
Overview

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Although the phenomenon of “decentralization” is worldwide and its meaning, implementation, and effects vary from country to country, the experiences point to three lessons applicable anywhere.

First, decentralization often has major effects on concerns ranging from macroeconomic stability to poverty alleviation, the provision of social services, and the quality of governance (Burki, Dillinger, and Perry 1999). For this reason, a country decentralizing its public sector needs to develop a coherent *decentralization strategy*. Decentralization, properly done, can have many economic benefits as well, producing greater efficiency, responsiveness, and accountability in the delivery of services desired by the local population. Improperly done, decentralization can have undesirable consequences, leading to macroeconomic disequilibrium, exacerbating regional differences and conflicts, or reducing the quality and quantity of public services. Paying adequate attention to the interactions of various policy areas can avert many problems with decentralization. Although there is no one right path to decentralization, and determining the appropriate extent and nature of decentralization is a political decision for the country, a number of common mistakes can be avoided. For example, it is always a mistake to decentralize revenues without decentralizing a corresponding set of responsibilities, and it is usually wrong to give exactly the same revenue and responsibilities to small and large municipal governments.

Second, because decentralization everywhere is an ongoing, evolving activity, a successful strategy requires *adequate institutional infrastructure* to develop, monitor, and implement the decentralization policy. The necessary infrastructure includes legal and regulatory frameworks, organizations for coordination, and capacity-building programs. Even the best-planned strategies do not sustain themselves without such institutional support. In particular, experience everywhere shows the need to develop and publicize accurate, complete, and trustworthy information on all aspects of the

decentralization process. This reduces the confusion and political and bureaucratic conflicts that invariably accompany any major change.

Third, the Latin American experience with decentralization shows that abrupt, across-the-board efforts have generally failed. Countries have had to go back to incremental decentralization, with differentiated rules according to different management capacity of territorial units. This was the experience with the Colombian laws of 1986, the Brazilian constitution of 1988, the Venezuelan Organic Law of Decentralization in 1988, and the Bolivian Popular Participation and Decentralization laws of 1994 and 1996.

These lessons apply to Mexico. The country is progressing toward more autonomy, fiscal responsibility, and accountability at subnational levels of government. States now spend close to half as much as the federal government (see table O.1). The municipal share of public spending has also grown, although this trend is not as fully documented. This process is being driven by heightened political competition at all levels of government and by the desire of the federal government to include decentralization in its program for broadening political participation.

Each country must, however, develop its own strategy of decentralization and its own particular institutional infrastructure in accordance with its history, its objectives, and the constraints it faces. The models of decentralization found in the world range along a spectrum. One end, exemplified in Canada, may be labeled full legislative federalism in the sense that the main source of funds for subnational governments is their own taxes, and they have almost complete autonomy as to how they spend them. Canada carries provincial autonomy so far as to have no federal constraints

Table O.1. Fiscal Magnitudes: Federal and State Governments, 1997

	<i>Percent of GDP</i>	
	<i>Federal</i>	<i>States*</i>
Own spending	11.5	4.9
1991	8.4	3.0
1996	7.7	4.9
Own revenue	15.8	1.0
Disposable revenue	13.2	5.4
Primary balance	-1.3	0.0
Overall balance	-4.9	-0.1
Debt service	18.4	0.3
Debt stock	31.0	1.5

* Tabasco and Tamaulipas not included; no data.

Source: SHCP and authors' estimates.

at all on provincial borrowing, leaving the regulatory task entirely to the capital market, although the provinces impose strict controls on municipal borrowing. The regional inequalities arising from differences in the tax base in Canada are partly equalized through federal transfers. Switzerland and the United States follow variants of this model, though with less equalization (none in the United States), less uniform state tax policies, and more detailed federal attempts to influence state spending. In Latin America, Brazil's decentralization is closest to this end of the spectrum, with the larger states raising much of their own revenue and designing their own social sector programs. But the federal government in Brazil has frequently gotten involved, often disruptively, in the personnel policies and debt management of the states.

The model at the other end of the spectrum—administrative federalism—is found in Germany and Australia. Transfers are the major source of states' revenue, and federal (or joint) policies guide most subnational expenditures. Regional equalization policies, largely implemented through transfers, are very strong. Moreover, tight central controls are imposed on subnational borrowing. Colombia and Venezuela follow this model in Latin America, although the equalization component is largely absent.

Varying combinations of the features mentioned—revenue independence, expenditure autonomy, debt autonomy, and equalization—may be found in other countries. In Argentina, for example, transfers are more important than in Brazil, but states have more autonomy in controlling personnel costs and the market plays a larger role in debt management.

Mexico could, in principle, mix and match these characteristics as it wishes. Given that Mexico has already made the major decisions about decentralization of spending responsibility and subnational borrowing, the next critical decision concerns the importance of transfers and the extent to which the tax system should be decentralized. This will go hand in hand with the decision about the degree to which federal transfers will compensate for the regional disparities that would otherwise follow from tax decentralization. Another important decision, which may require revision as the transfer system evolves, is the extent to which the center will guide, monitor, or control the details of expenditures (for example, through financial market regulations or conditions of transfer). The institutional structures mentioned earlier will be needed to attain consensus on these policy objectives and to implement and sustain them.

Mexico has already started down the road to decentralization, with its own model being constructed in Mexico, as it must be. Some actions already taken seem desirable and should be sustained and strengthened, such as the end of discretionary transfers and support for more uniform and comprehensible state accounting and public reporting. Others seem less desirable. This book is a collection of papers that draws on worldwide experiences

with decentralization in order to focus on what is needed to develop a coherent and sustainable decentralization strategy in Mexico, and the necessary institutional underpinnings for it.

In this overview, we distill the main messages that the authors deliver in those papers. The discussion here is organized around five themes: (1) institutions for decentralization, (2) spending and service delivery, (3) subnational taxes and revenue, (4) intergovernmental transfers, and (5) subnational borrowing and debt management. A vision of Mexico's path and options in decentralization then emerges and is articulated for the short, medium, and long term.

Institutions for Decentralization

The key institutional issues in decentralization are reinforcing confidence in decentralization among key stakeholders, improving intergovernmental coordination and conflict resolution, strengthening and democratizing the process for control and accountability, coordinating the multilevel budget process, regularizing the distinctions between municipalities with different administrative capacities, implementing cooperative capacity building, and dealing with the peculiarities of the Federal District's relationship with its neighbors and the federal government.

Intergovernmental Coordination

International experience shows the importance, and the difficulties, of collective institutions that steer the decentralization process and serve as forums for negotiations and preemptive conflict resolution (see box O.1). Developing such institutions is particularly challenging for Mexico, because of its trial-and-error approach to decentralization and the resultant political, regional, intersectoral, and even intrasectoral fragmentation. Thus far Mexico has improved its intergovernmental and intersectoral coordination largely through top-down mechanisms, such as conditional transfers and federal monitoring. Now it is necessary to create a consensus-building mechanism that is trusted by all parties and that takes care of the following critical tasks:

- Proposing a long-term view of decentralization, intermediate goals, and ongoing adjustments;
- Promoting forums for discussing and negotiating intergovernmental fiscal arrangements and preventing interjurisdictional conflict;
- Producing an annual report on progress and current issues in decentralization, keeping federal agencies and subnational governments alerted to their responsibilities within the decentralization process;

Box O.1. Coordination of Decentralization: Lessons in Latin America

The Latin American experience with coordination of the decentralization process indicates the following lessons:

1. Horizontal, intersecretary agreements (national level) or conferences of governors, mayors, or finance secretaries (subnational level) have had only modest effects, generally restricted to a few specific policies. Broader scope agreements seem to require presidential support and definite commitment from the Ministry of Finance.
2. Presidential Commissions may be more effective, but their sustainability depends on the continuity of presidential support, as indicated by the Comisión Presidencial para la Reforma del Estado (COPRE) experience in Venezuela.
3. Presidential support for a lower-level agency, such as the Bolivian experience with the *Sub-secretaría de Participación Popular*, is usually short-lived; in Bolivia it lasted only while it had unrestricted presidential backing.
4. A single agency at the ministerial level, like the Ministry of Government or the Interior, or the Ministry of the Presidency, has usually failed, as the Ministry of Finance or the planning agency became pivotal for the advance of decentralization.
5. A special unit at the presidential level, like the *Secretaría de la Presidencia*, usually lacks effective coordination capacity vis-à-vis sector ministries, and especially the Ministry of Finance.
6. Experiences where no agency is primarily responsible, as in Chile and Colombia, illustrate that the Ministry of Finance or the national planning office usually takes over when the process of decentralization is not clearly headed by another agency.

- Providing reliable information for the public discussion of federal, state, and local fiscal and financial policy, and evaluating the design and exchange of information;
- Designing, collecting, and disseminating key indicators for the implementation of decentralization, monitoring the changes of revenue and expenditure responsibilities, and evaluating the capacity of subnational governments to assume new responsibilities.

To help address these needs, in early 2000 the Mexican federal government established a Decentralization Committee within the *Secretaría de Hacienda y Crédito Público* (SHCP), with a Technical Secretariat, and chaired

on a rotating basis by the three undersecretaries—*Ingresos, Egresos, and Credito Publico*. This interagency committee will play an important role in coordinating intergovernmental fiscal relations and preparing a revision of the fiscal pact and a new *Ley de Coordinación Hacendaria* (dealing with revenues, transfers, and responsibilities at all levels of government). The Secretariat will be responsible for technical analysis of the evolution of the decentralization process in order to guide federal policy on the matter. The unit will design and test indicators for monitoring intergovernmental fiscal relations and decentralization as a whole; collect and publish subnational fiscal statistics; and disseminate periodic analysis, promote public debate, and maintain communication with congresses, their accounting offices (*Contaduría Mayor de Hacienda de la Honorable Camara de Diputados*), and the *Secretaría de Controlaría y Desarrollo Administrativo* (SECODAM). The committee will put together and coordinate the decentralization efforts currently developed by each of the three undersecretaries, and coordinate the various technical assistance and subnational strengthening programs offered by SHCP, Banobras, and other federal institutions. The committee will not be formally institutionalized during the Zedillo administration, leaving it to the next administration to decide whether and how to do this.

