Mexican Fiscal Federalism And the National Fiscal Convention

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Last February we saw the first stages of the National Fiscal Convention. This important event, that brought together all the representatives of the elites and the national and state political forces, aims to generate consensuses about solutions to the difficulties of fiscal federalism in Mexico. What does fiscal federalism look like in Mexico and what solutions might come out of the Fiscal Convention?

Public Finances and the States

In Mexico, both by law and de facto, the federal government is involved in more activities than economic efficiency would dictate. While the Constitution stipulates that those powers not assigned to the federal government are reserved to the states, their spending functions are not clearly defined. This is due to the fact that their main powers are exercised concurrently with the federal government and, sometimes, with municipalities, without defining the participation of each level of government.

The lack of clarity in assigning powers has an impact on the effectiveness of expenditures and public service provision. Public policies are not clearly defined and public services are not nec-

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essarily provided by whoever has the best information about local preferences and needs. It also becomes more difficult to attribute responsibilities among different authorities for performance in service provision. That is to say, it is not clear which level of government should be held responsible for the deficiencies. In addition, defining policies and planning becomes more complex because of uncertainty about actions by different levels of government.

We should say that since 1998, as a result of various decentralization processes, local governments have more resources than the federal government because of the transfers that the latter makes to finance many different services. However, the resources transferred do not necessarily translate into greater discretionary power for local governments.

The federal government spends differently in the states. In the first place, it spends directly through federal public investment or service provision. Another kind of spending (called joint spending) is done by different levels of government together. One example is spending in state universities, in which the federal government and each state contribute resources in a relatively stable proportion, but which varies from state to state. Another example is the expenditure made in social development pacts (CEDES), applied to urban development projects, public works and social programs in which federal financing is accompanied by a contribution from the state and municipality. Since 1996, the CEDES have used transparent formulas for the distribution of certain federal resources for social development linked to poverty, marginalization and backwardness indexes.

Finally, so-called decentralized spending is the largest component of federal expenditures in the states. It is done through the revenue sharing with state authorities for use in specific areas in which functions that the federal government previously performed in the states have been decentralized. The most notable case is basic education because of the sheer size of human and material resources involved and the impact on state finances, although similar reforms have also been carried out involving certain health and social development services.

Criteria of equity have made the distribution of federal revenue sharing among the states more homogeneous.

Decentralization is a big step forward in strengthening federalism, making the states responsible for public service provision. However, problems also arise that reduce these measures' effectiveness. This is illustrated by the case of basic education, which was a model for the decentralization of other levels of education and health services.

Until 1992, the federal government operated and financed 75 percent of the country's primary schools. Through decentralization, the responsibility for operating the basic educational system, together with all the schools, teachers and other assets that had previously been federal, was transferred to the states. The federal government retains the main power to create norms and design educational policy and continues to be the main source of financing. This measure exacerbated the fiscal imbalance or gap that the states face, the gap between their spending responsibilities and their income. To close this gap, the federal government currently assigns monetary transfers to the states; the amount for each state, at least in the case of basic education, is based on what the federal government spent directly there, in addition to resources for teachers' wage hikes and other items.

Just like with the CEDES, decentralization also affects state spending decisions because it forces the states to increase the resources destined for decentralized services at the cost of reducing the budget for other public services or goods.

The increase in educational spending is basically derived from costs associated with the reform, many of which are outside the control of state governments. Almost all educational expenditures, including federal transfers, go for paying wages, but until recently, they were negotiated centrally between educational and Finance Ministry authorities and the National Educational Workers Union (SNTE), with little participation of state governments. For those states that have their own educational system (the State of Mexico and Nuevo León), decentralization has been particularly difficult because of the need to harmonize wages and benefits.

