

TAX REFORM IN MEXICO

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OVERVIEW

- **In the past, changes to Mexico's tax code were often motivated more by the need to raise revenue than by a strategic decision to improve the nation's tax system.**
- **The Fox administration's inability to negotiate an agreement with congressional leaders to win approval of the tax bill was of secondary importance to Congress's outright opposition to the tax proposal itself.**
- **Ultimately, political support for tax reform will depend on the public's perception of the government's efforts to implement austerity and fight corruption as genuine.**

The Failure of Tax Reform in Mexico

In his inaugural address on December 1, 2000, President Vicente Fox pledged to pursue a comprehensive tax reform. As it would turn out, however, his approach would only focus on consumption taxes. After five months in office, Fox submitted a proposal to Congress that relied mainly on raising value-added tax (VAT) revenues by extending this tax to food and medicine. In spite of the logic behind this proposal, it did not meet the public's expectations for change that the new government had inspired during the presidential campaign. Moreover, the administration submitted the proposal without first conducting a comprehensive study of its redistributive impact or even explaining why the proposed tax reform veered away from Mexico's traditional reliance on consumption and income taxes to balance the tax burden among social groups. Fox's initiative thus offered a conventional fiscal package (proposing a regressive tax) rather than a profound tax reform that demonstrated the government's ingenuity in maximizing potential tax revenue.

Previous administrations had also tinkered with VAT rates: the Salinas administration lowered VAT rates in 1992, assigning a zero rate to food and medicine, whereas the Zedillo administration raised VAT rates in 1995 but kept the zero rate on food and medicine intact. Before leaving

office, however, the Zedillo administration modified its thinking and recommended higher VAT rates on food and medicine, further eroding the image of change that Fox had cultivated in his campaign.¹

The Fox administration's first error lay in its failure to appreciate that the public image that had been created during the campaign was one of an efficient, businesslike, and pragmatic government that would adopt no-nonsense policies, not a government that would increase expenditures and raise taxes. Like a newly appointed CEO in charge of restructuring an ailing firm, the Fox administration was compelled to make deep cuts in the bloated bureaucracy it had inherited from its predecessor, the Institutional Revolutionary Party (PRI), and eliminate—rather than create—bureaucratic structures. A proposal to raise taxes should have come only as a second stage of Fox's reform efforts, preferably not while the country was in a recession. Ultimately, political support for tax reform depended on whether the public perceived the administration's efforts to implement austerity and fight corruption and crime to be genuine.

¹ Fox finally gave up the hope of distinguishing his government from that of his predecessors when, in fall 2003, he offered the Institutional Revolutionary Party's president, Roberto Madrazo, an opportunity "to co-govern change." See Lorenzo Meyer "El futuro inmediato o más de lo mismo," *Reforma*, Enfoque (supplement), January 4, 2004, p. 6.

A second flaw in Fox's proposal was that his tax reform strategy was based on a misdiagnosis of Mexico's social and political climate. Public opinion carried a great deal of weight with many of the political actors who would influence the outcome of the congressional debate on Fox's tax reform proposal, especially members of the PRI. Rather than automatically supporting the executive branch's proposal, as Congress would have done under a PRI government, on matters of national importance PRI legislators, who belonged to the opposition for the first time, now tended to side with public opinion rather than with the president.

The Fox administration's misdiagnosis of the political environment was evident during the long public debate on tax reform, during which the administration insisted that a flat value-added tax rate was the optimum way to reduce the incidence of tax evasion and boost revenues. The public showed little interest in the technical issues of taxation, however, focusing instead on their perception that a new tax on basic consumption goods would have a disproportionate negative impact on the working class.

The government disregarded the public sentiment revealed by opinion polls,² and it also misread the opposition in Congress as based on isolated political interests. Meanwhile, Congress capitalized on the opportunity to oppose new taxes and emerge as a representative of the best interests of the people. Fox insisted that the Congress's inability to propose an alternative would discredit the legislature in the eyes of businesses and international financial institutions. The general public, however, continued to side with the opposition to the proposal. This may partially explain the PRI's otherwise surprising recovery in the midterm elections in July 2003. The Fox government's loss of significant political capital should not be underestimated.

