Eugenio J. Alemán, Senior Economist
eugenio.j.aleman@wellsfargo.com • (704) 715-0314

Mexico Needs a Game Changer

The Transition is over; Long Live the Transition

The Mexican political transition needs to end. For 71 years, a one-party system, headed by the Partido Revolucionario Institucional, or PRI (Institutional Revolutionary Party), dominated the country and its institutions. In the 2000 election Mr. Vicente Fox, a former CEO of Coca-Cola Mexico, and the candidate from the opositi0n party, Partido Acción Nacional PAN (National Action Party), broke the spell that kept the PRI in power for more than 70 years and presided over the first transitional government. In 2006, Vicente Fox's successor also came from the PAN when Felipe Calderón Hinojosa was elected as president.[1] Felipe Calderón's term is slated to end at the end of this year and his successor will be determined by the presidential election scheduled for July 1, 2012.

For the last 12 years, the PAN has been in charge of the transition from a one-party dictatorship to a more open and competitive political system. The PAN's management of this political transition has not been smooth, but it has been better than what was expected at the beginning of Fox's term. The risks were tremendous but the PAN was able to manage the transition as well as anybody else could have in the prevailing historical circumstances. The chief problem the PAN presidents have had was that they were very unlucky, especially on the economic front. They tried to manage the transition based on luck in external factors (for example, expecting the U.S. economy to continue the stellar performance it had shown during the 1990s), but were surprised by just the opposite, a U.S. economy that had serious growth issues during the 2000s and continuing today.

The PAN has been in charge of the transition from a one-party dictatorship to a more open and competitive political system.

This is the basic issue that has defined the Fox and Calderón presidencies as transitional presidencies. Both presidents were limited in their abilities to make changes due to external factors (the U.S. economic crisis and weak economic growth), as well as internal factors (the inability to break the back of the PRI and PRD [Partido de la Revolución Democrática, or Party of the Democratic Revolution, which was originally a division of the PRI]), to produce the far-reaching changes that the country's economy needed.

One of the most telling indicators of this inability to be a game changer is that all across the world investment in new exploration and production of petroleum has produced an impressive increase in petroleum reserves that has delayed the day of reckoning for the world petroleum industry (that is, lower levels of petroleum production). However, Mexican petroleum production has continued to decline due to the inability of the Mexican government to open the petroleum sector to private investments, despite the fact that Mexico's potential petroleum production has been estimated as one of the largest in the world.[2,3] This means that PEMEX, the country's state-

[1] Mexico's constitution does not allow for the reelection of a president. This is also the case for senators and representatives.
[2] A very timid effort of partially opening the sector to what are called "contratos de servicios," or service contracts, has not been successful in reverting the downward trend in petroleum production.
[3] The CIA World Factbook estimates Mexican proved oil reserves at 10.4 billion barrels, 17th in the world ranking of proven petroleum reserves.

owned petroleum monopoly, would have to invest billions of dollars in new exploration and production; it simply does not have the money to do so, due to the Mexican government's insatiable fiscal revenue requirements.

But nothing has been done since democracy was "restored" in 2000.

Nothing has been done since democracy was "restored" in 2000 to reduce the Mexican government's fiscal revenue dependency on PEMEX's proceeds. The Mexican government takes almost 35 percent of its fiscal revenue from the petroleum sector, very similar to what happened before the advent of democracy. Foreign direct investment in the petroleum industry is one of the potential solutions for PEMEX's ability to survive and remain a feasible petroleum company. However, the Mexican constitution still prevents private capital from aiding in the development of this industry. This is one of the reasons the country needs a game changer, a leader–either a person, but probably a party–who can change Mexican history for good. This is much more significant than having merely an administrator of the transition, which is what Mexicans have had since the start of political democratization early in this century.

Reform the Constitution: The 1910 Revolution is over

Every time change is needed in Mexico, the blame falls on the 1917 constitution and the inability of the Mexican Congress to overcome such a large and descriptive "treatise" in rulemaking. The latest document of the Mexican constitution, which includes the original constitution plus all of the changes and additions made to it for almost 100 years, has 181 pages. In order to change or reform the constitution, two-thirds of the Congress members must approve such changes. After that, the changes need to be approved by a simple majority of the state's legislatures. Thus, making major changes, such as altering the rules governing the petroleum sector, has always been considered an almost impossible endeavor. If the rules governing constitutional reform are stringent, the ideological underpinnings that would permit a change in the constitution to allow for private capital investment are even tougher. Domestic capital cannot take over such a role and the development of the industry will have to be left to foreign capital, a taboo in Mexican nationalistic circles.

