Historical Forces: Geographical and Political

Thomas Courchene, Alberto Díaz-Cayeros, and Steven B. Webb

Fiscal federalism is evolving in Mexico. Expenditures have been significantly devolved over the past few years, and the associated financing has been incorporated in myriad conditional grant programs. Although the pattern of decentralization in Mexico is similar to that observed in other Latin American countries, the speed and depth of the process have gone beyond most expectations (Garman, Haggard, and Willis 1999).

How did the system of fiscal coordination and revenue-sharing agreements between states and federation in Mexico emerge? Why was such a highly centralized fiscal arrangement reached, notwithstanding centripetal forces for state autonomy and a long tradition of resistance in the “provinces” to imposition from the center? Contrary to conventional accounts, fiscal centralization in Mexico was not a necessary outcome, but a contingent result of political processes. Moreover, the specific revenue-sharing agreements between states and the federal government can be understood as consequences of incremental reforms, rather than of an overarching grand design. Although political actors in the first half of the century well understood the advantages of a certain degree of fiscal decentralization, they were unwilling to give up extensive fiscal authority.

Federal Concentration of Revenue

The basic dilemma in the Mexican political economy at the beginning of the twentieth century was the prevalence of fragmented markets and a weak tax authority, both state and federal. Local taxation was chaotic. Given the financial disarray of both local and the federal governments, public expenditure was mostly financed by debt and monetary emission. The alcabala—the colonial tax on the movement of goods across jurisdictions which
inhibited the extension of markets in the nineteenth century—haunted the regional economies of Mexico. National and regional politicians in Mexico attempted to improve the regional flow of market transactions within the federal system, seeking to rationalize and unify state tax systems into a coherent national tax system and a system of tax settlement between levels of government. They met in National Tax Conventions in 1925, 1933, and 1947 for this purpose.

Alberto J. Pani, the charismatic federal finance minister who convoked governors to the First National Tax Convention, expressed the situation in 1925 this way:

Each state establishes its own revenue system, the Federal Government maintains its own, and since the objects taxed happen to be the same, since there is no concrete and defined plan for the limitation between the federal capacity and the local capacities to create taxes, since states often rival each other leading into true economic wars and creating, in the name of a sales tax; e.g., true local import duties in order to sustain internal production taxes that are incorrectly established; the tax becomes increasingly burdensome due to the multiplicity of rates, fines and penalties, increasing the complexity of the system and increasing in a disproportionate and unjustifiable manner the deadweight expenses for revenue collection, surveillance and administration.1

While the first two National Tax Conventions made little progress, the Third in 1947 envisioned a centralized fiscal system that (a) local governments would rely on as exclusive sources of revenue on the property tax and some other minor taxes, eliminating their taxes on trade and industry; (b) states would receive revenue shares from federal excises on natural resources, alcoholic beverages, matches, and so forth, and they would be guaranteed 25 percent of any additional revenue collected through those federal taxes; (c) a national sales tax would be introduced where the rate would be shared between states and the federal government, but it would be administered as a centralized federal tax; (d) the income tax would become exclusively federal, although states would retain some tax authority over taxes with very low yields on agriculture and livestock; (e) the contribución federal would be finally reduced to 5 percent in all states, in order to gradually phase it out during the next years. These proposals were fully accepted by the assembly.

During the second half of the twentieth century the federal government consolidated its fiscal centralization by becoming the only level of government allowed to levy taxes on foreign trade, natural resources (includ-
ing all oil and mining rights), banks, insurance institutions, electricity, 
tobacco, gas, matches, alcohol, forestry, and beer (art. 73-XXIX). Although 
states theoretically still retained the capacity to levy an income tax, payroll 
taxes, sales taxes, and other taxes not explicitly stated in article 73, in prac-
tice the federal government came to monopolize almost all sources of rev-
ue. The federal treasury provided tax revenue shares (*participaciones*) to 
the states, which increasingly came to constitute the most important source 
of local government finance.

