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## Chapter 17

# *Latin American and the Caribbean* **Mexico**

*Using credit ratings can be an effective means of instilling a culture of creditworthiness.*

*Steven Hochman and Miguel Valadez*

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### **Lessons**

Mexico has traditionally been a highly centralized state, with the states and local governments having centrally assigned duties and limited fiscal autonomy. Except for the local property tax, local revenue options are limited, and the states especially are heavily dependent on federal transfers. However, reforms in recent years are improving financial flexibility at the municipal level and increasing capacity to borrow in private markets.

In the 1990s Mexico's federal government inadvertently involved itself in the decisionmaking for subnational borrowing through pledged transfers and the implicit guarantee of local government bailouts that came with them. Accordingly, creditors took little time to conduct thorough evaluations of subnational finances, and some local governments borrowed beyond their means. The 1994–95 financial crisis exposed these deficiencies and necessitated a costly federal bailout program that forced a rethinking of subnational lending parameters.

To avoid a recurrence of the fiscal indiscipline and to remove itself from the local lending equation, the Mexican government instituted reforms that induced subnational governments to acquire internationally recognized credit ratings. The mandate placed the onus on banks, and thus subnational borrowers, by requiring that loans be supported by risk-weighted reserves that raised the cost of borrowing. Loans without credit ratings were assigned the highest reserve ratio. In addition, further reform to the intergovernmental transfer regime added clarity to local finances.

These positive steps, particularly the institution of credit rating requirements, have sparked the beginnings of a credit rating culture and spurred a nascent domestic capital market for subnational debt. Indeed, subnational governments have discovered that they can finance large projects more cheaply through bond issues than through bank loans. To encourage prudent local borrowing, the government has created a conservative trust fund structure for local government debt issues, a structure that is viewed favorably by international credit rating agencies and has boosted the ratings for several issues.

As the case study shows, the strong mechanisms inherent in the trust fund raise the certainty of repayment and lower risks. Thus despite the remaining institutional deficiencies in intergovernmental relations and judicial processes, a borrowing framework that demonstrates a political will to repay has allowed a viable market for subnational debt to begin to operate.

Mexico is the world's thirteenth largest economy, eighth largest exporter of goods and services, and fourth largest producer of oil. Far-reaching stabilization and structural reform efforts since the late 1980s have been rapidly transforming the Mexican economy and putting it on a faster growth track. Despite the massive setback from the 1994–95 financial crisis, the economy grew by an average of nearly 3 percent a year in the 1990s after virtually stagnating in the 1980s. The initially export-led recovery after the 1994–95 financial crisis has brought the economic growth trend close to 5 percent.

Mexico has benefited from its increasing integration with the North American economy, especially that of the United States. Trade liberalization, particularly through the North American Free Trade Agreement, has clearly contributed to Mexico's rapid economic transformation.<sup>1</sup>

## Decentralization

In the past two decades the relationship between the federal and subnational governments in Mexico has changed significantly. The enactment of the Fiscal Coordination Law in 1980, the decentralization of public services initiated in 1992, the financial bailouts of states and municipalities in 1995 and 1997, and, most recently, the introduction of credit ratings as a factor in obtaining loans all have reshaped the institutional framework.

For decades Mexico has been constitutionally a federation. However, until the 1980s there had been a trend of increasing centralization (see Giugale and others 2001). This trend has been reversed most noticeably since the mid-1990s, when the country began devolving significant spending responsibilities to the local level. Nonetheless, the federal government still dominates the fiscal landscape, raising about 94 percent of all revenues and accounting for about 70 percent of all direct spending in the country (table 17.1). As a result, the states and municipalities rely greatly on transfer payments from the central government.

**Table 17.1. Spending and Own-Source Revenues as a Share of GDP by Level of Government, Mexico, Selected Years, 1991–97 (percent)**

|              | 1991 | 1994 | 1997             |
|--------------|------|------|------------------|
| Own spending |      |      |                  |
| Federal      | 8.4  | 11.5 | 11.5             |
| State        | 3.0  | 3.2  | 4.9 <sup>a</sup> |
| Municipal    | —    | 1.2  | —                |
| Own revenues |      |      |                  |
| Federal      | —    | 16.9 | 15.8             |
| State        | —    | 0.2  | 1.0 <sup>a</sup> |
| Municipal    | —    | 0.3  | —                |

— Not available.

a. Data are for state and municipal governments combined.

