Explaining Borrowing Patterns of Mexican Cities: The Case of the State of Guanajuato

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Summary:

This paper seeks to describe how and why municipalities in Mexico run up public debt with a particular emphasis on analyzing the circumstances and conditions under which municipalities should resort to indebtedness. More specifically, the paper analyzes when and why municipalities take on debt; the best offers (in terms of interest rates, public or private debt service); the purpose of the loans (investments in infrastructure, economic development, covering operating expenses); and the rates of repayment and/or default. The main objective is to better understand the borrowing patterns of Mexican cities and whether they run up public or private debt.

Introduction

The 2008 financial crisis hit Latin America hard, and Mexico was hit the hardest, primarily because of its close economic and commercial ties to its northern neighbor, the United States. In order to have strong financial systems to confront such upsets, local governments need be able to demonstrate their financial management to their citizens. It can be argued that by developing capital markets in emerging economies such as Mexico, better public services can be rendered and more civic engagement can be created at the local level. Recently, several academics have evaluated the ability to boost capital markets within emerging economies (Canuto and Liu 2010; Cecchetti, Mohanty, and Zampolli 2010; Cernuschi and Platz 2006; Leigland 1997; Martell and Teske 2007). Relevant research ranges from work to determine national policies on soft and hard budget constraints (Abuelafia, Berensztein, Broun, and Di Gresia 2004; Alesina and National Bureau of Economic Research. 1996; Bahl and Wallace 2005; Bailey 1984; Tabellini and Alesina 1988; Uña, Cogliandro, Bertello, Melamud, and Wang 2009), the fly paper effect (Inman 2008) and the establishing of new financial transactions in these emerging economies (Fitch ratings 2002; Fitch Ratings 2009; Torres and Zelter 1998).

For example, several scholars in Mexico have studied the "flypaper effect," which holds that the increased use of federal transfers displaces local revenue generation (Cabrero and Carrera 2002; Sour 2008; Werlin 2003). The majority of these authors found a correlation between increases in transfers with the displacement of local tax collection. The federal government in Mexico still dominates

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the majority of decisions regarding the budget, policies, and standards. Yet, there is little doubt that Mexico's fiscal decentralization efforts have ensured state governments more sovereignty and discretion to perform financial transaction than before (Merino Huerta 2008).

1. Mexico as a case

As a major federal system with a long multifaceted history of centralization and a history of recent democratization and decentralization starting in 1983, Mexico provides a good case for an analysis of fiscal decentralization, public debt and municipal autonomy (Diaz-Cayeros 2006). This is not only because of its recent political turmoil and transition from a one-party centralized controlled government and transformation into a multi-layered democracy, where election races now be conducted at the national, state, and local levels. Mexico also reformed its legal framework in 1997 to provide subnational financing and enable borrowing at the state and local level. As a major emerging economy, Mexico provides an intriguing example for other developing countries to follow.

Even as Mexico has become more democratized, many academics have acknowledged that there are several problems in the intergovernmental system (Cabrero 2000; Cabrero and Carrera 2002; Hernandez-Trillo and Jarillo-Rabling 2002; Hernandez-Trillo and Jarillo-Rabling 2008; Raich 2002; Tamayo-Flores and Hernández-Trillo 2006). For example, research (Moreno 2004; Sour 2004; Sour 2008) has suggested that the transfer funds created since 1998 have reduced the incentives of local governments to collect taxes, particularly property taxes, which are the most important tax revenue source for municipal governments.

State governments in Mexico now have greater political influence especially because the hegemonic party system is gone. States increasingly have used the formal powers granted to them by the Constitution. Municipalities have also benefited from an explicit policy of strengthening their powers and resources, which not only led to the reform of Article 115 in the Constitution on two occasions (in 1983 and 1999), but also to reforms to the national system of fiscal coordination and a long list of legislative changes (Merino Huerta 2008). Municipal governments have begun to be a principal institutional player in the operation of public policy in the federal system. Municipal governments now manage more policies such as: urban development planning, granting of building permits, the provision of public services and municipal public security. These developments have represented a loss of authority for state governors and, on many occasions, new sources of conflict between them and local councils. Furthermore, with the additional responsibilities, many local municipalities are looking for new resources to finance projects.

2. Subnational Public Debt

Mexico's most recent subnational debt policies expose another way to interpret municipal autonomy and fiscal authority. New legislation and reforms of sub-national debt financing is a way to better understand each city's ability to become independent from the national government. The new law (Article 9 of the National Fiscal Coordination Law) requires two private rating agencies to appraise municipal budgets by evaluating their financial systems, operational activities, economic profiles and performance along another eight rating criteria (such as economic, liquidity, debt, finances, systems support, etc.). The four major rating entities in Mexico include Standard & Poor's, Moody's, Fitch and HR Ratings, a local rating agency. According to one ratings firm, of Mexico's 2,454 municipalities an estimated

155 have access to commercial banks and 40 municipalities have public debt issued from private banks.

