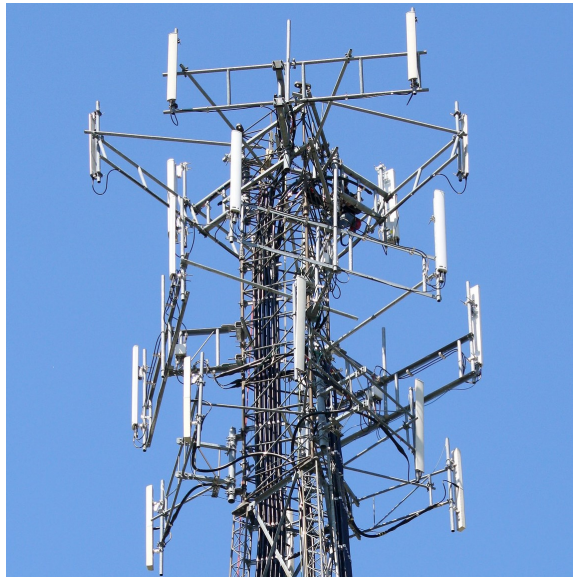
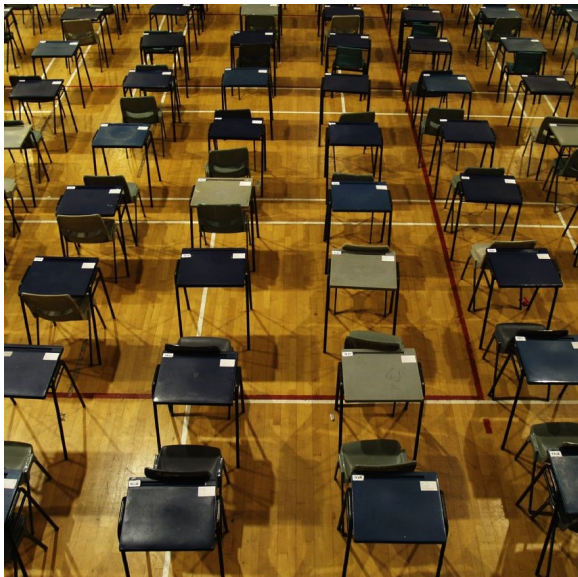


# Mexico's Reforms and the Prospects for Growth



By Pedro Valenzuela

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## Executive Summary

Over the course of the **last 30 years**, Mexico has diversified its commercial and industrial policies. Greater emphasis has been placed on liberalization, openness, and increasing the role of the private sector in the economy.

The **strategy in the 1980s and 90s** entailed advancements on three fronts: control of government spending and fiscal conservatism, removal of barriers to trade in goods and services, and liberalization of financial flows simultaneously with institutional change.

While this strategy was somewhat successful, it was limited in achieving sustained and inclusive growth, establishing fair and effective regulatory capacity, and building the institutions of democratic governance.

Between **2012 and 2014, an extraordinary set of structural reforms were approved by the Mexican Congress**. The reforms were founded on a strong political consensus regarding the need for change.

The recent comprehensive reform agenda was propelled by a political mechanism negotiated by the Federal Government. It is divided into 5 categories (democratic governance; transparency, accountability, and the fight against corruption; rights and liberties; security and justice; economic growth, employment, and competitiveness) and focuses on 95 initiatives.

A **labor reform** included changes in the resolution of labor conflicts, incorporated different models of contracting, and addressed productivity, gender, and inequality. These changes aimed to reduce hiring and firing costs and incentivize productivity as the key to promotion.

An **economic competition reform** included the creation and strengthening of agencies in charge of monitoring the new rules of the market. Concurrently, innovative tools for the enforcement of the law were added and expanded. These changes will impact the credibility and capacity of regulators to promote a truly competitive environment in highly concentrated industries in Mexico.

A **fiscal reform** had the main objective of gradually increasing non-oil revenues for the government, mainly through increases in consumption taxes, closing of loopholes and exceptions, and limits on corporate deductions, among other changes. While it is positive to reduce the government's dependence on oil revenues, the greater challenge is to translate those additional resources into improved public services and productive investments.

A **financial reform** was created to expand access to credit for both households and small businesses by reducing costs and risks, as well as to increase options through both development and commercial banks.

A **telecommunications reform** has generated huge expectations, since it allows foreign companies to invest both in telecommunications and broadcasting. Furthermore, it ordered the creation of an optic fiber network, a new television network, and new transmission rules.

An ambitious **energy reform** has come to be seen as the most important change in this process, given its scale and implications. It transformed the state-run oil and electricity monopolies into private-like enterprises with the goal of generating revenue. It also allowed them to form partnerships and give contracts to private national and international companies to invest in practically all stages of the production cycle.

This reform also included the founding of new regulatory agencies, detonated additional investments in human capital and research institutions, and spurred the creation of public funds in order to stabilize public finances in the long-term.

If the energy reform was seen as key for investment opportunities, the **education reform** is key for the long-term success of the country. It aims to increase education quality, mainly through the evaluation of teachers, expansion in parent and community involvement in basic education, and investment in education infrastructure.

Directed at some of the biggest shortfalls of the Mexican transformation, **the rule of law, the transparency, and the anti-corruption reforms** were created to successfully transition towards an oral adversarial criminal justice system from the inquisitorial one that existed before. At the same time, the reforms were aimed at creating national-level systems to protect transparency and fight corruption. These latest reforms have the immense task of giving credibility and punishing corrupt practices at all levels of government and from individuals in all sectors.

Mexico is now in a highly complicated phase: implementation. **The great challenge for the country is to translate changes in the law into actionable public policies with clear results for the majority of the population.**

**The major challenges** for the implementation of the reforms will be the fight against inertia, corruption, inefficient and excessive bureaucracy, low labor productivity, and low confidence in authorities. **On the positive side**, the country has an important demographic dividend, abundant natural resources, and a diversified production base, which could be the drivers that translate the reforms into a stable and higher rate of economic growth.

In conclusion, the reform process was centered on **opening markets and allowing other players to compete and invest in Mexico, creating and strengthening regulatory agencies, and increasing the productivity and quality of education in the medium- and long-term.** Currently, the main task is to translate the successful approval process of the reforms into an equally successful process of implementation.

## **Introduction: Moving Mexico Forward**

The extraordinary set of structural reforms that were approved by the Mexican Congress between 2012 and 2014 was unprecedented in the country's recent history. The sweeping legislative program, founded on a broadly-based political consensus regarding the need for change, and on the initial enthusiasm with which Enrique Peña Nieto's government was received, was successful in fundamentally altering the constitution as well as myriad secondary laws. These reforms, aimed explicitly at boosting national productivity and competitiveness, were seen as a major departure from the legislative stagnation of the previous two PAN administrations, when gridlock on major reforms had been the norm.

The background to these reforms, as well as the prospect that they will positively impact Mexican economic growth and development, are the focus of this paper. Heralded around the world as an example of what is possible when executive and legislative branches cooperate, and when a climate of cross-party collaboration prevails, the reforms hold the potential to strengthen Mexican economic growth in the near- to mid-term future. By addressing many of the structural challenges most commonly identified by analysts of the Mexican economy, the reform agenda represents a consolidated attempt to modernize the economic system and to further the opening of the economy begun in the 1980s and 90s.

## Section 1. The Winding Process of Economic Liberalization

During the last century, the Mexican economy has been characterized by drastic changes in its direction, objectives, and ways of relating to the world in general, and to the United States in particular. The country has gone from recurring economic crisis, debt repayment problems, and a closed-economy structure primarily directed by the government to an open economy with a flexible exchange rate, inflation control, and solid management of public finances, conditions that have allowed Mexico to become the fifteenth largest economy in the world measured by its Gross Domestic Product (GDP), which is about \$1.97 trillion USD based on purchasing power parity (OECD, 2015).

Of course, this story has been neither smooth nor steady. For the first half of the last century, the country implemented *import substituting industrialization* as the main strategy for economic growth. At the center of this approach was the idea of protecting so-called infant industries in order for them to develop certain comparative advantages and then be able to successfully compete in the international market.

Although some of these companies did generate knowledge and skills to compete, many others never had the incentive to improve the quality of their goods or products, as they had a sufficiently large captive domestic market inside Mexico to maintain their profits. In short, this strategy - which lasted roughly until the 1970s - was characterized by commercial protectionism (mainly through import licenses and other tariff and non-tariff barriers) to favor domestic industries, coupled with direct involvement of the state in the productive economy, mainly in industrial processes but also through the provision of a diverse range of goods and services, from grains and foods, to oil and electricity.

From the late seventies, Mexico began to diversify its commercial and industrial policies. On the one hand, greater emphasis was placed on export promotion and the development of capital-goods industries and the regulation of foreign investment; but on the other hand, major oil discoveries, coupled with high international energy prices, prompted the government to participate more and more in the economy, mainly through bigger and bigger public spending (Moreno-Brid and Ros, 2010).

This last period, characterized by loose fiscal policy, made public finances particularly vulnerable to foreign shocks, specifically because that spending was increasingly financed through foreign debt at a time when the country had a fixed exchange rate. With the collapse in oil prices and the onset of the Latin American Debt Crisis in 1982, Mexico was plunged into major financial catastrophe resulting from international capital flight, declining international reserves, and ultimately the suspension of payments of the external debt. This would be the watershed moment when real and sustained efforts would begin, from both the government and the private sector, to modernize Mexico and open the country to global competition.

## 1.1 First waves of change and their consequences

The debt crisis in Mexico highlighted the need for a new institutional framework for economic development and growth, which required substantive support from economic leaders, public and private, national and foreign. The International Monetary Fund (IMF), World Bank (WB) and foreign-trained Mexican economists spurred a revolution in economic policy in Mexico, as a new generation of technocrats came into power, establishing a vision that has, to a significant degree, dominated economic thinking in the country ever since. Despite changes in ruling parties, and the make-up of the national cabinet, a common perspective centered on liberalization, openness and increasing the role of the private sector has characterized Mexico's economic strategy since the 1980s.

The new strategy entailed major economic and institutional changes that took place through the 1980s and especially the first half of the 1990s. First, public finances were reformed to reduce government spending, ushering in a new era of austerity and fiscal conservatism. Second, a number of economic reforms were enacted to remove barriers to trade in goods and services, liberalizing financial flows and aimed at attracting foreign investment. Finally, by privatizing public companies, the presence of the state in the economy was substantially curtailed.