An extended political debate on the tax reform proposal revealed a widening gap between the opinions of the middle class and the working class on the one hand and that of business groups and the government on the other. This gap would prove to be pernicious when the administration proposed further initiatives that the business sector would

² In April 2001, shortly after the tax reform bill was submitted, 71.7 percent of those surveyed in a national poll believed that the reform would hurt the poor. This percentage grew to 76 percent in a poll conducted in December 2003. Similarly, those who thought the reform would improve income distribution amounted to 21 percent in an April 2001 poll and 12 percent in a December 2003 poll. See Mund Americas, "Estudio Mundos," April 14, 2001, and written communications to the author from the pollster; available at <http://www.mundamericas.com>.

otherwise have welcomed but that, under the circumstances, generated opposition among citizens' groups and the general public.³

With the benefit of hindsight, when the failure of tax reform in 2001 and 2003 is examined, it seems that the administration's inability to effectively negotiate an agreement with congressional leaders to win approval of the tax bill was of secondary importance to Congress's outright opposition to the tax proposal itself. For that reason it is difficult to imagine that more able political negotiators alone would have been able to achieve legislative passage of a tax reform bill in either of these cases.

The failure of tax reform has entailed a much higher cost to the administration than the 1.2 percent of the gross domestic product (GDP) in additional revenues that it was estimated to produce. Other costs included the loss of the public goodwill toward the government, the administration's growing detachment from a wide base of potential support that could be mobilized to pursue other reforms, Mexico's lost prestige with international investors, and the loss of momentum to develop and move forward with Fox's agenda for structural change. Therefore, it is not an exaggeration to say that the failure of Fox's tax proposal was the Mexican government's greatest defeat since the peso crisis in 1994.

Poorly coordinated governments do not necessarily learn from experience. The misdiagnosis of the opposition to the 2001 tax proposal was repeated when Fox submitted his new tax reform proposal in 2003. After the PRI won the majority of seats in the Chamber of Deputies in July 2003, the Fox administration tried to get a similar tax bill approved by brokering a deal with a small faction of PRI deputies who were predisposed to support the reform before submitting a new bill to Congress. Although this group of PRI legislators was apparently convinced of the feasibility of the proposal—which they had a hand in authoring by lowering the VAT rate from 15 percent to 10 percent before extending it to food and medicine—the initiative was ultimately unable to gain the support of the party's rank and file in Congress. This second attempt elevated the issue of the VAT on food and medicine to the level of a cause célèbre capable of unifying large social groups in opposition to the reform. The unsuccessful legislative tactic of attempting to split the PRI vote by negotiating with like-minded PRI legislators has left a lasting imprint of ill will

³ A conflict erupted between the government and a grassroots community where Fox had won the vote in the 2000 presidential election. This was caused by government errors in planning and executing a land expropriation for the construction of a new airport in Mexico City, a plan that also ended in collapse.

within the PRI leadership and may augur poorly for other reforms on the government's agenda.

Why Raise Taxes?

Table 1 (see page 9) shows public finances for selected years over the past decade as a percentage of GDP and illustrates the stagnation of revenue and public expenditure requirements. Revenues have not risen significantly with the exception of those coming from the VAT, which rose modestly from 2.4 percent to 3.9 percent of GDP between 1992 and 2003. The figures clearly show that, despite efforts to simplify the tax code and reduce tax rates, the share of revenue from income taxes has barely increased. In addition, although the table does not include these data, revenue from special taxes has fluctuated, and revenue from import taxes has declined. Moreover, most of the 1.5 percent increase in income from the VAT is attributable to the higher tax rate, which went from 10 percent to 15 percent in the aftermath of the 1994 peso crisis.

A second feature of Mexico's public finances shown in table 1 is the fluctuation in the revenue provided by royalties from hydrocarbons—between 2 percent and 4 percent of GDP. This revenue is the main contribution to federal revenue by the state-owned petroleum company, Pemex, and has exceeded 3.5 percent only in extraordinary circumstances when oil prices were very high, as was the case in 2003. The amount of royalties, however, may fall sharply from one year to the next if oil prices drop as they did in 1999, when falling prices forced the government to cut public spending three times in one year. Mexico's vulnerability to fluctuating oil prices is demonstrated by the fact that, despite a significant slowdown in the growth of tax revenue in 2003 (to only 0.8 percent), budgeted revenue increased by 12.1 percent in real terms, as the data in table 2 (see page 9) show. Thus, the slowdown was more than offset by the revenue from hydrocarbon royalties, which jumped by 80.2 percent between 2002 and 2003. Apart from these royalties, the public sector receives other oil revenues for the income accruing to Pemex and from the taxes levied on production and consumption of oil-related goods. The total contribution of oil revenue has fluctuated between 25 percent and 32 percent of total public-sector revenue in the period shown in the table.