The system of tax coordination which characterizes the Mexican feder-
al system today was the consequence of a regional compromise struck 
between the federal and state governments. The compromise required that 
local politicians delegate financial power to the president, in exchange for 
sources of patronage through the federal bureaucracies, attractive careers 
in the federal government, and an active involvement of the federal gov-
ernment in state development. The arrangement took almost two decades 
to become stable. The solution was achieved through institutional rules and 
a very peculiar political organization. The configuration of veto players 
made it self-enforcing, in the sense that local and national players were bet-
ter off with this arrangement, and therefore willing to abide by it. The loser 
in this arrangement was federalism.

[The weakening of the local machines] was coupled with the ever-
increasing financial dependence of the formal state governments 
upon the central authorities, because just as the growing com-
plexities of social and economic life called for greater expendi-
tures by governmental agencies, the national government was 
busily preempting most of the major sources of tax revenue for 
itsel. This forced the local officers to go to Mexico City, hat in 
hand, seeking grants from the national government to satisfy the 
demands of their constituents (Scott 1959; p. 135).

Electoral success compensated the governors for the loss of local finan-
cial independence and fiscal initiative, although many Mexicans disap-
proved of this tradeoff, since it led to an overwhelming federal government 
(Casanova 1965).

Two parallel developments converged to create the tax system that 
characterizes intergovernmental relations in Mexico today. The first was 
the establishment of a complex system of revenue sharing between states 
and the federal government at the beginning of the 1940s, which gave 
states unconditional transfers (*participaciones*) out of the collection of rev-
ue from exclusive federal excises. The revenue-sharing system was comp-
plicated because it established state shares case by case, on each specific tax. 
The incorporation of all states into the same national sales tax in 1974 was
achieved through what federal financial authorities called a “prudent strategy which quietly but stubbornly achieved its goal” (Secretaría de Hacienda y Crédito Público 1973, p. 6). In contrast with the Tax Conventions, which had been open debates, the changes of the 1970s were decided through closed bilateral negotiations.

The second development was the final implementation of a federal sales tax in 1947 (the Impuesto Sobre Ingresos Mercantiles—ISIM), which states could join if they agreed to coordinate their rate with the federal rate. By the early 1970s all states had joined the system, obtaining most of their local tax collection from this tax, in addition to receiving unconditional tax transfers through the revenue-sharing systems.

Both developments—the revenue-sharing system and the unified federal sales tax—came together in 1979 when fiscal relations between states and the federal government were merged into a single system, with the replacement of the ISIM with the Value Added Tax (Impuesto al Valor Agregado—IVA) at the federal level: all states would receive unique revenue shares out of federal tax collection, according to previously agreed formulas. This unification meant that local budgets would be financed mostly through unconditional federal transfers (participaciones) contained in the revenue sharing agreements. After 1980, state governments depended almost completely on federal revenue transfers.

While every state had been encouraged to join in the federal sales tax, the introduction of the Value Added Tax in 1979 produced a major redistribution of resources among states. On the one hand, the IVA would be collected where value was added, not where sales occurred, since the latter would require that when the tax was paid by the final consumer in one state, there had to be a credit for the tax paid in other states, with a consequent redistribution of where revenue is accrued. On the other hand, the success of the IVA required the elimination of some remaining state-level excises, in order to bring about more horizontal equity among regionally dispersed producers. These issues were addressed through the negotiation of the Sistema Nacional de Coordinación Fiscal (SNCF or Pacto Fiscal) among states and the federal government, including the Federal District. The arrangement tied participaciones to explicit formulas that considered population, education expenditure, revenue collected in the past, and indicators of state performance in tax collection.

The revenue-sharing arrangement of the SNCF was a contract between states and the federal government. There was no constitutional provision that forced states to give up their authority over taxation: states belonged to the system by agreeing to withdraw their own taxes and receive participaciones in exchange. Thus, governors retained the legal power to withdraw from the system. When the system was created, governors also signed
administrative collaboration agreements, which involved working closely with federal authorities on issues of federal tax compliance.