Prevention and Resolution of Conflicts

Sound intergovernmental coordination will require specific institutions for negotiations and conflict resolution, because effective decentralization requires more than the design of revenues, transfers, borrowing, and responsibilities. No system can foresee and specify everything in advance. Issues and disputes arise that need to be settled, and the method for doing this has important incentive effects for how the system actually works.

Like other decentralizing countries, Mexico has a growing number of interjurisdictional conflicts. The courts need to strengthen their capacity to handle constitutional and administrative disputes that arise in connection with decentralization. The country could also develop alternative means for resolving disputes, because court procedures tend to be expensive, time-consuming, and often unnecessary. Some conflicts are being averted or resolved through informal negotiations and willingness to compromise. The lack of institutionalized alternate channels for resolving disputes often makes the outcome a question of which side has greater political power, and this undermines the credibility of the rules. It would help if the non-judicial means to resolve interjurisdictional conflicts were institutionalized and if conciliatory experts and judges were trained in the principles and operating rules of decentralization. In the health sector, the National Health Council (*Consejo Nacional de Salud*) resolves many disputes, and this institution could be a model for other sectors with major decentralization issues, such as education, water, road transport, and environment.

Democratic Accountability and Control

Effective controls are both a prerequisite and an essential component of strengthening management capacity, autonomy, and accountability at subnational levels. Because the impetus for decentralization in Mexico has come not only from the federal government, but also from democratic competition in Congress and subnational governments, it is important to have systematic public disclosure of all government accounts, opening the potential for decentralized democratic control.

In a decentralized Mexico, institutional development toward effective controls should capitalize on the strengths of the existing mechanisms. Mexico has accumulated significant experience and technical expertise at SECODAM and some of the state comptrollers (in the executive branch). The congressional accounting offices, independent units of increasingly pluralist congresses, are emerging as some of the more trusted institutions in the country. The *Homologación* Program of SHCP also tries to standardize the states' financial reporting. Besides these official institutions, some states and federal agencies now conduct external audits through specialized firms.

In the Mexican model, controls are a matter of intergovernmental coordination. The congressional accounting office dictates guidelines for the accounting offices of state legislatures to follow. To strengthen the political autonomy and credibility of these institutions, Mexico might consider the models of the U.S. General Accounting Office, which Congress endows with considerable autonomous investigative authority, or the parliamentary finance committees in some British commonwealth countries, which the Constitution establishes under the chairmanship of the opposition party. On the executive side in Mexico, SECODAM coordinates with state comptrollers and assists them with knowledge-management programs. The states are legally responsible for fiscal control of municipalities. Although in principle each level of government should have its own independent controls, the federal level has organized arrangements that provide the basis for strengthening controls at all levels during the transition to a more decentralized system.

Budget Coordination

At present, budget coordination in Mexico involves primarily the harmonization of spending priorities at different levels of government. Mechanisms are different for federal–state budget coordination and for state–municipal coordination, and for federal–municipal coordination.

Federal–state budget coordination operates through the federal budget process and other mechanisms. States used to submit annual sectoral operating plans (*planes operativos anuales*, POAs) that were then adjusted and incorporated into the federal sectoral plan submitted to SHCP. This process was partially replaced in the Fiscal Coordination Law by automatic formula

mechanisms, but the federal ministries of education and health still require states to prepare some sort of POAs for the sector budget. Once the plan has been submitted, SHCP further filters the sector POAs and submits the budget bill to Congress. Although the present budget preparation mechanism ensures some exchange of information and opportunities for reconciliation of federal and state priorities, it still falls short of explicit and transparent criteria for allocating federal resources across the states.

Besides preparation of the federal budget, the regular federal–state coordinating meetings (the quarterly meetings between SHCP, both the Income and Expense departments, and the finance ministries of the states) and the federal Fiscal Pact are also contexts for coordinating the budget. Revenue coordination and tax harmonization between the federal level and the states are achieved mainly through the Fiscal Pact and the corresponding general revenue transfer of nearly 22 percent of the *recaudación federal participable* (the *participaciones*).¹ However, since the fiscal year is the calendar year for all levels of government, the federal budget data go to states and municipalities only at the very end of the previous fiscal year or the beginning of the new year, which makes subnational budgeting increasingly difficult because federal budgets and transfers are less predictable and are approved later in December.

Further budget coordination takes place through the growing number of pari-passu programs, agreements for sector matching grants, and earmarked transfers for sector decentralization, such as the Educational Federalization Program, now the first and largest fund of Ramo 33.² Extraordinary transfers for specific investment purposes may also be seen as coordination mechanisms.³ In fact, extraordinary transfers have stimulated the agreements for uniform accounting and reporting between the federal government and the states (the *Homologación* Program).

State–municipal budget coordination involves state-level approval of municipal budgets and borrowing.⁴ In theory, municipal budgets have to conform with the state development plan, primarily for investment, but this is rarely practiced. Special agreements between states and municipalities can provide an additional opportunity to reconcile the spending priorities of these two levels and to coordinate revenue-raising goals and instruments.⁵

Federal–municipal budget coordination, even federal–state–municipal coordination, is also pursued through the transformation of Ramo 26 (budget category 26) into Ramo 33. Formulas already specify most of the allocation of the special funds of Ramo 33—primarily, but not exclusively, sector funds. Therefore, Ramo 33 is in practice a mechanism by which the federal level (Congress and executive branch) guarantees the territorial allocation of resources according to federal priorities. Accounting and reporting for Ramo 33 resources are still deficient, however, and neither stimulates intergovernmental trust nor allows for monitoring or impact evaluation.⁶

The current mechanisms for budget coordination—mostly spending—hinder subnational autonomy and initiative. Rather than stimulating more efficient allocation of resources in the territories, they tend to increase federal control of the allocation of resources, even as states are granted more political responsibility for them. As a result, these mechanisms confuse the distribution of responsibilities among levels of government and reduce the accountability of each level. In addition, these mechanisms do not help true bilateral spending coordination because they are mainly formal budget and planning tools.⁷

Categorizing Municipalities

The diversity of state and local governments needs to be matched with differentiated federal rules toward local governments (see box O.2 for international experience). There is wide variation in the scale, administrative capacity, tax bases, and poverty levels of states and municipalities in Mexico, but the legal framework for decentralization does not recognize these differences. At present, federal rules do not categorize municipalities by size and capacity to determine differential spending authority, tax authority, borrowing authority, reporting requirements, or eligibility for technical assistance. The details of the problem and the appropriate solution may be different for municipalities and for states.

Box O.2 International Experience with Differential Treatment of Municipalities

Experience in Latin America shows that, when responsibilities of subnational units are not explicitly differentiated according to effective fiscal and/or management capacity, *de facto* differentiation takes place, often in ad hoc, chaotic ways. It is therefore advisable to explicitly differentiate among subnational units while at the same time establishing the standards to move from one category to another. The Colombian process of certification is an example of flexible categorization that stimulates regional and local governments to qualify themselves to assume responsibilities in education and health. To be certified, departments have to demonstrate to the national government that they can assume the new responsibilities in health and education—that they have developed the required planning, financing, monitoring, and reporting capacity. After a department has been certified, its municipalities may apply to the department for certification. In another example of categorization and upgrading, Spain has gradually increased the number and responsibilities of the *autonomías*—areas like Catalonia with special status—and expanded their responsibilities.

Mexico has over 2,400 municipalities, spanning a wide range, from cities with several million inhabitants, policymakers with high levels of formal education, and computerized fiscal accounts, to small towns with populations under 5,000, leaders with little formal education, and informal accounting practices at best. Only 25 to 40 percent of the municipalities measure up to standard indicators of capacity: having a budget planning unit, an evaluation unit, and computerized accounts; having and using an internal administrative code; having regulations for the *cadastre*;⁸ and raising more than half of their own resources. It seems unrealistic to have the same rules for all municipalities. In practice, states often demand less than the legal requirement from small and poor municipalities. Still, small municipalities doing an appropriate amount of reporting for their size should not be in a state of noncompliance. Large municipalities frequently do more than the minimum to satisfy the requirements of their own management or of their private sector creditors. Still, some larger cities have inadequate administration, even though they meet the letter of the law.

The fiscal and administrative capacity of Mexico's 32 states also varies widely. For example, as of 1997, only three states had a fiscal coordination law, a budget, accounting, and public spending law, and a public debt law; seven states had none of these laws. All states now have these laws, although their effectiveness varies in part because of their newness. Targeted transfers for capacity-building programs, such as those in the 2000 budget, could help to bring states up to a uniform standard. As state and municipal governments become more democratic and more accountable, citizens will demand better reporting from their governments.

Capacity Building

All stakeholders agree on the need to improve the technical and administrative capacity of subnational governments. For example, technical shortcomings deter proper accounting and reporting of the Ramo 33 transfers, particularly in municipalities with low fiscal and management capacity. There is less agreement, however, on the best way to strengthen subnational capacity. Federally run programs for strengthening subnational administrative capacity, such as the *Homologación* Program, have had limited impact. Some federal funds for institutional development at the municipal level come from the option each municipality has of using 2 percent of one Ramo 33 fund (municipal infrastructure) for this purpose. For small municipalities, however, which need capacity building the most, the amount comes to only a few hundred pesos—too little and too scattered for Mexico's 2,400 municipalities. The state of Puebla has developed a series of agreements with its municipalities to concentrate and augment these resources at the state level and to provide a program of capacity building, based on a survey of local needs. The federal government is also planning new programs for supporting capacity building at state and local levels. There will

be pressure on these governments in order to improve their access to credit markets when these are reformed as described below.

Civil service reform at subnational levels is needed and perhaps inevitable, but it will have limited success or impact while the old incentives remain in place. State and local government officials, like federal government officials, respond to the incentives with which they are faced. If those incentives discourage initiative and reward inefficiency, it should come as no surprise to find unaccountable and inefficient subnational administrations. Solving the problem of limited administrative capacity in some jurisdictions will require altering the federally controlled personnel incentive system to allow honest, well-trained people to pursue an attractive career in subnational government.

