1. Introduction

Following the need for more equitable development in Mexico, the federal government through the competencies attributed to the Mexican Congress of the Union by the Constitution has during the past fifteen years, attempted to implement policies and measures that have slowly decentralized processes of fund allocation to state and local government structures. Since the inception of the National Fiscal Convention in 1947 up until the establishment of the National System of Fiscal Coordination (SNCF) in the late 1970’s and the creation of the Fiscal Coordination Law (LCF), state and municipal governments have forgone their tributary rights in exchange for un-earmarked intergovernmental grants (Participaciones).

Such redistribution mechanism in theory was designed to provide states and local governments with more funds that they could otherwise accrue themselves with state and local taxation. The main three channels that have been a target of decentralization policies regarding development have been the social, urban, and rural sectors within the 31 regions of Mexico. Nevertheless there have been problems in such decentralization process that have caused in turn deficiencies in regional development. The affected sectors range from general transportation infrastructure in urban areas, to basic health and sanitation measures in rural sectors as well as social development policies such as education.

Since the past 8 years, security concerns have pressed the national agenda, in turn making evident the lack of institutional capacity of many local and state governments to effectively guarantee the safety of their
entities. Furthermore, the economic implications regional development policies have on the Mexican state surpasses local economic growth, employment and interstate trade. Implications are in turn global and include global competition, foreign direct investment (FDI), currency stability and general national prosperity. The decentralization process that has begun to take place in Mexico has managed to delegate certain functions from a federal level to state and local governments. Nevertheless, there have been problems regarding the financial redistribution and allocation of resources such as intergovernmental grants both earmarked and unrestricted, which are still in part controlled by the federal government and do not include funding for pet projects from localities that are needed to foster development.

Another intrinsic part when dealing with the risk of decentralization policies is the shift of human capital that has to occur from a federal level to state and local levels. Such implications impose an economic burden that has to be taken into consideration when planning the allocation of the federal budget to the ministries. Decentralization is a process that is used to determine a correct development structure that ensures tailored policies to target specific state and local needs that are not met by federal planning strategy. Furthermore, the process of decentralization, if implemented properly, can provide with accountability mechanisms for local authorities and even citizen involvement in decision making process.

The process of financial decentralization in Mexico has managed to shift economic resources and faculties to state and local authorities regarding specific development areas. Nevertheless, a place-based approach in order to generate appropriate cohesion policy implies more than financial transfer from federal to state and local. Successful development policies need to include the current amount of fund transfer from federal to state and local, as well as additional funds which target specific needs required at local levels. All of this requires to be accompanied by the appropriate legal framework that ensures the proper use of such funding. This paper will analyze the issues surrounding in finance decentralization in Mexico. It will begin by framing the issue of risk through a general introductory framework that presents the institutional composition of Mexico’s current federalist system, the general overview of the decentralization process in Mexico as well as the level of place-based approach implementation. It will then analyze the risks of finance decentralization vs. current centralization policies dealing with resource allocation and decision making. It will conclude by analyzing the Mexican Fiscal Coordination Law (LCF) and how it affects states and municipalities in terms of performance and their

1 Refers to horizontal mechanisms of cooperation to ensure equity and efficiency in regions of under-used capacities. See Fabrizio Barca (An Agenda For a Reformed Cohesion Policy: A place-based approach to meeting European Union challenges and expectations, 2009).
ability to compete both nationally as well as internationally for investment and growth opportunities.

2. Federalism as a response mechanism

Why is it that initially centralized states vest power in lower tier governments in federations? Federalism is what Mueller describes as “The United States contribution to the evolution of representative government” (Mueller, 2003). He explains federalism as the opposite of a direct democracy, where individual citizens vote and decide according to their preferences. As mentioned by Stevens in the Economics of Collective Choice, the United States “Consists of a federal government, fifty state governments and over 80,000 units of local government” (Stevens, 1993: 329). It is a government structure in which local and global goods and services are provided but with tiered decision responsibilities (Figure 1.0).

Muller argues that if one imagines a polity of several people that proceed to separate themselves according to their preferences, then different clusters of people will form depending on their individual preferences. The allocations of public general goods like defense or healthcare (arguable) are simply efficiently allocated in the point that according to the median voter corresponds to the maximization of everyone’s utility. The complicity emerges when trying to apportion local goods and services. One community might want different amounts of one particular good with respect to another. Delegating the decision making to each local community efficiently allocates the local public resources; hence, creating a federalist structure (Mueller, 2003: 209-227). For example, Mexico’s fuel industry is currently federalized, so prices as well as the infrastructure and supply are federally controlled (private concessions are granted), whereas each state entity can decide upon the amount spent on public sanitation services.

Figure 1.0 Polity of Individuals and Provision of Public Goods

![Figure 1.0 Polity of Individuals and Provision of Public Goods](image)


According to the Federalist perspective, it is noted that the federal government should have total power when it concerns the defense of the nation. “The authorities essential to the common defense are these: to raise armies; to build and equip fleets; to prescribe rule for the government of both; to direct operations; to provide for their support” (Hamilton, 1787).
It is in the nation’s interest that the constitution represents the people’s rights, but also that it protects those rights at all costs. It is imperative that the federal government is provided with the required petitions from the states due to the fact that the government at a federal level is there to protect the nation. There cannot be limitations to the government’s power because there is no way of determining the possible problems and in what magnitudes they can be presented.

Federalism has two traits that can are illustrated with the example of defense mentioned above. “A federalist state has two salient properties: (1) separate and overlapping levels of government exist and (2) different responsibilities are attached to the different levels of government” (Mueller, 2003: 209-227). Mexico’s economic and political history has been encompassed by centralization since the creation of the Mexican State in 1810. This was further enhanced in the 20th century with import substitution policies which led to the creation of a very “strong” federal government alongside “weak” states. The table below illustrates the percentages of public revenues in the Mexican government. It can be seen that the federal government has a clear financial authority over the states and municipalities (OECD, 1998: 22).