Discretionary public spending fell sharply between 1992 and 1999, in large part as a result of the privatization of state entities, whose revenues had previously been part of the public sector's income. In addition, discretionary expenditures were reduced in the early 1980s because of a decision to reduce the size of the government bureaucracy in response to international consensus that bloated and inefficient state structures were an impediment to economic

efficiency. As entities were privatized and markets deregulated, policymakers considered the resulting lower share of public spending a positive outcome. The Fox administration has reversed these policies, seeking to collect more in order to spend more. Even without implementing tax reform, between 1999 and 2003, discretionary spending has risen by as much as 3.3 percent of GDP, much of it funded by additional revenue from hydrocarbon royalties.

The administration's greatest mistake, however, was its failure to recognize from the very beginning that its predecessor had increased public spending by 12.9 percent in real terms in the year 2000 alone. This \$26-billion peso increase in expenditures between 1999 and 2000 (shown in table 3 on page 10) was more than twice the amount that would have been generated as a result of the tax reform proposal pursued in 2001. The error lay in not treating this spending as extraordinary and hence a one-time occurrence. After all, a sharp spending increase was common practice among presidents at the end of each PRI administration, but it was equally common for each new government to reverse the spending increases immediately on taking office. In addition, the economy had grown at a high rate of 6.6 percent in 2000—growth that should not have been taken for granted, especially because it coincided with a recession in the United States. Prudence dictated that spending be cut sharply in 2001.

It is thus difficult to explain why the Fox administration actually entered 2001 with an even higher budget than the government had in 2000. By 2001, spending by all measures was too high, with the rate of growth in discretionary spending (1 percent in real terms) higher than both the rate of GDP growth (which in fact declined that year) and the rate of revenue growth. Measured in dollars, public spending increased steadily and did not begin to stagnate until late 2003, and then only slightly, as the government began to make selective cuts in expenditures. Of course, belated and modest cuts were never a substitute for a comprehensive reform of the bureaucratic structure and its legendary profligacy.

The lack of adjustment in spending was a strategic error on the part of the administration. Discretionary spending has risen by more than 3 percent of GDP since 2000, but two-thirds of this amount is absorbed by current expenditures, of which one-half is allotted to salaries (up by \$7.6 billion since 2000, or \$13.7 billion since 1999). Between 1999 and 2003, direct capital spending in the public sector declined from a meager 1.5 percent of GDP to 1.2 percent. With such a low budget for capital expenditures, the bulk of investment in the energy sector has been made through off-balance-sheet financing from energy contractors. Even

though this type of investment is better than none at all, it comes at a high financial cost, because constitutional restrictions prohibit private parties from possessing energy assets in Mexico. The lack of progress made in 2001 toward curbing excess spending and reducing the bureaucracy inherited from the PRI regime did not put the Fox administration in a position to take advantage of the windfall gain of high oil prices in order to boost investment or expenditures for social services. The windfall from hydrocarbon royalties during the 2001–2003 period was an accumulated 3.6 percent of GDP over the 1999 level. Thus, contrary to the common perception, Mexico recorded additional revenues of 5.2 percent of GDP from higher oil prices alone, including the windfall recorded in 2000.

Despite efforts at fiscal stabilization, the cost to service Mexico's debt has remained high, especially in the 2000–2002 period, because of the new costs associated with rescuing commercial banks since 1996. These costs, which reached a peak of 1 percent of GDP in 2000, cover only the cost of real interest on the outstanding debt owed to banks in exchange for bad loans. The rest of the interest has been capitalized to the stock of debt, which naturally has increased, but not in real terms. Thus, the share of the cost of debt service has not fallen since 1992, despite much lower interest rates.

The precarious condition of public finances in Mexico is thus not attributable solely to low revenues. More important causes include Mexico's overdependence on oil revenues, the rigid components of current spending (already at a high level), the decline in capital spending, and steady charges resulting from the bank bailout. This last factor does not include the principal on the debt, which the Federal Auditing Office has estimated to be \$94 billion in current U.S. dollars.