The creation of the SNCF was accepted by the states with almost no resistance. This was attributable to the political conditions, the timing of the reform, and the state of federal finances. The dominance of the party in office (the PRI) during the late 1970s was overwhelming: President López Portillo ran unopposed in the 1976 election. The reform was also skillfully timed around the temporal horizons of governors: during 1980 when the reform would come into effect, most of the incumbent governors would be just finishing their terms, according to the staggered timing of local elections. Finally, the country was in the midst of an oil boom, bringing the federal government a substantial amount of revenue from the windfall gains of the nationalized oil company, PEMEX. Since taxation of natural resources, and oil in particular, was exclusively federal, states were not directly profiting from the expansion in available resources. They did receive more resources and projects through Inversión Pública Federal, but those transfers were ultimately controlled by the president and his bureaucracies. The SNCF offered the opportunity for states to reap part of the benefits of the oil boom as unconditional tax transfers, although the arrangement made state governments more dependent on the federal government.

The formulas have been changed frequently ever since. At first the main ingredient in the formulas was to assure states the same revenue they were previously collecting from local taxes, to ensure participation of all states. Later on, the formulas also reflected some measures of the effort at tax collection, in local taxes, federal IVA collection in each state, or formerly federal taxes transferred to the state administrations collecting them (namely, the tax on new cars, Impuesto Sobre Automóbiles Nuevos, ISAN). This suggests that the system then moved into greater concern for incentive compatibility and performance. Since the beginning, the formulas also included a complementary fund, which attempted to compensate states that were receiving the least resources. This introduced an equalizing tendency in the shares, which has been further reinforced in recent years by giving a greater weight to population factors. (For discussions of the formulas and their changes, see Chapoy Bonifaz 1992; Arellano 1996; Aguilar 1996; Díaz Cayeros 1995.)

Thus, the overall pattern through time has been, abstracting from the subtleties of each individual formula, that at the beginning states received revenue shares much in line with the revenue they were collecting beforehand from their own taxes, their rate in the federal ISIM, and their participaciones. That meant, in fact, that poorer states had smaller per capita participaciones than richer states. It also meant that the oil-producing states received a disproportionate share of resources, because they had previously
been receiving high participaciones on federal oil taxes. However, as formulas have been changed, there has been a slight tendency toward per capita convergence, since poorer states have witnessed larger increases in participaciones than richer states, consonant with the larger weight given to population in the calculation of revenue shares (Díaz Cayeros 1995, pp. 94–95).

Rise of Democracy and Opposition Parties

The end of Mexico’s hegemonic party system has accompanied democratization from below. This process, although limited at first, has been extended throughout the country. Local political forces have come to question the concentration of resources and authority at the federal level. Political pluralism is driving the decentralization witnessed during the past few years.

The dominance or control of the political system by a single political party intrinsically contradicts fiscal decentralization. From the viewpoint of governance, state and municipal governments are democratically elected in Mexico. To a large extent, the tradition of central control within a single dominant political party led at first to deconcentration—regional administrative units reporting to the center—rather than to decentralization proper, where territorial governments are chosen by and are accountable to the local populace.

Both decentralization and deconcentration have accelerated since the Zedillo administration came to power in December 1994. The impetus for decentralization is the result of the need to address the increasing levels of public debt held by some states and the need to improve efficiency and rationalize service delivery in key sectors, such as social welfare, education, health, and transportation. The Mexican government rightly sees decentralization of these services as the key to more efficient public expenditures. This has come in contradiction, however, to Mexico’s long tradition of centralization and the federal government’s de facto control of the tax system. This has added to the confusion about what is an appropriate strategy for decentralization and has had a direct impact on decentralization policy. The lack of a clear vision for sectoral policies, such as the final direction of education and health reform, has added to the state of flux of fiscal decentralization in Mexico.