**Figure 2. Public Revenues in Mexico**

<table>
<thead>
<tr>
<th>Year</th>
<th>Federation</th>
<th>States</th>
<th>Municipalities</th>
</tr>
</thead>
<tbody>
<tr>
<td>1900</td>
<td>63</td>
<td>24.1</td>
<td>12.9</td>
</tr>
<tr>
<td>1923</td>
<td>72.6</td>
<td>14.5</td>
<td>12.9</td>
</tr>
<tr>
<td>1930</td>
<td>68.7</td>
<td>22.9</td>
<td>8.4</td>
</tr>
<tr>
<td>1940</td>
<td>71.4</td>
<td>23.3</td>
<td>5.3</td>
</tr>
<tr>
<td>1950</td>
<td>78.3</td>
<td>18.4</td>
<td>3.3</td>
</tr>
<tr>
<td>1960</td>
<td>78.6</td>
<td>18.6</td>
<td>2.8</td>
</tr>
<tr>
<td>1970</td>
<td>86.4</td>
<td>12.0</td>
<td>1.6</td>
</tr>
<tr>
<td>1980</td>
<td>89.4</td>
<td>9.4</td>
<td>1.1</td>
</tr>
<tr>
<td>1991</td>
<td>81.1</td>
<td>15.5</td>
<td>3.4</td>
</tr>
<tr>
<td>1992</td>
<td>73.6</td>
<td>21.9</td>
<td>4.5</td>
</tr>
</tbody>
</table>

*Source: Desarrollo Económico e Inequalidad Regional, 1995.*

In Mexico, each state has its own state police as well as support from a federal police organ (Procuraduría General de la República PGR). Local governments are in charge of their own policing, however depending of the penal classification of the situation the PGR has ruling authority over local security entities. As it is seeded in the Federalist Paper # 23, there cannot be a federal government that has only the power to intervene in matters of general defense and a state government that possesses all the real power when it comes to internal affairs. There has to be a greater scope of what is

2 “If we embrace the tenets of those who oppose the adoption of the proposed constitution, as the standard of our political creed, we cannot fail to verify the gloomy doctrines which predict the impracticability of a national system pervading entire limits of the present confederacy.” (Hamilton, 1787).
considered to be a global good or service that benefits all citizens equally, if such quality actually exists. It seems that there has been a question of what goods should correspond to the provision of the federal government and which to state and local entities. Stevens argues that “Higher levels of government should-for efficiency reasons-encourage the production of goods that have positive externalities” (Stevens, 1993: 332). To further explain this concept via economic terms, if the decision making process for the provision of all goods is delegated to local governments, then they would produce $Q_0$ of any given good if the demand of the population would be $D$, and if $S=MC$ (See figure 3.0) For them, that would be the optimal equilibrium, however if you account for the potential people who do not reside in that locality but actually consume in that locality, one could argue that there is demand unaccounted for. That would lead to a production of $Q^*$ creating positive externalities. (1993: 332)

**Figure 3. Positive Externalities in the Production of Local Public Goods**

![Figure 3](source: The Economics of Collective Choice (Stevens, 1993: 322).

3. **Roadmap towards parliamentarism?**

Parliamentarism, known to work effectively in developed economies throughout Europe, rests upon the unity of the party. The party is viewed as the core functional unit of government which in turn appoints a Prime Minister, who leads the country and protects its national interests. There are several aspects of Parliamentarism that seem to be more transparent or effective in terms of decision making process and national unity. Generally parliamentary governments have less nuisance legislating and achieving majority votes due to the deficit of separation of powers (Executive Vs Legislative branch). Several economic models have been created that better explain the differences between integrated and divided executives.

Rational Choice Theory, which consists in “involving the application of the methods of economics to the study of politics” (Hindmoor, 2006)
provides a rational economic approach in politics and tries to explain why parliamentary systems are better in terms of integrated executives and decision making process. In the article *Competitive Governments* by A. Breton (Breton, 1998), rational choice decision making is viewed to be far more efficient in parliamentary governments due to the fact that a lot of the bills usually originate from Ministers and Bureaus instead of the Executive and Legislative power. In the case of integrated executives in the United Kingdom for example, the Minister of Finance is always in charge of allocating the budget. Taking into consideration the essential component of rational choice which is to assume that individuals are rational and always try to maximize their utility, there are two negotiation strategies that can be employed by ministers when procuring a budget. They can have soft bargaining strategies, which are close to Bayesian equilibrium and are most likely to be achieved or hard strategies which happen when a minister wants a lot of money and drifts always from equilibrium. The economic model proposed by Breton is called the *Shadow of the Prime Minister* and involves decision making process based on maximization of utility, taking into consideration the position of the Prime Minister is he should intervene, whilst reaching a Nash Equilibrium (1998).

![Figure 4. Shadow of the Prime Minister Model](image)

An increase in F’s resources over initial M expectations would shift M to M’. M could adopt a “Hard” Strategy.


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3 Revenue Budget in the U.K. is responsibility of the Minister of Finance (F). Ministers represented by (M) and two bargaining strategies are possible Hard – Less likely to reach equilibrium - & Soft –Closer to Bayesian Equilibrium. M demands $X for any given agenda. F offers $Z (Less than $X). t=Nash Equilibrium (Bargaining outcome) and M & F are considered as functions of bargaining.
Some Latin American nations could benefit from these kinds of mechanisms. One country that is ready to transition to those models of government could be Chile. Probably one of the most developed nations of Latin America; Chile has been one of the most democratic nations of the region. History shows that the country suffered a violent regime under Augusto Pinochet in the 1970’s which threatened the entire stability and future of the country. In Party Politics and the Crisis of Presidentialism in Chile, Valenzuela argues that “The crisis of the Chilean democracy was exacerbated by the lack of congruence between the nation’s competitive and polarized party system, on the other hand, and its institutional system, on the other” (Linz, 1994). He explains that the government of Chile has had problems making compatible the framework of the constitution with a polarized multi party system in which no party could manage to elect a president with majority.