State governments are more likely to take out loans than local municipalities. Loans are used to finance a wide variety of public services such as removal of groundwater, sanitation, and telephones as well as municipal waste disposal, roads, and traffic lights. Mexican states and cities have several optional ways to take out public loans. City officials can select higher or lower interest rates and longer or shorter terms for the services by using either public or private sector packages. Figure 1 illustrates the four categories of loans which are possible in Mexico: the national development bank (blue line), trust funds loans guaranteed from own-source revenue (red line), trust fund loans with guarantees from the Mexican stock market (green line) and public loans guaranteed from future transfers (purple line). Less developed states like Chiapas, Veracruz and Coahuila take out more loans from the national development bank than from private investors or directly from the capital markets.

The private sector loan option is relatively new. Traditionally public sector loans were only issued by the National Bank of Public Works and Services (Banobras). This national development bank was established in 1933 to finance public works and municipal

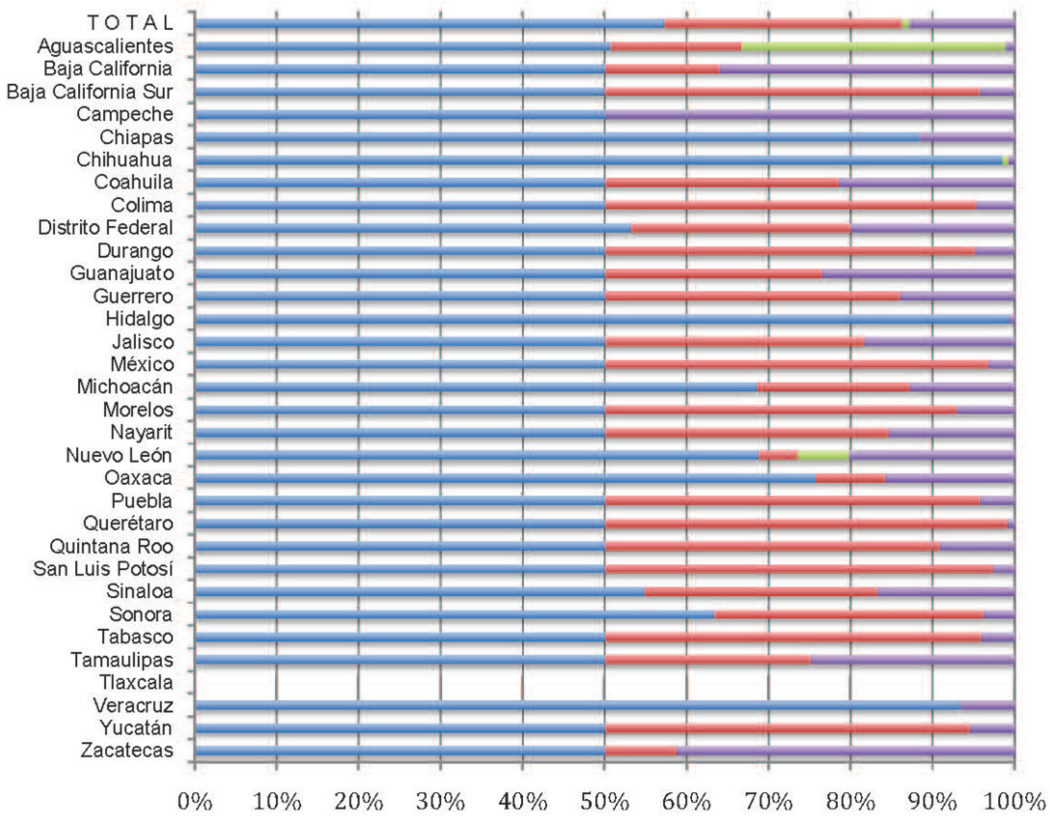

Fig. 1: Types and amounts of Public Debt of Mexican States (2008)

Source: Cámara de Diputados H. Congreso (2008 Mexico) Data measured in Current Pesos governments. Banobras managed a loan portfolio of more than $10 billion dollars in 2010. The type of loans a state selects is based more on its economic development and its appetite for risk. Banobras uses funds of the Federal Reserve to guarantee state government financing. One way of doing this is by using a trust fund as a special funding vehicle, which pays the debtors directly, while leaving a remaining funds in the Federal Reserve. This is important because of the potential influx of foreign exchange, inflation or other macroeconomic factors that devalue the funds in the account. Some states securitize their loans by promising future inter-governmental transfers to pay them directly (Thau 2011).