On the other hand, the federal government has power over the main sources of tax revenues, such as income tax, the value added tax (VAT), tax on foreign trade, rights paid for fossil fuels and special taxes on production and services. It also has say over some taxes and rights that are transferred in their totality to the states, such as the tax on new automobiles (ISAN). By contrast, the power to tax of the municipalities and particularly state governments is very limited, and the tax base they have access to is poor and difficult to exploit. The main power the municipalities have is property tax. State governments can tax payrolls, public entertainment, some sales and the purchase of alcoholic beverages.

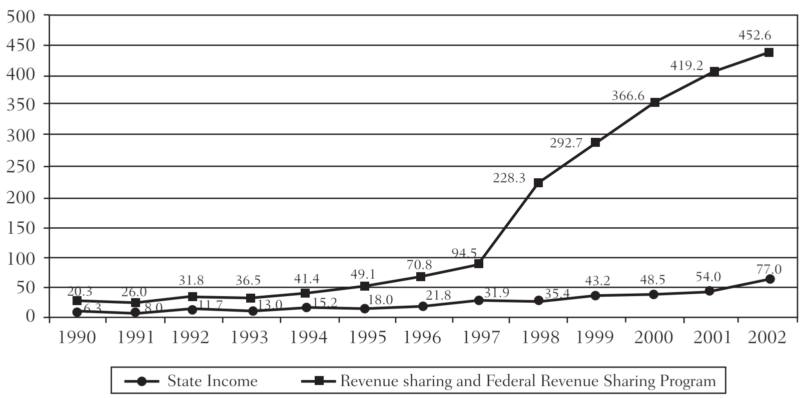
As a result of this division of the power to tax, around 80 percent of public revenues are collected by the federal government, 14 percent by the states, only 2.4 percent by the municipal governments and the rest by the Mexico City Federal District government. It should be taken into account that the high degree of centralization of revenues is a product of the National System of Fiscal Coordination (SNCF), dating from 1980. Through the SNCF, the states increasingly ceded the power to tax, including the ability to change the rate of some taxes that they still controlled; this was in exchange for larger federal transfers, particularly shares in federal revenues from some taxes.

It was in this framework of SNCF decentralization and operation that the last decade saw a large increase in federal revenue sharing as a percentage of local governments' total resources. This is why, while the states' revenues represented less than one percent of the gross domestic product from 1995 to 2001, federal resources came to more than seven percent of GDP in 2001.

The system of revenue sharing originally played a compensatory role in favor of the states to make up for the income they would stop receiving when they became part of the SNCF, but with time, the criteria for assignation of funds became more equitable, even though there continues to be a bias in favor of oil-producing states, which receive more. The General Revenue Sharing Fund is at the center of the system of assignations, representing 84 percent of the total in 1998. Of this fund, 45.17 percent is distributed based on each state's population to promote greater equity. An equivalent proportion is distributed using a territorial criterion based on assignable taxes, that is, those that are assigned to the place they are generated regardless of where they are collected.[1] The rest of the fund is distributed in inverse proportion to number of inhabitant.

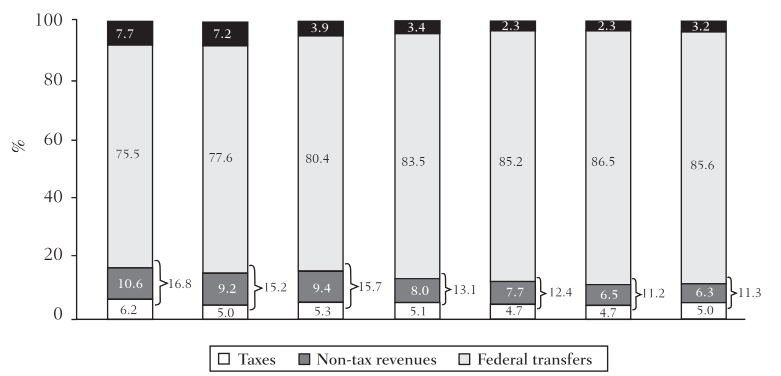
Criteria of equity have made the distribution of federal revenue sharing

GRAPH 1
STATE-GENERATED INCOME AND FEDERAL TRANSFERS 1990-2002
(BILLIONS OF PESOS)