Sources: Giugale and others 2001; Amieva-Huerta 1997.

Even as Mexico progresses toward greater local autonomy, fiscal responsibility, and accountability, there continues to be a noticeable lack of institutional elements to strengthen the state and local sector. Mexico has 31 states in addition to the federal district and more than 2,400 municipalities. These range widely in skills and resources. Many lack training programs, reliable information systems, agencies for coordination, and a legal and statutory framework (Giugale and others 2001). Without these, devolution remains immature and fragile. Decentralization policies have applied almost exclusively to the state level. Most municipalities received few new responsibilities even after the reforms of 1998, when a large share of the new resources allocated to municipalities were directed to federally mandated expenditures. Meanwhile, large municipalities take on many critical tasks without additional funding from the center.

Moreover, despite the increased devolution of spending, effective decentralization for Mexican states decreased throughout the 1990s. On average, states receive 85–95 percent of their revenues from federal transfers. Most transfers from the central government to the states are earmarked for specific purposes, typically to finance federally mandated employees in municipalities or for matching grants programs. The center still mandates how states are to fulfill their fiscal obligations, which is inconsistent with states' increasing political and economic power. In addition, the fiscal transfer regime is seen as too complex and opaque, based on historical inputs rather than performance or caseloads, and subject to political manipulation.<sup>2</sup> Until the late 1990s states rarely had a clear picture of how much funding they would receive, and the discretionary nature of transfers discouraged efficiency.

### **Revenues and Responsibilities: The Fiscal Coordination Law of 1980**

Mexico's Fiscal Coordination Law provides for a revenue-sharing system in which all states and municipalities participate. This system enables states and municipalities to receive a share of the federal revenue collected from various sources, the most important being the value added tax and oil revenues. About 20 percent of the federal revenue collected goes into the General Fund for Shared Revenues (*Fondo General de Participaciones*), which is distributed to the states under a formula that takes into account population, the collection effort for certain taxes (*impuestos asignables*), and a compensatory mechanism that effectively subsidizes poorer states. While states may spend these shared federal revenues, called *participaciones*, as they please, they must pass on to their municipalities at least a fifth of the shared revenues they receive.

Decentralization initiatives have led to a notable increase since 1995 in spending responsibilities shared by the states and the federal government, particularly in health and education. Expenses in these areas are covered primarily by specifically appropriated funds, or *aportaciones*. State responsibilities also include administration, state infrastructure, and security, while water supply and treatment are often municipal responsibilities. In addition, the federal government provides discretionary financing for investment in basic infrastructure programs.

There are important distinctions among these three categories of funding. Shared revenues are a recurrent revenue source but subject to fluctuation with the level of tax collections. From the perspective of state governments, they represent a flexible resource that may be used for any purpose. Appropriated funds are also recurrent but are subject to yearly appropriations. Because the use of appropriated funds is federally determined, they are a less flexible revenue source for states than are shared revenues. Discretionary financing is nonrecurring, and the amount available for a state depends on the effectiveness of its lobbying efforts. These resources are the least flexible for states, since the funds are directed to specific projects and often must be matched by state funds.

The most important tax levied by states is the payroll tax, while the most important one for municipalities is the property tax. States and municipalities also collect fees and user charges and earn interest income from financial investments. In addition, state governments use federal taxes collected at the state level that are transferred fully (such as taxes on new vehicle registrations) or partially (such as those on alcoholic beverages); there are also significant state taxes in northern border states (on cross-border activity, such as trade and tourism) and oil-producing states (on oil).

Despite the gains in financial autonomy, states and municipalities continue to have only weak revenue-raising powers, with few revenue sources, low rates, poor financial record keeping, and inefficient revenue collection procedures. Municipalities have traditionally relied on the property tax, which is levied at low rates and often (along with user charges) subject to relief.<sup>3</sup> Nonetheless, in the larger municipalities property taxes can account for 20 to 40 percent of revenue.<sup>4</sup> The potential exists for better collections, particularly for property taxes and some excises and user charges, if the political will for reform can be mustered.