An alternative financing mechanism is the Bank of North America (NADB) for the Border States, which provides loans for projects that meet US environmental protection standards. Private commercial loans are also available. Most offer short term interest rates. Recently, states like Guanajuato have begun to manage a World Bank loan program, which allows access to municipal bonds. According to Mexican law, in order to protect state sovereignty, subnational governments cannot borrow without the approval of the national government.

Legally, municipalities may use loans to finance public works and other forms of economic development activities, thus allowing the national governments to implement more social programs for poverty reduction. States are discouraged, and even prohibited, from taking loans to fund re-occurring expenses, such as employee wages. Municipalities need independent audits to evaluate the costs of economic development programs. With the best allocation of resources and increased local taxes, communities can make better decisions about how to use their municipal budgets. Figure 1 shows that rather wealthier cities are more likely to engage in public debt policies in the bond market. But the question remains open as to under what types of loan terms are local governments willing to take on such debt. Therefore, we next look at one state within Mexico and evaluate three cities' public finances in order to determine borrowing patterns.

3. Case study: The State of Guanajuato, Mexico

The State of Guanajuato has the sixth largest economy in Mexico and a population of nearly five million people (4,893,812). The state is in the heart of the "Bajío," a region of fertile land, which grows much of the nation's food production. Guanajuato is also where former Mexican President Vicente Fox (2000-2006) began his political career as a Governor elected from the reform minded PAN. The state government has a unicameral legislature and a tradition of being pro-business and conservative. In recent history, Guanajuato has been instrumental in encouraging the democratic reform of the national government. Because of this, Guanajuato is often credited as having given major impetus to political decentralization in Mexico's recent history. Ultimately, the election of Vicente Fox as President of Mexico marked the end of the almost 80 years of the PRI's one-party rule of Mexico (Tulchin and Selee 2004). The PAN political party has remained in power in Guanajuato and continues this tradition.

Guanajuato is one of the smallest states in the country. However, it is also one of the most densely populated with 4,893,812 inhabitants, a density of 152 persons per kilometer. The large industrial complexes are the cities of Leon, Irapuato, and Celaya, which comprise of 42 percent of the state's population. In general, Guanajuato's population is very young. The 2005 census reported that 60 percent of the population was under the age of 30.

During President Fox's administration, the

PAN politically managed 36 municipalities within the state. Even after the regional elections in 2009, the PAN held a majority in 27 municipalities, which is nearly 80 percent of the state. The PAN's state leadership has been strong for many years. Two major factors contribute to Guanajuato's importance to national politics. The first is the traditional Catholic political movement, and the second has been the political aspirations and success of the former Coca-Cola executive and Harvard graduate, Vicente Fox.

Many people attribute the PAN's fight against the status quo from the states' tradition of *Sinarquismo*.[1] This is the political culture that originates with strong pro-Catholic, hardworking individuals. Many of the "*Sinarquistas"* political party joined the PAN after the 1964 local election, sharing many of the same values. Shortly thereafter, the party began to win municipal elections. For the past 20 years, Leon, the largest city in Guanajuato, has been managed by PAN administrations.

4. The Capital City, Guanajuato's Municipal Finances

In the capital city of Guanajuato, which bears the same name as the state, the mayor and the municipal treasurer jointly manage the city's finances. Often, these two public officials have traded positions in order to avoid the no re-election rule for municipal officials in order to maintain public policies within the municipality. According to one public official, it has been said that 40 years ago the mayor made all major budget decisions, but now there is a high reliance on the municipal treasurer, who is a certified accountant. The current official has been continuing in office through four consecutive mayoral terms and is renamed to this post after each election, which