The debt from the commercial bank bailout and the obligations relating to off-balance-sheet financing for the energy sector contributed to a growing public-sector borrowing requirement (PSBR), which reached 3.6 percent of GDP in 2003. This percentage exceeds the official 0.5 percent deficit reported for the same year, a figure that is widely advertised as a measure of fiscal discipline. The disparity between the official deficit and the PSBR compelled the government to rename the 0.5 percent figure "traditional public deficit." In all likelihood, Mexico is the only country in the world whose deficit varies so greatly from the PSBR. The fact that the Fox administration inherited the deficit and the corresponding accounting from its predecessors raises a question: Why did neither of the two previous governments acknowledge the higher figure as the true deficit? The answer probably lies in the difficulty these governments faced in trying to maintain low

visibility on the bank bailout for as long as possible, given that Congress had not authorized the incurrence of the debt. The discovery of this double accounting sparked acrimonious political debate and threats to prosecute public officials and bankers.⁴

If only for this reason, Mexico has been in need of tax reform since 1999, when the Zedillo government reached a compromise with Congress to capitalize the inflation component of the outstanding debt owed to the banks, while using the federal budget to pay for the real interest on the debt. However, without complete information on the bank bailout program and with multiple suspicions that it had been plagued by abuses and illegal transactions, congressional support for higher taxes would have been out of the question. The bank bailout would loom for years as a stumbling block for the government and a barrier to reaching an understanding with Congress on fiscal issues. This was made amply clear when the National Action Party (PAN) insisted on excluding any senior official who had been part of the agency handling the original bank bailout from the board of the Institute for the Protection of Bank Savings (IPAB), the newly formed institution in charge of handling the aftermath of the bailout.⁵

When Vicente Fox came to power, one issue of concern was how his administration would handle the political negotiations on the government's outstanding debt to banks and how it would raise tax revenues enough to ensure timely repayment of the debt. The lack of political agreement is illustrated by the fact that the congressionally appointed Federal Auditing Office has clashed with the Fox government several times, claiming that many loans purchased in past years did not meet the appropriate standards and demanding that those loans be deducted from

⁴ Similar double accounting was used for calculating the public debt. Even as late as October 2000, the International Monetary Fund's Web site reported Mexico's public debt to be 29 percent of GDP. A few months later, the Bank of Mexico quoted it at 47 percent of GDP, with the entry for the cost of the bank bailout lumped together with other liabilities relating to off-balance-sheet financing of the energy sector.

⁵ The IPAB Organic Law drafted by Congress in reaching a compromise with President Zedillo reads: "the request to consolidate into the public debt the obligations incurred by the said [Fobaproa—the bank fund in charge of the bank bailout] funds is not approved (Article 5, *Transitory, Ley de Protección al Ahorro Bancario*, IPAB.) Article 2 reads: "Any individual who served as minister of the treasury, governor of the Bank of Mexico, or president of the National Banking Commission and in such capacity performed as a member of the technical committee of Fobaproa from 1995 to 1997 will be barred from participating on the board [of IPAB]" (*Marco Legal y Normatividad para la Protección del Ahorro* [Mexico City, 2001]).

the principal due. In addition, the series of crises at IPAB, which by law is prohibited from meeting the government's demands for a prompt conversion of the nonliquid notes into public debt proper, also shows that no agreement on this issue was reached. This conversion would make the debt to banks liquid, but more importantly, it would close the chapter on the bailout by the government and end the embarrassing investigations into the legality of many loans. The crises at IPAB have led to a high turnover of senior officials in that agency: in three years the IPAB has lost three executive secretaries and currently has two vacancies on its board, positions that were formerly held by two of the binding three independent members recruited from outside the government.

Mexico also needs more revenue from taxes in order to reduce its overdependence on oil revenue. The discovery of crude oil was a godsend in the late 1970s, but Mexico has made no major discoveries since that time. The Cantarell field, unique in its kind, is responsible for nearly two-thirds of the 3.4 million barrels per day in oil output, but it is becoming fully developed and facing irreversible decline, a conclusion that is suggested by recent huge investments to boost secondary recovery. At the very least, the costs of extraction will rise and eventually offset the high rent the government is currently earning from this field. A scenario of declining output is likely to materialize in a few years unless Pemex allocates significantly greater resources to oil exploration than it has in the past, but the company will not be able to do so because the bulk of oil revenue is absorbed by the government's operating expenses.

Additional tax revenue is also needed to upgrade basic social services, especially education and health care, which have suffered from a long period of economic stabilization and fiscal consolidation.