Federal District Relations

The Federal District faces particular challenges in its relationship with the federal government and with the neighboring states. For example, the Federal District has to have its budget and borrowing limits approved annually in the federal Congress; it does not get some of the Ramo 33 funds; nor is it responsible for basic education. The Federal District believes that it subsidizes its neighbors via support for the metro train system, while its neighbors feel that they subsidize the Federal District via water sector investments. The rapid transformation of the political and fiscal status of the Federal District, and the possible creation of municipalities within it, have made a review and reform of its vertical and horizontal inter-governmental relations necessary. International experience, such as from the São Paulo metropolitan area in Brazil, may help to elucidate the range of options.

Spending and Service Delivery

Decentralization is expected to provide many economic benefits in the areas of spending and service delivery. These benefits include choosing the mix of public sector activities that best suit the taste and needs of citizens in a local area, providing the services in a more cost-effective way by adapting the method of delivery to local circumstances, and allowing citizens to express more directly their concerns about service provision. The benefits will also depend on strengthening the link between subnational spending choices and self-taxing decisions. Realizing these benefits in Mexico will depend on the actions of local authorities and citizens, but the federal government can help by creating an environment that gives states and municipalities more incentive to take responsibility for their own programs and finances. This is not a matter of just changing rules, but also of creating a culture of devolution. It will take time. The agenda here sets out some possible steps, which will build on those taken in the past decade.

Two features dominate the current assignment of expenditure responsibilities. First, there are many concurrent obligations at all three levels, especially between the federal and state governments for important services such as education, health, or social assistance. Second, few responsibilities are assigned to the municipal level, especially in areas with important benefits, such as education or health (see box O.3).

There appear to be five main problems with the current allocation of decentralized spending responsibilities: (a) inadequate *fiscal autonomy* for

Box O.3. Education and Health

Education

The 1992 *Acuerdo Nacional para la Modernización de la Educación Básica* was a pioneer step that established a limited decentralization precedent. According to the *Acuerdo*, the federal government remains responsible for general policies and standards (normative and policymaking functions), teacher training and territorial distribution, production of textbooks, evaluation and monitoring, and the provision of financial resources needed to ensure proper coverage and quality of the educational system.

In 1998, Ramo 33 complemented the *Acuerdo Nacional* by guaranteeing transfers and introducing greater transparency in resource allocation for education. However, inasmuch as Ramo 33 enshrined inertia in territorial allocation of resources for education, it may be considered more a tool for deconcentration than a decentralization measure that enhances efficiency. Indeed, Ramo 33 brings no incentives for improving subnational performance or mobilizing additional local resources for education, which are two goals of the decentralization processes.

Health

Decentralization in the health sector started earlier and proceeded more gradually, allowing states and municipalities more time to learn. Six features of the system today make it work relatively well:

1. Resource allocation from the federal level to states according to well-recognized criteria;
2. Fundability for states and sanitary jurisdictions in the use of health sector funds;
3. Careful and effective transfer of human resources from the federal level to the states, negotiated with the national union;
4. Complete transfer of infrastructure, goods, and equipment to states;
5. Municipal cofinancing of new infrastructure and participation in planning;
6. *Consejo Nacional de Salud* has resolved many conflicts and monitored the process of decentralization.

states, given their political and economic power and the scope of service delivery responsibilities delegated to them; (b) inefficient and nontransparent basis for *allocating sectoral transfers*; (c) remaining ambiguities in the *assignment of expenditure responsibilities* and failure to take account of *disparities between municipalities* in their capacity; (d) unclear responsibility and therefore generally inadequate funding for *pensions* (elaborated in the debt and borrowing section); and (e) lack of effective *procedures for dispute resolution* (discussed above).

State Autonomy to Increase Efficiency

Although more resources pass through their books than ever before, states in some ways have less fiscal autonomy now than they had a decade ago. With the exception of the Fund for Strengthening State Finances and the Program of Support for Strengthening the Federal Entities, most of the resources they receive from the federal level (including from shared revenues) are effectively earmarked either for transfers to municipalities or social sector salaries, especially schoolteachers and university professors with federally mandated pay scales, or they are claimed by the terms of matching grant programs (*pari passu*). This situation is inconsistent with the growing economic and political power of the states.

The Fund for Strengthening State Finances was set up within Ramo 23 in the wake of the 1995 crisis and disbursed money on the condition of a state's fulfilling a fiscal adjustment program agreed with SHCP. Although the agreements for these funds were not transparent or by uniform formula, they represented an advance of the earlier pattern of the President personally allocating major resources to states, also via Ramo 23. In 1998–99, as the fiscal reform agreements ended, the fund was phased out, with a residual going to a national disaster relief fund with transparent rules of access. In 1999, a few incidents, especially with Chihuahua and Nuevo Leon, demonstrated power of states to demand ad hoc resource transfers—debt relief or federal spending on state-priority projects. In the budget for 2000, the Program of Support for Strengthening the Federal Entities was created in Ramo 23, but with Congress allocating the funds to states, not at executive discretion. It remains to be seen how much the nominal earmarking of the fund will be binding, or whether the funds will be fungible and relatively free for the states to spend. But freedom to allocate funds will not be enough. A more fundamental way to increase autonomy of the states would be to give them greater control over spending, especially for personnel, and over taxes, as discussed below.

Efficient and Equitable Basis for Sectoral Transfers

Transfers for education and health are allocated mainly on the basis of the number of staff and physical sites (schools, clinics, hospitals). In the education sector, staffing in 1992 is the base from which allocations are adjusted

at the margin for inflation and population growth, and sometimes increased further by special request. Although this system does not explicitly penalize states that have controlled costs since 1992, neither does it penalize those that fail to improve efficiency, and it actually hurts states that improve student attendance rates, in the sense that they have fewer resources per attending student. In health, the allocation is still based mainly on the current number of establishments and staffing, but the system has improved since 1996. Now, requests by the states for incremental health resources are evaluated by SHCP and the Ministry of Health on the basis of demographic and health data. It is understandable that the initial values of the transfers matched previous cost levels, because the states had neither the authority nor the time and money to change staffing quickly. But now it makes sense to move to a system with better incentives. Evidence from a number of countries indicates that formulas for sectoral transfers are more equitable and encourage efficiency better if they are based on a capitation formula, with adjustments made for population density, age, and gender. Moving toward such a system, as the social security system is starting to do, would improve the efficiency and equity of transfers.

Assignment of Responsibilities

The broad assignment of responsibilities by sectors in Mexico is reasonable: education and health to the states, local streets and sanitation to municipalities, and other sectors to the federal government. The problems are in the details. Concurrent obligations at all three levels and especially between the federal and state governments in important services such as education, health, or social assistance often leave functions like maintenance, regulation, and inspection without any level taking adequate responsibility. Responsibility is ill-defined for roads, water, and higher education. The water issue is especially problematic, because it has so many dimensions in terms of users and geography. A separate study on water is needed to clarify the issues, only some of which relate to decentralization. Although some states have shown strong interest in local environmental issues where their involvement would make sense, the mandate and funding remain largely at the federal level. A pilot program in the 2000 budget offers some federal funding to encourage states to develop their environmental sector capacity and cost recovery. Federal involvement in personnel issues remains problematic. The municipal level has few assigned responsibilities, especially in social sectors. Individual schools and hospitals have little autonomy or community involvement, although international experiences in Colombia (the New School Program), Nicaragua (the Participatory Fund for Maintenance of Social Infrastructure), and El Salvador (the EDUCO Program) indicate that this part of decentralization does the most for performance on various indicators: attendance, test scores, and cost control.

The thorny problem of nationally negotiated teachers' salaries probably cannot be solved with direct confrontation and will not need to be. The fundamental problem is not that their pay is too high. As Mexico's private sector grows and its labor market gets more integrated domestically and more closely linked with the rest of the world, the most serious problem will be that a national salary does not attract qualified teachers in the areas with the fastest private sector growth and the most international linkages. These areas will have to pay more or witness a decline in quality, because only less-qualified personnel will stay or they will spend more of their time and energy in outside employment. If the federal government cannot afford to pay for wage increases nationwide, it may need to give local governments and voters the option to raise more resources locally to improve pay and working conditions above the national (minimum) standard. At the other end of the spectrum, isolated areas are already having trouble attracting enough teachers that meet the usual national standard, even though the national salary is high compared to local wages. The federal transfer system may need to provide extra support there. Faced with these economic realities, the teachers may see the necessity and benefit of having their union focus less on negotiating national raises and more on setting standard negotiating frameworks for local branches.

Separating the assignment of responsibilities for maintenance and operation of infrastructure facilities from responsibility for capital investment has been a persistent problem in Mexico. For example, municipalities are in charge of maintaining school buildings, while the federal and state governments carry out most capital investments. This dichotomy often leads to insufficient levels of both maintenance and infrastructure investment. Each level of government can blame the other for not doing its part, and each has an incentive to refrain from using its own resources, with the expectation that the other levels will give more. Rigid separation of construction, maintenance, and operation decisions has led to notorious inefficiencies in allocation and production, as evidenced by all Latin American countries that transferred building responsibilities to specialized funds while keeping operation under traditional sector ministries and leaving maintenance responsibilities unspecified.

