Increasing decisions making capacities of local governments: Mexico's quest for economic growth

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Fiscal Decentralization & Growth

Large-scale quantitative studies <u>have found a mixture of results</u> relationship of fiscal decentralization to economic growth.

Favoring:

1. Glaeser et al. (1995) used panel data of 260 cases in the US, found a positive association between public sector investment and a city's economic growth

2. de Mello's (2008) study of Brazilian municipalities found public financing and government spending impacts the growth of an area's population.

3. Gemmell et al (2009) use OECD data to evaluate long-term effects on economic growth and its effects on the size of the state, the optimal levels of local taxation and expenditures (Mexico drops out of their model)

Against

1. Davoodi and Zou (1997) to evaluate growth in developing countries found no casual links

2. Rodden (2003) tax competition between subnational governments and found it limits growth.

3. Rodden and Wibbels (2002) used 15 LAC concluded that fiscal federalism with wide-ranging autonomy can create overall fiscal deficits but lowers inflation rates

From Fiscal Decentralization to Fiscal Federalism (Rodden 2003) how to create capacity and discretion?

Social scientists have suggested that the process has been difficult for three reasons:

> 1. Economists have focused on moral hazard— the likelihood that municipalities borrow more money than they can pay back forcing the national governments to bail out municipalities (Wiesner 2003).

> 2. Political scientists suggest it is a problem institutional power — similar to the apportionment of representatives from localities into congress—creating disincentives for politicians to stay local, be faithful to their constituencies and manage their own resources (Eaton 2004).

> 3. Public Admin specialist suggest that Local Governments are perceived to have low levels of autonomy, fiscal capacity and human resources, which makes it difficult for them to deliver public services effectively and efficiently (Campbell 2003; Tulchin and Selee 2004)

Fiscal Decentralization effects on Economic Development

Autonomy (Total own source revenue)

H1: More revenue autonomy (total tax revenues collected locally) improve the decision of local governments to promote economic development

Discretionality (debt decisions)

H2: More revenue discretion (how local governments manage and decide their debt decision) will create more economic growth.

Inter-governmental relations and Economic legacy (convergence)

H3: The more inter-governmental relations allow for economic legacy and discretionary capacity of the local municipalities, there will create more (convergence) eliminating the gap between municipalities. Are we eliminating the gap between municipalities?

Structural Conditions of MEXICO

- Low subnational administrative and professional capacity (Avellaneda 2009 Canuto and Liu 2010, O'Toole and Meier 1999)

- Low subnational fiscal transparency and oversight (Cecchetti et al. 2010; Kelemen and Teo 2014)

- Inadequate subnational capital market controls (Leigland 1997; Martell and Guess 2006; Martell and Espinoza 2016)

- High vertical fiscal imbalances (Rodden 2006)

Mexico's Subnational Debt Market

Requirements:

- Mexican peso debt only
- For "productive" purposes only
- Must report to federal government

Policy Process:

- Opened access for institutional investors to invites in bond market (1997)
- Two credit ratings required (2000)
- States set borrowing limits (after 2004 state by state initiatives)
- Fiscal accountability law to standardize procedures (2012)
- State Stop Light observations by Ministry of Finance (2016)
- Bankruptcy laws (TBD)