Simultaneously, institutions were created to give credibility to the country in terms of its economic aspirations and long-term commitment. During this first period of reforms, an independent central bank was created with the mandate to control inflation, and the federal government adopted a flexible exchange rate in order to alleviate external pressures and create the flexibility for fiscal adjustments. Of enduring importance for Mexican governance and democracy, an independent Electoral Institute was formed, with the express goal of promoting free and fair elections.

**Figure 1. Annual Inflation (1961-2014)**



Source: own elaboration with data from the World Bank (2015).

In 1986, the country joined the General Agreement on Trade and Tariffs (GATT), sending an unambiguous signal that the new growth strategy would be founded on an export-led economy (Conger, 2015). If joining the GATT represented an important step towards openness for Mexico, the highpoint would come in 1993 with the ratification of the North American Free Trade Agreement (NAFTA) and in 1994 with its implementation. The agreement gave Mexico privileged trading and investment relations with two of the largest economies in the world, Canada and the United States of America, under a set of common rules and high standards for both production and exchange. On top of this, Mexico joined the Organisation for Economic Cooperation and Development (OECD), the World Trade Organization (WTO), and the Asia-Pacific Economic Cooperation (APEC). Since then, the country has signed 11 free trade agreements with 46 countries and nearly 40 specific trade agreements with other nations, giving it preferential access to markets representing more than half of global GDP and becoming one of the most open economies today (*Secretaría de Economía*, 2015).

The changes initiated in the eighties and nineties were successful in many aspects. As suggested by Conger (2015), based on interviews with various experts and stakeholders from the public and private sectors who were intimately connected with these changes, the two most significant impacts of this period were the stabilization of the economy and the opening of the country to international trade.

Regarding economic stabilization, the main result is that today all domestic and foreign social and economic actors can assume with a high degree of certainty that the country has strong and accountable public institutions that control inflation and seek balanced fiscal budgets, which in turn provides favorable conditions for greater domestic and foreign investment. As mentioned by Mexico's former Deputy Finance Minister Santiago Levy, (Conger 2015): "nothing good can happen in an unstable economy with high inflation and deficits."

The opening of the country to international trade and investment represented a major paradigm shift. Through international commitments, Mexico changed the rules of the game and forced all players to follow the same set of economic rules. This was necessary to attract the investments Mexico would need to compete on the global stage; as Luis Rubio (2014) has written: "NAFTA constituted a milestone in the political life of the country because it entails a set of 'disciplines' [...] that are basically impediments to a government's acting as it feels or as the various interests that operate within the political apparatus would like. Acceptance of this set of disciplines is a decision to 'self-limit,' that is, to accept that there are rules of the game and that there is a severe cost for violating these norms."

Stemming from the economic opening of Mexico, there has been a major shift in the production base of the country during the last three decades. From an economy based on the export of natural resources and agricultural products, Mexico has become a complex and diversified economy dominated by

manufacturing and complemented by strong agricultural, extractive, and services sectors (Moreno-Brid and Ros, 2010).

Macroeconomic reforms and trade liberalization therefore allowed Mexico to become an attractive country for international investment and greatly heightened national competitiveness. Furthermore, the country succeeded in implementing policy changes that have endured for a long period of time, giving legal certainty to stakeholders within and outside the country. In short, during the period of the late 1980s and 1990s Mexico institutionalized its historic shift toward acceptance that fewer barriers to trade, credible rules and institutions, and a stable economy were reliable tools to build the basis for sustained economic growth.

## 1.2 Inertial trends and need for further change

Despite this major revolution in economic thinking and strategy, new challenges have appeared in Mexico and others become more apparent in a country that has struggled to maintain robust economic growth. The new rules were (and still are) incomplete, as demonstrated by challenges in reaching three major objectives: achieving sustained inclusive growth, establishing fair and effective regulatory capacity, and building the institutions of democratic governance.

The first set of factors relates to obstacles that the Mexican economy has faced for many years such as poverty, inequality, and informality in the labor market. The second category relates to difficulties of the institutional design that was adopted, such as a lack of credible and strong economic regulatory institutions and only partial (at best) implementation of the reforms in some sectors of the economy. Finally, the third type of factors relates to challenges that have become increasingly apparent as political and economic liberalization have progressed, such as low confidence in the government, uneven institutional development at the state-level, corruption, transparency, and violence.

To illustrate some of the challenges and in order to contextualize the recommendations that will be explained later, it is sufficient to describe the following three figures.

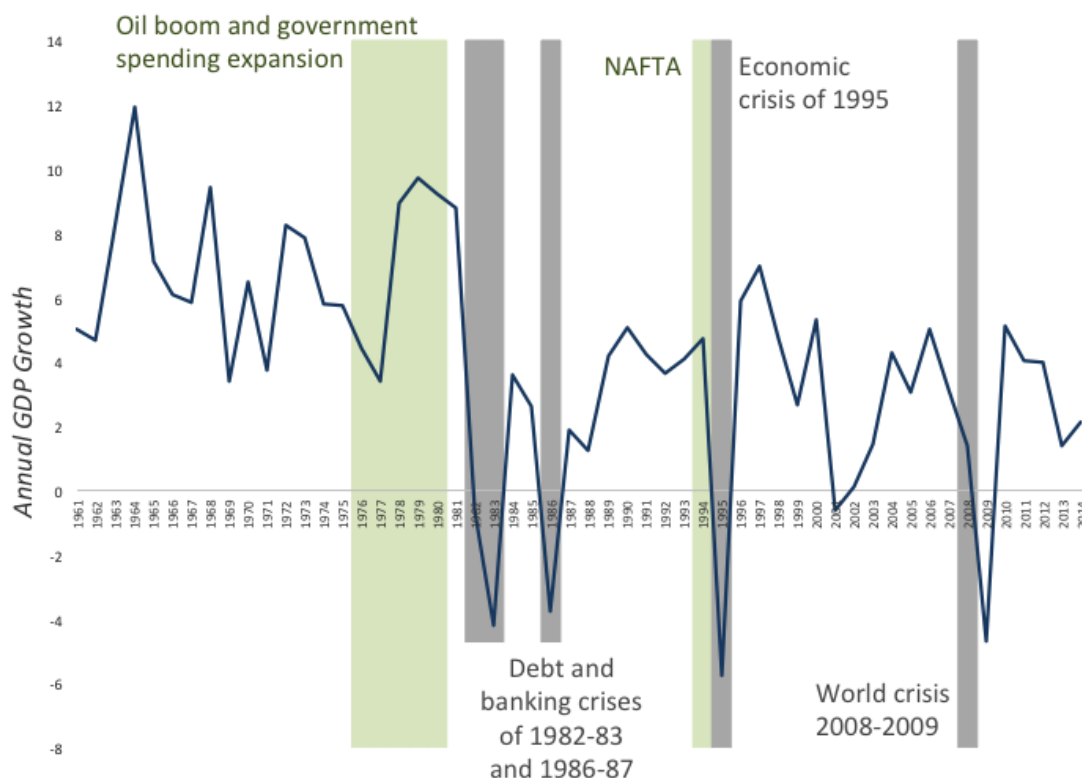
Figure 2 shows the annual GDP growth rates for the period between 1961 and 2014 in Mexico. At least three observations should be highlighted. First, it is clear that in comparison to the period prior to the 1980s where growth was almost 7% annually, during the last 20 years, growth has been significantly lower. However, lower growth has been matched by lower inflation and greater fiscal restraint. Second, the 1980s were particularly harsh for the country; during that decade the country suffered two economic contractions of more than 2% of GDP each. Third, after Mexico's severe 1995 crisis, growth rates have failed to take off and have been averaged around 1.8% during 2000-2010 and 2.8% between 2011 and 2014, giving Mexico the macroeconomic profile of a developed country rather than an emerging market. It is worth noting, however, that the major economic slowdowns,



including in particular the global financial crisis of 2008-2009, were caused primarily by external factors, in contrast to prior recessions, which tended to be caused or compounded significantly by domestic issues.

This figure, then, indicates that despite the first wave of reforms, the country has been unable to settle on a path of significant and sustained economic growth and that remains one of the great challenges for the Mexican economy.

**Figure 2. Annual Percentage Change in Mexico's GDP (1961-2014)**



Source: own elaboration with data from the World Bank (2015).

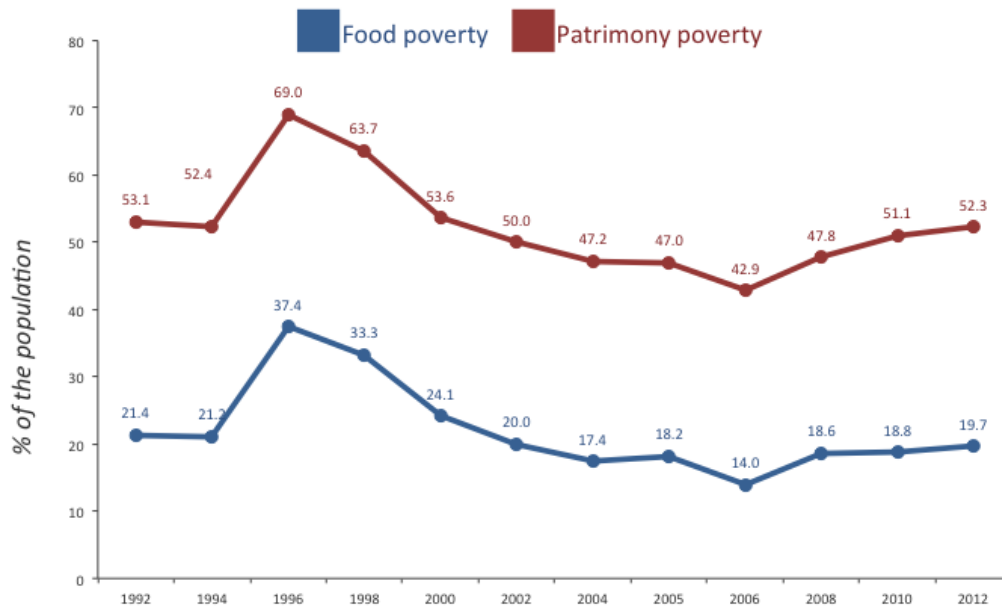
Figure 3 shows the evolution of the percentage of Mexicans living in poverty from 1992 to 2012. Food poverty is defined as insufficient income to buy the basic food basket and patrimony poverty is defined as inadequate level of disposable income to purchase the food basket and make the necessary spending on health, education, clothing, housing, and transport (CONEVAL, 2015).

At first glance and according to both indicators, the percentage of the population living on the type of deficiencies described above is not very different today from what existed in 1992 and, as expected, the absolute number of people has increased, for food poverty from 18.6 million people in 1992 to 23.1 in 2012 and for patrimony poverty, from 46.1 to 61.4 million people from 1992 to 2012, respectively.