Subnational Taxes and Revenue

Subnational governments in Mexico should raise more taxes for three reasons. First, the public sector needs more tax revenue for when revenues from oil decline, not only temporarily because of low oil prices but also permanently as a share of gross domestic product (GDP) because of economic growth and diversity. Second, to give citizens more control over the size of public spending within their jurisdictions, subnational governments

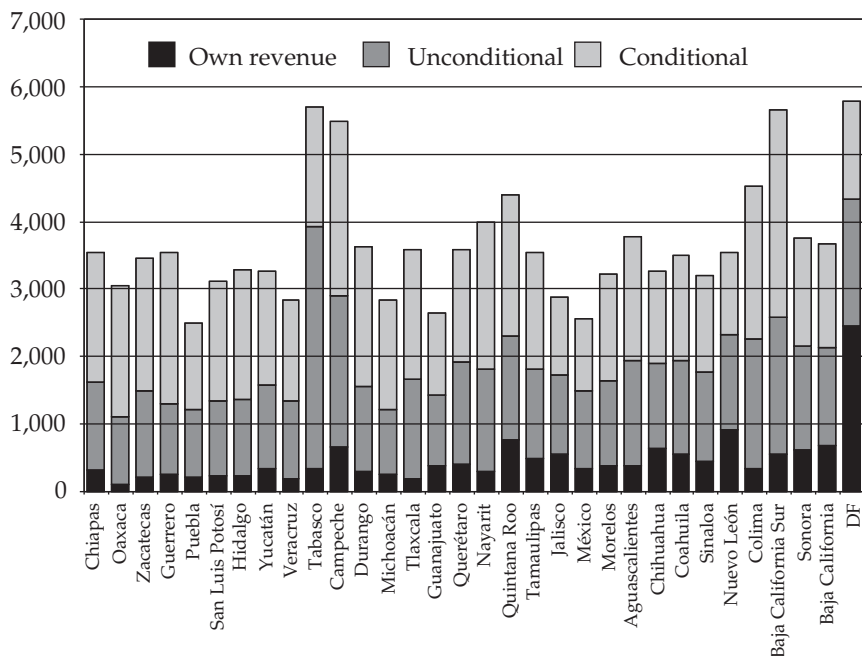
need to have adequate taxing authority. If they want to spend more money in an area, they can raise taxes; if they decide to save money on a program, they can reduce taxes. This involves, primarily, having control over marginal (incremental) revenue—what a subnational government can affect by its own actions, especially by changing tax rates, but also by imposing new taxes or repealing old ones, by changing the tax base, and by varying administrative effort. Third, and related to the second, states that borrow need to have some source of funds to repay their debts. If they experience an unexpected adverse shock, relative to their fiscal plan at the time of borrowing, they need to be able to raise additional revenue (or cut costs) by enough to sustain their debt service.

States typically have their own payroll taxes, annual taxes on automobiles, and fees. Currently they are legally prohibited from taxing interstate trade and some excises. Taxes represent only about 4.5 percent of total revenues of states (other than the Federal District). Payroll taxes are the most important, levied in 23 of the 32 states. Rates range from 0.5 to 4 percent, with most rates in the range of 1 to 2 percent of payrolls (18 states). Only one state has a rate above 2 percent. The definitions of taxpayers are generally similar, but tax bases and exemptions differ substantially across states. The structure of these taxes is not consistent with the bases for the federal payroll taxes that finance social security and housing; making them more consistent would reduce the costs of enforcement and of compliance (and audit) for firms operating in more than one state. The federal personal income tax has a different, narrower, base than the payroll taxes. Moreover, each state administers its own payroll tax, following its own procedures, which are independent of those used for federal payroll taxes. Inconsistent tax bases and duplicate administration are wasteful practices for both taxpayers and administrators. The administration and, for most states, the rate of the payroll tax, both offer substantial opportunities to increase states' own revenues. Most states seem to lack the incentive, however, because they have too little control over how they spend money and relatively too much opportunity to negotiate discretionary transfers, at least prior to 1999. Most of their resources, however, come from formula-based transfers, mostly unconditional. See figure O.1, which is illustrative and based on preliminary estimates for 1999, as described in Chapter 5.

Municipal governments are on average only slightly less dependent than the states on revenue sharing and transfers. In the aggregate, municipal governments receive about two-thirds of total net revenues from these sources. This pattern differs markedly across and within states. The incentive structure in revenue-sharing arrangements partly accounts for low rates of tax collection. At least the larger municipal governments would benefit from having access to additional sources of revenue and from improved incentives. The main sources of revenue for municipalities are taxes on

Figure O.1. Composition of Total Subnational Revenues, 1999

Pesos per capita



states ranked by poverty index

Source: Courchene and Diaz (Chapter 5).

property and water-user charges. Property taxes average only 13 percent of total municipal revenues, although some municipalities have significantly increased their property tax revenues in recent years. Property taxes constitute 22 percent of revenues in the Federal District, showing the potential in large cities.

The most challenging institutional issue in the case of property and payroll taxes is to find the right incentives for states and municipalities to raise their taxation to levels compatible with tax efficiency and equity, and to limit tax distortions of the market allocation of resources.⁹ The problem seems to go back to the states' revenue initiative, which diminished as a result of the federal Fiscal Pact.

A good strategy for many countries, including Mexico, would consist of surcharges levied by subnational governments on a tax base (or bases) defined by the federal government and administered by them either alone or jointly with the states. In this scheme, subnational governments would

exercise the politically important choice of tax rates, while avoiding most of the complexity, inequities, tax exporting, and locational distortions that result from independent subnational legislation and administration. That is, tax surcharges combine the simplicity of tax sharing with the advantage of allowing subnational governments to determine tax rates. Canada makes substantial use of this type of system. Such surcharges could be imposed on excise taxes, a residence-based income tax, or even the value added tax (levied at the destination of sales). This could be accomplished with a compensating value added tax. States might still impose payroll taxes, preferably with a unified base. For any such piggyback tax to work for states in Mexico, the federal level would need to improve the design and implementation of its corresponding tax, the value added tax, or the income tax.

Excise taxes, for example on alcoholic beverages and tobacco products, are good candidates for assignment to the states, as is done in many countries. State excise taxes should be levied by (or on behalf of) the states where consumption occurs, not the states where production or importation occurs. Because excise taxes are relatively visible, they would help to ensure the accountability of state officials. The federal government might wish to impose floors, below which state excise rates could not go, to prevent a “race to the bottom” caused by competition among states seeking to attract sales of products they know are intended for smuggling to other states, and to protect local merchants from competition with products smuggled from low-tax states.

States that support their municipalities in administering the property tax—compiling and updating the cadastre—could negotiate some revenue sharing with the municipalities, with formulas that reward states for their support. Similar arrangements exist in Colombia, where the Antioquia Department manages a multipurpose tax for its municipalities. In El Salvador, larger municipalities and municipal associations keep registration and current accounts for smaller municipalities. The federal government in Mexico might support such arrangements by sponsoring pilot programs and disseminating lessons from foreign and domestic experiences.

As a practical approach for simulation and policy analysis, it is useful to consider reform measures that would be revenue-neutral, substituting revenues from state and municipal taxes for transfers from the central government. Such measures would (a) lower federal taxes to provide “tax room” that state and municipal governments could fill or not, at their option; (b) reduce aggregate transfers to states by the amount of the reduction in federal revenues; (c) assign taxes to state and municipal governments that could, on average, replace lost transfers if levied at similar rates;¹⁰ and (d) adjust transfers to maintain funding levels for individual state governments, if they use the tax room provided. However, Mexico may want to

reduce the overall reliance of the public sector on oil revenues. In that context, it may be useful for part of the increased national tax effort to occur at the subnational levels.

Intergovernmental Transfers

Intergovernmental transfers perform a variety of roles in federal systems. First, they balance the interplay between expenditure needs and the revenue of subnational governments. Second, they integrate fiscal federalism and social and political dimensions of federations. For example, more conditionality for intergovernmental transfers signals an increase in the centralization of the federation and vice versa—less conditionality means more decentralization. The alternative approaches to transfers offer the flexibility to generate a desired degree of horizontal equity across subnational governments and can embody important incentives by enhancing accountability or encouraging tax effort. They are also the main channel for implementing society's intentions regarding the nature of the Fiscal Pact and the degree of equality of opportunities among citizens living in different states.

Mexico has undergone an amazing degree of decentralization in the past few years, enabled by a great increase in the number and variety of transfers. Although selected aspects of these new transfer arrangements may need rethinking, the bold expenditure-cum-transfer revolution in Mexican fiscal federalism is impressive.

The two main categories of transfers are *participaciones* and *aportaciones*. *Participaciones* were originally revenues of states and municipalities whose collection was delegated to the federal level in the Fiscal Pact for tax efficiency reasons. Legally, the federation only collects those taxes and distributes the proceedings to their owners. In practice, the federal government writes the formula for distribution of these funds and augments them from federal sources, like oil revenues, so they are different from tax sharing (where revenue collected in a state stays there) and are more like a transfer program of the general revenue-sharing type. Most of these transfers go out under Ramo 28. *Aportaciones* were conceived as federal money earmarked to pay for (formerly) federal commitments and transferred to the states and municipalities together with those commitments (for example, education and health). These funds, formerly under Ramo 26, now go out under Ramo 33.

The transfers to states from revenue sharing within Ramo 28 (not counting ramos that pass directly to the municipalities or Ramo 33 funds earmarked for teachers and health sector workers) were almost six times as large as states' own revenues in 1996. Federal and state transfers to municipalities under Ramo 28 were almost twice municipalities' own revenues.

Including Ramo 33, total state revenues equaled about 6 percent of GDP and total municipal revenues equaled about 1.5 percent. The shares were even higher in 1999.

There are also Ramo 23 funds that relate neither to previous revenues of the states nor to previous responsibilities of the central government. Once they were partly at the discretion of the president, but then most of them went into the Fund for Strengthening State Finances that individual states negotiated with federal ministries, mostly SHCP. In 1998 and 1999, discretionary transfers under Ramo 23 declined to less than one-tenth of their pre-1995 value. In the 2000 budget, the transfers at the discretion of the executive ended completely.

There are important transfers within the budgets of sectoral ministries, too. Some go to the states as matching funds under state-by-state agreements (described in the institutional section). These are especially important in the education, road, and health sectors. Sector ministries also spend money directly for projects in particular states, which can be important implicit transfers. Both of these kinds of transfers were traditionally negotiated with the governors, with the terms not disclosed publicly. In 2000 SHCP is publishing the standard rules for access to the *pari-passu* programs and the matching-grant ratios for all major programs.