The Tax Legacy of the PRI Regime

The tax system rests on three traditional sources of taxation: income, consumption, and special taxes. These sources have been established for decades, but successive governments, especially since the 1980s, have made excessively frequent changes in tax rates and exemptions. Such changes were often motivated more by the need to raise revenue than by a strategic decision to improve the nation's tax system. This was the case with the increase in the VAT rate in 1995—from 10 percent to 15 percent—as Mexico began a process of economic stabilization in the wake of the December 1994 peso crisis.

During the long period of PRI political control, it was not difficult to make frequent changes to tax rates or expenditures, including allocations to state governments,

because Congress swiftly approved tax changes and state governments accepted a lower share of federal taxes as deemed necessary by the executive branch. Beginning in the mid-1970s, however, the ruling party suffered a gradual loss of political control, especially in light of the repeated economic crises the country experienced and growing evidence of government corruption. Taxpayers' trust in government eroded as well, giving rise to an expanding underground economy that led to increased incidences of tax evasion. In an attempt to halt or reduce the incidence of tax evasion, the government changed the tax code, but this often meant that reporting income and fulfilling the legal reporting requirements for applying tax exemptions became increasingly cumbersome. This situation has had a pronounced effect on small businesses, which have been forced to hire professional accountants simply to file tax returns and to keep abreast of changes in tax rates and regulations. Mexico's tax system under the PRI regime seemed to ignore Adam Smith's maxim: "Make the tax as convenient as possible."

In 2003, the government estimated that tax evasion accounted for a loss of 50 percent of collectable taxes—a figure that is high compared with other countries at a similar stage of economic development. One of the private sector's most frequent demands is for the government to simplify the tax system. This step might alleviate taxpayers' growing frustrations, given the difficulties they face in trying to stay current on tax obligations, the poor state of public services, and the perception of the government as a big spender. In response to the demands to simplify the tax system and abide by Adam Smith's axiom, the Fox administration modified the tax code to be used starting in 2004, requiring Mexican taxpayers to both file and pay their taxes electronically. This change will benefit medium- to large-sized companies that already possess Internet capability, but it will adversely affect the many small businesses that do not have the necessary technology to carry out electronic transactions.

The gradual transition from a PRI-controlled regime to a more open and democratic one presented an opportunity for the incoming administration to better inform the public about the need for higher taxes. Hence, although the public was aware that the government had rescued commercial banks and had used off-balance-sheet financing to help the energy sector—both representing future demands on people's personal income—the public has not been provided sufficient detail or a clear enough explanation of these actions to persuade them to support the government's reform proposals. Instead, what reached the public on these issues were reports of bankers engaging in frauds and abuses, conflicts of interest between lenders and borrowers, and unethical practices in the management of institutions in

the run-up to the banking crisis and the government's bailout.⁶ The PRI legacy on tax issues did not lend itself to a quick reform via tax increases, even one undertaken by a new government with plenty of political capital.

The Fox Approach

Part of the trend observed in the 1990s and clearly shown in tables 1 to 3 was that the share of income tax collected has remained relatively constant while income tax rates have fallen modestly. This trend was consistent with the experience of most countries in the world that were seeking to create an investment-friendly regime. The Fox government validated this approach and focused its efforts on generating additional tax revenue through indirect taxation.

The Fox administration's initial approach in 2001 was to adopt a uniform 15 percent VAT rate on all goods, including those that had previously been treated with a zero tax rate, including food and medicine. To date, the zero tax rates have allowed producers and distributors to credit the VAT they paid along the production chain to the overall VAT rate charged, which according to the government, creates loopholes that encourage tax evasion.

Knowing, however, that taxing food and medicine would be a regressive policy and that the VAT would have a negative impact on income, the government supplemented its proposal with a scheme to reimburse consumers who were at the lowest income level. The reimbursement would be achieved through social programs that would send refund checks to these households. Despite the laudable intentions behind this proposal, no one in the administration stopped for a moment to consider the implications of the tax on food in strict economic terms. Businesses, for example, are allowed to take a tax deduction for depreciation of their machinery caused by normal wear and tear; without this tax deduction they would need to raise the prices of the goods they sell in order to save money that they would need for future investments in machinery. By the same token, food and medicine are part of the daily sustenance of the worker and therefore a necessary expense; it would seem foolish for anyone to try to determine at what income levels consumption becomes a luxury. Consequently, increasing the cost of these items should eventually lead to a

corresponding increase in wages.⁷ It is therefore surprising that business organizations were in favor of this tax.