Underground natural resources are owned by Mexicans.

Mexicans argue that the government, which is the representative of the people of Mexico, is the owner of underground natural resources and that it is the prerogative of the government to exploit these resources for the "people." Thus, allowing for private investment in the petroleum sector has always been considered taboo in Mexican politics, to the point that no politician has even attempted to bring the issue to the forefront of the political discussion. It is true that small attempts have been made through the implementation of "contratos de servicios" (see footnote #2 above), but the capital investment effort needed to bring back the Mexican petroleum sector is so large that these "service contracts" have proven incapable of solving the issues the sector continues to face. It is not that the petroleum sector in Mexico is not "productive." The problem is that the Mexican federal government takes 35 percent of all its federal tax revenue from the petroleum sector, making the Mexican petroleum company unprofitable and incapable of investing what is needed to replenish depleted reserves.

Can the Mexican petroleum sector be self-sufficient, remain in the government's hand and invest in its future? Of course it can, but not under the current environment because PEMEX, the petroleum monopoly, does not have the resources it needs to remain profitable and invest in new production after the Mexican government takes 35 percent of what PEMEX earns to satisfy the government's infinite need for financing.

The worst part is that one would think the dependency on the petroleum sector would have diminished as petroleum prices have increased from the low $20s per barrel in the early part of this century to over $100 per barrel today, but that is not the case. Every increase in the price of petroleum has been "integrated" into the government's expenditure projections, meaning that the government was collecting 35 percent of the revenue from the petroleum sector when the price of petroleum was $20 per barrel as well as at today's prices, that is, at the price of $100 per barrel.

This means that a collapse of the price of petroleum will create serious issues for the Mexican government; the fiscal deficit will soar if the government does not adjust expenditures to match the decrease in government revenue. Instead of creating a "rainy day" fund with excess revenue collected during good times and using some part of those funds to invest in exploration and production, the political system has used this excess revenue through increases in government expenditures.

Across the world, it is clear how difficult it is for governments to wind down expenditure programs when revenue falls short. The ongoing Eurozone debt crisis is just one example of this problem; Mexico will likely not be any different. Thus, even if the Mexican government is not willing to open the petroleum sector to private capital, the best course of action to avoid a severe crisis is to start reducing the government's fiscal dependency on the petroleum sector before reality imposes tough and non-negotiable solutions.

Political Sector Reform

Another roadblock to making the Mexican political system more efficient is the inability to reelect senators and representatives to the Mexican Congress.

Another roadblock to making the Mexican political system more efficient is the inability to reelect senators and representatives to the Mexican Congress.[4] It is true that the opposite scenario, the indefinite reelection in the U.S. political system, can also create its own issues. However, the absolute policy of no reelection in Mexico continues to be one of the biggest issues to solve. No reelection of the lower House of Congress means that every three years, 500 new legislators have to be elected to substitute for those who were working for the previous three years, meaning that the new legislators have to start from zero as they learn how the political process works. This learning curve complicates the decision making process in the country. Senators (currently 128), on the other hand, serve for a period of six years and cannot be reelected either to consecutive terms.

The no-reelection policy of legislators worked its magic for the PRI during its 70-plus year reign, as the party did not care who the legislating individuals were; the party controlled all aspects of political life in Mexico during this period.[5] Now that democracy has been reinstated, allowing the reelection of members of the legislature is a must, though reelection may be limited to several periods rather than an indefinite period of time as is the case in the United States.

Some advances have been made on this political reform during the last several years, but the PRI, which has regained a majority representation in the Lower Chamber of Congress with 237 out of 500 representatives continues to oppose reelection, something that the Senate had already approved in its version of the project.[6] This is not a good omen if the PRI wins the July election as the reform will probably be abandoned again. Even if the reform were to be approved this year it would not be implemented until future elections, but at least it would improve the ability of the political system to change over the years according to the present needs and experiences of the country rather than in keeping with the issues the country had before the 1917 "revolution."

Tax System Reform

The first step for reforming the state is tackling a reform to the tax and tax collection system.