In Mexico, as in many countries, society's intentions with regard to transfers are in flux and unclear. There were at least 10 major transfer programs in the 1999 budget, up from three in 1997. In the 2000 budget, Congress added another major transfer in the Program of Support for Strengthening the Federal Entities, which is allocated by Congress in the budget law, rather than by executive discretion. Each program addresses multiple objectives, and each objective is addressed in several programs. This makes it harder than necessary for subnational governments to calculate how much money they will receive and for the federal government to determine how well the transfer system is addressing its objectives. The constitution and the revenue-sharing law do not give explicit goals for the transfers, but their actual pattern reveals something about the intentions. The principal objectives of transfers in Mexico seem to be to (a) let states share in the federal government's greater potential to raise revenue, (b) subsidize subnational governments' provision of services with national externalities (basic health and education), (c) strengthen the autonomy of municipalities, and (d) provide additional resources to states with a high incidence of poverty. A fifth possible objective would be to compensate states with low per capita tax bases, as Canada does. Mexican transfers do not address this objective explicitly, although they address it partially through poverty-targeted transfers, because poverty is positively correlated with low tax base per capita.

Reflecting the first objective, the federal government makes transfers to the states and municipalities under Ramo 28 in order to bolster their rev-

enue capacity, which is weak compared with their expenditure mandates. The states seem to receive considerably more mandates than funding, and municipalities (especially small ones) seem to receive more funding than mandates. For the states, about half of transfers are earmarked funds under Ramo 33; unconditional funds are mostly from Ramo 28. Furthermore, part of the “unconditional” funds have to be used to match funds from other federal programs or to pay federally mandated salaries that are not covered by Ramo 33. State population is important in the formulas for some funds (*Fondo General de Participaciones* and *Fortamun*), and a few (mainly *Fondo de Fomento Municipal*, *Tenencia*, and Excise Shares Ramo 28) attempt to share revenue with states on the basis of origin. In the past, when states could make a case that revenues were inadequate, the federal government often increased the transfers, although this approach may be coming to an end. These ad hoc transfers were neither automatic nor free from politics. For municipalities, in contrast, a little over half of federal transfers (passing untouched through state accounts) are unconditional revenue shares, and more than half of the rest (Ramo 33 transfers) are also unconditional.

Reflecting the second objective, many federal transfers are targeted to specific sectors—some, like education and health, apparently because they have national externalities. The sectoral targeting of transfers to municipalities (parts 3–7 of Ramo 33) seems to be a transitional arrangement intended to start decentralized municipal services at the same level of funding as they had under the previous system. Reflecting the fourth objective, the formulas of the infrastructure funds in Ramo 33 have strong poverty-targeting elements.

When all the programs are added, state by state, the amount of per capita resources available to the states (total of their own revenues and all the various transfer programs) varies considerably (mostly in the range of \$Mex2,500 to \$Mex4,500, estimated for 1999, with three states receiving almost \$Mex6,000). The resources per capita are about the same on average for states with middle and high levels of poverty, however, and the richer states (low levels of poverty) have only slightly higher-than-average resources. High per capita revenues in rich, low-poverty states are counterbalanced on average by poverty-targeted transfers to high-poverty states. This equality of per capita government resources across income levels may reflect a basic social value in Mexico. The nominal equality across income levels corresponds to some progressivity in real terms, because the cost of public services is generally lower in poorer states, meaning that the same pesos per capita buy more.

The current transfer system has four main problems: (a) it is too complex to achieve a coherent set of purposes. Consequently the federal government distributes more resources than necessary to achieve its objectives, and states are treated inequitably. The main beneficiaries of this complexity are states that get more than they would under a simple and transpar-

ent system; (b) basing many transfers on historical or current costs, rather than using per capita or per potential recipient costs, is inequitable and discourages efficiency; (c) at least up until 1999, the availability of ad hoc transfers for politically favored states undermined the incentives for managing spending well and for enhancing revenue; and (d) earmarking and matching grant requirements leave states with little autonomy for improving efficiency or adjusting allocation to meet local needs.

Other Latin American countries have similar problems. Colombia's distribution formulas for general revenue sharing are too complex to convey transparent signals and effective incentives to subnational governments. The formulas include four criteria (per capita, per territorial unit, fiscal effort, poverty incidence), plus combinations of these criteria. Some of the criteria apply to indicators that are not readily available to subnational governments. As a result, subnational governments do not perceive clearly the intentions of the national level, nor do they respond appropriately to signals and incentives.

The future of the Mexican tax-expenditure-transfer subsystem will depend on the way the Mexican federal system itself evolves. There is a range of possible models. With the Canadian-type model—full legislative federalism—transfers would be characterized by:

- An equalization program to ensure that all states have some minimum acceptable level of untied revenues (that is, own revenues plus equalization). This could be the level of the national average, for instance.
- Formula-based conditional transfers, but only where there are obvious national externalities. These would likely be equal per capita to a large degree, since the horizontal balance across states would be addressed under the equalization program.
- Conditions associated with this transfer in the form of a set of socioeconomic principles relating to spending areas such as education and health. The idea would be to provide considerable discretion to subnational governments in implementing these principles.
- A federal-state "accord" or fiscal pact on the socioeconomic union, replete with provisions for addressing disputes. One version of such an accord would extend the procedures for appeal and dispute resolution to Mexican citizens.

With the German-type decentralization model—administrative federalism—a significant proportion of own-source revenues would come from revenue sharing, but there would still be a substantial vertical imbalance in the federation. This would be addressed by a set of conditional transfers designed to ameliorate both vertical and horizontal imbalances. The conditions on these grants could be of two sorts. First, the legislation relating to the spending area could be federal with the implementation delegated

to subnational governments, or, second, the grants themselves could be targeted to specific spending areas with associated conditions. Over time, these conditions could be relaxed to allow for more subnational autonomy on the spending front, but there would always be more revenues under federal control than the alternative model where subnational governments have access to unconditional own revenues. The administrative federalism model would represent an evolution of the existing Mexican model, but it could also be an appropriate transition toward legislative federalism, if that is what Mexico ultimately chooses.

Subnational Borrowing and Debt Management

Subnational debt in Mexico has not been a national macroeconomic problem, but it could become one. More important, the burden of debt has been a fiscal problem for some states (municipal debt is small, except for the Federal District, which is effectively a state), and the way in which the federal government has treated subnational debt in the past has created inappropriate incentives for the states' fiscal affairs. For states to have an incentive to control costs and increase their revenues—a stated goal of state and federal governments—it is important that neither states nor borrowers expect a federal bailout. Otherwise, borrowing becomes a means through which states can obtain extra federal resources, transferred to them or their creditors. This has often been the practice in Mexico. (All states received bailouts in the wake of the 1995 economic crisis, and a few states have received bailouts since then when guarantees came due on large infrastructure projects.) Moving to a new practice of no bailouts will require not only changing the rules, but also assuring that challenges to the new rules are not overwhelming, especially during the transition, and that there is adequate political support for the rules.

Most borrowing by states and municipalities has been guaranteed with state *participaciones* as collateral. The federal government (SHCP) handled the collateralization, so the banks and their regulators treated the debt as being virtually riskless. Furthermore, the federal government was not always strict in reducing the *participaciones* of some states when creditors exercised the guarantee, meaning that the rest of the federation had to pay. Thus neither the states nor their creditors worried much about the repayment capacity. This contributed to a state-debt crisis during the general crisis of 1995. The federal government has been the only stakeholder with a strong motive for concern about the state's true creditworthiness; sometimes it has refused to register and collateralize state debt, but at other times politics or other considerations allowed the excess borrowing.

Following the 1995 series of bailouts, to prevent a recurrence, SHCP tried to end its involvement with the collateralization of state and local debt, but

the states and commercial banks, still traumatized by the crisis, did not agree on mutually acceptable private sector *fideicomiso* arrangements to handle the collateralization. So SHCP agreed on a temporary basis to accept mandates from the states to act as *fideicomiso* for borrowing transactions of which they, SHCP, approved. In 2000 SHCP will end this role and is now working with banks and states to assure that an adequate regulatory framework will be in place for private *fideicomisos* to collateralize state debt with *participaciones*, if that is what the parties want.

Of the many political problems with imposing a hard budget constraint on the states, the most difficult arises because the large share of spending for wages has created strong political pressure to use federal bailouts to avoid large cuts in spending rather than to service debt. Solving the problem will require not only firm resolve by the federal government to avoid bailouts but also more fiscal authority and political responsibility by the states to raise additional revenue (to service debt or pay wages) and to control costs. In other words, there will be an interdependence between hard budget constraints that motivate fiscal responsibility for the states and true fiscal autonomy of the states that makes such constraints politically realistic.

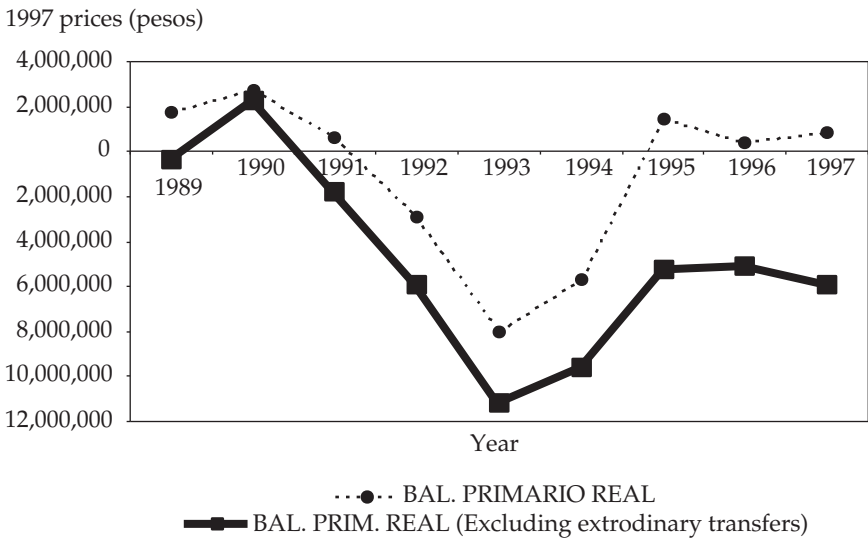
Subnational debt rose from \$Mex27 billion in 1994 to \$Mex71.6 billion in 1998. The 1994–95 financial crisis, and the rise in the interest rate, expanded the states' real debt outstanding, but this was considerably reduced by the bailout package put in place by the federal government in 1996–97. In 1997 subnational debt was only about 6 percent of the total public debt and 2 percent of national GDP. By comparison, subnational debt was around 5 percent of GDP in Argentina, almost 20 percent in Canada, and somewhat above that in Brazil. Much of the subnational borrowing in Mexico has been from Banobras, a federally owned development bank. States with high debt ratios and a repeated history of needing bailouts have still received loans from Banobras, but this will presumably be less of a problem with the introduction of tighter lending practices and the end of implicit federal guarantees, through the *mandatos*. Banobras's cost of funds is higher than that of commercial banks (because Banobras cannot accept deposits), which have been getting an increasing share of the subnational business. None of the debt is external because the constitution prohibits states from borrowing in foreign exchange or from foreign creditors.