The National Council for the Evaluation of Social Development Policy (CONEVAL) is the institution in charge of measuring poverty in the country

and evaluating government's social interventions. Its poverty measurement was adjusted in 2008 and according to data from 2014, the trend mentioned above was confirmed, finding 24.6 million Mexicans earning less than the "minimum welfare line" (people who cannot acquire the value of a food basket) and 63.8 million earning less than the "wellbeing line" (people who cannot acquire the value of the sum of a food basket plus a basket of goods and services).

**Figure 3. Percentage of People Living in Poverty in Mexico (1992-2012)**



Source: own elaboration with data from CONEVAL (2015).

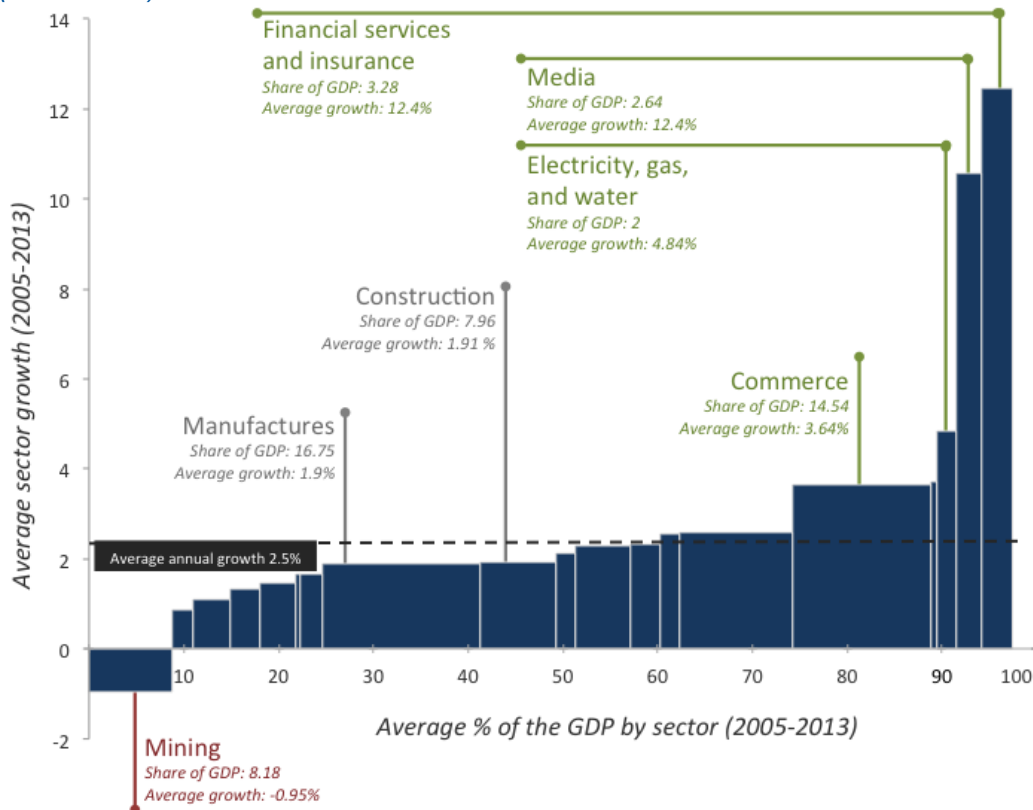
Finally, Figure 4 attempts to represent various challenges that the country faces in terms of having several competitive and thriving industries that raise the growth of the national economy. The height of the lines represents the average growth of the economy sector and its width represents the share of that sector of the total GDP. The average growth of the economy for the period under review (i.e. 2005-2013) is also noted.

In line with what many experts have found, the McKinsey Global Institute study, "A tale of two Mexicos: Growth and prosperity in a two-speed economy," (2014) emphasizes that the country has diverse and contrasting realities in its productive base. On the one hand, part of Mexico, the modern industrial economy, is growing at comparable rates with Southeast Asian countries. Among that group (seen on the right hand side of the figure) we can find sectors such as: financial services and insurance, electricity, gas, and water, and commercial activity. Almost all these sectors, except the last one, each represents a relatively small portion of the GDP (around 5%).

On the other hand, there are sectors that account for a significant share of GDP (between 5% and 20%) that have annual growth rates in line with the national average or a little below (i.e. about 2%). Among these sectors we can find construction and manufacturing. Finally, there are sectors that do not

grow at significant rates and sometimes, as in the case of the mining sector, have even negative growth rates, at least during the period analyzed.

**Figure 4. Average Sector Annual Growth and Their Share of the GDP (2005-2013)**



Source: own elaboration with data from INEGI (2015).

This last figure shows us that growth is unevenly distributed throughout the economy. With this in mind, in recent years policymakers have been trying to adopt several reforms designed to change the part of Mexico that still needs to be efficiently integrated into the modern global competitive economy. For example, during the Felipe Calderón administration (2006-2012), a constitutional reform of the criminal justice system was approved and a major emphasis was placed on improving the institutional framework to fight organized crime and violence. However, at the same time the administration unsuccessfully attempted to reform the economy with changes to legislation governing the energy sector and fiscal and competition policy. Although some progress occurred in the area of economic competition, time and again the government failed to generate the required political consensus in congress to bring about significant change. It was only on Calderón's last day as President, with substantial assistance from the incoming President, Enrique Peña Nieto (2012-2018), that a labor reform was approved.

This labor reform set the stage for the triumphant start of a political mechanism created by the current administration called the Pact for Mexico (*Pacto por México*), through which the leadership of the major parties came together to agree on key policy aspects and make significant changes to certain areas that had previously seemed impossible to change. The *Pacto*

itself was a remarkable achievement of the Peña Nieto administration. Negotiated during the transition period between the July election and the beginning of the administration in December 2012, the agreement focused on 95 initiatives, divided into five categories:

- Democratic governance.
- Transparency, accountability, and combating corruption.
- Rights and liberties.
- Security and justice.
- Economic growth, employment, and competitiveness.

As a product of this successful political mechanism, rules and processes were modernized and institutions were created in sectors such as telecommunications, economic competition, energy, and education. Beginning in 2014, in the wake of damaging government scandals involving corruption and organized crime, a second wave of reforms were presented to the Congress. These reforms focused on issues of rule of law and anti-corruption.

Although these reforms represent a great opportunity to transform the face of the economy in Mexico in the years to come, they will require political commitment and aggressive implementation from this and future administrations. The next section offers an analysis of the key reforms and their potential impact

## Section 2. The Reform Agenda

As mentioned above, the efforts to reform were not new, as different authorities and policymakers had tried to change key legislation and the incentive structure in areas considered crucial for Mexico in order to put the country in a sustainable economic growth and development path.

This section briefly explains the recent reforms and, where appropriate, its main background is highlighted. Each section is accompanied with a brief discussion about the potential medium-term and long-term impact they could have on the Mexican economy.

### 2.1 Labor reform

In November 2012, during the transition period between the outgoing and incoming administrations, a reform of the Federal Labor Law was approved by Congress. The legislative debate had started at the beginning of the congressional period in September of that year and was heavily influenced by prior initiatives discussed in Congress.

The government's diagnostic behind the reform was threefold: first, the country has a problem with workers and enterprises working in the informal labor sector. This phenomenon is multifactorial and complex and affects the entire economy, having a deleterious impact on the ability to create new and successful businesses and the adoption of new technologies. Second, the overall productivity level in Mexico is low; it has not advanced at the pace some sectors need to become competitive in a global environment. And third, the rules and procedures in the labor market are slow and do not provide incentives to hire younger workers and in general have high costs for both for the employers and the employees.

The changes included in the reform can be organized into three categories: resolution of labor conflicts, inclusion of different ways of contracting, and productivity, gender, and inequality.

Regarding resolution in labor conflicts, the rules for workers' layoffs were modified by making clearer the procedure for the employer but also by limiting the payment that the firms have to make to workers in the event of dismissal. With the previous legislation, in the case of a disagreement, the compensation was calculated since the start of the layoff until the final resolution date, creating incentives to lengthen the process and causing financial problems and instability for both the worker and the employer.

The reform also simplifies processes and professionalizes staff in conciliation and arbitration boards (institutional bodies in charge of hearing and solving labor disputes). In fact, it centralizes the resolution of federal disputes in one Federal Board for Conciliation and Arbitration and, at the same time, improves the internal organization of both federal and local boards by making compulsory certain level of education and experience.

Furthermore, the reform increases fines and penalties for employees and employers that delay resolution processes and expands the reach of the fines for lawyers, representatives, and public servants in order to make labor resolutions more expeditious.

Regarding new ways of contracting, the new law defines and regulates outsourcing and, of special interest for young professionals, regulates first-time work. For the latter, two new forms of contracting were included: initial training (that may last from 3 to 6 months) and recruitment test (up to 6 months). In each one of these types, the worker shall enjoy the benefits and rights entitled by all the other types of workers. The reform also added seasonal contracts, which have similar characteristics to the before mentioned contracts.

These changes represent a fundamental change from the previous legislation, which established that in the absence of a contract, working relationships would be time-undetermined. In addition, the reform also established hourly salaries both for the new ways of contracting and the existing ones, which was not specified in the previous legislation.

Finally, regarding productivity, gender, and inequality, the law included for the first time a definition of productivity and made it a key feature to determine fair treatment in the promotion process. In fact, promotion by seniority or by having a family tie with an employer was substituted by aptitude and productivity as a criterion to advance in work. What's more, the law established specific prohibitions for job discrimination by gender.

The public reception of the labor reform was mixed. Proponents of the reform highlighted benefits such as: increasing access to formal jobs for young people; shortening the length of labor disputes and limiting the awards and compensations that workers or employers may receive derived from such actions; and increasing productivity and gender equality (*Secretaría del Trabajo y Previsión Social*, 2012).

In contrast, critics argued that the reform would negatively impact workers' rights. Presenting the reform in zero sum terms, they stressed the perspective that more flexible labor markets, in particular easier processes for firing workers, would benefit employers and damage employees (BBC. 2012).

More balanced assessments have emphasized that, while the reform was a good first step in making the labor market more flexible, the conflict-resolution mechanisms it includes do not increase the certainty either for the employer to avoid paying excessive payoffs or for the worker to receive something fair in return in case of a controversy (Kaplan, 2012; NEXOS, 2012). Furthermore, while greater flexibility in the formal market may encourage additional hiring, the reform cannot be said to address the huge issue of informality in a comprehensive manner.