The first step for reforming the state is tackling a reform to the tax and tax collection system. Mexico is one of the countries that collects less tax as a percentage of GDP than almost any other emerging-market economy. While tax collection has "improved" during the first decade of this century, rising from 15.8 percent of GDP in 1999 to 18.0 percent of GDP in 2010, one of the reasons for this improvement has been the high price of petroleum rather than a reform of the tax collection system or a widening of the country's tax base. Thus, the petroleum sector continues to be the cash cow of the Mexican government. The average tax collection in terms of GDP for the members of the OECD, of which Mexico is a part, is close to 34 percent. This does not mean that Mexico should get close to that rate but it should make an effort to increase collection from sectors of the economy that remain protected from paying taxes. Once this is achieved, then the Mexican government should start reducing the importance of the petroleum sector and allow the

---

[4] Reelection of the president of Mexico is also forbidden and is probably as big of a taboo as reforming the constitution to allow private capital in the petroleum industry.
[5] While the PRI remained in power for 71 years, the party lost its legislative supremacy just before the 2000 election, which meant it did not control the congress during the same time period when it controlled the presidency.
[6] The PRI does not have a voting majority, but has the largest representation in the Lower Chamber. The PAN has 143 and the PRD 72 with the remainder allocated to smaller parties.

petroleum sector to use its profits to invest in new exploration and production. The alternative would be to privatize the petroleum sector, but, as previously argued, this alternative continues to be taboo for the Mexican political establishment. This new investment would counteract the recent downward trend in Mexican petroleum production by allowing PEMEX to replenish its reserves and increase petroleum production in the future.

Some of the new tax revenue should probably come from a reform to the country's value-added tax system.

Some of the new tax revenue should probably come from a reform to the country's value-added tax system. During the first decade of this century, value-added taxes in Mexico represented about 3.5 percent of GDP, a very small tax collection rate considering that the value-added tax (VAT) rate is 16 percent for the majority of the country, with the exception of the region bordering the United States. This region is defined as the 20 kilometers south of the Mexican border with the United States, where the value-added rate is 11 percent.[7] This rate of VAT collections is one of the lowest of any country that collects a VAT. To provide an example, Spain's VAT rate is 10 percent while VAT collection as a percentage of Spain's GDP was 5.6 percent during the first decade of this century. Israel had a 16 percent VAT rate, similar to that of Mexico during the decade, but VAT collections as a percentage of GDP were 8.0 percent.[8]

As is the case in many developing countries with a large underground (informal) economy, a doubling of the VAT collection rate is a difficult task, but an undertaking that has to be successful in order for the country to move away from underdevelopment. Furthermore, a higher VAT collection rate would allow the Mexican government to move away from depending so much on its petroleum monopoly and would allow PEMEX to invest in exploration and production. Thus, the Mexican government needs to find a way to make the Mexican economy more inclusive and needs to cut the red tape for the private sector to grow at a faster pace. This will probably need to include a comprehensive labor reform, which would give the labor market more flexibility to adapt to the characteristics of a modern economy.

Labor Reform

A labor reform, although difficult to implement, is fundamental to improve Mexico's competitiveness.

Labor reform will also be very difficult to implement, especially if the PRI and/or the PRD win the presidential election, something that is almost guaranteed. The reason for this is that the party that wins the upcoming election will need the support from the labor unions in order to govern. Thus, we should expect a myriad of vested interests, especially from the labor movement, to try to limit the degree of freedom the new administration will have with respect to changes in labor regulations. Either the PRI or the PRD have a strong labor base, meaning a comprehensive labor reform may not be possible.

However, this is the fundamental reason we argue that Mexico needs a game-changer. Who other than the parties that represent the labor movement in the country should be the ones in charge of changing the rules? Of course, no one is saying that this endeavor will be easy, but any progress in freeing Mexican labor so it can be allocated to the best uses will provide the Mexican economy with a boost to worker productivity, helping firms, workers and the economy grow as a whole. It is no mystery that productivity improvements are the base for wages and salaries and making the labor market more adaptable to the current conditions of the world economy would be a welcomed change.

Mexican labor regulations are very onerous and while wages in Mexico are still low compared to those in the United States, the costs of hiring workers in Mexico are very high; these costs include sharing the profits of a company, social security/health insurance, Christmas bonuses, paid vacations, legal holidays, contributions to workers' retirement funds, contributions for the purchase of a home and so forth. Although these costs are discounted from the salary of every

---

[7] **These rates are the current rates. Before 2010 the rates were 15 percent and 10 percent, respectively.**
[8] **For a complete list of VAT rates across the world please see http://en.wikipedia.org/wiki/Value_added_tax#cite_note-tmf-20; for a list of VAT rates across the world see OECD, Revenue Statistics–Comparative Tables, VAT as a percentage of GDP at http://stats.oecd.org/Index.aspx?DataSetCode=REV.**

worker, the fact that these monies are not paid to the worker does not mean that these expenses do not represent part of the cost of hiring a worker.