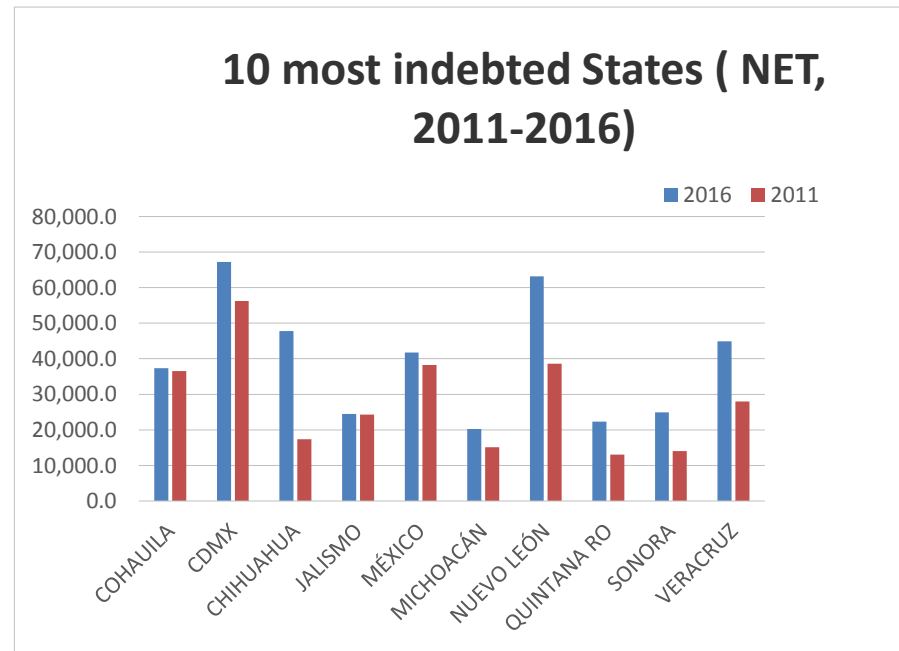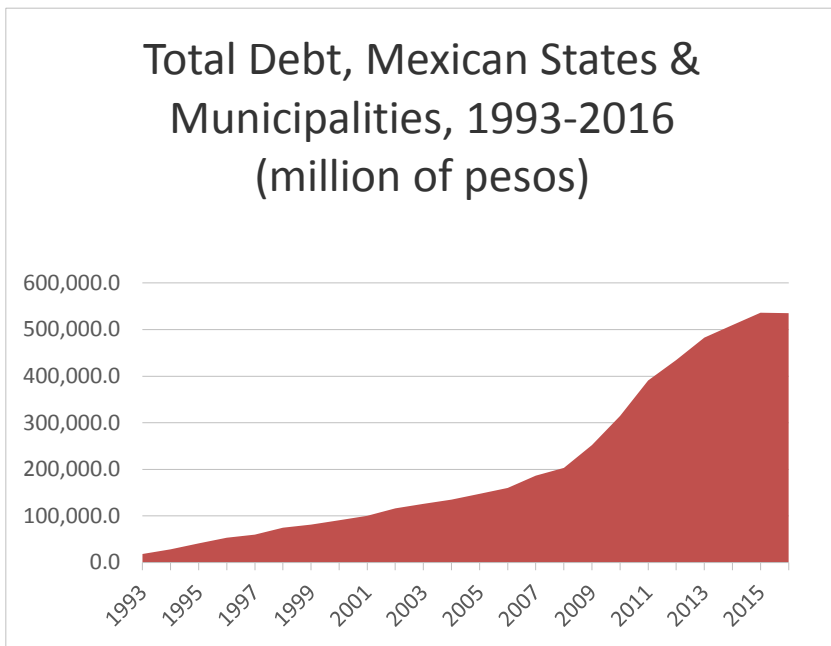# Fiscal Federalism and Hardening Budget Constraints

- **top-down oversight** because poor decision-making can be hazardous to national fiscal finances and the macroeconomy (Canuto and Liu 2010, Leigland 1997, Cecchetti et al 2010, Cernuschi and Platz 2006).