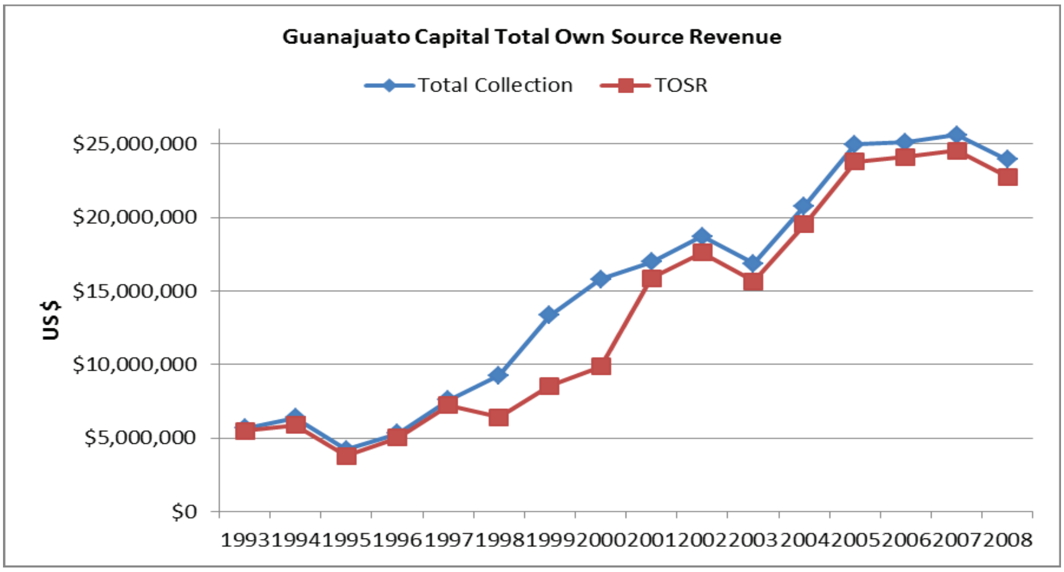

Fig. 2. Total Own-source Revenues in Guanajuato (capital)

Source: INEGI

[1] The sinarquistas comes from the National Synarchist Union (Unión NacionalSinarquista) is a Mexican political organization founded in Leon Guanajuato in 1937 as part of the Roman Catholic extreme right, in some ways similar to clerical fascism which, violently opposed to the secularist policies of the PNR, PRM, and PRI governments that ruled Mexico from 1929 to 2000.

occurs every three years. The municipal treasurer testified that his continuing role as treasurer has helped to solidify the finances of the city and its public policies. As Figure 2 demonstrates, the city relies heavily on collecting its own tax revenue to finance its activities. Its own-source revenue is nearly the same as the total collection rates.

The city's excellent record of financial solvency is due to the skill and efforts of its well-educated municipal staff. For example, the city took the very unusual initiative of annexing the Museo de Las Momias (Mummy Museum), one of the country's archeological treasures, to increase local revenues. With the museum's administration under the auspice of the municipality, the museum has generated supplementary revenue totaling more than the city's property tax revenues, rents, and fees combined. which attracts tourists annually to the city.

Guanajuato's largest revenue source is the mummy museum. Additional funds come from 1) revenues generated by the municipality; 2) property taxes; and 3) general services such as organizing events in locations, charging for home sales and cultural funds from tourism (which includes sales tax on general goods, rent of equipment and hotel tax). Of the nearly US$ 33 million dollars generated by the state government in tourism annually, almost 35 percent, or about US$ 12 million dollars are given back to the local governments. Figure 3 disaggregates the spending of the city of Guanajuato. Much revenue is transferred back to the state and national government as their part of revenue sharing.

After the 1997 revenue decentralization reforms, Guanajuato has more funds to

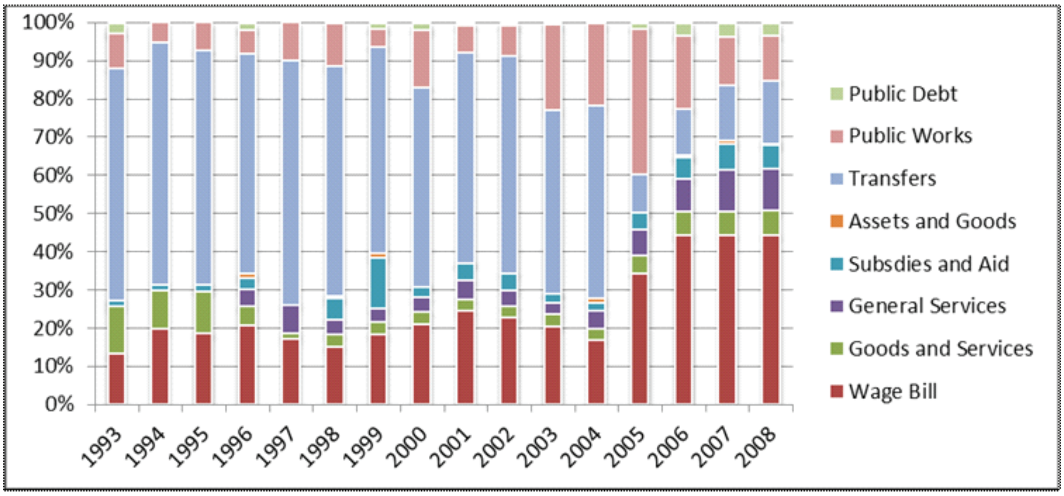

Fig. 3. Disaggregated Spending in Guanajuato (capital)

Source: INEGI

This translates into the ability to make more investments in public works and the tourism sector. For example, Guanajuato is the first place where the Spanish extracted gold and silver within the Americas. As such, the city has developed a cultural tradition of celebrating the *Cervantino* street festival, allocate to the municipal projects. Of its total transfers from the federal government, the city receives an estimated 65 percent from transfer law 28 and 35 percent from transfer law 33. Law 33 has helped to strengthen local infrastructure. On the other hand, funds from law 28 can be spent on current expenditures, debt, and public projects. However, the municipality cannot pay for civil servants (wage bill), which cannot reach over 16 percent of recurring costs, with these funds.

