

Four Rule of Law Policies to Make Mexico Grow

Viridiana Rios

These are the good times for Mexico. From everything we read, hear and see, it feels like this time, nothing can stop our southern neighbor. Mexico will leap forward.

In the public's eyes, Mexico has transformed. It is now an economic partner rather than a fragile economy needing assistance. It is a forefront reformer rather than a second mover following the development prescriptions of international organizations. As some analysts have pointed out, this is Mexico's moment, the moment when it may well become the next Brazil.

But Mexico's economic growth has consistently fallen short of expectations and, unfortunately, it is already showing signals that it will again. Its GDP contracted 0.74 percent in the second quarter of 2013 over the previous quarter, and its central bank has modified its estimations from a yearly growth rate of 3.45% to just 2.96%, quite below the 3.9% at which Mexico grew in 2012.

Poor growth is not what we should expect from a country that has pushed an agenda of liberalization and free markets since at least the early nineties. Other Latin American countries with similar agendas like Chile have performed much better than Mexico. Chile's output per capita doubled during the second half of the nineties while Mexico's grew by only 20% (Hausman et al 2009). Asia is another example. As economists like Kehoe and Ruhl (2010) pointed out, while GDP per working-age person grew 8.2% yearly in China from 1985 to 2008, it grew only 0.4% in Mexico.

The puzzle is clear: Why, despite its market-friendly reforms and its strategic location as the U.S.'s southern neighbor, has Mexico performed more like Argentina and Venezuela, "the region's black sheep in terms of economic policy (Hanson 2010)"?

Most recent studies of Mexico's growth-constraints point to the same suspect: a poor justice system¹. It has been shown that its lack of rule of law was what had inhibited investors to efficiently define

¹ This is not the only constraint but one that surprises by its ubiquity in the literature. Other factors identified are lack of credit (Bergoing et al 2007, Hanson 2010), distortions of supply of non-traded inputs (Hanson 2010, De Mel et al 2008), and rigidities in the labor market (Kehoe and Ruhl 2010).

bankruptcy proceedings (Bergoing et al 2007), or to be confident that non-performing loaners would be punished (Tornell et al 2004). Without clear rules, business cannot thrive. Mexico's justice system is incapable of punishing and thus reducing the highly unproductive informal economy, and as O'Neil (2013) pointed out, public insecurity costs up to 1% of Mexico's GDP annually.

The lesson is loud and clear: Mexico's economic development will hit a wall unless the promotion of the rule of law becomes a priority.

In fact, Mexico hit this wall two decades ago. When President Salinas took office in 1989, hope abounded for the future of Mexico. Embracing an agenda of aggressive free-market reforms, his government earned international approval and political momentum. DC's establishment and DC's reformers all agreed. Mexico was unstoppable: "Like the Aztec Eagle, Mexico is rising again. The Mexican renaissance has begun," said President George H. W. Bush during one of President Salinas' visits to the U.S. President Clinton later agreed: Salinas was giving Mexico "better leadership than ever" (Preston and Dillon 2004, pg. 227). Yet, economic growth did not materialize. Instead, by 1994, Mexico went through one of its most painful economic crises: In just a week, its exchange rate went from a value of 4 pesos per dollar to 7.2.

Months before the 1994 crisis, foreign investors' confidence weakened due to events that Mexico faced as a consequence of long disregarding the construction of an effective justice system. The leading presidential candidate, Luis Donaldo Colosio was assassinated at Tijuana, some claim by organized crime, before the crisis erupted. The brother-in-law of Mexico's president, who was the head of the incumbent party and a former governor, was also assassinated a few months before Colosio. What's more, a guerrilla movement, composed of indigenous groups fighting over land issues, developed in the southern state of Chiapas.

Yet, even in front of this clear historical evidence, the construction of an effective justice system remains the weakest part of Mexico's current policy agenda.