The biggest problem with the cost of doing business in Mexico is the difficulty for firms to lay off workers, which makes the Mexican labor market extremely inflexible to the whims of the business cycle. Laying off workers is an expensive endeavor, costing three months in salary plus 20 days of pay per year of service. If a worker is dismissed, he/she has the right to fight for reinstatement in the courts. If the employee wins, the firm has to reinstate the worker and pay full back pay. Additionally, the firm may be liable for punitive damages. Furthermore, employees with 15 years or more on the job who leave voluntarily are paid a minimum compensation of 12 days pay per year of service.

The biggest problem with the cost of doing business in Mexico is the difficulty for firms to lay off workers.

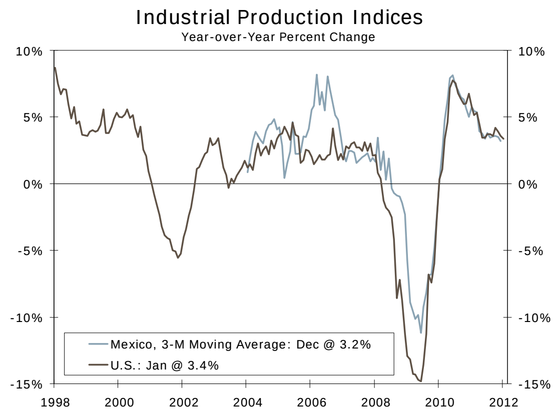
As previously argued, unions are an important component of the Mexican labor market. Those who advise companies regarding the Mexican labor market recommend firms hire a Mexican labor lawyer before hiring the first worker; this gives an idea of how difficult and cumbersome labor relationships can be. This has enormous repercussions on the cost of opening "legal" small businesses which, as is the case in any economy, should be the lifeline of economic growth. On the other hand, Mexico has a low rate of strikes compared to other developing countries (or even other developed countries). One of the possible reasons for this is that the labor market is overregulated and there is little, in terms of labor relations and regulations, that has been left for interpretation. Furthermore, the labor movement has been an appendix of the dominant party, the PRI, and as such, has been manipulated by that party for many years.

The Mexican Economy: A Different Stroke

While the fate of the Brazilian economy rests more on the fate of the Eurozone, the rest of Latin America and China, the fate of the Mexican economy rests more on the fate of the U.S. economy and petroleum prices. Thus, Mexican economic growth was stronger than Brazilian real GDP growth in the second half of last year, a trend that likely will continue this year.

Figure 1

Figure 2



Source: IHS Global Insight, Federal Reserve Board and Wells Fargo Securities, LLC

The Mexican economy has been very resilient to the slowdown in economic activity across the Latin America region and, as previously mentioned, the reason for this is not a mystery: for the first time in many years, the U.S. economy, while not booming, has remained relatively stable compared to other regions of the world, especially Europe. Though the performance of the U.S. economy is not something to cheer about, the fact that economic activity has remained relatively stable has led to growth stability in the Mexican economy.

The Mexican economy slowed in 2011 compared with the growth rate of 5.4 percent achieved during 2010, but nonetheless, the economy has remained relatively strong with a growth rate of 3.9 percent in 2011. In the last quarter of 2011, the Mexican economy grew by 3.7 percent compared to the same quarter of 2010. The economic output of the primary sector–agriculture, cattle and fisheries–decreased by 0.5 percent during the last quarter of 2011 compared to the previous year and was also down on the year by 0.6 percent. Meanwhile, secondary sector output, which includes manufacturing, construction, public utilities and the mining sector, increased by 3.2 percent during the last quarter of the year and by 3.8 percent during the whole of 2011. The tertiary sector, composed of the service economy, was the strongest sector in 2011, growing by 4.3 percent during the last quarter of the year and by 4.2 percent overall in 2011.

While data on the demand side of GDP has yet to be released, our expectation is that growth in domestic personal consumption remained strong during the last quarter of the year and should come in strong for the year as a whole. All supply sectors related to domestic demand remained strong, indicating that, while external demand slowed from the pace it had achieved during the first half of 2011, the domestic economy remained robust.

The challenge for the Mexican economy this year will be to minimize the effect of the current slow-paced U.S. economic recovery during 2012.