That generated problems of governance due to the fact that achieving consensus in decision making process was stagnated. The military regime managed to unify the country by force and coercion, achieving unilateral decision making. It is noteworthy to point that during the military regime, Chile had a positive economic growth helped by the establishment of a productive national industry sector. The temporary military regime left the country with the need for Presidentialism but with a certain degree of caution. Presidentialism thrived with the government of Patricio Aylwin in the early 90’s, however, the historical consequence of the military regime and the current structure of the political system point towards a need for further change, leaning towards Parliamentarism.

Another example that supports the idea of Parliamentarism as a better choice in Rational Choice terms is a model which explains the “Three Tier System” of decision making in Budgetary Process in the UK. Professor Patrick Dunleavy explains that decisions are more likely to be reached in Parliamentary Governments because Congress is not in charge of allocating resources, but the responsibility lies upon the Minister of Finance (MF) and the Public Expenditure Committee (PEX) in this case. Traditionally Latin American governments have struggled with the approvals of Federal Budgets because Congress cannot reach an agreement. Taking the example of Mexico into consideration, the legislation of the budget required by the Mexican Health Institute (Instituto Mexicano del Seguro Social, IMSS) cannot apply directly for its budget to the Secretary of Economy (Secretaría de Economía SE), but has to be included as a yearly package that the Executive branch proposes to Congress. Further changes take even longer due to the fact that committees have to revise, and then propose changes to the floor of a Bi-Cameral Legislative. In Parliamentary Governments, Ministries have more freedom and can better accommodate their interests as institutions. Dunleavy mentions that the Three Tier System is designed as a decision mechanism which ensures that a decision is achieved. If any given Minister (M) cannot come to a
budget deal with the Minister of Finance (MF), then the Public Expenditures Committee (PEX) becomes involved in the process. If an agreement is not reached, the petition escalates a further level, where the Prime Minister (PM) has the final decision. Similar to the Shadow of the Prime Minister, Ministers and the MF can anticipate the position of the PEX and the PM; hence, avoiding an escalation and reaching an agreement which benefits all participants. The Three Tier system is a clear example of how conflict can be avoided when it comes to allocation of government resources. This is a case of where adjusting Parliamentarism to the need of a nation becomes beneficial (Dunleavy, 2005).

Figure 5. Three-tier structure UK Core

![Figure 5. Three-tier structure UK Core](image)

PEX= Public Expenditure Committee
PEX(T)= PEX Reflection point from Treasury
PM(T)= Pm’s Reflection point from Treasury

Represents the possible negotiation strategies in securing a budget.

4. Finance centralization vs. decentralization

4.1 Risks of finance centralization vs. decentralization

The economic theory of public finance plays a pivotal role in determining a correct structure of government. What is the optimum form of regime, if any, that can solve the economic raison d’être of the public sector, as mentioned by Wallace Oates? The polarized debate of centralization vs. decentralization has strengths and weaknesses. There is no perfect solution and polarization has been proven inefficient; hence, a federalist system that combines centralization and the latter approach would seem like the optimal form of structuring a government.

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According to Oates there are three main economic functions of the public sector: efficient resource usages, distribution of income, promoting employment, and price stability. This can be summed up as allocation, distribution and stabilization (Oates, 1972: 3).

Centralization clearly solves the issue of stabilization. Having a central monetary policy ensures proper taxation and local revenue production as well as inflation control. Central governments can stimulate the economy with additional resources such as foreign debt. Regarding distribution, central governments can coordinate more efficiently distribution of income through tax programs. Dealing with allocation, there is evidence that supports centralization as well. When dealing with certain public goods (defense for example) decentralized decision making is not likely to maximize output of the given good (Oates, 1972: 3-10).

Decentralization attempts to address the needs of individuals or groups within given communities, localities or jurisdictions. Production of central goods involves compromise and a loss of welfare for one community or another. “A decentralized form of government therefore offers the promise of increasing economic efficiency by providing a range of outputs of certain public goods that corresponds more closely to the differing tastes of groups of consumers” (Oates, 1972: 12). As seen in the Theory of Clubs\(^5\), mobility is also a consequence of different options across geographical regions. Oates refers to three positive economic traits of decentralization: tailored goods to the preferences of localities, competition for production of goods to promote efficiency, and better decision making in analyzing costs for local programs (Oates, 1972: 13).

4.2 Risk perception mapping

As previously mentioned, there is no perfect configuration of centralized vs. decentralized government but rather each nation needs to tailor its own structure taking into consideration the risks that exist. The current level of centralization vs. decentralization of the Mexican government can be illustrated in terms of the risks involved in implementing such policies. Risks can be classified as (1) economic and (2) political risks. Economic risks entail corruption in the government that can lead to misuse of funds, lack of monitoring of expenditures and incorrect implementation of development policies. Political risks encompass a lack of national unity, a divergence from a national development strategy and an overall weakening of the national government that may lead to separatist movements in less developed regions such as Chiapas and Oaxaca. It is clear that there is a risk tradeoff between decentralizing the federal government and a better efficiency and equity regarding regional development.

4.3 Risk tradeoff: Weakening of federal government vs. Efficiency and equity in regional development

Much of the debate that generally arises with centralization and decentralization policies tends to focus directly on development policies that attempt to address efficiency and equity in financial allocation, development of states and closing the income gap across regions. Nevertheless, much debate tends to lead to a comparison between both approaches. One aspect that tends to be absent in such debate is the general tradeoff that could exist in changing the existing system regarding the political stability that centralized Presidentialist systems have generated across nations in Latin America. Even though decentralization policies attempt to address one of the biggest challenges in Latin America, including Mexico, it was centralization which made possible the consolidation on nation states across Latin America. In Mexico Presidentialism played a crucial role during the early 20th century and served as the “glue” for national stability.