### **Overview of Subnational Borrowing**

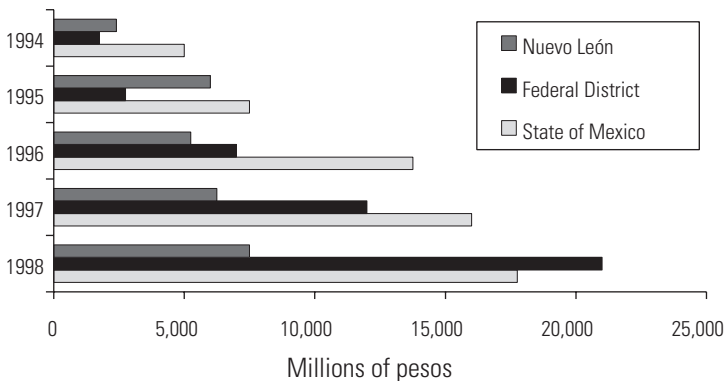
Until recently subnational borrowing was a product of Mexico's top-down intergovernmental relations, with the central government largely setting

the rules and making the decisions—on an ad hoc basis and through negotiations between players belonging to the same political party (Giugale and others 2001). However, the increased political competition in Mexico and the devolution and greater subnational autonomy led to a need for stricter and more transparent rules for governing subnational borrowing. In 2000 the Mexican Treasury promulgated a new subnational borrowing framework. The new regulations eliminated discretionary federal transfers, required lending institutions to adopt prudential limits and get risk assessments (ratings) on state debt, and provided incentives for regular financial reporting by states and municipalities.

As Mexico moved toward greater decentralization, its total subnational debt doubled between 1994 and 1998, but the debt is concentrated in a few subnational entities. Three states—the Federal District, Mexico, and Nuevo León—together account for 65 percent of the outstanding debt (figure 17.1).

### The Problem of Indiscipline: Credit Markets and Debt before and after the 1994–95 Financial Crisis

Federal transfers—general revenue-sharing funds and specifically appropriated funds—typically represent roughly 90 percent of total revenue for state governments and perhaps 70 percent or more for all but the most



Source: World Bank.

**Figure 17.1. Borrowing by Three State Governments, Mexico, 1994–98**

property-rich municipal governments. Subnational governments typically finance their major capital spending requirements through bank loans, both from commercial banks and from the government development bank, Banobras. The Mexican Constitution prohibits state and municipal governments from borrowing from foreign sources or in foreign currency. Denied access to international credit markets—markets that customarily insist on credit ratings as a lending requirement—Mexican governments that borrowed had little incentive until recently to seek independent evaluations of their credit standing.

### **Federal Revenue-Sharing Funds as Collateral**

Bank loans to Mexican states and municipalities have generally included a collateral pledge of the borrower's federal revenue-sharing funds as a debt guarantee. Lenders and borrowers alike viewed the involvement of the federal government in the process as an implicit guarantee, a perception that led some states and municipalities to borrow beyond their means and banks to lend without proper credit assessments. These factors exacerbated the financial turmoil experienced by most state governments in the fiscal crisis of 1995.

The importance of federal revenue sharing for state revenues and its relative reliability as a revenue source contributed to its use as collateral for state borrowing. The institutional arrangement supporting this practice was based on article 9 of the Fiscal Coordination Law, which authorized lenders, in the event of nonpayment by a state or municipality, to direct the federal government to deduct pledged shared revenues from state revenues and use them to pay the overdue debt service. When a government failed to pay its debt, the lender invoked the collateral pledge and intercepted that government's flow of federal funds. That left some governments with insufficient funds to pay for essential services. As a result, they sought additional financial support from the federal government, which was forced to come to their rescue. In the most recent rescues of note, mounted in 1995–97 in response to the fiscal crisis following the Mexican peso devaluation of late 1994, all states were bailed out. Many states have since refrained from borrowing, but a few have borrowed heavily.

### **Subnational Debt Profile in the Mid-1990s**

At the end of 1994 subnational (state and municipal) debt in Mexico totaled 25 billion pesos, an amount equivalent to 72.7 percent of the shared revenues received by the states that year. More than half the debt was at-

tributable to borrowers in four major states that had high ratios of debt to shared revenues: Sonora (254 percent), Nuevo León (125 percent), Jalisco (116 percent), and Mexico State (115 percent). While municipalities and smaller states tended to have lower ratios of debt to shared revenues, some had similarly high ones: Querétaro (215 percent), Quintana Roo (136 percent), Baja California Sur (121 percent), and Campeche (101 percent).