In the past, the state managed all municipal finances and tax collection, but now the city has its own system for the management of its tax base. According to one public official, current expenditures are typical for this size city. Social investment funds cannot be more than 17 percent of the total expenditures, and these funds must be allocated for improving housing, school, and family assistance programs, which consists of six percent of the budget. Employment operation, or salaries, are approximately 40 percent of budgets and include nearly 1,500 employees. One way the city manages the budget is by minimizing spending on personnel.

In 2009, the city borrowed US$3 million dollars from the Bank of Bajío at four percent annual interest set for ten years. The law prohibits long-term debt for current expenditures, but allows financing for infrastructure and development. In 2005, the city had a loan program of US$6 million dollars and received matching funds from the State's World Bank ten-year loan.[2] The city took advantage of this financing program and made improvements to its tourism sector through a citywide beatification project.

The city's plan is to "improve its urban vision," which consists of 12 steps to improve streets, sidewalks, and monuments. The principal decision to take out private debt was to restore public areas and fix streets, urban store fronts and pavement. Nearly US 1.5 million dollars was dedicated to construction projects (the remaining amount was used to pay other city debts). From 2004 to 2009, the city increased its revenues by 45 percent, even with inflation rates at four and a half to five percent. Nearly 25 percent of this increase came from fines, which increased from nearly $21 million to $33 million dollars over that period. Local tax collection was helped when the city redefined its property tax assessment, which also systematized property tax payments and created a better auditing system.

Finally, the city has high levels of technical capacity in order to manage financial products and projects. Public finances have become innovative. For example, the Mummy Museum was personally requested by the mayor's office to be transferred to first a state agency, until subsequently the city could take it over. The level of professional development (e.g. education) allows for better technical management of projects. The capacity of municipal staff to manage the budget is important. For instance, pension funds are being used to finance projects. A national law allows retirement accounts to be used for public investments. In general, city officials have been slow to do this because of the potential risk. Yet, Guanajuato's public works office used its pension funds to fund a parking lot and commercial center and has recuperated 75 percent of the investment.

San Miguel's Municipal Finances

San Miguel de Allende (SMA) is a mid-size town within the State of Guanajuato that has a large amount of tourism, a thriving artist community, and an increasingly large amount of foreign-born residents who enjoy both its beauty and the arts community. American residents heavily influence the city and encourage its prospects for

[2] Trust funds (fidecomisos) are instruments used by the state and municipalities to finance projects. The funds are put into separate accounts and receive national backing by the automatic payments from of Ramo 28, which are the unconditional transfers from the federal treasury to the state governments.

economic development with their substantial financial resources. With respect to the fiscal solvency of the municipal budget, San Miguel has increased its wealth by having affluent migrants living in the community. The city also has worked to increase its property values in order to provide more financial revenues to improve municipal programs.

The municipal budget of San Miguel de Allende is rather small. The annual budget is estimated to be around US 3 million dollars, where 1 million in taxes is collected locally, 1.5 million is transferred from federal funds and a half million dollars comes from the budget. He admitted that the municipality had problems caused by offering too many benefits to staff. Benefits are another way that the city spends its budget on human resources. Figure 4 disaggregates spending by the city. In effect, the wage bill was as high as 50 percent in 1998 and decreased to less than 20 percent in 2008. The percentages of its expenditures by type of activity are found in Figure 4.

The budget expenditures include a large share allocated to the municipal wage bill. The next highest expenses included public works and goods and services and, finally,