What can be stated with certainty is that the changes embodied in the reform imply an intricate process to which governments, firms, and employers must adapt over time. It is predicted that the reform will have the following impacts on the Mexican economy:

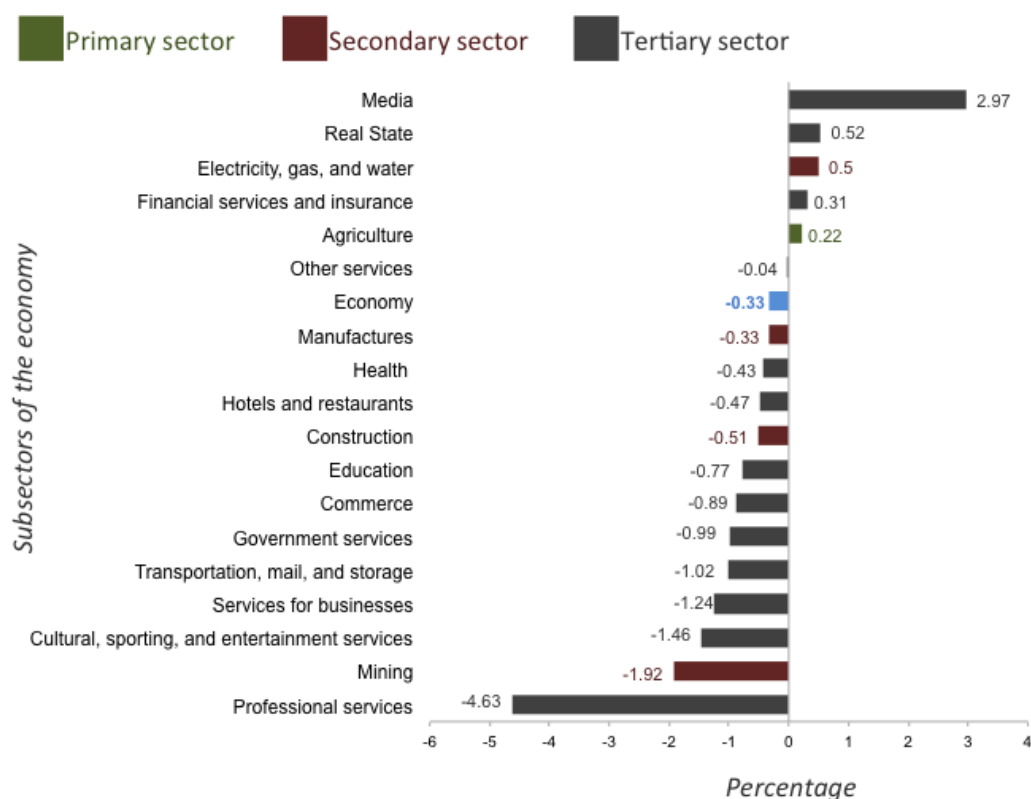
- Reduce hiring and firing costs by allowing different ways of contracting.
- Increase certainty to both employers and employees by speeding the resolution of labor disputes.
- Elevate productivity of the worker, enterprises, and the overall economy.
- Diminish transaction and administrative costs by professionalizing the judicial bodies in charge of labor-rights enforcement.

In the short-term, disappointing economic growth has meant that the government's promises regarding the job-creation aspects of the reform cannot be evaluated, and on the political front the reform has been somewhat eclipsed by the public backlash to education and energy legislation. The long-term economic effects of the labor reform will become clear over time, for now the usage of the new models of contracting is not clear under the data collected by the Federal Government and at least some attempts to measure the flexibility of the labor market have indicated that workers layoffs have been increasing but the same level of employment has been observed, situation that could mean a more efficient market (Valenzuela, 2015).

The changes included in the labor reform are aimed at attenuating issues such as low productivity and high costs. For example, by setting limits for redundancy payments, the risks and uncertainty associated with bad contracts are diminished. Similarly, by accelerating the resolution of labor disputes, the administrative costs associated with labor-rights enforcement could be reduced (Valenzuela, 2015).

Additionally, by permitting new modes of contracting, transaction costs could potentially go down. And finally, productivity is made a decisive factor for promotion, condition that may propel an economy to its potential. A way to track this over time could be total factor productivity (TFP) by subsectors. As shown in Figure 5, TFP in Mexico during the last 20 years has been stagnant across almost all subsectors; in fact the whole economy has diminished by 0.33% in the last two decades.

**Figure 5. Total Factor Productivity in Mexico, from the Value of Production, by Sectors and Subsectors of Economic Activity**  
(Growth Average 1991-2014)



Source: own elaboration with data from INEGI (2015).

## 2.2 Competition reform

Competition is a necessary condition for proper functioning of the markets. In a competitive environment, innovation allows the best emerging companies to succeed, current producers become more productive, and consumers have more choices, higher quality and better prices in both goods and services. In Mexico, this has been a problem in recent years. CIDAC (2012), one of the country's most respected think tanks, calculated the Herfindahl-Hirschman Index<sup>1</sup> for some sectors of the Mexican economy and compared them with those of the United States. The result (calculated before the reforms covered in this paper were enacted): the largest industries in Mexico do not compete on market terms because of regulatory constraints, dominance, prudential regulation or other measures, and in all cases the indicators were higher than in the U.S. These results include the monopoly in oil, the near-monopoly in electricity, and other sectors such as telecommunications, media, ground transportation, airlines, construction, and banks.

<sup>1</sup> This weights the number of firms in a certain industry and the level of competition in the markets. It goes from 0 to 10,000 where 0 represents perfect competition and 10,000 is perfect monopoly.



This situation affects all consumers but not equally, and it has pervasive effects in redistribution and development. For example, Urzúa found (2008) that in the case of consumer goods industries with little competition, the most affected are the poorest families, who have a welfare loss of 46% for rural households and nearly 40% for urban. By contrast, the richest households are losing 38% and 33%, respectively.

In June 2013, Congress approved a new Law on Economic Competition and the creation of two autonomous agencies to monitor compliance with the new provisions of the regulation: the Federal Economic Competition Commission (COFECE) and the Federal Telecommunications Institute (IFT).

Driving these changes was the fact that in Mexico there are sectors characterized by large players whose market powers provide incentives to engage in anticompetitive behavior and undue concentrations, increasing prices to consumers and reducing competition between industries. Additionally, antitrust specialists (Altamirano and Martínez, 2015) have stressed that these changes were the first to explicitly link the concepts of economic competition and consumer satisfaction.

Similarly, according to the Commissioner President of the COFECE, Alejandra Palacios (2014), the reform actually recognized two major downfalls of the economic environment in Mexico: "... on the one hand, the absence of conditions for competition in strategic sectors, which prevented the Mexican economy from achieving its potential; on the other hand, that competition policy is an extraordinary engine for growth, development, and equal opportunities for Mexicans and their families."

The stated goals of the reform were to:

- Increase the credibility and effectiveness of regulators to correct market failures and imbalances that prevent economic competition. In other words, finally there will be institutional actors that can cope with major market players in Mexico who occasionally engage in anticompetitive practices.
- Improve legal certainty and checks and balances to clearly define the scope of several sanctions, views, and opinions of regulatory bodies.
- Promote the concept of economic competition as a key element in the markets for increasing the quality of goods and services and allowing prices to adequately represent what the customer is buying.
- Increase the level of productivity in the economy by creating incentives to boost innovation, employment, and quality of products so that enterprises can be competitive.

The reform can be divided on two pillars. On the one hand, a new institutional design that creates autonomous bodies with operational and decision-making independence to interpret and enforce the law. On the other hand, the

inclusion of new tools and concepts attached to international standards to determine the lack of economic competition.

Regarding the new institutional design, the COFECE has been redesigned with seven independent commissioners, elected from a process involving both the executive and legislative branches. The main objective of the Commission is to enforce the new economic competition law in all areas of the economy, except in telecommunications. The IFT has a similar structure but is responsible for the regulation and enforcement of the rules in the telecommunications sector.

As for the tools and concepts attached to international standards, the new regulation clearly defines various concepts of economic competition such as absolute monopolistic practices or collusion, relative monopolistic practices or creating barriers due to abuse of a dominant market position, among others.

Also, the regulatory powers have been expanded, not only to punish wrongdoing but also to issue best practice guidelines, approve mergers or acquisitions, give opinions regarding permits and other regulations affecting the economic competitiveness environment, and identify and eliminate anti-competitive barriers, among others. Additionally, new specialized courts are being created in order to punish behaviors in this sector.

Both the new bodies and the new powers are subject to a new process of internal and external scrutiny such as publishing quarterly reports by each independent body and opening of the plenary sessions plus increased penalties for conflict of interest among the commissioners and periodic reviews by an external comptroller appointed by the Chamber of Deputies.

## **2.3 Fiscal reform**

Mexico's fiscal fragility has been a major concern for economic analysts and for successive governments over the past two decades. Despite the conservative fiscal strategies mentioned in an earlier section, the dependence of the Mexican government on revenues from the oil industry (specifically PEMEX), which has amounted to around 33 percent of total government revenue in recent years, has become a major source of concern, particularly given the volatility of the oil price and the drastically declining fortunes of the national oil company. Recognizing this problem, the past four administrations have all focused on dual strategies of attempting to improve oil income at the same time as they try to diversify the sources of tax revenue.

As the Peña Nieto administration contemplated an ambitious energy reform involving breaking the monopoly enjoyed by PEMEX in the oil and gas industry, it became clear that, at least in the short term, oil revenues would need to be supplemented or replaced by income from other sources.

With this in mind, the fiscal reform had as a main objective to "increase tax collection and close loopholes and exceptions" (Wilson and Valenzuela, 2014). Underlying the reform were two fundamental motivations: on the one

hand, a slight change from past administrations in the sense that the state should actively participate in the economy to trigger changes both on public investment and on the promotion of industrial activity. Secondly, progress in decoupling the budget and therefore government spending from oil revenue.

“The fiscal reform included, among others, measures that limit corporate deductions; eliminate taxes on cash deposits; establish a 10% tax on dividends; increase the income tax rate for the highest earners; harmonize the value added tax throughout the country –by eliminating the special discounted rate for the border zones–; establish special tax rates (excise taxes) for sugary drinks and snacks; and impose additional taxes on the mining industry” (Wilson and Valenzuela, 2014). Some tax simplification measures were also added to reduce administrative costs for businesses by eliminating, for example, minor corporate taxes. At the same time, some tax benefits for companies were limited such as depreciation of assets and fiscal consolidation.

This reform also included changes to guarantee the long-term fiscal balance, forcing the government to have a coherent countercyclical policy: it requires the federal government to have a surplus when the GDP growth is above trend but still maintains the flexibility to have deficit when GDP growth is less than expected.