Generally a trend that favors Presidentialism is the fact that that developing countries require and benefit from rapid decision making process when it comes to legislation and national interest. During the 1950’s in Mexico, President Miguel Aleman led the country throughout a series of economic reforms, including the IS model which consolidated the Mexican economy and national industry. That period was known as the Mexican Miracle (El Milagro Mexicano). Furthermore Shugart and Mainwaring (Presidentialism and Democracy in Latin America, 1997) provide a list of elements that gives an advantage to the Presidential System. They explain that Presidentialism
offers a greater choice for voters, meaning that there is more participation and involvement in the *Choosing of Leaders* and *Electoral Accountability*, which makes presidents responsible for the wellbeing of the country. Having a president gives the executive organ *Congressional Independence in Legislative Matters*. Finally the authors emphasize on a concept originally stipulated by Linz which refers to *Winner takes all approach*, referring to relative majority in decision making process.

It seems that the tradeoff consists in (1) Allowing a decentralization policy that has a possibility of closing the income gap and fostering development through a comprehensive place-based approach vs. (2) weakening the national State, which has served as a pillar for unity and stability in Latin America since the 19th century. By allowing a decentralization policy, the direct impact will be felt by the federal government’s capacity to monitor and control policymaking. This may in turn lead to lack of political unity and corruption, which may in turn prove counterproductive to more efficient spending and development programs. Furthermore, this lack of controls may lead to a weak national growth strategy. Weakening the national government may render it incompetent to provide the adequate resources to less developed communities. Nevertheless, it is important to point out that the risks associated with not doing anything are also damaging for the nation state. By continuing with a heavily centralized policy that is known to promote unequal regional development, broadening the intra regional income gap and fostering population migration to highly developed areas the national economic panorama also looks meek and unpromising.

As argued by Shugart and Mainwaring “*The strengths of presidents and their ability to influence legislation rests of two categories of presidential powers; Constitutional and Partisan*” (Mainwaring & Shugart, 1997). It is important to distinguish both types of power due to that fact that not all Latin American countries are the same in terms of government. Mexico for example is a country that has evolved and changed in the past eight years. Shugart argues that Mexico’s Presidential system rests vastly on party unity due to the political regime and control of PRI (Partido de la Revolución Institucional), where the President was not only the leader of the country but also of the Party; hence providing him with constitutional powers (those granted by the constitution which cannot be contested by Congress due to the separation of powers), and legislative power by possessing relative majority in Congress.

Certainly a lot has changed in Mexico since Mainwaring and Shugart’s publication, due to the fact that Mexico’s Presidential system has lost all partisan powers. A long sought democratic change occurred in Mexico which closed the chapter of a single party rule where elections were won basically through Executive mandate (Dedazo) to a working democratic electoral system, which in turn opened the door for PAN (Partido Acción
Nacional) to win the 2000 elections. This new era that Mexico ventured in comes along with turbulent changes that were not seen before in the traditional Mexican Presidential system. There seems to have been a loss of national unity, where even though the president might want what is best interest of the nation, multi party factions have appeared which impede legislation proposed by the Executive. The country, used to working with a relative united government is now suffering an institutional weakening. It is important to point out that this transition however painful was a needed step towards the establishment of a democracy. This current process of political instability creates a risk that did not exist before. During the 71 year party rule of PRI, Mexico has party unity and political stability, which would have made a gradual process of financial decentralization more viable. Today the risk of a weak government that becomes incapable of directing national strategy and keeping the direction of the country is ever-present. Even though there seems to be no evident cutthroat solution, gradual implementation of decentralization tools may serve as a way to mitigate the risk of an insolvent federal government. This may be accomplished via (1) resource allocation, (2) Intergovernmental Grants, (3) Taxation and redistribution and (4) through a moderate program of delegation in decision making. Nevertheless this should be the last step of the process.

5. Tools for decentralization

5.1 Resource allocation: Production of local goods

When dealing with public policy, polarity always tends to generate arguments in favor and against. Regarding public finance and expenditures, the debate of centralization vs. decentralization becomes more apparent when dealing with costs and levels of output in the production of local goods. Using Wallace Oates Decentralization Theorem\(^6\) as a base, more efficient (Pareto-Efficient) levels of output will result from local governments rather than central ones given equal costs. “Welfare is maximized if each local government provides the pareto-efficient output for its constituency” (Oates, 1972: 36). Another argument that further supports decentralization has to do with local output maximization. Taking into consideration that centralization tends to provide standard levels of goods and services across geographical localities, the level of output of all local residents would not be maximized. Decentralization could help generate more efficient local output. However this would only happen if costs were fixed for all goods and services. Economies of scale in the provision of goods at a national level could help mitigate the issue and allow for centralized finance (Oates, 1972: 36-37). On the other hand, decentralized decision making at local levels could lead to inefficiencies in maximizing communities’ welfare leading to free rider incentives. “Decentralized jurisdictions will tend to provide sub efficient levels of goods and services because of the failure to

\(^6\) See (Oates, 1972: 54).
take into account the benefits conferred on residents of other jurisdictions” (Oates, 1972: 32).

5.2 Intergovernmental grants

When dealing with the provision of public goods, intergovernmental grants could help mitigate such problems. Intergovernmental grants, divided into conditional and unconditional are tools used by central governments to allocate resources and allow lower tier governments to use funding for the provision of local goods and services. “Matching grants are needed to compensate for external effects and the use of unconditional grants for equity purposes” (Oates, 1972: 94). While one helps mitigate inefficiencies resulting from spillovers in localities, the latter is often used to prevent discrepancies in the distribution of income within a federal system (Oates, 1972: 85). Supporting that claim, Cullis argues that “Central governments can use grants to change both the distribution of income and the pattern of spending between local authorities” (Cullis & Jones, 1998: 315). Furthermore, local governments may not be completely aware of spillovers that certain benefits may have over other localities, hence under producing a given good. Central governments may resort to intervention via grants to correct that issue (Stevens, 1993: 334).