Undoubtedly, the two most important events in Mexico’s recent political history are (a) the winning of governorships by opposition parties since 1989, and (b) the loss of the PRI’s majority in the federal Chamber of Deputies in 1997. Both of these events have affected the political processes and debates over Mexican federalism. Baja California was the first state governorship to be won by an opposition party (Partido Acción Nacional, PAN). Other PAN victories followed in Chihuahua, Guanajuato, and Jalisco. As of the beginning of 1999, the PAN controlled five governorships
(Aguascalientes, Baja California, Guanajuato, Jalisco, and Querétaro), while the other major opposition party, the Partido de la Revolución Democrática (PRD) controlled two more (Baja California Sur and Zacatecas) plus the Federal District. At the municipal level, by the end of 1997, opposition parties controlled 28 percent of municipalities, which account for 45 percent of the population. The partisan plurality of local governments has increased the demand for devolving power over resources, to the point where even PRI governors and mayors are advocating decentralization, federalism, and greater local autonomy.

The absence of a single-party majority in the federal Congress’ Chamber of Deputies since 1997 is particularly important for federalism. All the major reforms tending toward greater decentralization pursued since then, such as the creation of Ramo 33 and the federal transfers (aportaciones) in the Fiscal Coordination Law, have required the support of at least one opposition party, namely the PAN. Any changes that deepen federalism will require partisan coalitions. The lack of a majority party in the lower chamber could continue in the near future no matter which party wins the presidency in 2000. Moreover, since the Senate does not have authority over the federal budget, the most important debates concerning further devolution of expenditure authority and the size, composition, and allocation of transfers will take place in the Chamber of Deputies.

By now, all the major parties are committed to federalism and to deepening the decentralization process. This was not true some years back, when the PAN was alone in advocating for greater local autonomy, consonant with its regionalist strategy of electoral competition and its stress on the subsidiarity principle, that each government responsibility should be assigned to the lowest level practicable. At that time, both the PRI and the PRD were highly centralist in their approach to national problems. But this has changed very quickly, as the presidency has relinquished some of its dominance, governors have become heavier political players, and the PRD has won governorships and seen its electoral support spread beyond Mexico City. By 1999 the most important contenders for the presidency had all been governors: Cuauhtémoc Cárdenas (Michoacán and the Federal District), Vicente Fox (Guanajuato), Roberto Madrazo (Tabasco), Manuel Bartlett (Puebla), and Francisco Labastida (Sinaloa).

**Transfer-Led Decentralization**

In the last ten years Mexico has rapidly decentralized public expenditures, quickly reaching almost the extent of the other large federations of Latin America—Argentina and Brazil—which have a long tradition of decentralization. Figure 2.1 shows this decentralization as a movement out along the x-axis, but the closeness to the x-axis also shows the small extent to
which the subnational expenditures are financed through their own revenues. The vertical distance from the diagonal line, the locus of fiscal balance along which taxes would equal spending, shows the dependence on transfers (and deficits). The great increase of subnational spending in Mexico over the past 12 years has all been accompanied by increases of transfers, with earmarking for broad sectoral purposes, as Chapters 3 and 5 describe in more detail. Tax authority of states and municipalities has not increased along with expanding responsibilities, and the rules for transfers have not provided incentives to intensify collection efforts. So states in Mexico depend much more heavily on transfers than in Argentina and Brazil.

History and politics explain this pattern. The first wave of decentralization in the late 1980s and early 1990s came right after the culmination of the centralization of taxes described above. Decentralization was at first really deconcentration, with the center delegating spending and responsibility, but keeping control over the priorities for spending. A prime channel for this control was the earmarking and conditions on transfers, control that would be lost if states were raising most of their own money. So

Figure 2.1. Subnational Tax and Spending Shares in Argentina, Brazil, and Mexico (Shares of GDP)

SN Taxes, share of total public spending

SN Spending, share of total public spending

the center did not delegate tax authority, and the states had little interest in trying to tax more, because it was easier to go to the federal executive for transfers.