The result of the tax reform was twofold. First, the clearest benefit is that tax revenue is increasing and, according to the Finance Secretariat, this will continue until 2018. By contrast, there are some citizen’s concerns on how that money will be used and this last point has been accompanied by the anger of the business sector, which has said that the tax reform only limited their ability to invest and thereby weakened the domestic market. Furthermore, the equalization of the sales tax in the northern of the country brought a vehement response from border-region politicians and business groups.

The tax-structure change has been particularly controversial and many experts and former officials have maintained the position that “the leading method for raising taxes should shift from the current focus on taxing income of firms and individuals to greater emphasis on taxing consumption” (Conger, 2015). It was particularly unpopular with Mexico’s middle classes, who saw their income tax rate rise from 30 percent to a high of 35 percent, while relatively little attention was placed on increasing tax compliance or addressing the broader issue of labor market informality.

## **2.4 Financial reform**

The main motivation for the financial reform was the expansion of credit to the private sector from businesses to households. As mentioned by Guillermo Ortiz, former Governor of the Central Bank, (Conger, 2015): “Mexico’s financial system is too small for the needs of the country and the challenge is to increase the penetration of banks and expand financial inclusion.”

The financial reform can be divided into four major changes or pillars. First, it aims to increase transparency in the financial sector by strengthening the regulatory powers of the National Commission for the Protection and Defense of Financial Services Users (CONDUSEF) to remove unfair terms in contracts and issue opinions about services offered by financial institutions. At the same time, the reform involved reducing costs to refinance loans and loosening legal tools so banks may offer loans, for example, through other institutions such as cooperatives and other financial corporations.

Second, it will expand the scope and functions of development banks, a set of public institutions that are part of the Mexican banking system, aimed at providing financing, technical assistance, and financial training to sectors of the economy that have difficulty finding credit, usually issuing loans in more favorable terms than the market. This change had the objective of expanding credit, especially for the small and medium enterprises, rural producers, and entrepreneurs, and is notable as a deviation from the more hands-off, market oriented approach of other economic reforms.

Third, the reform attempts to expand credit and improve its conditions. For this purpose, some rules were relaxed. For example, to guarantee loans, processes have been improved in order to protect creditors and debtors in bankruptcy procedures. This pillar was reinforced through the creation of specialized courts in the field. In the end, the idea was to remove obstacles and diminish risk to banks in order to expand loans.

And fourth, some rules were created in order to monitor the levels of capitalization of the banking institutions and the Financial Stability Board System has been created in order to coordinate and to evaluate the potential risks to domestic financial stability.

The financial reform has potentially significant macroeconomic effects, of which the following can be highlighted:

- Expand credit for individuals and businesses that have not normally had access to it such as: small and medium enterprises, small producers, and entrepreneurs, among others.
- Increase state participation in the economy, firstly, through increased revenues and secondly through increased lending by the development banks.
- Reduce overall risk in the domestic financial system through greater regulation of banks and other financial institutions.
- Strengthen regulatory institutions in the financial system and increase the capacity of the judicial branch to address these specialized topics through specific courts.

According to the World Bank's Doing Business 2016 report, Mexico advanced 4 positions, going from place 42 in 2015 to 38 in 2016 among the 189 nations

that are evaluated. The report highlights that one of the causes for such improvement was the regulatory change that expanded the description of assets granted as collateral. In fact, the country is located at the fifth place according to the “ease of getting credit” indicator, well above the average of the Latin America & The Caribbean region.

On the other hand, the same report notes that substantial improvements are expected in terms of solving insolvency cases, in order to give both creditors and debtors certainty about payments and access to guarantees to continue businesses operations. These situations are also covered by the financial reform but haven't been enacted through instruments such as a specialized court system.

## 2.5 Telecommunications reform

Along with the energy reform, changes in the telecoms sector have generated huge expectation and enthusiasm both nationally and internationally for their economic implications. Through the reforms, a number of deeply-rooted paradigms are being changed in the Mexican psyche, with the heightening of competition and greater opening to foreign and private investors.

The telecommunications reform has been justified by a diagnosis of the sector that focuses on its monopolistic nature and the subsequent high cost for consumers, which has resulted in negative spillovers for Mexican economic growth. In 2012, a study by the OECD found that in Mexico, the lack of competition in telecommunications “has led to inefficient markets that impose significant costs to the Mexican economy [...] the sector is characterized by high prices [...] and lack of competition, which results in a low rate of penetration of services and poor infrastructure development required to provide them.” According to this perspective, the telecoms sector is crucial because it provides part of the basic infrastructure for modern commerce (as well as for local and national development) in a way similar to transportation infrastructure (roads, rail and ports). By forcing an opening in the industry, the government hoped to not only lower prices for telecoms services, but in turn generate economic growth and investment.

In Mexico, under the terms of the telecoms reform, access to information and to communication technologies is now defined as a fundamental right protected by the Constitution (Cortés, 2014). Moreover, for the first time foreign investment is allowed up to 100 percent for fixed telecoms and up to 49 percent for radio and television. Similarly, the new rules command the transmission of open television in all private systems, the creation of a fiber optic network and of a new television network. In short, the substantive dimension was centered on opening the market and allowing other players to compete in it.

The regulatory and institutional dimension of the reform involved the creation of the aforementioned IFT, whose main function is to regulate the spectrum, networks, and telecommunications services. In addition, the regulator will be in charge of putting in practice legal concepts such as asymmetric regulation,

prevalence, and entry barriers. As also mentioned above, new specialized courts to resolve conflicts and thus raise the certainty to investors accompany the creation of this regulatory body.

Finally, the reform focuses on broader developmental goals in Mexican society. In general terms, the reform proposes the use of diverse bandwidths and parts of the spectrum so that broadband services, among others, may be more widely available in the country. Furthermore, the reform seeks to advance specific policies and challenges such as Internet and broadband coverage, and the transition to digital television.

This reform will not be without problems and controversies in its application. On the one hand, there is a debate regarding the use of the available frequencies and the criteria used by the regulatory body, the IFT, for its allocation, either for broadband or for TV. In this sense, the regulatory goal, as mandated by the Constitution, will be the expansion of services coverage and benefits for the majority of the population, as the country remains behind in terms of Internet penetration and telecommunications access.

One of the first actions of the IFT was to declare two of the most powerful groups in the media (Televisa) and in the telephone (TELMEX) industries as dominant economic agents, which means that they would have to comply with special rules and share their infrastructure to ensure competition in these markets. In response, Televisa successfully fight the decision in court while TELMEX initiated the divestiture of assets to avoid those special rules due to asymmetric regulation.

On the other hand, there are positive signs of international investment arriving to Mexico. In 2014, AT&T announced an investment in Mexico of more than \$3 billion USD from 2015 to 2018 to create a network that serves the entire country. Its entry strategy was the purchase of two companies (Nextel and Iusacell) and the deployment of technology to deliver broadband wireless coverage. With this bold start, AT&T will be the second operator by revenue and coverage, generating positive pressures to consumers forcing competitors to react in order not to lose market share.

So far, the clearest result of this reform has been on the telephony rates, not only with the arrival of new companies to compete in the Mexican market, both in fixed and in mobile services but also there are foreign and domestic companies that try to integrate telecommunications services among Canada, the United States of America, and Mexico. According to the Secretariat of Communications and Transportation, from January 2014 to November 2015, the international long distance prices declined 41 percent, mobile telephony decrease 28 percent, and fixed telephony went down by 4 percent.

In the same sense, according to the Global Information Technology Report 2015 of the World Economic Forum (WEF), the country climbed 10 spots (from the 79th to the 69th out of 143 countries) in the pillar of affordability mainly from the reduction on tariffs. In contrast, the same WEF report notes that the country has still significant lags in other pillars such as regulatory, tax

level, environment for innovation, widespread use of information technology, among others.

As highlighted by an analysis of The Economist Intelligence Unit (2016), although the decline in prices has helped increase penetration levels, they still remain low and in order to deepen their effects in all the population, it is necessary to increase competition and investment in infrastructure.

## 2.6 Energy reform

Reforming the energy sector in Mexico has come to be seen as the “mother of all reforms,” given its scale and the enormous implications of opening the industry to private and foreign investment. Since President Carlos Salinas de Gortari, successive Mexican governments have attempted to bring about an opening of the sector, most recently with the Felipe Calderón administration. The efforts of Calderón, as with presidents Fox, Zedillo, and Salinas before him, ultimately ended in defeat as he lacked the political support necessary to permit a constitutional change that would allow for private investment and for ending the state-run monopolies that dominate the industry.

The political environment created by the *Pacto*, of course, provided just such support for the Peña Nieto’s attempts. Even when the left-wing PRD party refused its support for the government’s reform plans, the center-right PAN party pushed the government to adopt an even more ambitious approach to the reform, allowing for an almost-complete opening of the hydrocarbons industry. As Duncan Wood (2014) has pointed out, the energy reform in Mexico was by itself an innovative and surprising process, because in a few months, it was able to achieve the political support to pass an even more ambitious reform from the one sent originally by the President.

At the first level of analysis, the energy reform attacks the problem of the inefficiencies of state-run monopolies. The constitutional reform (passed in December 2013) and the secondary legislation (approved by Congress in August 2014) transform the state-owned energy companies -Petróleos Mexicanos (PEMEX) of oil and the Federal Electricity Commission (CFE) of electricity- into productive state enterprises. This makes PEMEX look a lot more like a national oil company (NOC) than prior to the reform, when it acted as a “decentralized organ of the state.” With PEMEX now behaving more like a company, the sector has become a hybrid between public-sector and private-sector type, where the State keeps ownership of the natural resources but the market is opened to competition in all stages of the value chain, from extraction, generation, distribution and even the sale of refined products. PEMEX is to become just one, albeit huge, competing company among many.

In the case of PEMEX, it may associate with other companies to reduce its risk and to increase its investment capacity. Of a similar scope, the Federal Electricity Commission (CFE), the only state-owned company responsible for providing electricity throughout the country is going through a historical process with greater autonomy for decision-making. Under the new rules, there will be more competition in the market because both foreign and

domestic companies may enter into the generation and commercialization of electricity. CFE will keep control over the activities of transmission and distribution of electricity but can form alliances with the private sector to modernize and improve the quality of infrastructure.

Now the CFE will be an energy company that on top of controlling a significant amount of the electricity sector in Mexico, it will be capable of developing new businesses and even market primary inputs such as natural gas, fuel oil, and diesel, among others.