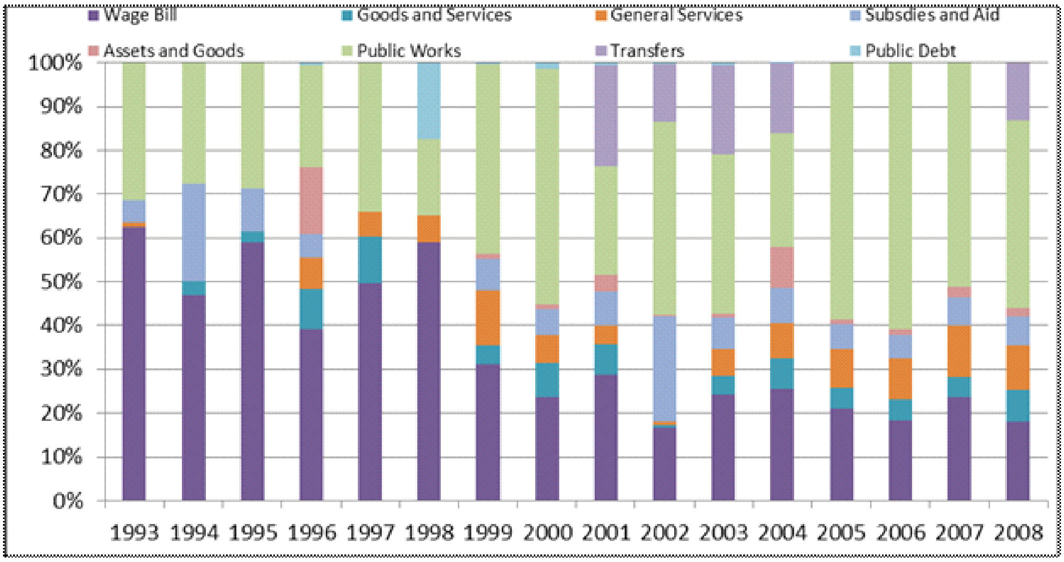

Fig 4: Disaggregated Spending in San Miguel de Allende *Source: INEGI*

State of Guanajuato. Nearly one quarter of the local tax collection comes from property taxes. In 2009, the city took out a nine year loan for city improvements which was to be paid for with 25 percent taxes and with an interest rate of 1.5 percent, which was financed through the state and the national development bank, Banobras.

One public official indicated that cutting costs within the municipality is done by not offering overtime employment to employees, which is critical for maintaining a balanced payments for transfers to the national government. Figure 5 describes the total own-source revenue (TOSR) as part the total revenue collection for the city. It can be noted that the collections were closer to the local collections prior to the decentralization laws in 1997. Afterwards, the total budget increased substantially, yet the TOSR has retained its relatively low level.

The local budget is posted annually on the municipality's Website as a government

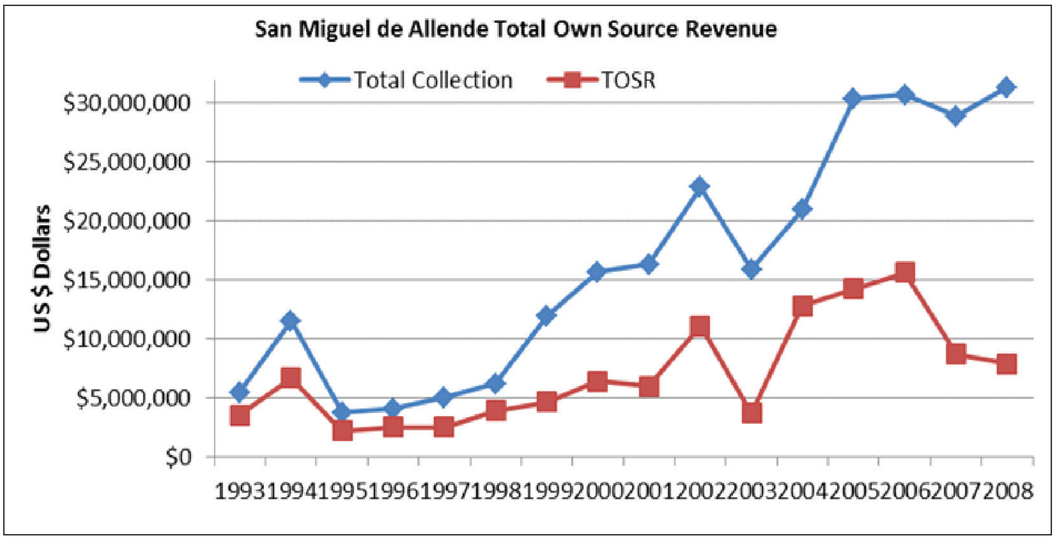

Fig 5: Total Own-source Revenues in San Miguel de Allende *Source: INEGI*

report. Generally, estimations of the budget's expenses include 50 percent for public works (which is composed of half local funds, and the rest from national and state funds); 25 percent social programs (where 80 percent comes from the national Social Fund), and the remaining 25 percent is used for the municipality's operations. The municipal staff totals 911 employees.