An example of why centralized states vest power in lower tier governments in the form of grants is explained by Mueller and deals with locally provided goods that have positive externalities with respect to other localities.7 Roads and highways are used by different localities; however the demand for roads in any given jurisdiction is measured by the demands of each locality’s citizens. As demand is underestimated, supply is not Pareto-optimal. Community A and B’s same amount of public good (G_a or G_b respectively) consumed equals A and B’s roads (R_a or R_b) plus a fraction of each other’s roads used (S_a or S_b):

\[
G_a = R_a + S_a R_b \quad \text{and} \quad G_b = R_b + S_b R_a
\]

Controlling for income disparities, both communities would agree to construct the amount of roads followed by maximizing the following Lagrangian:

\[
L_i = U_a(X_a, G_a) + \gamma(Y_a - P_x X_a - P_r R_a)
\]

Where P_x and P_r represent the prices of the private good X and roads, and G_a satisfies G_a = R_a + S_a + R_b. The same would have to be done for country B. That would result in grants offered that equal the amount of proportional spillovers onto other communities (Mueller, 2003: 216-217).

7 For detailed example refer to Public Choice III (Mueller, 2003: 216-217).
There can however be negative externalities when implementing grants in practice. Collective action could induce ineffective behavior due to incentives that could cause a re-modification of such pre established behavior; hence moving away from an efficient established pattern or resource use (Oates, 1972: 64). The more people involved in the decision making process, the harder it is to achieve consensus. That is why it may be beneficial for central governments to assess grants in a case by case basis. If there is a good that might have spillover benefits to a few neighboring communities, sharing responsibility and jointly planning that provision would result better than giving grants to all communities for that given good (Oates, 1972: 68-69).

5.3 Taxation and redistribution

The national economic status of a nation and the economic condition of its citizens is considered to be of vast importance. People must be taxed in order to enable the government to survive and coexist with society providing the required public goods and services.8

Taxation and wealth redistribution plays a vital role in the federalist structure. Nevertheless, the proportion of local vs. federal taxation and redistribution policies vary depending on the country. Mexico possesses a very strong federal government that collects taxes from each state proportional to the amount of revenues they generate (Ingreso Federal Tributario), then proceeds to distribute it through intergovernmental grants in the annual budget (Presupuesto de Egresos de la Federacion).

The federal government sometimes intervenes in the way public money is spent by local governments. As stated before, Mexico taxes more revenue generating states and redistributes it according to the federal national priorities. One could argue that allocation of resources in government’s springs from Tiebout’s Public Choice model, which proposes that local governments compete and offer services at various prices hence incentivizing mobilization according to community preferences. (Tiebout, 1956) Nevertheless there are other factors that contribute towards federal intervention. National agendas and general macroeconomic externalities can influence changes in the allocation of goods (Government services included). As mentioned before, grants are a way the government can help distribute wealth to local governments so they can use them to provide local goods. “One level of government may not actually provide a public good for another level, but merely transfer money to it” (Mueller, 2003: 215).

8 “The power of creating new funds upon new objects of taxation, by its own authority, would enable the national government to borrow as far as its necessities might require” (Hamilton, 1787).
Taking the example of Mexico, the total amount of federal taxation revenue collected in 1995 from Nuevo Leon (Largest state economy besides the Federal District) was 68,473.6629 MXN (Aprox. $4.7BN), while its federal spending budget was 26,028.2MXN (Aprox. $1.7BN). Oaxaca on the other hand is one of the less developed states, dependent on agriculture as its main source of income. In the same year, it contributed 3,448.456 MXN (237Mdd) to the federal government and received 25,212.6 MXN (Aprox. $1.7BN). Restricted, general and matching grants are given to each state for general services such as Education, Health, Infrastructure and Security (Ramo 33, 28, 39) This gives local governments such as Oaxaca the opportunity to invest its revenues in specialization, development and develop other potential economic sectors such as tourism or even textile manufacturing.

6. Fiscal competencies

6.1 Law of fiscal coordination

The principal legal instrument established that deals directly with the issues pertaining to fiscal matters and particularly addresses the issue of financial allocation of funding to states and municipalities is represented by the Fiscal Coordination Law (LCF). It is in principle a very complex legal framework composed of several sub-segments which addresses the myriad that is the Mexican fiscal taxation and redistribution system. From a broad perspective, the general composition of the LCF refers to the Federal Participatory Levy (RFP), the Fiscal Advancement Fund (FFM), the Audit Fund (FF), the General Grant Fund (FGP), and a set of earmarked grants (Aportaciones Federales). All this is coordinated through the National System for Fiscal Coordination (SNCF).

The history of both the LCF and the SNCF lie in the need experienced by the federal government during the period of Import Substitution (IS) and national consolidation to centralize resources and promote national unity. Prior to the economic boom referred to as “El Milagro Mexicano” of the 50’s, national tributary policy as well as fiscal coordination was a responsibility that relied upon individual states and municipalities. This lack of centralization attempted to coordinate at a national level through two principal mechanisms, these being income distribution legislation and through national fiscal conventions. (Soria Romo, 2009) The growing need to establish a solid national economic policy during the 40’s and 50’s led to the need to centrally administer the national economic resources in order to establish a unilateral development strategy. After the National Fiscal

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Convention of 1947 and up until the establishment of the SNCF in the late 70’s, there was heavy resistance put up by states, unwilling to relinquish their economic sovereignty to the federation. After the principal tributary instruments were in control of the federation, such as the value added tax (IVA) and income tax (ISR), states had no options but to accept the established intergovernmental grant system FGP which was established a few years after the establishment of the SNCF through the legal framework of the LCF in 1980.

