and in its many strengths in order to advance the reforms on this agenda. The country has the support of the OECD, its Secretary-General and officials, and over fifty years of work and experience in the design and enhancement of better policies for better lives. That support will become further consolidated following the recent establishment of a strategic alliance to broaden and deepen the collaboration.



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