Borrowing has been low or zero by most states since 1995; some states have paid off their debt. But a few have borrowed heavily, and the debt imposes a burden on them, because they have so little disposable income with which to service it. The ratio of debt stock to disposable revenue, defined as own taxes plus untied transfers, ranges from a maximum of 1.8 (in Sonora) to a minimum of 0.02 (in Hidalgo). The Federal District, although it has the highest absolute debt, is ranked among the least-indebt-

ed relative to disposable income, because it collects substantial revenue. The eight most indebted states are Baja California Sur, Jalisco, the State of México, Nuevo León, Querétaro, Quintana Roo, Sinaloa, and Sonora, all with a ratio of debt stock to disposable revenue greater than 1.¹¹ If one uses an alternative definition of disposable revenue—total revenue minus wage payments (personnel and educational and health decentralization) and minus transfers to municipalities—the same states are the most indebted, with the addition of Baja California (Norte). The main difference is that the ratio is higher for states like Nuevo León that use much of their own revenues to pay salaries. By this measure, 12 states had debt stock greater than disposable revenue in 1997.

The debt stock of Mexico’s subnational governments is considerably less than their accumulated past fiscal deficits. A substantial part of their fiscal gap has been repeatedly relieved by the federal government through extraordinary, discretionary transfers (to cover unanticipated wage increases, investment expansion, and so forth) and other forms of bailouts like the 1995 ad hoc transfers for debt reduction and rescheduling. The primary balance of subnational governments in Mexico was positive in 1995–97, in contrast to deficits in 1992–94 (see figure O.2). But this resulted mainly from an increase in extraordinary transfers from the federal level. Netting out these extraordinary transfers, the states still had a primary deficit in 1995–97 and,

Figure O.2. Mexico: States’ Primary Deficit, 1989–97



Source: SHCP and World Bank estimates.

of course, a larger overall deficit. SHCP made annual fiscal adjustment agreements with each of the states (except the Federal District) as a result of the bailouts implemented after the 1995 crisis. The main federal program for these transfers (the Financial Strengthening of the States in Ramo 23) was dropped from the budget for 1999, and other parts of Ramo 23 were greatly reduced. It remains to be seen how states will cope and whether the federal government will remain committed to ending bailouts to the states.

They are also some important contingent liabilities of the subnational governments, such as pensions and health schemes for employees. Furthermore, the Federal District, states, and municipalities provide guarantees on loans to their respective decentralized agencies and public enterprises. There is a consolidated record of these only where they were registered in order to use the state's *participaciones* as collateral. In a few cases defaults of decentralized entities were large enough to trigger a federal bailout, as occurred with the Monterrey metro and the toll road in Coahuila. For most places, water companies are likely to be problem debtors.

Pensions of state employees are mostly unfunded, and few states have the fiscal capacity to operate them even on a pay-as-you-go basis. Nuevo León has reformed its pension system independently, but it was an incomplete reform and remains an exception. A partial estimate of the states' contingent debt for pensions reached \$Mex167 billion in 1997 (about 6 percent of national GDP).¹² Among the 25 states with sufficient data to estimate the year in which the system would run out of reserves, given present contribution rates and so forth, five were already in deficit in 1998 and seven more were projected to be bankrupt in 1999–2002. Most state governments see the pension liability as a legacy left by the pre-1990 practices, when state governments were under the complete domination of the federal government. Consequently, some state governments view pensions as an implicit liability of the federal government. The lack of clear assignment has given both sides an incentive *not* to make adequate preparations, hoping that the lack of preparation will result in the other side bearing more of the cost in the end. When the problem is ignored, it grows quickly with the maturation of the labor force. Furthermore, when a large debt of this type becomes imminent, it reduces the incentives for a state to manage prudently the rest of its fiscal affairs.

The experiences of Argentina and Brazil show the absolute necessity of dealing with state pensions. Brazil has yet to reach a solution, although one is under active discussion; Argentina has federalized most of the responsibility. It may be best to separate the design of a future system, where options are wide, from the development of procedures to deal with pension liabilities built up in the past. The latter could be a federal responsibility, at least the part for workers originally hired by the federal government. In any case federal responsibility needs clear limits. The future

system could be dealt with at the state level; experience indicates that a defined-contribution scheme is more likely to be sustainable.

The policies on subnational borrowing in the past evolved when Mexico's intergovernmental fiscal relations could be kept on track by ad hoc transfers and negotiations between players in the same party hierarchy. Now that states and municipalities are more independent politically and are often governed by parties in the opposition at the national level, the challenge has been to make a transition to a more strict and transparent system for managing subnational borrowing. Otherwise, debt problems could cripple the decentralization process and, in a worst-case scenario, eventually pose a macroeconomic hazard. Good fiscal behavior by states seems to be politically popular, which is fortunate, because much of the reform process will require actions by state governments and heightened vigilance by citizen-voters. The federal government is encouraging this by enforcing financial disclosure rules (as a condition for debt registration), demonstrating that governments are public entities using taxpayer money, not private operations with some right to privacy.

Although the past system at least prevented a major macroeconomic crisis from subnational debt, several things have already changed, the most important being the greater political independence of the states and the virtual elimination of extraordinary transfers. Thus a transition is already under way and requires further changes in order to be sustainable.

The federal government, as of 31 March 2000, ceased accepting *mandatos* from states to collateralize their loans with *participaciones*. States and their creditors will thus have to make alternative private *fideicomiso* or equivalent arrangements that do not carry an implicit guarantee by the federal treasury. SHCP will no longer be directly involved in the subnational borrowing process. Instead, it will only issue guidelines to explain what *fideicomiso* or other collateralization arrangements would be legally and financially sound, although a state and its creditors will have the option of agreeing on whatever guarantee arrangement suits them best. To make the transition to the new no-*mandatos* system as smooth as possible, during the first quarter of 2000 the federal government accepted *mandatos* only for states in the process of obtaining credit ratings from reputable international agencies (see below).

In parallel, bank regulation (and its impact on loan pricing) recently created incentives for more efficient and more transparent borrowing programs and financial management by states and municipalities, and for sounder, moral-hazard-free subnational risk assessments by their bank lenders. First, the so-called *régimen de excepción*, whereby all subnational lending was exempted from normal provisioning requirements and exposure concentration limits, was abolished in December 1999 formally and in practice. Second, bank loans to states and municipalities were subjected

to a punitive capital risk weighting ratio (150 percent) if they were not registered with SHCP, a process that was in turn made conditional on the borrower being current in its publication of debt and fiscal data and in its debt service obligations to the government's development banks. Third, new regulations introduced differential capital-risk weighting that links the capital-backing requirements for (and, thus, the pricing of) subnational debt instruments to the borrower's credit rating, as measured by two, current, published, global-scale local-currency credit ratings performed by well-known international credit rating agencies.¹³ There is always some danger of states shopping for ratings, but requiring two ratings from reputable international agencies will mitigate this risk. Using a global scale will increase the objectivity and reliability of the ratings, since the international firms will know that their rating of any Mexican state or city will be compared to the firm's other ratings around the world. Since the states cannot borrow abroad or in foreign currency, there is no exchange risk and thus local-currency ratings are appropriate.

To be complete, the hardening of budget constraints and the reduction in moral hazard requires a new lending framework for the public development banks, because they have not had the same corporate governance and market pressures as commercial banks. Thus, for their lending to state and municipal governments, the development banks (namely Banobras) will also be required to observe the same lending concentration limits and differential capital risk weighting as the commercial banks. In addition, and as a matter of corporate policy, the federal government (who owns the development banks) will allow development banks to grant loans only to subnational governments that require capital-risk weightings less than 100 percent.¹⁴

To avoid punitive capital risk weights of 150 percent, the state governments will also have to register their debt with SHCP, for which they will have to be current on their publication of debt and fiscal data and on debt service to development banks. The latter requirement will effectively prohibit Banobras from capitalizing interest arrears via new lending.

The new policies put in place in late-1999 and 2000 are moving Mexico toward a market-driven approach to state borrowing, excluding the possibility of federal guarantees and bailouts and including global credit ratings that determine capital-risk weighting and thus the cost and availability of bank credit to states. The federal government has an important role to play in motivating and facilitating improved accounting standards and public disclosure for states and municipalities, and financially prudent behavior by banks. Experience in Argentina, Colombia, and the United States shows how fiscally responsible behavior by states and their creditor banks requires good regulation and supervision of the banking system.

Options and Agenda for Action

It is useful to think of the policy agenda for decentralization not only as a list of actions for the short, medium, and long term, but also as steps that could initiate various paths of reform. Some important changes have already been made, such as ending discretionary transfers and the practice by the federal government of withholding debt service payments from states on behalf of the banks. Carrying on with these measures is an important part of the short-term agenda.

