Mexico
Back to the Future?

BY LAURENCE KERR

The inauguration of Enrique Peña Nieto as president of Mexico last December marked the return to power of his Institutional Revolutionary Party (PRI) after a dozen years in opposition. The party that the Nobelist Mario Vargas Llosa called a "perfect dictatorship" was again in charge. But, happily, the consequences may be different this time around, for the landscape in which the PRI ruled from 1929 to 2000 has changed significantly.

The old PRI was a superbly successful political enterprise on the authoritarian, corporatist model. The new PRI, by contrast, will have to bend to the demands of a more open, democratic and sophisticated political culture if it is to have any hope of governing for more than a single six-year presidential term. Equally important, it will have to address the country's urgent economic and social needs, which were hardly priorities in the bad old days.

THE GOOD NEWS

From the first weeks of his presidency, Peña Nieto has energetically pushed for sweeping reforms in governance and public policy. And he may have the muscle to pull it off. In the Congress, the PRI and its coalition partner PVEM, a minor green party, hold 241 of 500 House seats, 61 of 128 Senate seats and 21 of the country's 31 governorships. Moreover, the Pact for Mexico, an agreement subsequently negotiated among the three largest political parties to cooperate on legislation for essential change, gives the president a degree of political leverage not seen since the PRI lost power in 2000.

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But Peña Nieto's room for maneuver will largely depend on whether the PRI can consolidate support by appealing to the public as well as by logrolling in smoke-filled rooms. When voters in half of Mexico's states went to the polls in July, the *who* of victory was arguably less important than the *how*. Old-school PRI operatives – the so-called *dinosaurios* – were accused of vote-buying and other familiar bad habits. If the regional party chiefs cannot be reined in, the new PRI could lose the Pact and, along with it, any hope of keeping core reforms on track in the Congress.

During its 12 years in power, the National Action Party, or PAN (Mexico's center-right party that toppled the PRI in 2000), was badly hamstrung by the inexperience of its professional ranks. Peña Nieto's administration, by contrast, can draw on a pool of experienced administrators and technocrats. The PRI sought out talented young people for three generations, moving them along through posts of increasing responsibility. That talent was most often engaged in serving the institutional interests of the party, sometimes to the detriment of society as a whole. But harnessed to a new PRI that cares more about electoral survival than enrichment, they could prove to be a very sharp tip of the spear.

It's worth acknowledging here that the new government is also benefiting from the PAN legacy. In the PRI's earlier time in power, the fiscal cupboard was traditionally left bare every six years by the departing administration. Outgoing president Felipe Calderón of PAN, however, finished his term with the national accounts in order and the economy in passingly good shape.

During the 12 years of PAN control, Mexico's GDP grew from $915 billion to $1.76 trillion in terms of purchasing power. More telling, per capita income (again in purchas-

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ing power terms) grew from $9,100 to $15,300, lifting the country to the ranks of upper middle-income economies.

The government estimates 2013 growth will run at 3.1 percent, tepid by the standard of successful emerging market economies. But manufacturing is booming – most notably in the automobile sector. Audi recently broke ground for a $1.3 billion plant southeast of Mexico City. Honda is making a similar commitment in the state of Guanajuato in central Mexico, while Mercedes-Benz is widely reported to be considering Mexico as the production site for the company's new affordable hatchback. General Motors, which has operated in Mexico since 1928, and Ford, in Mexico since 1935, are expanding their already huge production bases there. BMW, Hyundai and Nissan/Infiniti are also investigating manufacturing sites.

It's not hard to see why. Labor costs for manufacturing (adjusted for productivity) are essentially at parity with China, Mexico's chief competitor in manufactures in the Americas. Distance to market, quality control and long-established relationships with North America as an export market give Mexico an edge in serving global supply chains; China, for its part, benefits from its huge domestic market.