The SNFC is in charge of the four principal pillars of the national fiscal policy, which is composed of (1) an earmarked grant system, specifically designed to centrally control certain policy areas which are deemed to be of national priority. Such grants are centrally assigned, but constitute decentralized expenditures enacted by states and municipalities. Both the (2) national fiscal policy as well as the (3) administration of policy issues also pertain to the competencies of the SNCF. Finally the general (4) grant coordination (Participaciones) in the form of unconditional grants also lies within the established competencies of the coordination system.

6.2 Current grant structure

The current structure mechanism for grant distribution has its competencies defined in the LCF coordinated by the SNCF. Traditionally, the concurrent competencies of the federal government have been gradually assigned by the constitution, developing over time a dependency of a centralized institution. The federal government as a central agent has several competencies and mechanisms for distributing and assigning funds. The principal federal fiscal mechanisms are attributed in the form of Public Federal Investment as well as several public services not provisioned by states or local governments. There exist other finance mechanisms such as bi-partisan cooperation frameworks such as state university expenditures or Agreements on Social Development; however most of the financial expenditures are conducted in the form of decentralized grants, both earmarked and unconditional (Merino, pág. 151).

As it was previously stipulated, grants are distributed via two principal allocation frameworks; (1) The General Grant Fund (FGP) which corresponds to block grants vis a vis the Fiscal Coordination Law (LCF) and the (2) Federal Earmarked Grants (Aportaciones Federales). Inscribed in the article 1st of the LCF are the coordination and establishment of the parameters for allocation of discretionary spending as well as establishing administrative collaboration frameworks between different fiscal dependencies. Regarding the distribution parameters, a formula for allocating resources is included in de 2nd article of the LCF, corresponding to the operational structure of the FGP which amounts yearly to the 20% of the Sharable Federal Revenues (Recaudación Federal Participable -
RFP). Excluded from the FTP are the surpluses of oil revenues, 2% from all exports, 3% from all oil export related revenues, and several specific taxes.\(^{10}\) The principal formula for calculating the allocation of resources to states is as follows:

\[
P_{i,t} = P_{i,07} + \Delta FGP_{07,t}(0.6C_{1,i,t} + 0.3C_{2,i,t} + 0.1C_{3,i,t})
\]

\[
C_{1,i,t} = \frac{PIB_{i,t-1}}{\sum_{i} PIB_{i,t-1} n_i}
\]

\[
C_{2,i,t} = \frac{\Delta IE_{i,t} n_i}{\sum_{i} \Delta IE_{i,t} n_i} \quad \text{with} \quad \Delta IE_{i,t} = \frac{1}{3} \sum_{j=1}^{3} IE_{i,t-j}
\]

\[
C_{3,i,t} = \frac{IE_{i,t-1} n_i}{\sum_{i} IE_{i,t-1} n_i}
\]

The formula corresponds to the allocation mechanism represented by \(C_{1,i,t}, C_{2,i,t},\) and \(C_{3,i,t}\) as distribution coefficients for FGP of entity “\(i\)” in the year the calculation was realized. \(P_{i,t}\) represents the amount corresponding to entity “\(i\)” in year “\(t\)”. \(P_{i,07}\) pertains to the sum received by “\(i\)” in the year 2007, while \(\Delta FGP_{07,t}\) refers to the FGP growth between the year 2007 and year “\(t\)”. \(PIB_{i,t-1}\) and \(PIB_{i,t-2}\) is calculated by the official GDP of the past year and past two years respectively, published by INEGI for any given “\(i\)”. \(IE_{i,t}\) constitutes “\(i\)’s” tax collection in year “\(t\)” and \(\Delta IE_{i,t}\) represents a three year average of \(IE_{i,t}\) relevant to the previously stipulated “\(i\)”.

Additionally included in the LCF are four additional funds that deal with the specific formulation to quantify support for municipalities in the form a (1) Municipal Development Fund (FFM), which corresponds to 1% of the RFP, a (2) Audit Fund (FF) equivalent to 1.25% of the RFP, and a (3) Compensation Fund (FC) which is composed of 2/11 parts of the total collection of quotas established in the article 2\(^{nd}\) of the Special Tax law on Production and Services (Ley del Impuesto Especial sobre Producción y Servicios). This latter FC is designed to compensate the ten state entities which have the lowest GDP per capita levels excluding oil and mining revenues. Finally, the (4) Hydrocarbons Extraction Fund (FEH) is composed of 0.6% of the tax revenue con hydrocarbons paid by Mexican Petroleum exploration and production (PEMEX) in accordance the article 254 of the Federal Taxation Act (LFD) and its destined to state entities which form part of the oil and gas extraction classification defined by the National Institute of Geography and Statistics (INEGI). (Diario Oficial de la Federación, 2009: 2-10).

\(^{10}\) Refer to article 2, LCF (Diario Oficial de la Federación, 2009).
The second grant mechanism established in the LCF, refers to the aforementioned earmarked grants (Aportaciones Federales) and constitutes directed funds which are targeted for specific national priorities. The appropriation channels used to funnel earmarked grants are inscribed in the “Ramo 33 Law”. The legal attributes are inscribed in chapter V of the LCF and include a total of 8 funds, as well an external trust fund, linked to the LCF, but excluded in the official coordination law, this being the Trust Fund for Infrastructure in the States (FIES). The FIES constitutes a percentage of excess oil revenues and is distributed to states as a method to strengthen entities in establishment with the National Bank and Public Services Bank (BANOBRAS), and being distinct for its “revenue-sharing system” meaning that it lacks redistributive properties, wealthier states receiving larger sums (Joumard, 2005: 16).