In the second phase of decentralization, after 1997, the opposition parties were flexing their political muscle to get resources for their constituencies. The federal government offered some increased tax authority to the states, but in isolation it did not look politically attractive to the states, especially without any rollback of federal taxation. So the second phase of decentralization also came with transfers, but with much looser earmarking and linkage to expanded responsibilities.

Inequality and Globalization

Two initial conditions set the boundaries for the future evolution of fiscal arrangements in Mexico. The first has long been a feature of Mexican federalism, namely the degree of inequality across states. Understanding this inequality is critical to designing a more decentralized federation. The second is the impact of the North American Free Trade Agreement (NAFTA). As with selected provinces in Canada, some Mexican states are becoming fully integrated economically within the new environment created by NAFTA, and they are demanding more fiscal and economic autonomy than some other provinces can handle (see Courchene 1998 on Canada). Unless an appropriate system for transferring resources and responsibilities is devised, the uneven pattern of regional integration may exacerbate political and regional tensions.

Inequality and Federalism

In the nineteenth century, Alexander von Humboldt, the great political economist, labeled Mexico “the country of inequality.” Income inequality in Mexico continues to be very high, even by Latin American standards. According to the 1996 income distribution surveys, the Gini coefficient for household inequality was 0.478, where the bottom 10 percent of the population had 1.8 percent of the income share, while the top 10 percent garnered 42 percent (INEGI 1996). Personal income inequality is also found at the state level, although to a lesser degree. According to the only available survey on income distribution at the state level, carried out by INEGI (the government’s statistical office) in 1996, the Gini coefficients of Campeche, Coahuila, the Federal District, Guanajuato, Hidalgo, Jalisco, México, Oaxaca, and Tabasco, where the survey was conducted, ranged from a low of 0.41 for Guanajuato to a high of 0.47 for Campeche (INEGI 1999; an INEGI survey in 1989 indicated a coefficient for Tlaxcala of 0.38).

In 1996, in the wake of the economic crisis, 62 percent of the population was below the poverty line, with 30 percent in extreme poverty. Although
growth since then has probably brought the rates down again, resuming the trend for the decade prior to 1994, the problem of poverty remains acute. Much of this poverty is concentrated in the southern states (Trejo and Jones 1998, p. 72). Inequality among households is also reflected in regional inequality.

Figure 2.2 highlights the differences in per capita gross domestic product (GDP) by state, according to the official statistics produced by INEGI for 1993. Some states have income levels similar to those in African countries, while others have income levels roughly at par with those of lower-income European countries. There is clearly a north-south difference in per capita GDP, with northern states generally much better off than southern states. Moreover, the regional distribution of GDP does not fully reflect levels of individual welfare since some southern states have high GDPs (for example, the oil-producing states, Campeche and Tabasco, on the one hand, and tourist havens, Cancún and Quintana Roo, on the other) that are not reflected in correspondingly high levels of welfare of the general population.

Figure 2.3 presents another overview of inequality—the index of illiteracy across Mexican states. Here, the north-south divide is even more strik-
ing, with the differences reflecting, in part, the concentration of indigenous populations in southern states and the fact that the northern states have taken more advantage of the development opportunities from open international markets.

In an era when human capital holds the greatest promise of economic growth and betterment, this evidence of unequal outcomes challenges the claims of some advocates of decentralization that it will improve the responsiveness of the Mexican public sector to the needs of the population as a whole. In particular, these data speak directly to the citizenship rationale for intergovernmental transfers. Any evolution of Mexican decentralization will have to ensure that future expenditure and transfer arrangements provide an acceptable equality of opportunity across states in key public services such as education and health.