Mexico does lag behind some competitors in the creation of human capital, which is crucial to economies at this middle stage of development. Just 28 percent of the age-appropriate cohort is enrolled in post-secondary education, compared with 75 percent in Argentina, 71 percent in Chile and 43 percent in Columbia. But Mexico has been closing the gap, beginning with the Calderón administration. And it should continue to improve going forward, as increased financing and a variety of reforms kick in.

Demographics are also on Mexico's side in this regard. Declining fertility (the rate has plunged from 3.4 children per woman in 1990 to 2.3 in 2011) and continuing urbanization (which reduces the need for schools in rural areas) will allow the country to invest more per student without further stretching its resources.

Despite the sunny news, though, fixing Mexico's social and economic problems will be no walk in the park. Three issues will test both the PRI's commitment to reform and the leadership of the Peña Nieto administration:

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Big Oil. Petróleos Mexicanos (Pemex), the state-controlled oil and gas monopoly, lacks adequate access to capital and is saddled with high operating costs driven by heavily padded payrolls. The company, long a huge exporter, will soon be unable to meet the country's internal energy requirements or to finance its outsized (34 percent) share of the government budget. Fiscal reform and a comprehensive rebuilding of Pemex are critical to the country's economic growth, but history, interest group politics and nationalism limit Peña Nieto's room for maneuver.

Trickle Up. The fruits of economic growth have been unfairly divided. Much of the tax burden falls on the salaried middle class, while subsidies aimed at the poor are often diverted to corporations and the affluent.

Drug Wars. Cartel violence compromises government authority in several states, as corruption, incompetent policing and a feeble judicial system hamper containment. There's simply no way the administration will be able to destroy drug-fueled crime in the short term – the profits are humongous. But it must show itself to be committed to reducing the level of violence.

PROBLEM ONE: FIXING PEMEX

Article 27 of the Mexican Constitution of 1917 declares national ownership of the country's "petroleum and all solid, liquid and gaseous hydrocarbons." Understanding its significance, like so much in Mexico, requires a bit of history.

Article 27 (and the rising nationalism behind it) set off an extended battle with the largely foreign-owned industry, which came to a head on March 18, 1938, when Mexican President Lázaro Cárdenas expropriated the reserves and in-country operations of United States and Anglo-Dutch companies. Pemex, now the second largest enterprise in the world that's not listed on a stock exchange, was created; American and European governments reacted with outrage and boycotts.

Long feeling ill-used by the foreign companies, Mexicans rose across class lines in support of their president. On April 12 of that year, an estimated 100,000 women demonstrated their support in front of the Bellas Artes theater in Mexico City's historic center, bringing donations ranging from expensive jewelry to fresh eggs to help the government pay its debt to the foreigners. In 1942, after extended diplomatic wrangling, Mexico agreed to pay about $30 million to the United States companies; five years later, the Anglo-Dutch interests agreed to a $130 million payoff.

Today, Mexico is the third largest supplier of crude oil to the United States, after Saudi Arabia and Canada. But because of undercapitalization, mismanagement and a national energy policy that underprices fuel sold at home, it is on track to become a net energy importer within a decade. Total production has fallen from 3.4 million barrels per day in 2006 to 2.5 million in May 2013. Production from the supergiant Cantarell field in the Gulf of Mexico, which peaked in 2004 at 2.14 million barrels per day, is now just 400,000.

By the same token, Pemex's natural gas program has suffered from exploration cutbacks since 2008, after a sharp marketwide price drop. The government chose instead to meet growing demand with cheap imports from north of the border. Without significant ongoing exploration, Mexico's proven gas reserves have fallen about 70 percent in the interim. Meanwhile, pipelines in development will soon make it possible to triple gas imports from the United States.

Pemex pays about 60 percent of its revenues to the Mexican government as taxes and royalties, while providing subsidized gasoline to the domestic market. This double burden is a key to the company's lack of internally generated funds for continuing operations, infrastructure improvements and, critically, exploration.

Thus, despite rising crude prices over the last decade, Pemex has been forced to borrow heavily; the debt load is expected to exceed $61 billion by the end of 2013. Taking into account retirement obligations, the present value of the company's total liabilities probably exceeds $100 billion.