In the regulatory and institutional dimension, agencies that already existed as the National Hydrocarbons Commission (CNH), the Energy Regulatory Commission (CRE), and the Energy Secretariat (SENER) were strengthened and new agencies such as the National Energy Control Center (CENACE), the National Center for Control of Natural Gas (CENAGAS), and the Energy Safety and Environment Agency (ASEA) were created. All these agencies will be the regulators of different sectors and different aspects of the reform, for example CENACE and CENAGAS were strengthened to regulate the electricity and gas markets, respectively; including their distribution, transportation, and sale. (Wood and Valenzuela, 2014).

Finally, there are significant public policy and developmental dimensions of the reform. First, the government is prioritizing the creation of human capital to reap the benefits of the reform, from scholarships to study energy-related disciplines within and outside Mexico, to efforts to strengthen the Mexican Petroleum Institute (IMP) as the central agency for the research and development of the industry. Second, funds have been created to serve as tools to stabilize public finances in the long-term (the Mexican Petroleum Fund, a sovereign-wealth fund) or to promote the development of national suppliers and contractors for the energy sector (Wood and Valenzuela, 2014). Third, mechanisms have been put in place to encourage investment in renewable energy. And fourth, anti-corruption, transparency and accountability mechanisms are included at all stages of the reform.

It is clear that the energy reform has brought with it the highest expectations for its potential benefits to the Mexican economy. Promoters of the reform have argued that the reform will:

- Increase investment in the country, both public and private. Both PEMEX and CFE will have more freedom to invest. At the same time, in both the energy and the telecommunications sector, there will be incentives for Mexican and foreign businesses to invest in infrastructure.
- Increase the productivity of labor. Regulators, private and public companies, and new entrants alike will need to invest in national human capital to operate. This effect will possibly lead to increase direct and indirect employment in various areas of the sectors analyzed.
- Reduce production costs and thus become more competitive abroad. This is one of the key expected outcomes in order to strengthen the position of



national industries and to offer better conditions for foreign firms beyond relatively low labor costs.

- Improve State financial planning through the stabilization funds but also possibly increasing tax collection through royalties or other payments.
- Strengthen regulators and new specialized courts in various areas of these sectors.

Evaluating the success of the energy reform will of course take years, but there are at least two main vectors that are worth considering, according to Negroponete (2014). The first concerns tax revenues from the sector and the second relates to governance and accountability issues. Ultimately, a more productive and successful energy sector will provide great revenue to the government and help to drive economic development. Secondly, the reform must be evaluated according to the interaction that emerges between regulators, international business, labor, and government. In the early stages of the reform's implementation, the Mexican government and regulators have shown a highly encouraging level of willingness to engage in conversation with investors and market actors, and to adapt key aspects of contracts and regulations to market expectations and requirements. The current low oil price environment may delay the expected windfall from oil revenues for the government, but in the long run the reform will transform the sector.

One of the major challenges of the reform is the pace at which the government reduces its dependence on oil revenues. On the one side, there are the low international oil prices and the current instability in the exchange rate, both out of the control of the Mexican government. On the other side, there is public spending, which will be reduced by 2016 and above all, the conditions that the Secretariats of Finance, Energy and the regulators are imposing in the energy contracts in order to give both flexibility and attractiveness to the private sector in order to incentivize investment in the country. In the end, the balance in these conditions will determine when and how the government will replace oil-related taxes in its balance.

The Energy Secretariat has mentioned that the expected investment in the energy sector in Mexico over the period 2015-2019 will be of about 60 billion USD. These figures offer an optimistic scenario for the bidding processes that will continue over the next few years, since the first three rounds in 2015 (see Box 1) accounted for \$1 billion, \$3 billion, and \$1.1 billion USD, respectively. Although the revenue from the first bid were in general terms lower than expected, the market and analysts called the second and third one a good result for Mexico and with expectations of improving with more profitable and areas to be contracted in future bids.

In December 2015, the bases for the fourth tender were published. The bid, to be held between late 2016 and early 2017, has spurred enthusiasm in foreign companies as 10 areas could be licensed to exploration in deep-water fields in the Gulf of Mexico; 4 of those areas are in waters bordering the United States.

According to the Energy Secretariat, contracts may be up to 50 years, doubling the duration of previous bids. Therefore, the expected long-term investment per field is around \$4.4 billion USD. The requirements for the entry of investors are more rigid in this round. However, according to the CNH, many global giants have already applied for registration process such as the American enterprises Chevron and Hess Oil and Gas, the Norwegian Statoil, the British-Dutch Shell, and the French Total, plus the interest of PEMEX to participate in the round.

According to the Five-Year Plan (2015) of the Energy Secretariat, it is estimated that between 2015 and 2019, Mexico's government will be signing contracts for exploration and extraction of hydrocarbons in an area of more than 68,000 square miles containing about 68,000 million barrels of oil equivalent (MMboe) for the extraction areas and a prospective volume of more than 39,000 million barrels for exploration areas. These areas include deep waters deposits.

The overall progress in the implementation of the energy reform in recent months has been mixed. On the one hand, the low oil prices and the persistent low productivity have deepened the already weak financial position of PEMEX. In addition, the level of production of natural gas, the volume of fuel for refining, the elaboration of diesel, liquefied gas, and gasoline have consistently decreased (Lajous, 2015). At the same time, financial pressures from pensions, low investment and low productivity continue to haunt the Mexican company.

In this context, in early February 2016, Emilio Lozoya ceased to be General Director of PEMEX and in his place came José Antonio González Anaya, to whom President Peña Nieto commissioned two main tasks: accelerating the transformation of the company to take advantage of the new opportunities of the reform and, despite the adverse international environment, strengthen its financial performance and increase productivity.

On the other hand, in the coming months PEMEX will be launching farm-out contracts in order to form strategic alliances with private companies to increase production and efficient processes in current oil fields. In addition to this, in September 2015 the government launched a new financial instrument called *Fibra E (Fideicomiso de Inversión y Bienes Raíces Especializados en el Sector Energético)*, which resembles the master limited partnerships. Through them, both PEMEX and CFE may use assets that can credibly generate cash flows to expand investment in infrastructure. For example, PEMEX could use refineries and oil storage centers and CFE transmission and distribution lines (*Secretaría de Energía, 2015*).

The medium-term expectation is that these new instruments plus internal changes in PEMEX help increase production, under a positive scenario, by more than 40 percent during the next 10-15 years. By contrast, on a conservative or negative scenario, they will help to stabilize production with a maximum fall of 7 percent in production over the next few years (see Box 2).

So far, the progress described is for the hydrocarbons sector; however, advances in the energy reform also include the electricity sector. In January 2016, the Energy Secretariat published the terms under which CFE should be separated, both horizontally and vertically, to meet the needs of competition and market efficiency. In parallel, the wholesale electricity market was launched and has already completed the registration of the first auction of the long-term electricity market, which included clean energy certificates. These changes add up to a number of opportunities available to increase investment and the number of domestic and foreign participants in the Mexican energy market (see Box 3).

#### **Box 1. Progress of energy reform: bidding rounds**

Since 2015, the National Hydrocarbons Commission (CNH) is conducting bidding processes (also called Round One) through which private national and international enterprises can participate to win contracts in the exploration and/or extraction of oil in shallow waters, land areas, deep waters, and unconventional areas in Mexico.

On July 15, there were made available 14 exploration blocks of prospective reserves in shallow waters, although it was hoped to place between 30% and 50% of them, only 14.29% was achieved (placing only 2 of the 14 blocks).

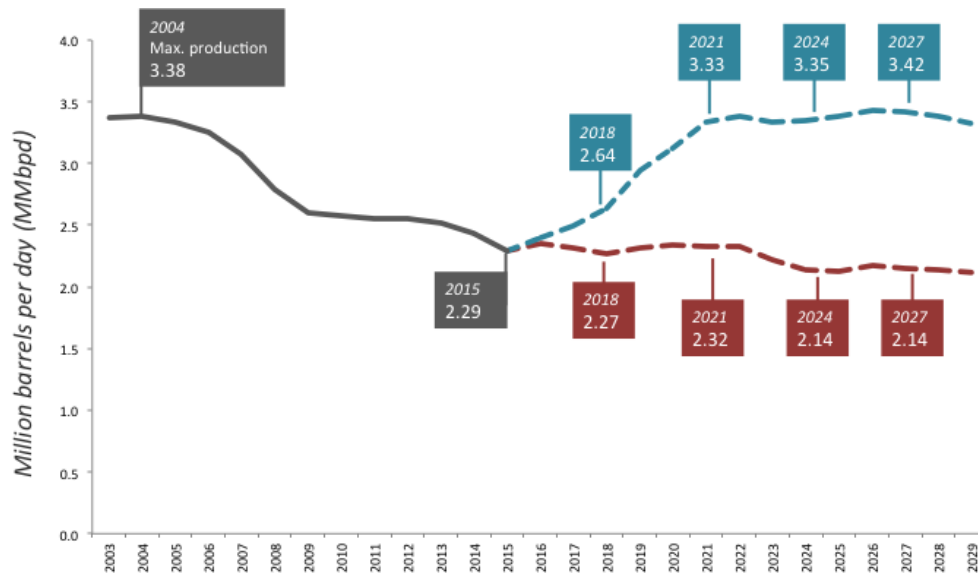
Both internal and external factors affected the outcome of this process that was characterized by transparency during the tender. For example, it was mentioned that the minimum participation sought by the government in operating utility and investment was too high for investors (40%) and also that the guarantees required against accidents were also higher than international standards. Additionally, some specialists mentioned that the fields were geologically unattractive or that the international oil price was too low to create enthusiasm. Above all, this was the first experience for the Mexican government, situation that could also had an effect both in the market and on the rules for the bidding itself.

On September 30, 5 extraction contracts involving 11 fields were tendered. This time, 60% of them was awarded (3 of the 5 blocks, 8 of the 11 fields), which included most of the probable reserves (2P) contained in the contracts. Analysts agreed that in addition to the fact that the fields were more attractive, there was an additional incentive in the fact that the Finance Secretariat reduced to 35% the average of the minimum profit required. Having said this, it was a huge surprise that the winning bids came in at so high a level, with ENI International B.V. offering almost 92% total government take.

Finally, in December 15, license contracts were tendered (the previous two processes were production-sharing contracts) to extract hydrocarbons in onshore fields. Two fields were in the Gulf of Mexico: North Fields (Campos Norte) in Tamaulipas and Veracruz and South Fields (Campos Sur) in Tabasco, Chiapas, and Veracruz, plus Burgos Fields in Tamaulipas and Nuevo León, kilometers away from the Mexico US border. All the 25 fields were awarded to Mexican, American, and Dutch companies.