The eight corresponding funds in the LCF (Diario Oficial de la Federación, 2009: 22-24) are comprised by the (1) Basic Education Grant (FAEB) which is the largest fund (Aprox. 55% of Aportaciones Federales -AF), complemented with a targeted fund to education related infrastructure and meal plans, (2) the Multiple Grant Fund (FAM), representing an approximate 2% of total AF. Also related to education, but earmarked towards adult education and technology, the (3) Technological and Adult Education Grant (FAETA) corresponds to an estimated 1% of the total AP. Regarding support for infrastructure, two funds form a part of the AP allocation, one of them being the aforementioned exception of the trust fund FIES, the other constituting the (4) Social Infrastructure Fund (FAIS) which, in difference to FIES, does include redistributive properties. Both FIES and FAIS represent an approximate 7.1% and 7.2% respectively. Two subsequent funds are established in order to empower municipalities and local governments, by strengthening their public finance capacity. The (5) State Strengthening Fund (PAFEF) as well as the (6) Municipal and Areas Strengthening Fund (FORTAMUN) represent 8.1% and 7.4% of the total earmarked grant system. The fund thy has endured the most changes in the past couple of years due in part by the growing security dilemma faced by the country, the (7) Security Fund (FASP) has increased significantly from its traditional percentage with was approximately 1.5% of the total AF. Finally the last fund is destined to develop the healthcare capacity of the country. The (8) Health Care Services Fund (FASSA) represents an approximate 10.5% and is redistributive in nature to account for uninsured and people with basic healthcare (Seguro Popular) (Joumard, 2005: 15-16).

12 All percentages of earmarked grants mentioned correspond to provisional data provided by the INAFED 2004 (Joumard, 2005:16).
6.3 Specific Attributions, Competencies and Cooperation Mechanisms

It is important to point out, that states are not bounded by any legal commitments to participate in the Federal Grant Program. Any of the 32 national entities can opt to be excluded from the FGP and conduct their own tributary collection. However, the “catch 22” exists in the fact that the most important tributary instruments such as the IVA and the ISR are legally attributed to the Federation for which States cannot participate. Regional governments are hence left with weak tributary mechanisms which in turn makes them, less competitive and dependant of the FGP.

Participation in the FGP implies submitting to the agreement established and coordinated by the SNCF and the SHCP, alongside approval of the Federal Congress, which is the only empowered organ to both include and exclude entities. There exist in place several mechanisms to resolve disputes whether it be between individuals and the SNCF or issues between states and the Federation. Imbedded in article 11 of the LCF, a dispute mechanism is established for individuals who are affected by an act of misconduct of the SNFC. Such mechanism of resolving the dispute

13 From Joseph Geller’s novel Catch 22, denoting a paradox where a need is present that can only be achieved by an action that eventually leads to the same need.

14 Expressed as “special taxes” established in the article 73 of the Mexican Constitution (Diario Oficial de la Federación, 2009: 14).
and ruling capacity is mediated by the SHCP. In both cases of individual disputes as well as inter-state and municipal cooperation, the empowered organ to serve as check and balance instrument of the SNFC is the SHCP. Such structure of oversight is defined and expressed in article 16 of the LCF, specifying attributions of development, oversight and “perfecting” of the SNCF via the National Reunion of Fiscal Servants (RNFF), the Permanent Commission for Fiscal Servants (CPFF), the Public Finance Technical Development Institute (INDETEC) and the Fiscal Coordination Assembly (JCF) (Diario Oficial de la Federación, 2009: 17-22).

6.4 Limitations and Current Lock-in Mechanisms

It is worthwhile to point out that part of the criticism regarding current established fiscal framework lies in its rigidity and its lack of adaptability to changing economic situations as well as external shocks. As mentioned by Rigoberto Soria Romo, professor and researcher of the University of Guadalajara, the institutional composition of the SNCF does not allow room for malleability at its fundamental core. He places its faults, particularly in the established mechanism for decision making and the zero-sum nature of the FGP, attributing its survival to the fact that it barely complies with the minimum needs, far exceeding the changes undergone by the State after more than 20 years of its inception (Soria Romo, 2009). In his analysis of the fiscal competencies and resolution mechanisms, Soria Romo concludes that beyond an apparent harmonious system of coordination between depending and dependant entities there exists a power struggle dynamic that is not foreseen in the established resolution mechanisms, de dominant actor being the Ministry of Finance (SHCP). This apparent struggle had led for other opposing groups such as States, to attempt to weaken the hegemony of the SHCP. The principal mechanism used by States has been through the National Conference of State Governors (CONAGO), establishing a fiscal participatory framework in the “Declaración de Mazatlán” (CONAGO, 2001). Such framework has, over the past few years managed create a power shift from the SHCP through the development of several proposals such as an amendment to the Ramo 33 grant structure in the form of a Federative Entities Support Program (PAFEF), a new National Fiscal Convention, as well as the creation of a trust fund to administer extraordinary oil revenues (Soria Romo, 2009).

7. International tax competition

Tax competition refers to a government structuring its tax policy to attract economic activity such as Foreign Direct Investment (FDI). As mentioned previously on this brief, when taking into consideration public choice theory for analyzing decentralization policies, Tiebout’s Theory of Clubs plays an important role due in large part to voting with your feet strategies. Prior to decentralizing tax policy at a national level and allowing for inter-state competition which could lead to race to the bottom externalities, an international tax harmonization mechanism could be envisaged to
help increase the inflow of FDI to small countries such as Mexico. Just as Tiebout suggested in his creation of a model for the market of public goods, the correct mix of provisions would attract more voters; in this case economic mobility factors such as FDI. This could in turn reduce unhealthy competition and promote more equitable strategies of development.

The current framework established by NAFTA would suggest a tax policy strategy coordinated at a multilateral level between Mexico, the United States and Canada to avoid harmonizing tax bases. This approach would differ from the current model present in the European Union. Such strategy emerges from the attempt to restrict harmful tax competition while allowing generous competition to proceed; this in part due to the size of the US relative to Mexico and Canada. By applying limited competition tax policy coordinated at a multilateral level, the loss of utility generally associated with tax independence can be compensated. Nevertheless it is in the best interest of Mexico to pursue a unilateral harmonization policy with the United States as a first step rather than engaging directly in a multilateral agreement (Cockfield, 2005: 161-164).