Mexico is focusing the most on promoting economic reforms that foster productivity (fiscal, energy, telecommunications and so on), leaving the development of a solid and fair justice system as a second priority. Most of Mexico's crime and justice policies are still awaiting proper definition, or have not been fully enacted. The creation of a new and more qualified police force, called gendarmerie, which was supposed to increase federal presence by at least 40% throughout the country, has now been cut to a force of only 5,000 elements (Castillo 2012). The implementation of oral trials, which should be completed in all 32 Mexican states by the end of 2015, has only been enacted in 13 states (<https://www.reformapenalmexico.org/>). The rates of the three crimes that were selected as the main targets of this administration's security policies (extortion, kidnapping and homicide) (<http://pactopormexico.org/acuerdos/#seguridad-y-justicia>) remain about as high as they were a year ago (SNSP 2013).

In terms of rule of law, public opinion seems to have forgotten that Mexico is still the same drug-war country it was in 2012, back when all talk of Mexico centered on cartel violence. From March to May of 2013, Mexico experienced approximately the same number of homicides related to cartel battles as in 2012—which was among the bloodiest years of Mexico's drug war (Guerrero 2013).

Mexico cannot afford to keep neglecting the work of strengthening its judicial institutions, spreading the rule of law, and combating impunity because without fighting crime and injustice, Mexico is on route to repeat history—a history of economic crisis where the U.S. had to bail it out and poor economic conditions drove millions of Mexicans to migrate north and establish themselves in the U.S.

Rule of law is not a secondary concern that will automatically flourish when more favorable economic conditions limit the attractiveness of crime. It is a necessary prerequisite to grow. Rule of law provides a foundation for economic development by fostering a secure climate for investment, creating an environment of certainty about conflict resolution, providing all economic actors equal access to justice, and limiting corruption, predatory behavior and informality.

Mexico must focus on four priorities, in terms of the rule of law, to pave its way to economic growth:

First, its business community and entrepreneurs must be shielded against crime—armor shielded. Due to high crime rates, Mexican entrepreneurs are less likely to plan expansionary business ventures (Yishay and Pearlman 2010 cited by Franco 2013), and firms pay quite high monetary costs in order to avoid crime (O’Neil 2013). By 2010, 42.8% of Mexico’s firms paid for private security, spending about 2.2% of their annual sales on these services (International Finance Corporation and The World Bank, 2012). Such constraints limit the accumulation of economic factors like human and physical capital, and inhibit the technological innovation required to trigger productivity.

Business and entrepreneurs are the fuel of economic development and as such must be particularly protected. Extortion, which according to some studies affects between 19% and 38% of Mexico’s middle class (Diaz-Cayeros et al 2011), causes the loss of millions of dollars and must be contained and treated as a national security problem. Police must focus its efforts in reducing robbery on commercial routes. A good share of Mexicans do not take public transportation (15%), have cancelled trips to other states or municipalities to avoid using highways (19%), and report that at some point could not attend school (5%) due to violence and crime (INEGI, 2011).

Second, Mexico must make sure that its justice system creates certainty among economic actors. It is confidence in the certainty of contract enforcement that fosters the development of complex trade transactions and more interconnected economies, particularly in financial markets (Kessler and Rubinfeld 2007). According to the OECD, “it takes 421 days and costs 20% of the contract value to enforce a contract in Mexico whereas it takes only 75 days and 5% of the contract value in Korea” (Arias et al 2010). This is obviously a major disincentive to invest in Mexico.

Striving for justice requires creating a professional career service for prosecutors and local judges. As of now, prosecutors are selected and removed discretionally, and judges too. There are not standardized procedures to evaluate prosecutors’ performance and their salaries are quite low.

Third, Mexico needs to create conditions under which every citizen has equal access to justice such that entrepreneurial behavior can emerge in all social classes rather than just among the elite. Mexico’s liberalization resulted in the capture of many public resources by elites, which reduced competition and created an economy of monopolies (Diaz-Cayeros 2011). If this trend toward inequality and the economic concentration of firms in a few hands continues, Mexico will not be able to compete in the global

economy. Monopolies have kept the prices of the non-tradable sectors in Mexico so high that final products end up being non-competitive (Tornell et al 2004).