In the administration's first proposal in 2001, applying the VAT to food and medicine would have generated additional revenue of \$12 billion pesos, or close to 2 percent of GDP. The government itself was never clear about what the cost of the planned reimbursement to poor households would be, but the press frequently quoted a figure of 0.8 percent of GDP, which would have resulted in net additional revenue of 1.2 percent.

It is not difficult to see that, in both the 2001 and 2003 proposals, the intended increase in revenue was very modest for the change in tax structure that it implied, especially the change in emphasis in favor of indirect and regressive taxes. In addition, the change would most likely have required an expansion of the bureaucracy in order to establish and maintain the reimbursement mechanism. As tables 1 to 3 demonstrate, if the government had instead decided to freeze current spending from the already high 2000 level, this measure would have saved 1 percent of GDP. Better still, had the government decided that current spending in 2000 was unduly high (as it was) and taken steps to correct this, this action would have generated a savings of 1.3 percent of GDP while keeping current spending on a trend of 2 percent real growth per year from 2000 through 2003. Table 2 shows that a 2 percent real increase in spending was still too high when compared with the 1 percent growth in discretionary spending experienced between 1992 and 1999.

The proposal submitted in 2003 was more subtle than the first proposal in that the proposed VAT rate was only 10 percent and would extend to all goods, which meant that the rate on taxable goods would fall from 15 to 10 percent. This proposal included a reduction in the income tax rate—from 33 percent to 30 percent—but would have had a net effect on revenue of only 0.7 percent of GDP.

Unfortunately, Fox's approach did not contain a simultaneous and categorical reduction in public expenditures, an item that would have made the proposal much more acceptable to the public. This is precisely the approach that the private sector follows when trying to restructure failing companies. However, after the government's proposal was rejected, and at various points

⁶ Frank Partnoy, *FIASCO: Blood in the Water on Wall Street* (New York: Norton, 1997). The chapter entitled "A Mexican Bank Fiesta" describes unethical transactions bordering on the illegal by Banamex and Serfin, two of the largest bailed-out banks.

⁷ This is another basic principle of taxation seen clearly by Adam Smith: whatever increases the cost of living must necessarily lead to an increase in wages; hence, a tax on consumer essentials is an effective tax on wages and thus must raise wages. See Adam Smith, *The Wealth of Nations: An Inquiry into the Nature and Causes* (Edinburgh, 1776).

during 2001 and 2002, the government made cuts in budgeted spending under a congressionally approved provision to mitigate the shortfall in budgeted revenue in order to meet the target for the fiscal deficit.

When cuts in budgeted public spending suddenly became necessary in the course of the fiscal year, however, they gave rise to uncertainty and concern, especially among state governors. In the end, this concern worked against the interests of the administration because of the damage it caused to the climate of cooperation and trust, a climate that is essential for building political consensus in favor of tax and other reforms. Eventually, the governors became skeptical about not only the fairness of the spending cuts but also the way in which hydrocarbon royalties were distributed between the federal government and the states. This skepticism led to the organization of a National Fiscal Convention, which started its work in February 2004 and was charged with studying ways to overhaul the tax system and establish new rules for the distribution of revenues—a veritable Pandora’s box. Although having a convention look into important national matters is always welcome, this one has great potential for failure, given the many participants, multiple agendas, and the background of the two previous failed attempts to raise VAT rates.

The government has not paid equal attention to income taxes as a potential source of additional revenue. Even though the emphasis on consumption taxes may be consistent with the government’s policy, ignoring income taxes altogether would ideally have required an explicit statement that the administration had shifted its emphasis, given that income tax is the largest of the three sources of taxation in Mexico. As the figures in table 1 show, VAT revenue has risen as a share of GDP over the past decade, but revenue from income taxes—5 percent of GDP—remains higher than revenue from VAT. Revenue from special taxes, which is not shown in the table, fluctuates at about 2 percent of GDP. Placing the emphasis of reform on a single source of tax revenue (consumption) and not on other sources (income and special taxes) amounts to a categorical redefinition of policy. Had the government effectively made the case that consumption taxes, as opposed to income taxes, were the most effective means of generating revenue, Fox might have laid the groundwork for congressional and/or public support for his proposal. Absent a convincing case, however, congressional support for the potential redistribution effects of the proposal was unlikely. To add to the problem, at a seminar organized by the Bank of Mexico in October 2003, James Heckman, winner of the Nobel Prize in economics, explained that a higher VAT was not the appropriate way for Mexico to raise revenue, because such a tax would give taxpayers an additional incentive to enter the underground economy.