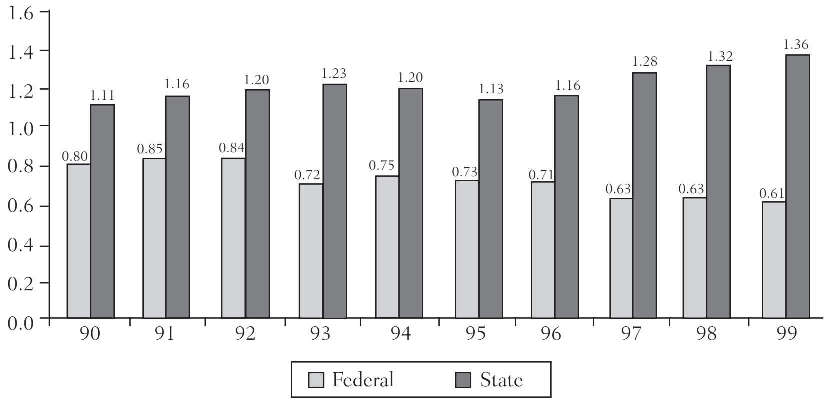
Source: Finance Ministry, State Public Accounts, Finance Ministry Transfer Data. For 2002, State Revenue Legislation.

GRAPH 2
INCOME STRUCTURE OF THE STATES
1995-2001



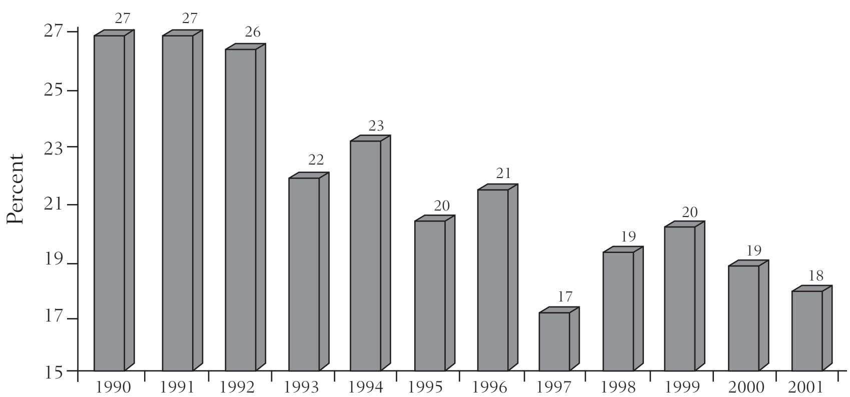
Source: Finance Ministry and State Public Accounts.

Graph 3
Federal and State Employees ** (Millions)



** Does not include teachers, primary school employees and public health personnel.
Source: Francisco Gil Díaz, speech at Ixtapan de la Sal, 31st National Meeting of Fiscal Officials.

Graph 4
Investment/Available state Revenues*
(average)



* Available state revenue is defined as state-generated income plus net shared revenues.

Source: Finance Ministry and data from State Public Accounts.

among the states more homogeneous. In fact, the state with the most funding and incentives per capita in 2002 received 3.6 times what the one which received the least financing got, down from 6.4 times in 1990. In absolute amounts, the ratio between the state that receives the greatest allotments from the General Fund and the one that receives the smallest decreased from 7.4 times in 1990 to 3.9 times in 2002. In addition, the five states with the most funding per capita in 2002 received 1.4 times the amount that the five states with the least funding per capita received, down from 2.0 times in 1990.

However, in the structure of state revenues, taxes, non-tax revenues and financing have tended to drop, evidencing weak efforts at tax collection by most states. Specifically, the percentage of their own taxes and non-tax revenues as a proportion of state revenues went from 16.8 percent in 1995 to only 11.3 percent in 2001. This shows that the stiff increase in total state revenues is explained by the growth in federal revenue sharing.