- **bottom-up approach** – allowing greater subnational autonomy in public investment, fiscal finances, and debt policy decisions – can encourage local innovation (Tabellini and Alesina 1990, Alesina et al 1996; Poterba and von Hagen 1999).
  - These scholars argue that political competition between parties for votes and market competition between subnational governments for voters will rein the incentive to make inefficient policy choices.
  - YET these mechanisms do NOT work when you don't have strong ideological differences between parties
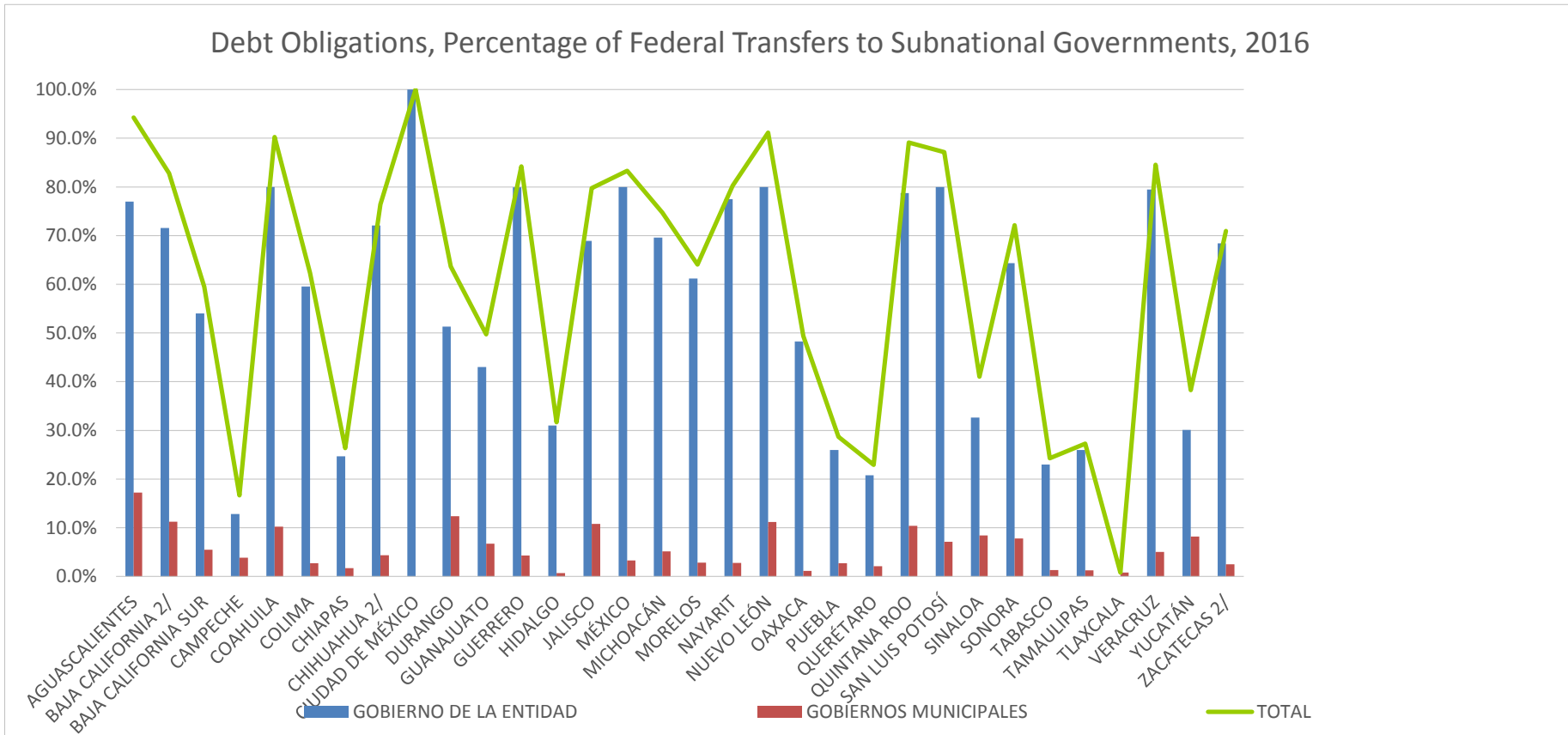
Political Economy Literature

- Opportunistic electoral fiscal policy cycles occur when governments of all partisan stripes undertake expansionary economic policies to improve voter perceptions of their policy performance and thus their electoral prospects at the polls (Alesina et al. 1997; Drazen 2001; Eslava 2011; Franzese 2002; Nordhaus 1975; Tufte 1975, 1978).

- Ideological partisan fiscal policy cycles occur when governments implement economic policies during elections geared toward the expansionary or contractionary preferences of their left-leaning or right-leaning partisan supporters in order to maximize their particular support (e.g., Alesina and Rosenthal 1995; Eslava 2011; Franzese 2002; Garrett 1998; Hibbs 1987; Rodden 2006; Rodden et al. 2003; Tufte 1978).

- MEXICO Weak Institutions/ party structures/ Local controls

- According to 2016 states that "in the last decade the debt of municipalities has increased by 121.2 percent in real terms."

  This is worrisome for the Mexican government, since it shows that the current regulation has been unable to reduce or maintain stable levels of municipal indebtedness (the state debt also presented an impressive increase of 182.3%).