Heckman recommended direct taxation instead,⁸ which came as a blow to the proponents of the VAT increase and also suggests that income tax in fact deserves a closer look.

The existing tax system that allows business groups to consolidate taxable income may need to be streamlined. In principle, the system encourages investment by permitting losses associated with the startup of a new business to be absorbed into the results of the entire conglomerate. In some cases, however, business conglomerates have acquired bankrupt companies at bargain prices and carried their accumulated losses into the group’s consolidated income, effectively reducing the business’s tax burden without necessarily increasing investment and jobs. By the same token, whether a tax system ought to encourage business conglomerates to venture into new lines of business—and how much encouragement the system should offer—is not a matter to be taken lightly. A highly diversified Mexican conglomerate is at a disadvantage vis-à-vis foreign competitors, because the extent of its diversification results in no single line of business being large enough or strong enough to have an impact on global or even regional markets. Thus, Mexican conglomerates are unable to compete with foreign conglomerates that have been strengthened through mergers and acquisitions in single lines of businesses. The many Mexican conglomerates that have been forced to restructure their debts or default on them raise questions about the benefits of diversification and hence the logic of a tax system that provides incentives for this trend.

Another aspect that needs closer government attention is large firms’ use of a mechanism aimed at exempting stock market investors from income tax resulting from the sale of equities—an instrument that was originally intended to encourage the growth of Mexico’s stock market. In practice, however, this mechanism has been used to benefit large sales of stock that are privately brokered between sellers and buyers at agreed-upon prices and exchanged exclusively between the two parties in the stock market. In this regard, it was unfortunate that the debate on tax reform in 2001 coincided with Citigroup’s purchase of Banamex for \$12.5 billion—a transaction that resulted in tax-free income to shareholders that amounted to about \$3 billion and was based on a very liberal interpretation of the exemption mechanism. The fact that in 1995 Banamex had sold \$6 billion in bad loans to Fobaproa, the savings protection fund, did not help the government’s case in Congress or in the eyes of the public. Once again, the bank bailout and its moral hazard were added to the obstacles that were frustrating the government’s efforts to raise

⁸ Verónica Galán, “Desacredita Nobel IVA general,” *Reforma*, October 10, 2003.

consumption taxes.

Outlook

Tax revenues continued to increase during 2001–2002 despite the recession, owing to the Treasury Ministry's improved tax collection efforts, but in 2003 this increase began to stagnate. Nevertheless, the average growth of government revenue from this source during 2001–2003 was a relatively high 4.1 percent per year in real terms, whereas GDP grew at a modest rate of 0.6 percent.

Tax revenues as a share of GDP approached 12 percent in 2002–2003, but it is difficult to see this percentage increasing further without tax reform. The outlook, however, for a conventional tax reform—that is, one based on a higher VAT—is very poor, given the fact that Congress has twice rejected the proposal. If the administration insists on raising the same proposal at the National Fiscal Convention, it risks contaminating the discussion of fundamental issues in the development of long-term, workable tax principles with a failed case.

Trends in Mexico's public finances show that the steady increase in oil prices is a key reason why Mexico has yet to face a fiscal crisis. Hydrocarbon royalties have grown 13.8 percent per year in real terms between 2001 and 2003. This represents \$10.4 billion more per year than the amount recorded in 1999. Such unusually favorable circumstances for oil revenues should not be taken for granted, however. The government should act quickly on initiatives that do not require congressional approval and should allow time for the tax convention and other negotiations to improve the political climate. This action is even more urgent today, with spending having jumped by a high 12.9 percent in real terms in 2000—or \$26 billion pesos—followed by \$17.6 billion pesos more in 2002. A major part of this expenditure is the share of current spending and particularly salary expense.

Until recently, fiscal policy in Mexico has been the exclusive domain of technical economists. Now that their proposals have met a brick wall in Congress on the matter of the VAT rate and energy deregulation, it is clear that the design of new reforms calls for more comprehensive approaches than we have seen to date. In particular, technical solutions to structural tax problems must be adapted to Mexico's specific circumstances and must satisfy the conditions of a more transparent and demanding political system.