Even among states with low ratios of debt to shared revenues, some were vulnerable because they had very short debt maturities: San Luis Potosí (2.7 years), Durango (3.8), Chihuahua (4.4), and Colima (4.7 years). The average debt maturity at the end of 1994 was only 6.6 years. Assuming a constant payment schedule, subnational governments would have had to devote more than 11 percent of their annual shared revenues on average just to cover their principal payments. Further complicating the debt profile, nearly all the debt carried floating interest rates, leaving states and municipalities with sizable interest rate exposure.

### **Subnational Debt Relief Programs, 1995–98**

This debt profile points to a high degree of vulnerability. Adverse developments in late 1994 that persisted through 1997 created a situation that made debt payments unsustainable. On 20 December 1994 the Mexican peso was devalued as the exchange rate against the U.S. dollar went into freefall, sending the nation into a fiscal crisis. Short-term interest rates rose sharply in 1995, peaking at nearly 75 percent in April. An economic crisis caused federal tax revenues—and thereby the pool of shareable revenues—to contract sharply; inflation—and thereby the cost of providing government services—rose rapidly.

During 1995 most states and many municipalities, including some with relatively little debt, missed principal or interest payments or both. In some cases the default period lasted only a few weeks; in others it extended over a year. The defaults resulted from the combination of heavy debt, shrinking revenues, and soaring interest payments. Some also may have occurred in part because of a belief that the federal government would step in and provide financial assistance.

In late 1995 the federal government put together the first of two debt relief programs for states and municipalities. It offered the program to all subnational governments regardless of their level of debt. Most states and many municipalities joined the program, which involved converting old debt into a new, inflation-adjusted unit of account (*Unidad de Inversión*, or UDI) that carried fixed interest rates and extending debt maturities. This arrangement



spread debt service payments over a longer period, though at the expense of increasing the peso cost of the debt (because UDIs were adjusted for inflation). In return, state and municipal governments agreed to restore fiscal discipline, increase transparency, and improve their financial reporting.

In addition, the federal government provided direct financial assistance to many states. The amount of this aid, often earmarked for debt payment, varied with states' financial need. In 1998 the federal government sponsored a second debt relief program that lowered the interest rates charged on UDIs and further extended debt maturities, up to 18 years.

As a result of the debt relief programs and the better revenue performance after the crisis, the debt profile of Mexico's subnational governments improved substantially. The average ratio of debt to shared revenues declined from 72.7 percent in 1994 to just 38.7 percent by the end of 2001. The average debt maturity almost doubled, from 6.6 years before the financial crisis to 12.5 years in 2001.

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### **Reform of Financial Legislation: Reasons, Objectives, and Preliminary Outcomes**

To avoid a need for rescues of subnational borrowers in the future, the federal government searched for a way to accomplish the following:

- Encourage banks to give greater weight to the evaluation of intrinsic credit factors in their decisions on lending to state and local governments.
- Give state and local governments added incentives to keep their finances in order and avoid excessive borrowing.
- Reduce the likelihood of financial problems arising at the state and local levels that would require federal intervention.

### **Collateral Procedures**

Since the end of the debt relief program in 1998 the federal government has put in place several reforms aimed at preventing a need for new bailouts. As a first step it modified article 9 of the Fiscal Coordination Law, ending a bank's ability to request a direct transfer from the federal Treasury of a state or municipal government's shared revenues. The aim was to reduce the federal government's involvement in the credit relationship between lenders and government borrowers.

Instead, state governments and the banks were to determine beforehand what collateral procedures would apply if arrears emerged. However, the new arrangement did not work as expected. Commercial banks, reluctant to participate, curtailed their lending to state governments and municipalities. As a transitional mechanism, the federal government accepted a temporary “mandate” from the states to transfer pledged shared revenues, a modified version of the original scheme that did not remove the federal government from the process.