Total Debt, Mexican States & Municipalities, 1993-2016 (million of pesos)

10 most indebted States (NET, 2011-2016)

Centro de Estudios de las Finanzas Públicas (2017), *Obligaciones Financieras de los Municipios de México al cuarto trimestre del 2016.* Palacio Legislativo de San Lázaro

- Mexico developed the Financial Discipline Law for Federal Entities and Municipalities Act that came into law on April 27, 2016 and required states to harmonize local laws by October 25, 2016.
- Although we know that tax regulations do not help reduce debt!
  - Velázquez (2006) finds that these first laws do not reduce or eliminate levels of fiscal deficit at the state level.
  - If the existence of a restrictive norm does not regulate behavior, it is a soft regulation (Smith, 2016) with Soft bailouts (Hernandez, 2017)

Debt Obligations, Percentage of Federal Transfers to Subnational Governments, 2016

Types of debt

Soures of Financial obligations of states and municipalities 2007-2012

Legend: ■ Comercial Bank ■ Development Banks ■ Bond Issuance ■ Trust Funds ■ Other

(Y-axis: Millones of pesos — $0 to $400,000; X-axis years: 2007, 2008, 2009, 2010, 2011, 2012)
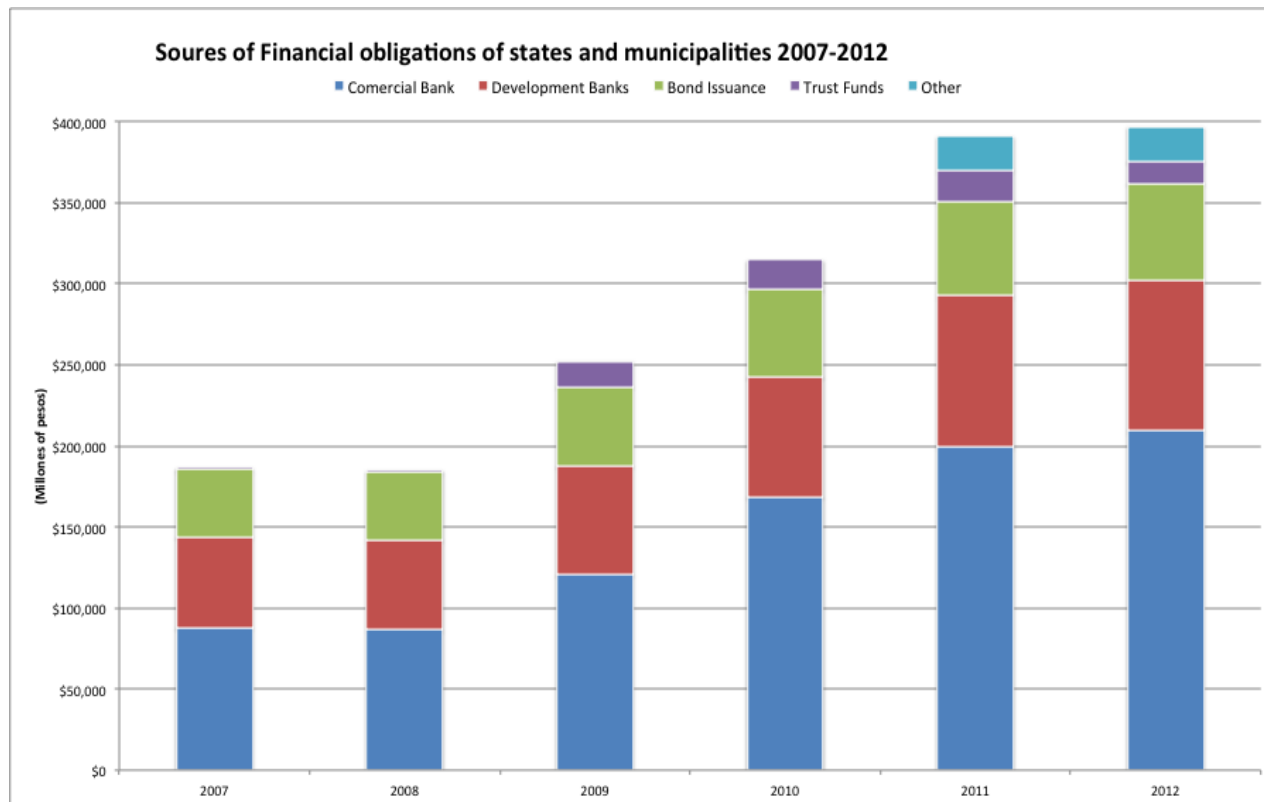
Debt laws changed in 2000 (and revised in 2004 and again in 2014) to include 4 types or models to incur debt: the Development Bank, Commercial Bank Local Bond Market & Trust Funds