International experience points to a few principles that could guide the development of policies for the medium and long term:

- Authority and responsibility for delivering services should be devolved to the most local level that is compatible with efficiency.
- Within each sector, the responsibility for carrying out the essential functions should be clearly specified, and the responsible level of government should have access to adequate resources, including tax bases, to finance the service.
- As much as is feasible in terms of efficiency and equity, state and local governments should raise their own resources, and should do so in a way that makes the users of public services pay the costs.
- Governments should be able to borrow when, and only when, they are able and required to fully service the debt.
- The governments and agencies that do the spending should provide clear and transparent accounts, not only to the next level up but also, more important, to the public.
- The democratic process, not a technical process, must determine the degree of equalization in financing for states (and municipalities).
- New scenarios based on these principles will sometimes require legislation and other fundamental changes to the roles and responsibilities of governments.

Mexico faces some fundamental choices about the type of federal system it will have. Continued public debate would be fruitful, even if it does not lead to a clear choice of system. In many countries the choice has emerged gradually from many smaller choices. It is important, however, to understand that decisions to move in one dimension—for example, toward more reliance on subnational taxation—affect how decentralization will move in other dimensions, such as total tax resources, equality of per capita public resources across states, local autonomy in spending decisions, and control of borrowing.

At present subnational governments have weak taxation and depend on federal transfers, making them subject to federal controls on spending and

borrowing. Mexico is following a model closer to the German end of the spectrum. Although there are many inequalities in funding across states, they are due mostly to historical and political factors, not to differences in the economic strength of the state economies. A variety of reforms would strengthen the institutions and clarify and simplify the rules.

In the longer term, the system may move part way toward legislative federalism—the Canadian model. This would occur if transfers do not grow as fast as the demand for spending on services that have been delegated to subnational governments, especially education, health, and roads. Then states, led by the ones with the best tax bases, might well choose to raise more of their own revenue. States can do that now in principle, but they will only do it in practice if they gain additional control over their spending and if the federal transfers do not penalize the state's tax effort. This requires not only the end of negotiable transfers, but also more autonomy for states. Moving on this path does not necessarily imply any reduction in resources for the poorer states with less tax base; indeed, such states will probably gain. But the rich states may increase their resources faster, thereby increasing inequality of per capita resources of local governments, unless there are stronger redistribution transfers than at present. In addition, the political market and the financial market would gain more influence on spending, taxing, and borrowing decisions than the central government.

Recent Steps: 1999–2000

The government's most recent step to improve the decentralization process focused on three main targets: (a) imposing hard budget constraints on federal resources provided to states and municipalities; (b) reducing moral hazard in subnational borrowing; and (c) increasing the transparency, efficiency, and public accountability of subnational fiscal and financial management and of the overall decentralization process. These will be valuable no matter where the system goes in the long term and will help create the incentives and capacity for taking the next steps, in the medium term, such as revamping the tax and transfers system and revising the assignments of spending authority.

Hard budget constraints will come about as rules rather than discretion govern subnational expenditure, transfers, and borrowing.¹⁵ The federal government is ending all cash discretionary transfers to states and municipalities. All large *pari-pasu* programs will operate with transparent rules and will be available to all states that qualify according to published criteria. The state-by-state distribution of federal spending on local projects in education and transport will be published in 2000, to increase further the transparency in the use of federal resources.

Rules on discretionary financing from the federal government are being complemented with the efficiency-enhancing, market-based incentives in

subnational borrowing, as described earlier, which will both harden budget constraints and reduce moral hazard.

Although there is little chance of solving the problem of state pension systems before 2001, it is important to get this issue on the table and initiate discussions. For this purpose, publishing a study of the state pension liabilities, including state-by-state estimates of them, seems a sensible step forward. This will be a key step in the process of clarifying the limits of federal responsibility, reducing the current impression that the states have a blank check from the federal government to cover pension liabilities, and eventually developing some common standards for allocating the burden.

Increasing the transparency of decentralized fiscal management, as a means of increasing the public accountability of both federal and subnational governments, is the third objective of the initial steps in the decentralization agenda. The federal government in the year 2000 budget increased the accountability of subnational governments for expenditures financed with federal resources. On a pilot basis, federal ministries and states will enter into performance agreements based on matching grant programs, which will be a signal that in the future subnational governments will be held more accountable for the sector-specific funds they receive through decentralization. To start, pilot performance agreements are being written and implemented for the environment and health sectors. These sectors appear particularly suitable for the performance agreement pilot because they enjoy a solid reform record with strong country ownership and ongoing decentralization agendas. The new Decentralization Committee, described above, will also improve transparency, especially when its Technical Secretariat makes more data and analysis publicly available.

To build a more consistent process of institutional development for decentralization, beyond the above-mentioned Decentralization Committee and Secretariat, a program of institutional training and strengthening at the state and municipal levels, covering accounting, budgeting, monitoring, reporting, auditing, and procurement, will be made available on demand. This program will be directly supported by an Inter-American Development Bank US\$400 million line of credit approved in late 1999, and will capitalize on ongoing federal efforts, such as homogenization of accounting practices; and state efforts, as in Puebla and at the University of Monterrey.

The federal government can also support improvement of local accounting and reporting practices in several additional ways by (a) setting minimum standards for different categories of municipalities according to the absolute volume of transfers received. States would not be required to differentiate between municipalities, but the federal minimum standards would effectively invite states to differentiate in a way appropriate to their situations; (b) supporting the efforts of the *Contaduría Mayor de Hacienda de Honorable Camara de Diputados* to establish common guidelines for Ramo 33

and other subnational expenditures financed by federal transfers; (c) actively pursuing synergies between PROMAP, other similar programs at the federal level, and the *contaduría mayores* of the states. SHCP could document practices for covering the costs that states incur to administer Ramo 33 (project preparation, budgeting, accounting, and reporting); (d) evaluating the impact of laws and practices of states that have taken initiatives toward closer monitoring of Ramo 33; (e) evaluating the impact of external auditing by specialized firms wherever they exist; (f) providing information and recognition to encourage credible civil society organizations to keep and disseminate their own indicators of performance by subnational governments; and (g) beginning pilot-testing nonmonetary incentives to states that fully and promptly comply with the intergovernmental agreements reached under the *Homologación* Program. Initial incentives may consist of public recognition and dissemination of good practices.

STRENGTHEN THE CAPACITY OF SUBNATIONAL GOVERNMENTS. Documentation, recognition, and dissemination of good practices have a powerful training and demonstration effect, especially in the early years of decentralization. To encourage training activities, SHCP could collect and disseminate good practices with local spending of the Ramo 33 contributions since 1998 (the year they began), promote municipal-to-municipal training on the basis of good intrastate practices with effective allocation of Ramo 33 funds, and compare the benefits of horizontal training and technical assistance among municipalities with those of federal or state training programs. Training could include identifying priorities, preparing budgets and projects, conducting monitoring and evaluation, and writing procurement contracts. To encourage capacity building in municipalities, the federal government could increase the amount of funds from Ramo 33 that can be used for capacity building and encourage states and municipalities to follow the example of Puebla in concentrating and augmenting their training funds at the state level, in order to realize economies of scale.

IMPROVE THE BUDGET PREPARATION PROCESS. Budget preparation and presentation offer a significant opportunity for the federal government to communicate its commitment to ensuring the fiscal transparency of sector units and subnational governments. The federal government may—as an experiment and while complying with the legally established timetable for budget preparation and approval—provide preliminary (and contingent) estimates of proposed transfers to states and municipalities, so that subnational governments may formulate tentative budget plans before the beginning of the fiscal year.

CLARIFY AND RATIONALIZE INTERGOVERNMENTAL RELATIONS WITH THE FEDERAL DISTRICT. To reduce current and future conflicts, the federal government

could clarify the rules of intergovernmental fiscal relations for the Federal District. These would include the technical criteria for reorganizing both vertical (federal to Federal District) and horizontal (Federal District to neighboring states and municipalities) transfers related to the Federal District and effective institutional arrangements for negotiations and dispute resolution. The proposed arrangements will need to be consistent with the Federal District's autonomy concerning revenues, borrowing, and spending responsibilities. A study may be necessary to support this proposal, drawing on international experience in intergovernmental transfers and institutional arrangements from other metropolitan areas (Buenos Aires, Santiago, and São Paulo from within Latin America, and other cities in Eastern Asia, Europe, and North America).

Medium- to Long-Term Agenda: 2001–2006

The decentralization reform agenda for the medium to long term includes revising the fiscal pact between state and federal levels—the joint design of tax allocation and transfers—and revisiting the assignment of authority to make spending decisions. Institutional development will need to continue in several ways. The national government will also need to sustain its reforms of 1999–2000 to the financial regulatory regime for subnational borrowing, so that the states will change their laws and practices appropriately.

Several states, including seven whose governors in December 1999 signed the Declaración de San Lazaro, have actively objected to the current system of transfers and taxes, demanding that they get more of the resources collected in their territories. Since there are no longer federal budget resources for cash transfers at the discretion of the executive, the immediate solution has been increased federal spending for local needs—effectively *ad hoc*, in-kind transfers—and the revival of the Fund for Strengthening State Finances, with allocations set by Congress. Almost all parties would benefit from a more regular and transparent solution, but agreeing on which particular solution will be difficult. Addressing several problems at once—especially both taxes and transfers—will allow more possible dimensions to the solution and thus could make it more likely.

Subnational Taxes

Both to have appropriate incentives for efficient spending and to allow state finances to withstand economic shock, states and municipalities need to have substantial control over their revenues at the margin.

INTRODUCE NEW TAXES, PIGGYBACKING ON FEDERAL TAXES, CHOOSING ONE OR TWO OF SEVERAL POSSIBILITIES. The federal individual income tax rate could be reduced to allow states to levy their own surcharge. There could then

be a corresponding reduction in federal transfers or revenue sharing. Some share of revenues obtained from excise taxes on motor fuels could be shifted from the federal government to the governments of states where consumption occurs. A similar shift of revenues from excise taxes on alcoholic beverages and tobacco products to be implemented via state surcharges could also be considered. With respect to excise taxes, the state excise taxes that fit within the current constitutional and legal frameworks could be identified. Then, experimentation could proceed with one or a few of the most promising excise taxes through federal and state agreements. Finally, SHCP could evaluate, adjust, and promote replication. The federal government could also shift to state governments the revenues generated from a given percentage point of the value added tax, employing the dual federal/state value added tax and the compensating value added tax for interstate sales. Stronger federal tax administration would be a prerequisite for any of these.