The recent drop in production, uncontrolled personnel costs and an aging infrastructure have generated urgent calls for reform – changes largely stymied by interest group opposition to date. The oil workers union has been closely allied with the PRI since the party's birth. (The current union secretary-


Wreckage after an explosion of a PEMEX pipeline in the town of San Martin Texmelucan, in 2010.

general, Carlos Romero Deschamps, is a PRI senator.) And for decades, the union has provided the PRI with huge vote margins from its membership and from the oil field communities where it operates. Hence, pushing energy reform around or over the union leadership will test Peña Nieto's clout. In August, he attempted to thread the political needle, proposing a constitutional amendment allowing joint investments with foreign oil. One catch; the return would be in profit-sharing rather than Big Oil's preferred output-sharing.

Pemex's problems go far beyond technology and cash scarcity, however. Since the 1938 expropriation, managers, labor union leaders and politicians at every level have used oil revenues as a source of personal enrichment. Corruption has been bold, large scale and often accompanied by violence. No surprise, then, that those challenging the status quo have faced intractable opposition from Mexico's elite – and, on occasion, from armed assailants.

The cost of energy sector malfeasance is generally estimated to be running at $1 billion annually, but fuel theft may double that figure. The drug cartels, notably the feared Zetas, have brought better technology and improved marketing to what was once considered bothersome pilfering. Theft from pipelines alone cost Pemex an estimated $250 million in the first quarter of 2013.

Moreover, all these numbers are probably eclipsed by the cost of the inefficiency derived from featherbedding and patronage-dependent management. In 2011, the 154,000 employees of Pemex generated approximately $115 billion in revenues. By contrast, Petrobras, the energy company controlled by the Brazilian government, generated $146 billion with 82,000 employees. About one-half of Pemex's exploration and operations personnel are stationed in fields generating less than 5 percent of the company's output.

As a practical matter, Pemex is bankrupt.

EPA/ULISES RUÍZ BASURTO

Revitalizing the company – increasing production and efficiency, and restoring profitability – seems a straightforward problem with a clear solution to most outside observers: the company must be privatized and recapitalized. Constitutional restraints and interest group opposition, however, limit Pemex's ability to right itself.

Pemex's CEO, Emilio Lozoya, a close associate of Peña Nieto, earned degrees in economics and law from prestigious Mexican universities before graduating from Harvard with a master's degree in public administration. Not yet 40, Lozoya has an exceptional resumé, with experience in private-sector finance, the Central Bank of Mexico, the Inter-American Investment Corporation and the World Economic Forum.

While Peña Nieto works toward constitutional change – the big picture solution – Lozoya's task is to build confidence through reforms that require no heavy lifting in the Congress. He has noted that the new pipelines carrying U.S. natural gas to Mexico can operate in both directions. Gas, even at current pricing, is clearly a profitable business for Pemex, and the company has the wherewithal to rebuild its capacity. Moreover, the idea of public-private partnerships in natural gas investment excites less xenophobic responses than messing with Mexico's oil patrimony.

Lozoya may also have some room to maneuver in downsizing Pemex's bloated work force. About one-fifth of Pemex's employees are not in unions, and thus relatively vulnerable to housecleaning. Reduction of the union work force through attrition may prove viable in the current environment as well.

Demand-side reform is already in the works. Prices at the pump for gasoline and diesel fuel are being raised through small, regular monthly increments. This allows business users to plan ahead and helps to diffuse the sort of consumer outrage that has plagued other oil-producing countries – from Nigeria to Iran – that have rapidly withdrawn fuel subsidies. And about time: holding domestic prices below global market prices cost the country more than 1 percent of GDP in 2012.

PROBLEM TWO: SHARING THE WEALTH

The constitution of 1917 declared health care, education and housing as rights guaranteed to every citizen. To that end, a substantial portion of the nation's productive capacity, most notably mineral and oil wealth, was reserved to the government for the people's benefit. Farmland, also considered part of the sacred patrimony, was given directly to the people through the *ejido* land reform program.