## Box 2. Mexico's current and prospective oil production profile

Crude oil production in Mexico reached a record high in 2003 of 3.3 million barrels a day. On average, half of Mexico's production is for export: the US is the country with the highest percentage of Mexican oil imports with 72%, followed by Spain with 14% and India with 8%. From 2015, under a positive scenario (blue in the graph) crude oil production is expected to increase, derived from the contracts that PEMEX will sign and the fields that the Mexican government is tendering. Thus, in 2024 Mexico will have a production of 3.35 million barrels a day (MMbpd), almost the record high and more than one million barrels than what was produced in 2015. Under a negative scenario (red in the graph), crude oil production may stabilize around 2.1 MMbpd, a 7% low from current production.



Source: own elaboration with data from Secretaría de Energía and PEMEX.

**Box 3. Key dates for upcoming investment opportunities in the energy sector in Mexico**

Year	Opportunities
Starting 2015	<ul style="list-style-type: none"> <li>• From 2015 to 2019, gasoline prices are subject to maximum prices.</li> <li>• First investments in infrastructure for fuels transport and storage.</li> </ul>
2016	<ul style="list-style-type: none"> <li>• Brands other than PEMEX can sell gasoline and diesel.</li> <li>• Short-term energy market starts its operation (day-ahead and real-time options).</li> <li>• Power market of electricity starts its operation (for undercover markets and compromised capacity).</li> <li>• Auctions for transmission rights in electricity starts.</li> <li>• <i>Fibra E</i> (master limited partnerships) may start both for CFE and PEMEX.</li> <li>• Bidding round 2.*</li> </ul>
2017	<ul style="list-style-type: none"> <li>• Free import and export of crude oil, gasoline, and diesel.</li> <li>• Second stage of short-term energy market starts its operation (now including hour-ahead bidding system).</li> <li>• Bidding round 3.*</li> </ul>
2018	<ul style="list-style-type: none"> <li>• Clean energy certificates market starts its operation (it may start until 2019, depending on regulators and other markets advancements).</li> <li>• Bidding round 4.*</li> </ul>
2019 onwards	<ul style="list-style-type: none"> <li>• In 2020, price determination on gasoline will be market-based.</li> </ul>

\* The next bidding rounds will include mainly deep waters fields and unconventional resources (shale) plus alliances with PEMEX (farm-outs).

Source: own elaboration with information from Secretaría de Energía, PEMEX, CFE, and other agencies of the Mexican Government.

## 2.7 Education

Though access to primary and secondary education has improved dramatically over the past several decades, their quality remains a significant challenge. Much of the diagnosis leading to the recent education reform focused on the quality of teachers, a sensitive but important topic given the traditionally strong role of the country's teachers unions in both subnational and national politics. The unions' role in electoral politics was accompanied by a large budget and an at times dominating influence over national education policy.

At the same time, the institutional design of having a centralized curricula but decentralized implementation system, made the quality of the students vary greatly between regions. Finally, since Mexico's first standardized tests, students in basic education have been found to be significantly behind their peers around the world in their knowledge of math and science. However, instead of mobilizing government to solve the issue, awareness of the problems long paralyzed the country, instigating a search for culprits, whether teachers, families or students themselves.

The educational reform designed very significant changes in public policy and in the ideology behind the educational model. Lucrecia Santibáñez (2012), a leading expert of the education sector in Mexico, explained that there were at least three differences that distinguished this administration's efforts to make changes in the sector over previous attempts. First, the change was made at the start of an administration. Second, the powerful teachers' union (which is over 70 years old, has 1.5 million members and is the largest in Latin America) did not play a leading role in the negotiations. And thirdly, changes were made to the constitution.

With the reform, the Professional Teaching Service was created to set national rules for hiring, promotion, and retention of teachers in the system. In order to design, implement, and evaluate all these policies, an active role was given to the National Institute for Educational Assessment (INEE).

For example, for hiring, it is determined that the candidates should take examinations and other tests. For job promotions, the teachers would also have to take exams, meaning seniority stops being a key component. Finally, for retention and recognition, several areas and types of teachers are planned to be incentivized in new and distinct ways, taking into account the diversity among educators across the country.

With the reform, the involvement of families and especially parents in the educational decision-making process is enhanced. Now, parents have the right to know the administrative processes of schools and may participate in the evaluation of teachers. For the first time in Mexico, a census was taken to determine the number of teachers, schools and students that were in the various types of education (i.e. rural, technical, indigenous education, regular programs).

Specific programs were created to reduce the backlog in infrastructure that continue to affect many campuses and this strategy was supplemented with programs designed according to different situations such as: as extended hours, digital inclusion, educational equity to meet migrants, indigenous, and disabled students.

Clearly, the effects of this reform will be seen in the very long term. To be successful, it has to pass through a complex institutional framework and, above all, involves increasingly active participation of civil society, families and students. Among others, some effects on the economy that are hoped for from this reform are:

- To increase the quality of human capital through the training of teachers and students in order to transform them into more engaged and more competent individuals.
- In the medium term, increase innovation and generation of new options for economic growth resulting from better professionals.
- Address specific regional inequalities in educational standards.

Progress so far has gradually allowed having a precise diagnostic regarding the children and the teachers and therefore the authorities have more data to make effective interventions in the sector. Last September, President Peña Nieto announced the issuance of bonds and other financial instruments to raise investment in education infrastructure and almost in parallel, the Education Secretariat launched a program called *Escuelas al Centro* (Schools to the Center) that will give greater autonomy to schools to make financial and administrative decisions. On the other hand, although the reform has partially identified what is needed, it is vital to progress towards updating education techniques, teacher and students training, and curricula at all levels of education.

## 2.8 Rule of law

One of the biggest (if not the greatest) shortfalls in the Mexican transformation during the last 30 years is the absence of a genuine rule of law. The figures related to crimes, security, and confidence in the authorities are a cause for alarm. According to the 2014 National Survey of Victimization and Perception of Public Safety (ENVIPE), the total cost of insecurity and crime for the country is nearly 1.27 percent of the GDP annually. Additionally, of total crimes, 93.8 percent of them went unreported or with no investigation. Among the reasons for not reporting, the first cause is the feeling of wasting time and the second one is severe distrust in the authorities.

Many policymakers have included this situation in their agendas. In 2008, an amendment to the Criminal Justice System was approved. The central change was the shift from an inquisitorial system to an oral adversarial one.

The goals were to expand the human rights of the victim and shorten criminal proceedings.

This reform was complemented by a constitutional reform on human rights in 2011, which included in the Constitution the rights protected by international law and ratified by the Mexican State, for example the right to life, integrity, rights of children, among others.

Later in 2013, two important reforms were passed to accelerate the pace into the new adversarial system. First, a new National Code of Criminal Procedures was approved. With it, the country finally would have the same criteria in all states relating to criminal proceedings, crimes, and sentences, hopefully making procedures faster, more accurate, and more transparent. Through the new code, judicial procedures are harmonized and alternative methods of justice are included to reach a solution before presenting to a judge. Second, a new *amparo* (similar to the habeas corpus principle) law was approved. This constitutional figure is very particular to the Mexican system and is used to protect the human rights of individuals against decisions of the authorities (and now also among individuals).

These reforms and changes have a very clear and cross-cutting effect on the economy. If all respect the rules of the game, the playing field will be even, creating better conditions for entrepreneurs, investors, public servants, and society. As Conger (2015) puts it: "Having a functional rule of law in place would permeate all aspects of national and civic life and, of course, impact the economy." However, the challenge is huge and we should expect the change to be generational rather than in the short-term.

## 2.9 Transparency and anti-corruption

The issue of lack of corruption and lack of transparency has been a problem in Mexico for decades. Public servants scandals and abuses of authority have deepened two deficits of the Mexican reality, as expressed by John Bailey (2014): compliance with the law and trust in institutions. In response, we have seen a citizenry that is increasingly informed and involved in the discussions, and several think tanks and non-governmental organizations have raised their voices against corrupt officials and authorities when they commit excesses and have also promoted an agenda to establish clear rules on the matter. However, it is clear that these reforms have been advancing at a slow pace.

In 2014, a transparency reform was approved. Its key elements were: increased access to public information, consolidation of a national system and renovation of the National Institute of Transparency, Access to Information and Protection of Personal Data (INAI).

First, the list of organizations obliged to make public their information was expanded to include, on top of all branches of government, autonomous bodies, political parties, unions, and any person or company using public resources. Second, a national standard has been set so that all local governments are entitled to create state-level transparency autonomous



agencies with the same reach than the national one. Finally, the new institute has significant autonomy and its resolutions are binding and unquestionable for all authorities.

In 2015, the general rules for what will be a National Anti-Corruption System were approved. The aim of the whole system will be to combat this phenomenon, which is seriously eroded in public and private spheres. The reform involves 3 main pillars to fight corruption. First, the Chief Audit Office of Mexico (ASF), which oversees revenues and expenditures of the federal government, expands its reach to oversee local institutions and investigate expenditures over the previous years. Second, the Public Administration Secretariat, which is responsible for monitoring and, where appropriate, punishing public officials involved in corruption issues, now will expand its reach and sanctions and, under the new scheme, the head of the agency has to be ratified by the Senate. And third, the office of a new and autonomous Anti-Corruption Prosecutor has been created, which will be responsible for prosecuting individuals. This new agency will be part of the new Attorney General's office that will be autonomous in 2017.

Furthermore, the reform creates two committees to oversee national policy against corruption, one involving authorities and the other including citizens. They will be in charge of the design and promotion of policy and include best practices and accountability in public policies.

Similar to the reforms and changes in the field of rule of law, these changes have the immense task of changing the public system to improve the efficient use of public resources and increase the certainty that corruption will be punished.

### Section 3. Long-term Prospects for the Mexican Economy

The reform agenda was very broad in its content and extremely successful in its approval process. Now begins an even more difficult phase: implementation. One thing is to have approved changes on paper and other very different is to translate them into actionable public policies and, hopefully, finally to take Mexico to a sustained growth and long-term development path.

As Cejudo and Ayllón (2014) have explained, in order to enforce decisions, it is not sufficient to simply obey an order or activate a process; in addition the basic conditions for that decisions to be implemented must already exist. To be successful in the implementation of the reforms, a modern public administration, enough resources, capable and committed citizens and businessmen, and effective intergovernmental coordination will all be needed, among other factors. In the end, the success of these reforms will be as broad or limited as the effective implementation capacity.