In late 1999 the federal government notified states and municipalities that it would terminate the mandate arrangement in March 2000 and announced its intention to develop a new mechanism that would minimize the federal government’s role. The mechanism, a master trust agreement (*Fideicomiso Maestro*), would enable subnational governments to use their shared revenues as debt collateral by channeling a share of these funds directly to the trust.

### **Subnational Credit Ratings**

In December 1999 Mexico’s Treasury introduced new bank regulations, the latest in a series of steps to enhance transparency in credit and capital markets and encourage state and local governments to assume greater responsibility for their own affairs. The regulations, which took effect in April 2000, require that a bank lending to a state or local government set aside capital reserves according to the risk-weighted credit exposure represented by the loan. Independently issued credit ratings serve as the measure of risk. The new regulations relate each state or local government’s credit rating to that of the federal government and require banks to set aside reserves determined by the rating gap that results. The larger the gap, the higher the capitalization requirement.

The regulations do not require state or local governments to obtain credit ratings. However, borrowers without a rating are penalized, since banks must apply the highest capital reserves—and in all likelihood will charge the highest interest rates—for these loans. The use of ratings was intended to encourage banks to give greater weight to credit factors in their lending decisions and to give state and local governments added incentives to keep their finances in order and reduce the likelihood of a new federal bailout.

Since the new regulations took effect, most states and many municipalities have obtained credit ratings. By late May 2002 all but three of Mexico’s 32 federal entities (31 states and the Federal District) had been assigned

credit ratings by at least one and, in most cases, two internationally recognized rating agencies (one state has three ratings). Some cities also have been assigned ratings, and these reveal important differences in creditworthiness between state and municipal governments. The three agencies assigning the ratings are Moody's Investors Service, Standard & Poor's, and Fitch Ratings.

A handful of negotiable debt offerings—certificates whose payment relies on state or municipal financial backing—also have been rated. As governments have grown increasingly aware that, for a large project, a certificate issue can offer lower interest costs than a bank loan, more certificate offerings are being prepared. A capital market for state and municipal governments is developing in Mexico.

Since the initial assignment of ratings, some have been raised and others lowered. When a rating is assigned or changed, the rating agencies publish press releases or reports explaining what factors support the rating and what trends may affect the rating in the future. Using these explanations and other data, some market observers have published predictions of future rating assignments for issuers not yet rated.

Growing numbers of subnational governments are submitting their financial statements to independent audits. State and municipal finance officials—and lenders—are developing the habit of asking, "What can be done to improve this rating?" or "If we borrow this much more, or if we take these steps involving government finances or debt, how would that affect the rating?" These are signs that a new credit culture is developing among state and municipal governments in Mexico.

While it is still early, it appears that the Mexican government's goals in requiring credit ratings—promoting a new credit culture and removing the federal government from the credit relationship between state and local governments and their lenders—are being realized to an extent beyond some of the most optimistic expectations.

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### **Recent Subnational Borrowing Experience, 2000–02**

The chief federal restrictions on subnational borrowing in Mexico are the ban on foreign currency loans and the requirement that the proceeds of borrowing be used solely for capital investment.<sup>5</sup> State-enacted debt laws also regulate state and municipal borrowing, requiring approval by the state congress for state borrowing in most cases and establishing parameters for short-term borrowing. Municipal borrowing typically requires only

local legislative approval if the loan is payable within the term of the borrowing administration, but longer-term debt issuance requires both municipal and state approval.

The recent legislation to improve financial and, by extension, subnational borrowing mechanisms has led to the first local government bond issues. Three subnational entities have issued debt under the master trust fund structure that the federal government proposed in 2000 (table 17.2). The Aguascalientes and San Pedro bond issues received ratings on a par with the national rating and are direct, fully binding obligations of the jurisdictions. The issues were assigned a comparatively high rating for two main reasons. Both municipalities have relatively large own-source revenues (San Pedro's are among the largest in Mexico, and Aguascalientes has robust property tax revenue). Even more crucial, however, is the secure structure provided by the trust fund arrangement.