Will state per capita GDPs converge, as suggested by the growing literature on economic growth? According to the convergence hypothesis, since poorer states have less capital, any capital they get has a higher mar-

Figure 2.3. Index of Illiteracy

Source: Authors’ calculations from INEGI data.
ginal return there and they tend to grow faster than richer states, and this will eventually lead to the convergence of income levels at the steady states. Within the neoclassical growth theory, once the steady state has been reached, differences in growth rates are attributable to variations in saving rates. There is also a technology argument for convergence, in that poor states have poorer technology and thus greater opportunity to catch-up by adopting state-of-the-art methods. Against this, some argue that the poor have less access to capital and are less able to access new technology. In its mild form, the convergence hypothesis does not require a reduction in the absolute gap between rich and poor, but it does require that poor states grow faster than rich states.

Table 2.1 and figure 2.4 provide indicators of convergence among Mexican states. (For definitions and the basic findings of this literature, see Barro and Sala-i-Martin 1991, 1995.) The coefficient of variation and the typical log deviation of per capita GDP suggest that regional inequality in Mexico peaked in absolute terms during the mid-1980s and decreased slightly but remained high in the early-1990s. The 1980–85 divergence (in terms of the coefficient of variation in table 2.1) presumably had its origins in the Mexican oil boom. Convergence is evident over the 1985–88 period, but this catch-up still results in a coefficient of variation higher than that for the earlier years. Arguably, the convergence process is running up against the highly unequal levels of education across states, as reflected in figure 2.1 (For a discussion of these issues, see Diaz-Cayeros 1999, Navarrete 1996, and Alzati 1998.)

Table 2.1. Convergence in Mexico

<table>
<thead>
<tr>
<th>Year</th>
<th>Standard deviation (σ)</th>
<th>Coefficient of variation (σ/μ)</th>
<th>Typical log deviation</th>
</tr>
</thead>
<tbody>
<tr>
<td>1970</td>
<td>17.21</td>
<td>.4169</td>
<td>.1762</td>
</tr>
<tr>
<td>1975</td>
<td>18.42</td>
<td>.3781</td>
<td>.1618</td>
</tr>
<tr>
<td>1980</td>
<td>27.24</td>
<td>.4628</td>
<td>.1731</td>
</tr>
<tr>
<td></td>
<td>(22.52)</td>
<td>(.4181)</td>
<td>(.3953)</td>
</tr>
<tr>
<td>1985</td>
<td>63.94</td>
<td>.8889</td>
<td>.2058</td>
</tr>
<tr>
<td></td>
<td>(23.39)</td>
<td>(.3953)</td>
<td>(.3953)</td>
</tr>
<tr>
<td>1988</td>
<td>34.07</td>
<td>.5413</td>
<td>.1804</td>
</tr>
<tr>
<td></td>
<td>(23.12)</td>
<td>(.4108)</td>
<td>(.4108)</td>
</tr>
<tr>
<td>1993</td>
<td>32.62</td>
<td>.5218</td>
<td>.1901</td>
</tr>
</tbody>
</table>

*estimates in parenthesis refer to measures excluding the outlier observations (Tabasco in 1980 and Campeche in 1985 and 1988).

Source: Authors’ calculation with Banco de México and INEGI data.
The convergence data can be placed in a longer-term framework. In figure 2.4 (which focuses on the 1960–88 period), the trend line is in the direction of convergence. However, from 1988 to 1996, this convergence effectivley disappears (figure 2.5). Arguably, this reflects the move to trade liberalization, introduced on a gradual basis in 1985 and given a substantial boost in 1987. It will be important to extend figures 2.1 through 2.4 to incorporate more of the post-NAFTA (post-1995) data. One would expect the NAFTA environment to favor those states that are better-situated geographically and have better-developed infrastructure and human capital. All of these factors favor the northern states.

There is a high correlation between per capita GDP and a more accurate indicator of human welfare in each state, given by the Foster-Greer-Thorbecke poverty index (see Mogollón 1999). Figure 2.6 reports the Foster-Greer-Thorbecke index for all states calculated with official INEGI wage data for 1995, using a poverty line set at equal to twice the minimum wage and taking into account the depth of poverty. The correlation between the Foster-Greer-Thorbecke and per capita GDP is −0.4965. Except for the outliers of Campeche and Quintana Roo, which have high per capita GDP, but...
low levels of welfare as measured by poverty, there is a very close link between the two measures.