According to those interviewed by Conger (2015), there are at least 12 policies that the country should concentrate on to become more competitive: 1) rule of law and security, 2) education and human capital, 3) corruption and accountability, 4) improvements too the tax reform, 5) capital accumulation and industry policy, 6) competition, 7) rebuilding trust, 8) financial and credit system, 9) strengthening North American integration, 10) inclusive growth and productivity, 11) empowerment, and 12) correct implementation of the reforms.

The depth and scope of the reforms discussed throughout this text have enough components to tackle the before-mentioned policies and improve the competitive environment in Mexico. In that sense, there is a dual challenge: during the same period, the country will have to strengthen existing institutions along with the newly created and have to start enacting the changes in crucial sectors.

These reforms will complement the reform cycle that began 21 years ago with the ratification of NAFTA. In many ways, these changes involve more and better opportunities for Mexico's prospective economic growth. First, these reforms recognize serious gaps that the country has to close if it wants to go ahead; like opening the country to free trade, these reforms recognized the need for a profound change in the structure of the labor market, the fight against corruption, the need for more transparency and the absolute priority of having a strong rule of law.

Second, again like NAFTA, Mexico adopted international practices that have helped other countries to boost their economic growth in key sectors for the economy such as energy and telecommunications. Third, and also equal to the barriers addressed more than two decades ago by signing a free trade agreement with bigger and more developed countries, reforms try to overcome obstacles that have stopped Mexican competitiveness in the global market such as poor quality education, lack of economic competition and

weakness of regulators, and low access to credit for the majority of the population.

A major challenge will be to fight against inertia on corruption, excessive bureaucracy, low labor productivity, and low confidence in the authorities. In addition to this, security and the rule of law are pending. These areas must be improved quickly as criticism from society increases; otherwise, the promises of the reforms are pending on a line. In another sense, it seems that political competition for the 2018 Presidential election will be very close. Although around one third of Mexican voters favor leftist ideology (Wood and Valenzuela, 2015), these are divided among several political parties, situation that complicates their competitiveness in the next election. Still, it is noted that if any leftist party were to win the next presidential elections, it would be almost impossible that could reverse any of the Constitutional changes, including the contested energy reform, mainly for two reasons: first, both the PRI (President Peña Nieto's party) and the PAN (center-right) will maintain a strong presence in the legislature. Second, there were not only important vested interests from the private and public sector involved in the reform, also important institutions such as the Supreme Court has ruled out the possibility of a referendum on the energy reform, for example.

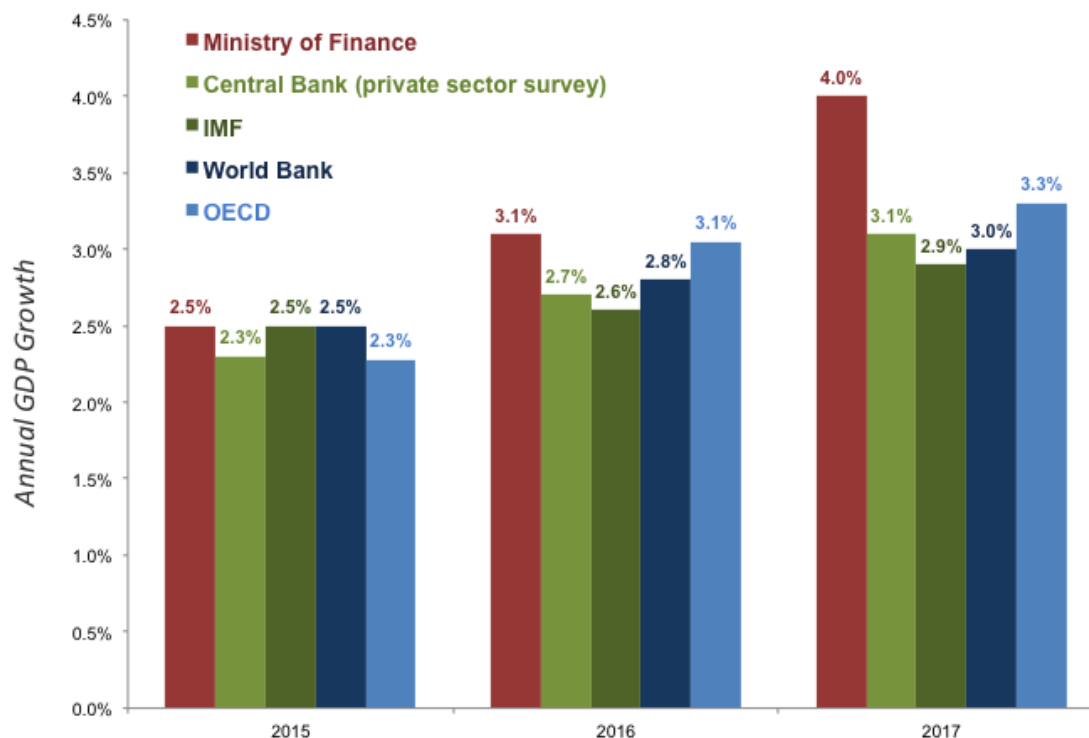
On the positive side, the country has huge demographic potential: according to the National Population Council (CONAPO), 2011 was the year in which the 15 to 24 years cohort reached its peak, with nearly 20 million people, about a sixth of the population. In a few years, they will be the largest Mexican labor force in the history of the country and, if the education reform actually works, if new enterprises are born into a more competitive environment, if there is more interest for the energy and international trade sectors, and if formalization of employment increases, they should be the drivers of a better economic environment.

In addition, Mexico has huge potential in natural resources both for petroleum-based and renewable resources. Furthermore, the Mexican market is becoming increasingly attractive to global companies, not only to produce and manufacture, but also to become the final destination of high-quality goods and services. At the same time, the country will continue to focus on increasing its integration with global value chains. The vulnerable side of the equation is that the Mexican economy is today and will continue to be highly sensitive to imbalances in the world economy in general and to the U.S. economy in particular.

In Figure 6, the forecasts for the growth of the Mexican economy for the next three years are shown. In them, there are measures of international institutions such as the International Monetary Fund (IMF), the World Bank, and the OECD plus the Ministry of Finance calculations and the Central Bank results of a monthly survey to the economists of the private sector. It can be seen the convergence towards a 2.5 percent growth for 2015 and more moderate expectations for 2016 and 2017. In the years to come, and partly as a product of the reforms, the country could climb first to a growth of near 3 percent in 2016 and slightly above that on 2017. Though the promise of Peña

Nieto that he would govern a country that achieved between 5 percent and 6 percent growth is unlikely to be fulfilled by the end of his term in 2018, the long-term future for the country appears bright.

**Figure 6. Forecast of Annual Percentage Change in Mexico's GDP (2015-2017)**



Source: own elaboration.

Note: the data for the Ministry of Finance was expressed in ranges for 2016 (2.6-3.6) and for 2017 (2.5-4-5). In this case, the average was taken. The data from the Central Bank is of the February 2016 expectations survey to the economists of the private sector. The median was taken in this case.

From late 2014 and throughout 2015 various external and internal pressures have overshadowed the progress of reforms and economic recovery has slowed in Mexico. On the one hand, the international economic environment has affected the exchange rate, which has depreciated more than 30 percent against the USD, but against other currencies it has appreciated. Similarly, international fuel prices have affected both government revenue and the participation of some international participants in the energy market in Mexico.

Furthermore, the political environment for the government during 2014-2015 was disappointing and characterized by corruption scandals and major issues of public safety as the disappearance of 43 students in Ayotzinapa, Guerrero. 2015 was also the year of the midterm elections, which made various political actors the first half of the year to focus on the logic of the political struggle in the implementation of reforms.

In this complex global economic environment, on February 17, 2016, the Finance Secretariat and the Central Bank announced some measures to ensure macroeconomic stability. On the one hand, public spending cuts were

announced for about \$7 billion USD, 75 percent of this reduction will be applied to PEMEX and the rest to other entities within the federal government and CFE. In parallel to that, the Board of Governors of the Central Bank decided to raise the overnight interest rate by 50 basis points to reach 3.75 percent. Finally, the Exchange Commission, a body formed by the two institutions, determined to stop selling dollars, a measure used to stabilize the exchange rate.

The consensus of private sector analysts welcomed these measures as signs of the Mexican government's commitment to give greater certainty to global markets and to stabilize the MXN/USD exchange rate. However, analysts also noted that the changes could affect the rate of economic growth by delaying some investments, further weakening the financial position of PEMEX, and raising the cost of credit.

## Concluding Thoughts: Mexico Stays the Course

The end of 2015 marked the halfway point for the Peña Nieto administration. The first three years have brought both highs and lows, from the passage of unprecedented economic reforms to a series of corruption and rule of law related scandals. Public confidence in the government is at a low point, but the foundations for growth are strong. During his 2015 annual Government Report (*Informe de Gobierno*), and taking stock of the state of affairs, President Peña Nieto promised to focus on public security and institution building; inequality; education; government investments in productivity and the implementation of the reforms, and growing Mexico's role on the global stage.

In early September, he made ten adjustments to his cabinet, moving former Foreign Minister José Antonio Meade to lead SEDESOL, the Secretariat of social development, an important post that heads poverty alleviation programs in the country. This strengthens his already robust curriculum; having now served as Secretary of Energy, Finance the Foreign Ministry, and now Social Development. In his place at the helm of the Foreign Ministry is now Claudia Ruiz Massieu, who previously served as Secretary of Tourism. Some have argued that she has little diplomatic experience, but she has proven herself capable of representing Mexico abroad in her former charge.

Despite some other minor modifications, it is clear that the administration has opted for continuity rather than drastic change. The two top figures in the cabinet, Secretary of the Interior Miguel Ángel Osorio Chong and Secretary of Finance Luis Videgaray remain in their posts, and the leadership of the crucially important energy ministry is untouched. Thus we can say that President Peña Nieto has signaled an awareness of the challenges facing his administration and a certain willingness to change, all the while keeping his inner circle intact. Long term, Mexico's ability to stay the course with fiscal conservatism, low inflation, and the reform agenda will depend upon the key factors of political will and governance to be able to react in a timely fashion to a changing world.

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## About the Author

Pedro Valenzuela is Chief of Staff at the Program for Energy Savings of the CFE in Mexico City. Formerly, he worked as a consultant with the Mexico Institute of the Woodrow Wilson International Center for Scholars and with Fundación IDEA/C-230. In the public sector, he was advisor to the Secretary of the Interior in Mexico and was in charge of quantitative and qualitative analyses of topics relevant to the national agenda. He holds a B.A. and an M.A. in Economics from the Instituto Tecnológico Autónomo de México (ITAM) and an M.P.P. from Georgetown University in Washington, D.C.