For both municipal bond issues, the trustee of the fund is given rights to 100 percent of the municipality's shared revenues from the federal government, and all these revenues are pledged so that they can be used as a guarantee for issue repayment. Legal provisions add further security. The state government, which distributes shared revenues to municipalities, is contractually obligated to redirect the funds from the municipal treasury to the trust fund. The Fiscal Coordination Law reinforces the obligation for

**Table 17.2. Subnational Bond Issues, Mexico, 2002**

| Entity  | Date of issue    | Type of instrument                                | Rating                              | Amount (millions of pesos) | Term (years) |
|---|------------------|---|-------------------------------------|----------------------------|--------------|
| Municipality of Aguascalientes (Aguascalientes) | 11 December 2002 | Certificado Bursatil (Capital Market Certificate) | Moody's: Aaamx;<br>S&P: AAA         | 90                         | 5            |
| State of Morelos                                | 11 December 2002 | Certificates of Participation                     | Fitch: AA+(mex);<br>Moody's: Aa2mx  | 216                        | 7            |
| Municipality of San Pedro (Nuevo León)          | 24 July 2002     | Certificado Bursatil (Capital Market Certificate) | Fitch: AAA (mex);<br>Moody's: Aaamx | 110                        | 7            |
| Total   |                  |   |                                     | 416                        |              |

Source: Serrano Castro 2002.

timely revenue transfers. In addition, both the Nuevo León and Aguascalientes state governments have a history of good fiscal health and timely payment of shared revenues. Moreover, any modification to the trust's rights to shared revenues must be approved by all creditors under the trust. Both issues state that additional debt can be acquired only if debt and debt service limits have not been reached (these vary with the jurisdiction) and that the new debt must follow the same trust fund structure.

Added security for all three issues in any events that threaten the repayment schedule is provided by a trigger for advance trapping of cash for the trust (for San Pedro and Aguascalientes, at 1.5 times the monthly amount required in the repayment accounts). Bondholders can respond to serious threats to their security (such as attempts to invalidate the trust contract or provide false information) by appropriating the full share of shared revenues allowed by the bond contract to accelerate full repayment.

For all three bond issues, cross-collateralized reserve funds limit the risk of nonpayment due to revenue shortfalls. One of the more interesting differences among the issues is the payment structure. Aguascalientes uses a bullet structure that pays periodic interest until the maturity, when the full principal is paid. Both Morelos and San Pedro use amortized structures with a three-year grace period on principal. A more significant difference relates to the Morelos issue. This issue stands out not only because it does not specify debt limits but because it has a lower rating—in part because the trust for this issue does not have access to 100 percent of shared revenues even in the event of nonpayment. The maximum that the trust can request is 30 percent of the revenues pledged to and received by the state's master trust fund. That amounts to 16.4 percent of the state's shared revenues.

Accordingly, the repayment contingencies for the Morelos issue are somewhat weaker and, with a two-tier trust fund structure, subject to competing financing needs. Nonetheless, nonpayment risk is quite low because the legal structure commits 30 percent of the revenue of the master trust fund to the issue offering. Moreover, the contract cannot be changed without the approval of senior lien creditors and the state congress. This contrasts with the other two issues, for which proposed changes require unanimous creditor approval. Significantly, the purpose of the San Pedro and Morelos issues is to refinance or retire outstanding loan obligations rather than provide direct project financing.

These examples of local borrowing in Mexico show that even with deficiencies in enforcement and institutional development, subnational bor-

rowing in the bond markets is possible. What is needed is a credible payment mechanism that demonstrates the political will to ensure timely and complete repayment of debt obligations.

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## Notes

1. As a reflection of the opening of the economy, Mexico's trade (imports plus exports) as a share of GDP tripled between 1980 and 2000, reaching 40 percent.

2. At least until 1999 politically favored states were able to receive ad hoc transfers that thwarted the incentives to manage well and enhance local revenue (Giugale and others 2001).

3. The effective property tax rate in the mid-1990s was estimated to range between 0.03 and 0.05 percent. Rural areas are taxed at half the effective rate. The rates are grossly inadequate, but authorities do not want to deal with the political problems of raising them. See Amieva-Huerta (1997, p. 575).

4. Cities have been given greater ability to control land use and to determine property tax values and rates under recent constitutional amendments (article 115, approved in 1999), powers traditionally exercised by the states. But property tax rates are still subject to state approval. The reforms are seen as providing the larger cities more revenue raising power and flexibility and more discretion over revenues. See Aldrete-Sanchez (2000).

5. This section is based in large part on Moody's Investors Service rating reports for the relevant municipal bond issues.