But something – well, many things – happened on the way to the forum. Unicef reports that some 20 million Mexican children live in poverty, five million in extreme poverty. (Total population of Mexico in 2012: 112 million.) From the beginning, the Institutional Revolutionary Party has proved more dedicated to institutions of the status quo than to revolution. The *ejido* system, intended to give every farming family its own plot of land, directed millions of acres into the hands of the privileged.

The poor, to be sure, have not entirely been denied the fruits of growth. Basic literacy has been expanded. And the *Oportunidades* program, which provides monthly cash to impoverished households on the condition that they send their children to school and medical clinics, has yielded a lot of bang for (too few) pesos. Moreover, substantial progress has been made in providing a basic safety net in recent years. Employees in the formal labor sector (private, civil service, military, government enterprises) are covered through several programs. For these workers and their fami-

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lies, financing for social benefits, including health, disability and retirement, depends on employee and employer contributions and is generally self-sustaining.

Those outside the formal sector – a very large number of Mexicans – receive some government services, and they have improved somewhat. But, as currently organized, public financing for the informal sector is both politically and fiscally unsustainable.

Wonky policy analyses on subjects as esoteric as budgeting for poverty reduction rarely rise to the public consciousness. But a recent article* on this subject, written for the Centro de Estudios Espinosa Yglesias (CEEY), a Mexico City think tank, has gone viral among Mexican decision makers. The problems outlined by the paper were well known, as were the recommended remedies. But the current high level of interest suggests the matter of fairness has truly arrived on the national agenda.

As described by the authors, extending a basic safety net to all – one including pensions, health care and life and disability insurance – would cost about 5 percent of GDP. Current expenditure: 1.8 percent of GDP. Eliminating wasteful subsidies largely benefiting the middle and upper classes, like those for electricity, fisheries and agribusiness, would constitute a good start at raising the missing 3.2 percent of GDP. What's also needed, the CEEY authors suggest, is to broaden the base of the national value-added tax to include food and medicine as a necessary step in balancing the social change budget.

Jorge A Chávez Presa, Fausto Hernández Trillo and Luis Felipe López-Calva, Public Finance and Social Protection System Reforms in Mexico: Parts I and 2 in Latin American Policy Volume 3, Numbers 2 and 3

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Several attempts have been made to expand the VAT, most notably by President Calderón in 2009 as part of a wholesale overhaul of the tax system. The current proposal, which would rebate outlays for the poorest quintile in what would otherwise be a regressive tax, should face less resistance from the left and gain more support from the thoughtful right – though many believe the tax on medicine would have to be sacrificed to bring around a majority in the Congress.

PROBLEM THREE: ENDING THE DRUG WAR

In 2006, just 10 days into his term, President Calderón escalated Mexico's fight against drug traffickers, sending nearly 7,000 soldiers into the state of Michoacán (a few hundred miles west of Mexico City) to battle one of the country's most savage drug gangs, *La Familia Michoacana.* During the five-plus years of its war with the federal government, *La*

Familia used a mix of money and violence to gain substantial influence, and sometimes control, in state and local politics. Though federal forces did finally break the cartel in late 2011, Michoacán remains outside the control of the central government. A less sophisticated but even more violent gang, *Los Caballeros Templarios* (translation: Knights Templar), has filled the void left by *La Familia.*

YURI CORTEZ/AFP/GETTYIMAGES

Versions of the security disaster in Michoacán have played out in other areas of the country, notably in the northern border area and along the Pacific coast. Conservative estimates of the number of Mexicans killed during the six years of the Calderón presidency run to 70,000.

One of Peña Nieto's first post-inauguration policy statements outlined his new drug strategy. His administration would redirect government efforts from actions against the cartels and their leaders toward citizen protection and violence suppression. Programs would center on the young, in hopes of reducing the pool of foot soldiers used by the cartels. The idea is to replace criminal activity with jobs in the formal economy.