RATIONALIZE THE PAYROLL TAX. The federal government could give incentives to states to harmonize the base for the payroll tax. One way would be to share in the collection costs if the states adopt the same base as the federal social security tax. The most challenging issue concerning payroll (and property) taxes is to find the right incentives to stimulate states and municipalities to increase revenues to higher levels that are still compatible with tax efficiency, equitable incidence, and limited tax distortions of market allocation of resources.

TAX ADMINISTRATION. The formation of cadastres, updating, and valuation, should be strengthened for the property tax. Exemptions (even intergovernmental exemptions) should be limited or eliminated to expand the tax base and make the taxes more neutral. Accounts of tax expenditures (via exemptions) could be kept and publicized, with models prepared by the federal government. Audit and collection should be strengthened for state payroll taxes and municipal (or state-administered) property taxes. To improve tax collection, Mexico could create a national tax agency, which would collect both federal and state taxes that have the same or similar bases. This would obviously become more relevant as states harmonize payroll taxes and (are allowed to) have their taxes piggybacked on federal taxes.

SUPPORT LOCAL PROPERTY TAX EFFORTS. It would be useful for a study to identify and evaluate the incentives that account for which states are effective in their support for the municipal property tax. State and municipal agreements could be encouraged to allow states to recapture part of the costs of administering the property tax or to share part of the additional revenues produced by improved administration. New state-municipal incentives and

agreements are needed to stimulate cooperation for higher local fiscal effort. The federal government could consider a program to recognize and reward municipalities with the highest gains in property tax revenues and states with the most effective support for the property tax. It would be helpful to explain the impact of the *ejido* (communal land holding) on property registration and fiscal cadastre. The Technical Secretariat for the Decentralization Committee could collect and evaluate information on revenues from and administration of the property tax.

On the basis of ongoing experience, the federal government could encourage states to establish rules for which municipalities can fully and efficiently administer the property tax by themselves and which municipalities would benefit from various degrees of state support for forming and updating the cadastre, keeping current accounts, billing, and collecting. Evaluating the impact and efficiency of the 100 Cities Program—insofar as it involves support for the formation and administration of the cadastre—would help to establish the capacity of cities vis-à-vis predominantly rural municipalities. Comparisons could include cost-effectiveness ratios and center-periphery distribution of revenues.

It would be useful to have technical and empirical studies (a) to identify and evaluate the reasons behind the relative decline over the past 20 years of property tax administration in some places (for example, Monterrey) and the relative strengthening in other places (for example, the Federal District)—studies should lead to proposals for policy reform and replication of good practices; and (b) to measure the impact of changes in rates of the payroll tax on fiscal revenue and on the state economies—employment, labor productivity, and competitiveness—compared with those of other states.

Intergovernmental Transfers

In coordination with the tax reform agenda, some of the matching grant transfers and perhaps even the *participaciones* could be reduced, along with the reduction of federal tax rates (for example, the individual income tax or the value added tax) and the devolution to the states of the right to collect surcharges on the taxes.

In the medium term, a simpler and more transparent system is needed to assure equal per capita resources (or whatever objective is agreed to by the national and subnational governments) and more equal treatment of states with similar levels of poverty. The measure of equity should be total per capita transfers plus the revenue that *could* be obtained from the state's tax bases. Conditions will need to respect state priorities and allow states to achieve equivalent standards in different ways. The formulas for transfers should not penalize states that increase their own revenue.

To simplify the transfer system, all special earmarked programs, such as the Plan for Public Security or the 100 Cities Program, could be included within Ramo 33. Lumping together these special programs under one

rubric would facilitate policymaking and move toward a simpler, more transparent system of transfers and greater subnational autonomy.

Spending and Service Delivery

The federal government could clarify sectoral responsibilities between levels of government, coordinating responsibilities for investment and maintenance and for hiring and salaries. States could be encouraged to adapt salaries and staffing to local conditions of demand for teachers and health personnel. This is already being done in Oaxaca for low-income areas and could be expanded to other states. States with an adequate tax base and extra demand for education could be allowed to raise teachers' pay above the national level, covering the extra cost with their own taxes. They could also take initiatives in the areas of performance indicators, pay, promotion, and incentives for improving public sector management.

IMPROVE INCENTIVES FOR EFFICIENCY. Some sector-specific reforms would improve the efficiency of incentives. In education, a new system of transfers could take existing allocations as a nominal floor and move the increases (or freezes) toward a formula based on the number of school-age children, according to the census and transparent projections from it. The federal formula eventually might try to reflect actual pupil attendance, but that sort of incentive should probably be left to the states. In the health sector, with existing allocations as a nominal floor, the increments should continue to move the allocations toward a formula based on some indicator of potential demand, like age- and gender-adjusted population. International experience shows that states should be encouraged to devolve authority and public accountability down to the units that directly provide services, such as hospitals and schools.

SHCP might evaluate the various state laws, de facto practice, and manuals that regulate state incentives and disincentives for municipal autonomy and for efficient allocation of Ramo 33. SHCP and SECODAM could compare state laws and practices on Ramo 33 with the tools of the *Programa de Mejoramiento de la Administración Pública* (PROMAP) and the new, results-oriented *Nueva Estrategia de Programación* (NEP), and propose recommendations for training *Comités de Planeación para el Desarrollo del Estado* (COPLADEs) and *Comités de Planeación para el Desarrollo Municipal* (COPLADEMUNs) (planning committees for state development and municipal development, respectively) in the new programming techniques. The study could compare those states where the COPLADE is responsible for executing a program with those states where it is not.

CLARIFY PENSION RESPONSIBILITIES ON A SUSTAINABLE BASIS. An agreement between federal and state governments is needed to clarify which level of government is responsible for the pensions of state employees. Perhaps it

would be necessary for the federal government to recognize explicitly some base-line part of a state's pensions not under its control (such as former federal employees and those over age 50) in return for the state undertaking fiscal reforms, such as servicing the remaining obligations, including social security. Alternatively, as was done in Argentina, the federal government might offer to take over the states' pension schemes (to reform them), along with the collection of contributions. Specific steps would come from the initial study to make explicit the size and nature of the pension liabilities.

Core Institutions for Decentralization

IMPROVE DISPUTE RESOLUTION. To deal with problems that arise even in the best-designed system and to give participants an incentive to find cooperative solutions, better institutions are needed for resolving disputes. Creating these institutions will take time, but starting soon is desirable. For major sectors such as health and education, sectoral boards could be developed. In the medium term, with lessons learned from the experience in the sectors, an overall intergovernmental board could be established to handle systemwide issues and appeals from the sectoral boards. Once the federal-state models are working, states could establish their own municipal-state boards to handle issues among municipalities and between them and the state.

IMPROVE ACCOUNTING STANDARDS AND INFORMATION. It is important to maintain clear accountability of each level of government—municipal reporting to the states and state monitoring of allocations. Some states currently impose sanctions on municipalities for slow reporting by suspending transfers, and this practice could be linked with the process of documentation and evaluation. Evaluation of ongoing practices could also distinguish executive controls from the controls exercised by the states' Congressional accounting offices. SHCP could evaluate whether the model being prepared by the *Contaduría Mayor de la Unión* adequately stimulates efficient allocation, and then formulate and publish corresponding recommendations. It is also important to implement uniform accounting and exchanges of sectoral and intersectoral information, both top-down and bottom-up.

IMPROVE COORDINATION BETWEEN AND WITHIN LEVELS OF GOVERNMENT. The Federal government may want to stimulate municipal associations to (a) achieve economies of scale (in procurement, specialized services, sharing of equipment, administrative costs); (b) identify fiscal or other technical solutions through coordinated, subregional efforts undertaken jointly by two or more municipalities (garbage disposal, interjurisdictional distribution of pollution charges); (c) identify and evaluate ongoing experiences; and (d) undertake short-term pilot projects that can be launched and evaluated

quickly. Intersectoral, interstate, and intermunicipal forums could be created to allow integral budgeting for a given region or subregion. Although initially informal or ad hoc, these forums could establish the basis for more flexible budgets and integral regional budgeting in the future.

ACCORD MUNICIPALITIES DIFFERENT TREATMENT ACCORDING TO CAPACITY. It is important to establish a set of criteria for certifying municipalities as having the capacity to execute certain programs or to borrow. Financial reporting requirements should be set according to the fiscal size of the municipality, whether it is a state capital, and whether it wants to take on additional responsibility and authority.

In conclusion, the agenda envisioned here has six main objectives:

1. Sectoral and intersectoral decentralization policies need to be formed within a more coherent strategic framework. This would help to address the need for clearer allocation of responsibility, more subnational autonomy, and more effective implementation strategies.
2. The administrative capacity of subnational governments needs to be strengthened, particularly at the municipal level.
3. The capacity of the states to tax and borrow needs to be expanded in a sound and sustainable way to match their new responsibilities.
4. To have adequate incentives for responsible fiscal autonomy, states need to face hard budget constraints from the federal government regarding transfers, debt, and responsibilities for service delivery.
5. Accounting practices need to be improved at all subnational levels because intergovernmental coordination and monitoring of the decentralization process require the exchange of uniform and relevant information. Such information has to be shared between governments and with citizen-voters, who are the ultimate champions of reform in a democracy.
6. Consensus-building processes and preemptive conflict and dispute resolution mechanisms are needed to help the widening circles of economic and political actors participate in the dynamic process of decentralization.

Although the steps outlined here may be politically and economically difficult, all stakeholders in Mexico are aware of the costs and risks of taking no coherent action. These costs would include underutilization of subnational tax capacity, inefficient spending due to lack of clear accountability and controls on service delivery, and potentially explosive subnational indebtedness, particularly arising from contingent debt or pension liabilities.