Fuente: Elaboración de los autores con la data de SHCP en pesos de 2013 (términos reales). Data del 2004 y después del 2012 no fue registrado como los siguientes años.

Development Bank Debt	Bonds on the Mexican Stock Market
Oldest form of credit (1933) Largest form ($10 billion in 2010) Banobras Federal Reserves guarantee state financing Own criteria for determining loans *Least cost efficient debt due to administrative costs*	Created in 1997 (reforms to CETES, creation of CONSAR, CNBV and CNSF in 2000) Structural considerations encourage use (credit ratings, structured finance, afores) *Most cost efficient form of debt*

Trust Fund Debt	Commercial Bank Debt
Payments managed through separate "trust" accounts (*participaciones* / own-source revenues) Since 2000, subnational governments make own *fideicomiso* arrangements with creditors for debt collateralization, states assume any legal risks Legal "Trusts" reduce risk of manipulation *More cost efficient than dev. and com. bank loans*	Short term loans (>180 days) Used to cover fiscal shortfalls (operating expenses) Bank capitalization requirements (two credit ratings) have made these loans more competitive But, interests still fairly high *Less cost efficient than trusts or bonds, but probably more cost efficient than development bank debt*

Discription of the data set

Series: 1989-2014

Total de 2,440 municipals x 25 years = 61,000 observations.

Dependents Variables:

- Change PIB (World Bank, 1990, 2000, 2010)

Independent Variables:

- INCOME: Vertical Imbalance/TOSR/Transfers (INEGI)
- EXPENDITURES: Infrastructure/ Salaries (INEGI)
- DEBT
  - Total municipal Debt (INEGI)
  - Kinds of Municipal debt (SHCP)
- CONGROLS: Rural/Marginality (INEGI), partisanship, elections (CIDAC).
- Convergence (change of time)

Model to evaluate discretion

Change in Municipal GDP/Per Capita= (a1+a2 TOSR + b3 public sector expenditures + b4 infrastructure expenditures + b5 types of debt + b6 beta convergence + Controls) +e

Beta convergence indicator seeks to have negative correlations because

$ln(yit)=a+(1−β) ln(yi,t−1)+uit$

Modelo FE (Efectos Fijos).
- Tiempo (year dummies), Estado (state dummies) (rather than state-clustered SEs)

Descriptive Stats

Variable	# obser	Mean	Std. Dev.	MIN	MAX
DV: Change of PIB per capita	83,816	1300.517	924.6057	44.8233	9067.073
TOSR	7,116	97.7466	300.6162	0	5208.515
VFImbalance	19,272	.8713987	.1282099	0	1
Assets per capita	19,270	3012.326	1991.51	1.508392	37446.27
Transfers per capita	7,116	673.1222	1426.44	0	17575.44
Salaries per capita	7,116	203.36	509.2354	0	9044.241
Infrastructure per capita	3,366	1529.821	2402.779	.2201916	25493
Convergente Variable	83,815	.0350449	291.7799	-8168.534	5151.362

Principal Results (Synthesis)

Table 3: Results of Economic Development on TOSR in Mexico					
	(1)	(2)	(3)	(4)	(5)
Infrastructure per capita	-0.0252	-0.00323	-0.00358	-0.00484	-0.00338
	(0.0236)	(0.0242)	(0.0244)	(0.0245)	(0.0245)
Transfers per capita	0.00892	-0.0230	-0.0228	-0.0183	-0.0215
	(0.0534)	(0.0543)	(0.0546)	(0.0548)	(0.0549)
Salaries per capita	0.550***	0.581***	0.586***	0.572***	0.577***
	(0.0993)	(0.101)	(0.101)	(0.101)	(0.102)
TOSR	0.638***	0.604***	0.592***	0.601***	0.606***
	(0.0616)	(0.0629)	(0.0633)	(0.0634)	(0.0635)
Convergence	-1.100***	-1.141***	-1.141***	-1.145***	-1.153***
	(0.0255)	(0.0260)	(0.0262)	(0.0263)	(0.0262)
Marginality Index		-64.78***	-70.23***	-70.72***	-68.90***
		(23.31)	(23.57)	(23.66)	(23.75)
Rural		-91.60	-106.6	-104.8	-101.7
		(65.07)	(65.87)	(66.14)	(66.43)
Post crisis		-3.265	6.930	1.795	-8.390
		(35.58)	(36.60)	(36.68)	(36.69)