A little perspective is in order here: as much as the crime cartels have stressed the social fabric, it is simply wrong to label Mexico a "failed state." To be sure, of the country's 32 federal entities, as many as six are significantly outside firm central government control. However, Mexico remains a powerful polity, united by language, religion, history and culture.

Moreover, lawlessness is hardly a new problem in Mexico. From colonial times until the 1920s, difficult geography and wretched infrastructure made it much easier for the citizens of the Yucatan peninsula to get to New Orleans than to Mexico City. Texas was so far from the Mexican heartland that it couldn't be held at all. And Mexican presidents from Juárez to Huerta were reduced to sending *Rurales* (rural militia) into the margins of the country to dispense rough justice where formal rules were few.

In its seven decades of continuous rule, the PRI built a coherent national administrative system. PAN, however, lacked the PRI's skill in imposing discipline. Between the administration's poor performance and the pressures of the drug war, governors and other regional officials have assumed more responsibilities. And while some have served their states well, others have become partners with criminal organizations.

Public security is further compromised by a weak judiciary. Fewer than one in three narcotics-related court cases results in a conviction, compared with about 90 percent in the United States. The Mexican conviction rate on murder cases is even lower – about one in five. And in criminal cases generally, successful prosecutions are often based on confessions wrung out of suspects.

Mexican criminal trials have traditionally followed the inquisitional system, in which there is no presumption of innocence, no jury, no live testimony and no physical courtroom. Communication is by computer, with the accused watching on a screen in a prison holding room. Besides lacking a sense of equity, this arrangement has shown itself to be very vulnerable to corruption.

The system is currently being replaced with an adversarial system on the Canadian and United States models. By law, the change must be completed by 2016, but fewer than half the states were in compliance as June of this year.

Policing, too, is changing in Mexico, albeit slowly. Local and state police officers have always been poorly paid, poorly equipped and badly trained. Officers in many jurisdictions are still required to provide their own uniforms and equipment, and (unofficially) to pay a portion of their subsistence salaries to those above them in the chain of command. Petty corruption is seen as a necessary evil, and providing protection for the cartels a less-than-mortal sin.

Mexico's federal structure inhibits reform; each state and municipality controls its own law enforcement. Pay, qualifications, training and professional standards vary wildly among hundreds of jurisdictions. Pay has been increased at all levels of federal law enforcement and in many of the country's states and municipalities. For the first time, significant numbers of university graduates are joining the uniformed ranks. The city fathers in Monterrey, a major commercial center, have raised qualifications for new police hires, recruited aggressively from outside the region and raised salaries sharply, with entrance-level pay now $1,100 monthly (up from $600).

Most public security stakeholders – a cynical, hard-to-impress group – have hopes that the greater investment will result in more effective and less corrupt police performance. This, along with broader exposure to international investigative standards, will create a circle of virtue in which professionalism begets professionalism. While the gruel seems thin, there's some precedent: many national law enforcement establishments were built in the same patient way.

THE REVOLUTIONARY MOMENT

Mexico has been said to be on the cusp of great things ever since the mid-1980s, when the collapse of the peso forced the PRI to start listening to foreign technocrats and to begin opening the economy to global market forces.

Mexico has, indeed, changed a great deal since then, with a functioning multiparty system replacing Vargas Llosa's "perfect dictatorship" and an export-based manufacturing economy replacing crony capitalism with a populist twist. But these genuine successes have ironically served to cast a harsh light on the remaining weaknesses of the polity and economy – the near-collapse of the linchpin energy industry, the failure of the rising economic tide to carry the poor, the horror of drug violence fueled by U.S. demand for illicit substances and abetted by government cynicism, corruption and incompetence.

Now the Institutional Revolutionary Party, which engineered Mexico's political and economic stasis, has come full circle. It has been returned to power, but can no longer depend on the party's traditional strengths to hang onto it. Serendipitously, the interests of the PRI's political machine and those of the Mexican people now seem to be aligned. What's yet to be determined is whether this new and improved version of the ancien régime can deliver on its promises.