We can also see that, as a reflection of the fact that the states have no direct influence in deciding the assignation of revenue sharing to them, their efforts at tax collection are feeble: only in four states does the percentage of their own revenues exceed 15 percent of all income, while in others, it does not even reach three percent. Some states even make more in interest payments than their total state tax revenues.

This tendency to make little effort to collect state taxes can be observed in the municipalities also. For example, property taxes bring in much less money than in other Latin American countries and, of course, less than the average in the Organization for Economic Cooperation and Development. In addition, the already scant revenues that come in as property taxes are showing a tendency to decline, dropping from 0.28 percent of GDP in 1994 to 0.23 percent in 2000. The potential for property tax revenues is, in fact, 2.5 times their current levels, that is, about 0.5 percent of GDP.

It should be pointed out that the states' and municipalities' meager efforts at tax collection are not an irreversible structural condition, but rather the reflection of their institutions' inefficiency: some efforts at local tax collection have resulted in automatically changing the ratio of local taxes to federal revenue sharing, favoring the former. For example, in 2000 and 2001, two states introduced a payroll tax. In addition, Veracruz carried out a successful tax reform that increased its direct revenues from 70.6 million pesos in 2000 to 521.3 million pesos in 2001, pushing up its own revenues from 0.2 percent in 2000 to 1.5 percent in 2001. Zacatecas is a similar case, in which its own earnings increased from 31.5 million pesos to 85.7 million between 2000 and 2001.

Local authorities' weak tax collection efforts cause increasing fiscal dependence on federal tax collection. This causes:

a) A split between local governments' income and spending.
b) Greater presence of states and municipalities in public spending than in tax collection.
c) Criteria of efficiency in tax collection and accountability have not been considered in the distribution of decentralized expenditures.
d) The Fund for Municipal Promotion and Economic Incentives (auto registration, taxes on new cars and administrative cooperation agreements) does take into consideration efforts at tax collection.

In addition to growing state dependence on federal transfers, there is another alarming trend. Increased transfers has meant an almost eight-point spike in operating expenditures, decreasing capital spending and debt payments. Specifically, operating expenditures went from 80.3 percent of available state income (state revenues plus net federal payments) in 1995 to 88.2 percent in 2001. In addition, personal services (wages, salaries, honoraria and benefits) went from being 34 percent of available state revenues in 1990 to 56 percent in 2001.

This is because of the jump in the number of state government employees from 1.11 million in 1990 to 1.36 million in 1999, while the number of federal employees dropped from 800,000 in 1990 to 761,000 in 1999.

> The states' and municipalities' meager efforts at tax collection are not an irreversible structural condition.

This rise in operating expenditures implies a reduction of investment. As a percentage of available state expenditures, investments have gone from 27 percent in 1995 to 18 percent in 2001, plummeting one-third. This has obviously had a negative impact on the expansion of infrastructure in the states.

It should be noted that there are profound differences in the structure of spending by state. The immense differences in the proportion of total educational spending financed with local resources are very noteworthy even though the process of educational decentralization is quite advanced in all the states. Thus, while in 2000 the State of Mexico and Nuevo León respectively financed 34 percent and 30 percent of their total educational costs with their own monies, Hidalgo and Baja California Sur only put up 4 percent. There are also stark contrasts in the proportion of total health expenditures financed with local monies: while some states cover an important amount with local funding, such as Tabasco and Mexico City's Federal District, with 50.2 percent and 39 percent, respectively, others contribute very little, such as Chihuahua and Chiapas, which contribute 0.5 percent and 1 percent, respectively.