The challenge for the Mexican economy this year will be to minimize the effect of the current slow-paced U.S. economic recovery during 2012, specifically in the weakness of U.S. personal consumption expenditures. In other words, as most Mexican exports are shipped to the United States, then weak consumer demand from the U.S. market will limit the growth of Mexican exports and thus of Mexican economic growth as a whole.

Once again, the strength in petroleum prices will to save the day for the Mexican economy as increased income from petroleum will help minimize the effects of the weakness in economic activity across the world. Thus, we expect the Mexican domestic economy to remain strong in 2012 as long as petroleum prices remain at current or even higher levels. Extra petroleum revenue will be used, as has been the case in the past, to support the domestic consumer market and will act as the cushion to any weakness in the export market.

The combination of a relatively stable and growing U.S. economy and strong international petroleum prices should continue to separate the Mexican economy from its Latin American peers in 2012 as it did in 2011.

Summary

Mexico is slated to end its transition from an autocracy to a democracy during the upcoming July 1st presidential elections. By December of this year a new president and a new party will take the reigns of the economy from the PAN, which has held power since breaking the monopoly power of the PRI in the presidential contest for the first time in more than 70 years.

Now it is time to break other monopolies in the country or to reform those whose power is such that it will be institutionally impossible to break. This is the case for PEMEX, the state-owned petroleum sector. Other potential reforms that could help the country advance toward a more modern and prosperous economy include a reform to the tax and tax collection system and a labor reform that would take care of the inflexibilities in the Mexican labor market.

At the political system level, the country would benefit considerably from a reform allowing for the reelection of representatives and senators in order to improve the effectiveness of legislators and give continuity to policies that would tend to come more from their constituents rather than from the parties. There is a case to be made for making political careers more dependent on the electorate rather than on party allegiance. This is a topic of strong disagreement even in the political science profession but since Mexico has already tried the current system for more than 80 years, it would be interesting to see if this change could render the political system more responsive to the needs of the country today rather than to the characteristics of the country in the early 1900's.

Very few believe that any of this will be possible, but our whole contention is that Mexico needs a game-changer, not another politician who will continue with the current transition. Thus, any progress in the direction argued in this report would be good news for the Mexican economy going forward. These are not the only reforms that would help the country continue its progress toward modernity–there are other reforms that will also be needed. For example, a comprehensive education system reform would make the country more competitive in the world economy.

The bottom line is that the Mexican government needs to continue its reform agenda to increase the productivity of its workers and of the economy. Any progress in this direction would be positive for the future growth prospects of the country.

If nothing happens, then the country will have to continue to depend on the fate of the U.S. economy and of petroleum prices. In other words, Mexico will have to continue to rely on external factors as it has done until today.

Wells Fargo Securities, LLC Economics Group

Diane Schumaker-Krieg	Global Head of Research & Economics	(704) 715-8437 (212) 214-5070	diane.schumaker@wellsfargo.com
John E. Silvia, Ph.D.	Chief Economist	(704) 374-7034	john.silvia@wellsfargo.com
Mark Vitner	Senior Economist	(704) 383-5635	mark.vitner@wellsfargo.com
Jay Bryson, Ph.D.	Global Economist	(704) 383-3518	jay.bryson@wellsfargo.com
Scott Anderson, Ph.D.	Senior Economist	(612) 667-9281	scott.a.anderson@wellsfargo.com
Eugenio Aleman, Ph.D.	Senior Economist	(704) 715-0314	eugenio.j.aleman@wellsfargo.com
Sam Bullard	Senior Economist	(704) 383-7372	sam.bullard@wellsfargo.com
Anika Khan	Economist	(704) 715-0575	anika.khan@wellsfargo.com
Azhar Iqbal	Econometrician	(704) 383-6805	azhar.iqbal@wellsfargo.com
Ed Kashmarek	Economist	(612) 667-0479	ed.kashmarek@wellsfargo.com
Tim Quinlan	Economist	(704) 374-4407	tim.quinlan@wellsfargo.com
Michael A. Brown	Economist	(704) 715-0569	michael.a.brown@wellsfargo.com
Joe Seydl	Economic Analyst	(704) 715-1488	joseph.seydl@wellsfargo.com
Sarah Watt	Economic Analyst	(704) 374-7142	sarah.watt@wellsfargo.com
Kaylyn Swankoski	Economic Analyst	(704) 715-0526	kaylyn.swankoski@wellsfargo.com