To empower entrepreneurs and smaller firms against stronger companies and monopolies, Mexico needs to invest in better training of its public lawyers. Only with a good public justice system, Mexican citizens will have access to justice regardless of their economic situation. As of today, public defenders are in quite precarious situations. On average, each is simultaneously in charge of 206 cases, and has a salary of only 16 thousand dollars (Cossio 2013).

Finally, Mexico must punish economically-damaging activities such as corruption, predatory behavior and informality. According to Transparency International, as recently as 2010, Mexicans paid a total of 32 billion pesos (\$2.5 billion) in bribes (The Economist 2011). Corruption is particularly damaging for the economy because it affects a country's composition of capital inflows in a way that makes it more likely to experience a currency crisis that is triggered/aided by a sudden reversal of international capital flows (Wei and Wu 2002). Informality is also a significant problem for Mexico's productivity. Calculations have shown that productivity would rise between 30% and 50% as a result of moving informal workers to the formal sector (Bosworth 1998 in Franco 2013). Given that productivity is one of the main areas of concern for Mexico's economy, it is clear that the country will not grow without first addressing corruption and punishing informality. Corruption is a disease that affects the economy in many other ways too: it weakens financial supervision, and it produces low-quality banking, firms and balance sheets (Wei and Wu 2002).

Fair punishment for crimes such as corruption, predatory behavior and informality will never be delivered unless Mexico's prison system is reformed, first to take innocent people out of prison, and then to admit the guilty. Only 57% of all inmates in Mexico have been sentenced, the rest (about 99 thousand) are still awaiting trial (Presidencia, 2012). As a result Mexico spent, just in 2012, 460 million dollars on keeping potentially innocent citizens imprisoned. Such resources could have paid for the college education of 183.6 thousand Mexican citizens².

Indeed, for all the above mentioned reasons, the rule of law is the key to Mexico's growth.

There is good news. The panorama for today's reformers is better than that faced by the nineties' reformers. Today's Mexico is much more aware of the need to tackle the constraints that have historically inhibited the country from fully achieving its economic potential. Reformers are working on reducing Mexico's credit constraints (Bergoing et al 2007, Hanson 2010) with a financial reform that will add flexibility to loan procedures; diminishing distortions of the supply of non-traded inputs (Hanson 2010, De Mel et al 2008) by promoting competition and productivity; making labor markets less rigid (Kehoe and Ruhl 2010) with the recent approval of a reform that reduces the cost of labor turnover; and improving the quality of its education system (Hausman et al 2009) with larger investments in research, education and teacher training. This is all good news since these are necessary reforms to move Mexico forward. It is not a coincidence that market confidence in Mexico has increased, translating into improved

² With 230.9 thousand prisoners (Presidencia, 2012), the average yearly public expenditure per prisoner is 4,629 dollars (total budget of prisons in 2012 was 1.07 billion dollars); this is 2.64 times the average cost of an enrollee in a public high-school, and 1.85 times a public college student.

outlooks on credit ratings. Just last March, for example, Standard & Poor's improved Mexico's long-term sovereign credit ratings outlook from "stable" to "positive."

If Mexico learns from its past, and realizes the importance of diminishing crime and having an effective justice system, the country will indeed grow this time.

Mexico now exports now more manufactured products than all of Latin America combined (Friedman 2013a); it graduates three times as many engineering students per capita as the U.S. (Anderson 2013) and as a result, is now a world leader in exporting information technology, ranked alongside India, the Philippines and China (Friedman 2013b). Furthermore, Mexico will experience a "demographic boom" in the next two decades, which will translate into having the largest proportion of employable adults in its history (CONAPO 2013). In other words, with fewer children and dependents per working adult, the country will be in a position to become significantly more productive. Additionally, Mexican women increasingly participate in the economy (30% more now than 20 years ago) and achieve higher educational attainment (INEGI 2010), which increases Mexico's available human capital.

Mexico will be able to take advantage of its situation only if justice pervades. The rule of law will pave the way for Mexico to leap forward.

About the Author

Viridiana Rios is an expert in security, justice and crime in Mexico. She holds a PhD in Government from Harvard University and is a collaborator of the “Program in Poverty and Governance” at Stanford University. All opinions are the author’s only and do not reflect her affiliations.

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