Leon's Municipal Finances

Leon is one of the largest cities in Mexico. The municipality meets with the G10, which is a conglomeration of the largest city governments of Mexico and was established by President Fox. In 2009, the City managed

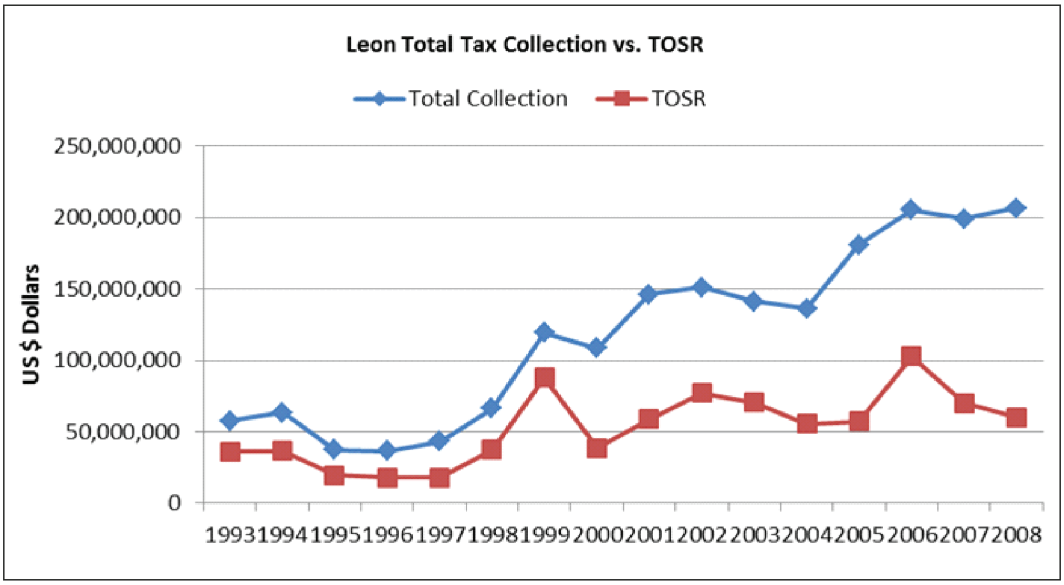

Fig 6: the percentage of TOSR collected by the municipality of Leon. Source: INEGI

a budget of US 169 million dollars. From the city's total local budget, 43 percent is collected locally compared to 57 percent in transfers from the national government. Public investments have increased the city's development efforts. Leon was rated from level of government. Most likely these are sent to the Congress which redistributes them back to the states. The other areas of expenditures include assets, subsidies, services, public works, and a very small amount for public debt.

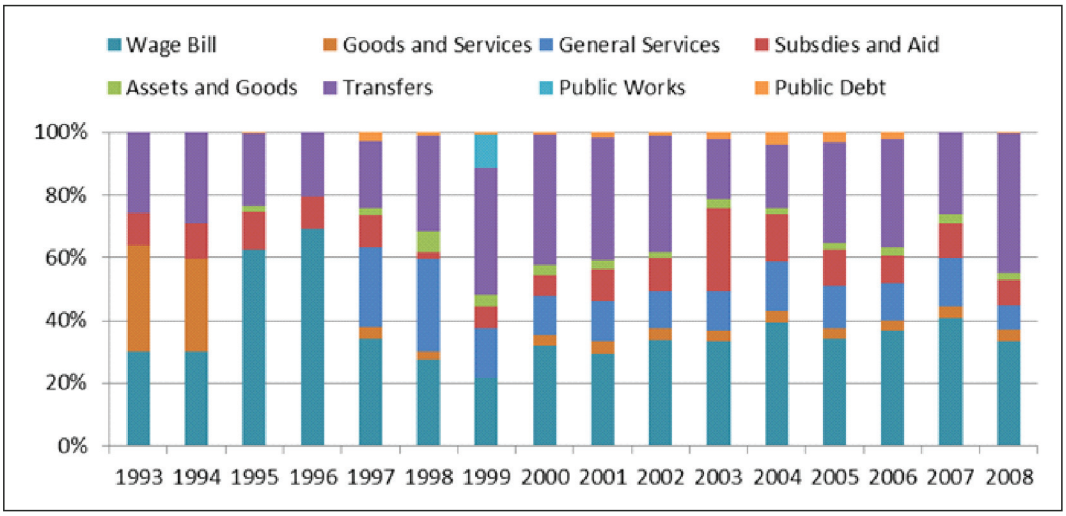

Fig 7: Leon's Disaggregated Spending (1993-2008) *Source: INEGI*

S&P as AAMx and Moody's as Baa3 for its municipal bonds. The city has public debt of $125 million pesos (which is approximately 10 million dollars) as part of its local budget, which it took out from Banco Baj⊠o, a private bank. The city employee's trust fund was created with 40 percent state, 20 percent neighborhoods, and 40 percent municipal financing and is used for financing projects. Figure 6 highlights that Leon's total own source revenue generation has been proportional to its total budget, but has continuously decreased since the 1997 fiscal financial rules change from the federal law.