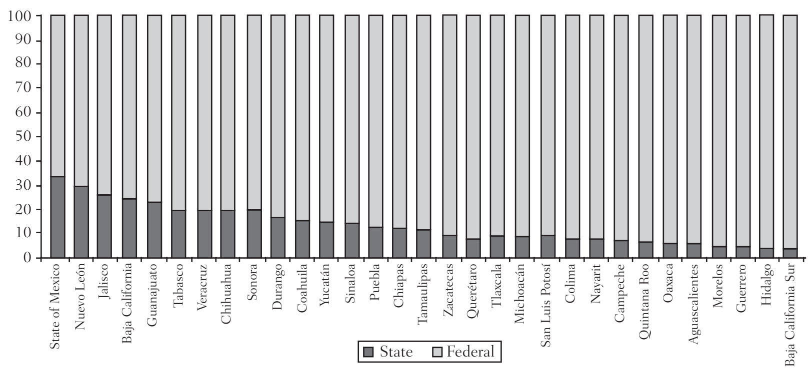
Lastly, there are also notable differences in the efficiency of states' spending. Suffice it to say that in surveys on the quality of public services, people expressed more satisfaction in northern states where greater electoral competition has ensured a higher degree of accountability from government officials.

Solutions

Given the complexity of the problems of Mexican fiscal federalism, it is not surprising that the preliminary documents presented to the National Fiscal Convention come to more than 1,200 pages and that fiscal officials and academic specialists alike have been invited to participate in the working groups in order to have precise, complete diagnostic analyses of all the difficulties to be resolved.

Although the final results of the entire exercise will only be available when the working groups make their recommendations, the analysis present-

GRAPH 5
STATE AND FEDERAL FUNDING FOR EDUCATION, 2000 (%)



ed in this article suggests the fundamental principles that they must base their conclusions on:

1) The solution to severe fiscal centralization requires greater local responsibility based on a division of the power to tax in accordance with minimums of economic efficiency.
2) The promotion of equality should be based on objective, transparent criteria and the promotion of tax-collecting efforts by local authorities.
3) The functioning of the federal fiscal system depends not only on the current legislative framework, but also on the efficiency of institutions.
4) Authorities' accountability to the citizenry is crucial for improving the effectiveness of public expenditures.

Based on these criteria, we can predict some common features of all the sensible proposals that seek to resolve the central problems confronting fiscal federalism in Mexico:

1) The operation of decentralized services and processes of decentralization should be reformed based on: a) giving more autonomy to state governments in the use of federal funds transferred to them; b) granting more flexibility to the states in defining plans and programs without requiring the authorization of federal authorities; c) reducing federal bureaucratic requirements, putting more emphasis on evaluating results than procedures; d) making the public dissemination of information about the performance of services financed partially with federal funds a condition for assigning them.
2) The states should be assigned the proceeds from the tax on new automobiles and given the power to establish a tax on the final sale of goods and services, in addition to the federal VAT. This tax would be accompanied by a partial fiscal credit for merchants for federal VAT and a proportional reduction of federal revenue sharing. In this way, all the states that levy this tax would receive greater revenues than they do currently.
3) Objective, transparent criteria should be established to determine the amount and distribution of federal revenues transferred to the states and municipalities. The distribution of resources corresponding to Item 33 should change in accordance with those criteria.[2] The criteria for distribution should be tied to: a) measures to ensure effectiveness in public service provision; b) indicators of need and lags in services vis-à-vis other states; and c) the states' fiscal efforts to collect their own taxes.
4) New local sources of income should be developed. In particular, taxes should be levied on public services charging higher rates for those who use more of the service.

The National Fiscal Convention is an excellent opportunity to try to come to consensuses to straighten out the muddle fiscal federalism in Mexico is in. Nevertheless, the issues under discussion are so complex, the amounts involved so high and the number of conflicting interests so numerous that the convention's outcome is still uncertain. Even so, the simple fact that Mexico's different elites and political forces are sitting down together to discuss this vital issue is an important advance toward establishing an atmosphere of civilized coexistence in the country. VM

NOTES

[1] Assignable taxes are those on the registration of new automobiles, special taxes on production and services and on diesel and natural gas, alcoholic beverages, beer and tobacco.

[2] Item 33 of the budget is for social spending to be determined at the president's discretion. Although the Chamber of Deputies decides its overall amount, it is the only item for which the president does not have to submit specific assignations to Congress. [Editor's Note.]