7.1 Unilateral and Bilateral Tax Harmonization

The following game theory model developed by Cockfield supports the notion of aligning tax policy of Mexico to that of the United States and considers limited tax competition by ensuring lower tax burdens on mobile factors in comparison to those the US has. The model involves two player game “USA” representing a large economy and the dominant player and “Mexico” representing a small economy dependant on FDI. Each player can choose one of two potential strategies: Harmonizing or independent tax bases. A five point payoff is awarded for independence due to sovereignty and the fact that States place a high value on autonomy in decision making. Utility points are awarded for proper harmonization due to the promotion of national welfare. This is possible by a reduction of tax distortions to cross-border capital inflow that promotes a reduction in capital productivity and in the long run reduced economic wealth. USA receives one point while Mexico receives ten points due to relative gains and economic dependence (Cockfield, 2005: 165-167).

![Figure 8. Risk Harmonization as a Sequential Game](http://biblio.juridicas.unam.mx)
Mexico’s sustainability in the long run is dependent upon its ability to attract FDI from USA and preventing race to the bottom schemes. Harmonization is therefore in the interest of smaller dependent economies such as Mexico.

7.2 Risks in Harmonized Tax Policy

The recommendation of pursuing a unilateral harmonized tax policy aligned to that of the United States could serve as a measure to attract further economic activity to Mexico. This can be done easier in a unilateral context due to the differences present in current Mexican and Canadian economic and political structures. Given the size and stability of the Canadian market, such legislation might prove difficult to implement at a national level. Nevertheless there are potential negative implications to Mexico in implementing such strategies and the following risks need to be considered prior to developing such a strategy: (1) Even if economic forecasting is accurate and previsions point towards a positive trend of potential FDI inflow from the United States to Mexico, the incentives and systems have to be very attractive to make up for the lack of sovereignty. One of the main limitations of the model explained previously lies on the lack of ability of properly quantify national sovereignty in terms of political and social capital. (2) Lowering tax burden on mobility capital may lead to potential revenue losses that could exceed revenues generated by increased inflow of economic activity. (3) The United States remains the dominant player and could react if harmonization proves to be too effective. An increase of outflow of national capital to Mexico could lead to retaliatory measures and permeate other areas such as the political spectrum. Finally (4) more distortions could occur that could in turn lower the overall welfare of the trade bloc (2005: 173-174).

8. Conclusions: Risks in decision making; Local vs. Federal

The level of power central states should vest on local governments depends greatly on social, economic and political factors of each nation. However, they should try to achieve what Oates refers to as a perfect correspondence in the provision of public goods. In a system, assuming equal levels of consumption for each good and fixed geographical distribution, “The optimal form of federal government to provide the set of N public goods would be one in which there exists a level of government for each subset of the population over which the consumption of a public good is defined” (Oates, 1972: 34). In other words the level of provision of each good or service takes into account the exact number of citizens that use each given good or service respectively. It would be utopist to have an ideal system in a real government structure due to compromises that have to be made. “The attempt to maximize the social welfare is likely to involve compromises between the costs and gains of increased decentralization” (Oates, 1972: 52). Population size, collective action, congestion problems
such as the ones explained by the Theory of Clubs\textsuperscript{15} and economies of scale, affect the level of delegation of authority. This is referred by Oates as imperfect correspondence (Oates, 1972: 53).

It would seem that Alexis de Tocqueville\textsuperscript{16} was correct when he stated “I am of the opinion that, in the democratic ages which are opening upon us… centralization will be the natural government”. Oates supports the idea that centralization is the tendency that seems to be more prone to dominate in government structures even if financial decentralization exists. Given globalization and mobility, the effects of output will be affected. For example, the educational system in one locality may have an impact on the welfare of other communities. Higher mobility may also lead to better redistributive fiscal programs (Oates, 1972: 223-224). The European Union has gone a centralization process where three tiers of institutions exist. It is clear that centralized states vest power to lower tiers of government to prevent welfare losses in the consumption of public commodities, as well to provide goods and services that are of crucial interest to local communities maximizing their general welfare. It can also be stated that decentralized finance can work for some local programs such as pet projects, however the need of centralization in ever present.

Financial decentralization has been used during most part of the 21\textsuperscript{st} century as a mechanism for development across developed nations. The European Union through a decentralized mechanism of structural funds has created a supra-national decentralized way of fostering development while maintaining political stability and centralized nation states. Financial decentralization seems to have two potential types of risks, economic and political, both which are causally linked to the State’s ability to maintain national stability and unity. The main issue pertains to the tradeoff that may exist between decentralizing a government and weakening it at the same time. Regarding fiscal federalism and expenditures, the main issue is set in finding tradeoffs between fiscal efficiency, aligning the expenditure side, and avoiding free rider problems on one hand, but at the same time to recapture externalities and economies of scale on the other. It is important however to point out that there is a problem with decentralized (Tiebout) systems. When you have imperfect mobility and sunk costs, even fiscal capacities due to uneven geographical development, you enter a vicious circle where rich localities reinforce their fiscal capacities and pull away from the less developed ones, fostering a snowball effect of inequality, selective migration and lack of cohesion oriented growth. That leads to the inevitable issue regarding redistribution. In a federalist system it is very complex to accomplish unless you have the correct configuration of institutions, leading to the first section of the paper regarding the correct institutional arrangement. It creates a “three dimensional” problem of

\textsuperscript{16} From Democracy in America (Oates, 1972: 221).
great complexity that requires further analysis particularly pertaining to the correct institutional arrangement, the appropriate expenditure mechanisms and the optimal cohesion policy for equal development in a case by case basis.

Bibliography