Figure 7, on the next page, presents the amount of spending for the city of Leon. The wage bill is nearly 30 percent of the total, with the next highest expenditure being transfers, which are funds that the city receives and redistributes to the higher

The city's first public debt was with the private sector prior to state's interaction with the World Bank. In 1992, the mayor initiated an increase in urban development activities, citizen participation and improved the collection of local property taxes. From 1982-1990, the city restructured its property tax rolls, applying a new property tax structure. This involved hiring small crop airplanes to fly over the territory of the city and take photographic images. One municipal administrator suggested that it was through the leadership of a strong the mayor that the new payment system was developed and the tax rolls for the municipality improved.

In 1992-93, the city again implemented a new tax-base system with airplane scans to evaluate its land base. Around the same time, the city government hired a cartographer to evaluate the land. Shortly thereafter, the city government requested that the public pay an estimated tax rate for their property. If a citizen did not pay the new rate, the city would charge the new rate plus five years of back payments. This encouraged people to pay their effective property values. As a result, the municipality increased its tax revenue by 92 percent.[3]

In 2003, the city increased the tax revenue again through an administrative change. The municipal offices of the treasury, cadastre, and development planning were forged to work together to increase local revenues. The municipality bought a computer server to create an online evaluation of property, which would be combined with the citizens' tax bills through a new Internet-based payment system. Thus, it transformed its procurement system of payments, its land management and its tax collection system into one system. The State's planning agency, which reviews the State's operational costs and evaluates the costs for the treasury, assisted in developing the revenue for the construction projects. Taxes at the local level are generated through property, special events, and fines for transit exclusively. The city of Leon's interest rate for their public loan is at two percent. The city posts their reports on the Website to be transparent.[4]

The city liquidated its 1990s public debt, which was set in pesos instead of U.S. dollars. The city managed to lower the repayment plan after the change in rates from the "Tequila Crisis" of 1994 when defaults were high. The loan paid off was 23 million dollars and a new line of credit of about 32 million dollars was taken out. At that time, the World Bank loan forced the state to use Banobras, which had higher interest rates. With the Banobras loan, the state paid back its debt in Mexican pesos in 2007. In November 2008, the city started a new line of credit at two percent interest. According to one public official, the World Bank offered higher rates than the private sector. For example, the Banco de Bajío has lower rates, but at a shorter term. With these rates, the municipality has to abide by the law as to how much it can take out in public loans.

Administrative capacity is high in Leon. For example, one public administrator remarked, "public debt isn't bad—it's how you spend the money that counts. The problems most municipalities have are the quality and capacity of the workers.

5. Conclusion

This paper has described the types of public debt for municipalities in Mexico. Due to various fiscal reforms, local governments are now better able to manage their resources. For example, they can now make complex financial decisions about their budgets. Municipal bonds are used not only for infrastructure, but also for managing the budget when extra revenue is needed, such as for paying wages and other expenses. Today, most large international banks provide loans for infrastructure managed at the national level with large amounts of national debt.

It was assumed that with a higher degree of fiscal decentralization, a country would be more likely to have fiscally autonomous states and cities. This research suggests that in reality, the history of inter-governmental relations is much more

[3] According to one public official, from 1997 to 2009, levies to property taxes went from $40 million pesos to $3,500 million pesos in tax revenue.

[4] The city's Website (www.leon.gob.mx) posts its month budget but does not aggregate the numbers, they do not report numbers programmatically and thus cause significant difficultly for researching expenditure and revenue generation. Once a new city administration comes on board they typically delete their predecessors Web site so there is no historic data to review on how the city has projected

complex. Whereas Mexico has recently seen an increase of fiscal decentralization and a stronger commitment by the national government to decentralize, principally after the 1997 reforms, the country has mostly decentralized expenditures, and, only to a very limited degree, has decentralized revenue raising capacity such as increasing taxes or assuming debt by issuing bonds

Decisions to take out public loans for a city are based more on its political interaction with higher level political actors than on the financial benefits for the city. For example, small cities such as San Miguel have only used the public bank option, Banobras, for their public debt. Guanajuato and Leon were more cosmopolitan and took out loans from a private commercial bank. Both cities paid their loans back when the state decided to take out a larger loan from the World Bank, yet the interest rate was high with the World Bank funds. So why would a public official take such a deal? Perhaps it was because of the technical assistance offered by the World Bank, yet, several officials complained of the bureaucratic processes and the additional paperwork involved with this loan. Another official offered that this type of project led to more public acknowledgment for their work by the national and state government and the citizens themselves. It is not that the cities are always looking for the best price, but favorable publicity also is key.

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