Discretionality

Commercial Debt			**36.21**	**-16.13****	
			(22.99)	(6.334)	
Banobras			57.89**	0.655	
			(24.44)	(2.841)	
Bond Market			-14.02	-37.40	
			(26.08)	(24.13)	
Trusts			-43191.8	-44170.9	
			(29994.8)	(30114.3)	
Other Debt			33.85	12.50	
			(32.83)	(31.69)	
Total Debt			-58.85**		-3.092
			(24.98)		(2.684)
_Constant	681.0***	788.6***	805.3***	808.1***	818.3***
	(36.80)	(60.13)	(61.08)	(61.31)	(61.43)
N	1166	1165	1165	1165	1165
r2					
chi2	3027.7	3191.3	3272.3	3265.6	3255.2
Standard errors in parentheses ="* p<0.10 ** p<0.05 *** p<0.01"					

Results

- Growth is encouraged and conversance is happening. Yet the Intergovernmental relations are still not creating the appropriate incentives

- Total own source revenue (TOSR) are important for encouraging growth. On the negative side, payments in public employment increase with more growth.

- While municipalities grow with more total debt, the types of debt both development banks and commercial loans is illogical. Finally the bond market isn't being accessed enough.

"irracional" Behavior

Portafolio (cartera) de deuda estatal en México

	Deuda Banco de Desarrollo (porcentaje total)	Deuda Bancaria Comercial (porcentaje total)	Emisiones de Bonos (porcentaje total)
North			
Coahuila	4	96	0
Nuevo León	22	60	18
South			
Chiapas	52	11	36
Oaxaca	5	5	90
Calificaciones MxA o mejor. Datos obtenidos de *Standards and Poors (S&P)* 2012.			

Ciudades con perfil similar (ideosincráticos)

Área metropolitana / Estado	Calificaciones*	Deuda total*	Banca Comercial*	Bancos Nacionales de Desarrollo
Monterrey, Nuevo León	mxAA	$1,858	$867	$991
Guadalajara, Jalisco	mxA	$1,777	$1,777	0
León, Guanajuato	mxAA	$683	$478	$205
Ciudad de Puebla, Puebla	mxA+	$481	$481	0
* Medido como pesos por persona deuda total en 2012 (datos de SHCP).				

Irrational Subnational Debt Decisions

- This behavior of irrational subnational debt motivates the development of this work. While the Mexican Constitution in Article 117 paragraph VIII, through the general law of public debt (LGDP) regulates all subnational debt, each state has the authority to regulate and create fiscal rules as they wish (CEFP, 2009, ASF, 2011).

- The Federation is unable to limit the indebtedness of states.

- Comparatively, all US states have some sort of balanced budget rules, whether they are statutory and constitutional; related to tax and expenditure limits; or some sort of local bankruptcy/fiscal distress provisions (Spiotto, Acker and Appleby 2012).

- State variations reflect individual policy decisions and fiscal behavior in the absence of federal bailouts. This is what Rodden (2006) suggests imposes fiscal discipline to the subnational credit markets.

- How do we create better financial incentive's to strengthen the bond market?

Evidence based policy decisions

- *How do we create better financial incentives to strengthen the bond market and ultimately encourage the <u>use of market mechanisms</u> is still not known.*

- *Problems of information asymmetries, public policy, mature markets, more education for public administrators could all provide some answers to these questions.*

- What will happen post 2018 elections?
    - Legal fights between states for fiscal autonomy
    - Transparency initiatives to publish which debt is contracted by whom and what rates
    - Subnational legislative reforms to create stronger controls