Thus regional inequality in Mexico is high and will likely remain high. Even if convergence were to take place at a rate of 2 percent, as has happened historically in other countries over the long run (Barro and Sala-i-Matín 1991), it would take more than 60 years for all states to arrive at the same level of welfare (estimates in Mexico find a slightly higher rate of convergence, but over a shorter period; see Navarrete 1996). Such convergence is doubtful without the achievement of similar levels of educational attainment; in the estimates for Mexico, education has sped up the convergence process. The rift between north and south, which is so obvious in the illiteracy indicators, is probably the greatest challenge facing Mexican federalism in the years to come.

**North American Integration and Mexican Federalism**

The opportunities presented by NAFTA might accrue, initially at least, primarily to the northern Mexican states, but the implications of NAFTA for Mexican federalism will likely go well beyond this economic dimension.
Courchene and Telmer’s (1998) study of “region states,” focusing on Ontario, Canada, reached some instructive conclusions:

- Ontario’s economic future progressively lies in the North American market rather than in the Canadian market. Already, Ontario’s exports to the United States are more than twice Ontario’s exports to the rest of Canada. Indeed, roughly 45 percent of Ontario’s GDP is now exported to the United States.
- Ontario’s policies will be increasingly oriented toward making the province a more attractive location for penetrating the NAFTA market.
- When considering its competitive position, Ontario cares much less about tax rates in its sister provinces, (although they are typically higher), than it does about tax rates in competitive areas with which it competes directly, such as Michigan, Ohio, and New York.
- Moreover, Ontario wants to secure enough policy flexibility to ensure its economic future within the new NAFTA environment.

States like Nuevo León, the industrial powerhouse in northern Mexico, will surely fall into this category of North American region states. The only issue is the degree to which they will pursue this role. In fact, according to some preliminary estimates (Diaz Cayeros and Martinez 1999), the degree

**Figure 2.6. Regional GDP Versus Poverty Index**

<table>
<thead>
<tr>
<th>FGT(2,2)</th>
<th>Per Capita GDP (pesos)</th>
</tr>
</thead>
<tbody>
<tr>
<td>0.00</td>
<td>0.00</td>
</tr>
<tr>
<td>0.05</td>
<td>5,000</td>
</tr>
<tr>
<td>0.10</td>
<td>10,000</td>
</tr>
<tr>
<td>0.15</td>
<td>15,000</td>
</tr>
<tr>
<td>0.20</td>
<td>20,000</td>
</tr>
<tr>
<td>0.25</td>
<td>25,000</td>
</tr>
<tr>
<td>0.30</td>
<td>30,000</td>
</tr>
<tr>
<td>0.35</td>
<td>35,000</td>
</tr>
</tbody>
</table>

*Source: Authors’ calculations from INEGI data.*
of regional integration of some border states is extremely high: foreign trade (imports plus exports) in Baja California, Chihuahua, and Tamaulipas already represents more than 100 percent of state GDP (171, 137, and 134 percent, respectively). Our view is that these border states, among others, will eventually press for more powers—taxation, expenditure flexibility, and the like. But border and rich states are not the only ones that will press for greater regional integration. Poor states like Oaxaca and Zacatecas already have highly developed networks of migration (both temporary and permanent), while worker remittances constitute a crucial component of the local economy. These pressures will complicate, if not exacerbate, the north-south divide and perhaps cut across unexpected lines. Unless the Fiscal Pact is substantially revised, some of these northern states may consider with increasing seriousness the option of withdrawing from the Pact and reintroducing state taxes.

The relevant point is that the transfer system (along with the rest of fiscal federalism) must be able to accommodate the preferences of these northern states while ensuring the social and political cohesion of all states within the federation. This is a tall order, but one that the transfer system can, in principle at least, deliver. Aspects of these inevitable north-south tensions will be an integral part of the simulations in Chapter 5, showing alternative scenarios of decentralization and future transfers.