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Table 1. Public Finances, Percent of GDP: 1992, 1999–2003

	1992	1999	2000	2001	2002	2003
Budget Revenue	24.7	20.8	21.6	21.8	22.5	25.0
Federal Government	15.3	14.7	15.8	16.1	16.0	18.0
Tax	10.6	11.4	10.6	11.2	11.8	11.8
Income	5.0	4.7	4.7	4.9	5.2	5.2
VAT	2.4	3.3	3.5	3.6	3.5	3.9
Non-tax revenue	4.8	3.3	5.2	4.9	4.2	6.5
Hydrocarbon rights	3.0	2.0	3.6	3.2	2.3	4.1
State entitles revenue	9.4	6.1	5.8	5.7	6.4	6.9
Expenditure	30.5	22.0	22.7	22.5	23.6	25.6
Programs	24.2	15.3	15.7	15.9	17.2	18.9
Current	18.3	12.5	13.0	13.3	14.0	15.2
Salaries	8.3	7.3	7.1	7.3	7.7	8.1
Capital expenditure	5.9	2.8	2.7	2.6	3.2	3.7
Direct investment	5.1	1.5	1.4	1.2	1.2	1.2
Nondiscretionary	6.3	6.6	7.1	6.6	6.5	6.7
Debt service	2.9	3.6	3.7	3.2	2.9	2.9
Banks' rescue charges	0.0	0.5	1.1	0.7	0.7	0.5
States' sharing of revenue	2.3	3.1	3.2	3.4	3.5	3.6

Note: Ecanal estimates for 2003.

Source: Ministry of Treasury, Mexico.

Table 2. Public Finances, Rate of Growth* in Real Pesos: 1992–2003 (in percent)

	1992–1999	2000	2001	2002	2003
Budget Revenue	1.42	13.41	0.63	3.89	12.07
Federal Government	1.64	17.6	1.68	0.3	13.54
Tax	1.61	1.84	5.84	5.88	0.84
Income	1.49	9.35	3.74	6.17	1.6
VAT	2.3	14.54	3.33	-0.21	11.73
Non-tax revenue	1.71	71.44	-6.75	-12.55	54.08
Hydrocarbon rights	1.83	98.02	-10.08	-28.7	80.19
State entities revenue	1.06	3.4	-2.21	14.01	8.53
Expenditure	1.15	12.94	-1.2	5.97	9.05
Programs	1.04	11.58	1.04	9.16	10.74
Current	1.17	13.38	1.88	6.07	9.96
Salaries	1.36	6.22	1.42	7.63	5.75
Capital expenditure	0.63	3.57	-3.09	24.99	15.44
Direct investment	0.28	1.08	-16.53	2.37	2.16
Non-discretionary	1.57	16.09	-6.19	-1.64	4.94
Debt service	1.5	11.71	-12.05	-9.69	1.2
Banks' rescue charges	NS	132.31	-38.09	5.08	-33.9
States' sharing of revenue	2.18	15.66	3.93	3.9	3.42

Note: In pesos, divided by nominal GDP, Ecanal estimates for 2003.

Source: Ministry of Treasury, Mexico.

* 2000–2003: annual growth; 1992–1999: total increase of 1999 spending over 1992.

Table 3. Public Finances, Income and Expenditures: 1992, 1999–2003 (in billions of U.S. dollars)

	1992	1999	2000	2001	2002	2003
Budget Revenue	89.911	100.052	125.418	136.414	141.989	150.578
Federal Government	55.781	70.539	91.686	100.763	101.264	108.798
Tax	38.401	54.569	61.426	70.265	74.543	71.126
Income	18.356	22.607	27.324	30.636	32.588	31.328
VAT	8.875	15.814	20.022	22.361	22.358	23.638
Non-tax revenue	17.380	15.969	30.260	30.498	26.722	38.959
Hydrocarbon rights	11.025	9.463	20.712	20.129	14.380	24.519
State entities revenue	34.130	29.513	33.731	35.650	40.725	41.823
Expenditure	110.775	105.580	131.801	140.737	149.432	154.191
Programs	88.018	73.712	90.910	99.277	108.574	113.767
Current	66.518	60.212	75.456	83.089	88.302	91.876
Salaries	30.115	35.269	41.407	45.387	48.943	48.967
Capital expenditure	21.500	13.500	15.454	16.188	20.272	22.143
Direct investment	18.717	7.291	8.146	7.349	7.537	7.286
Non-discretionary	22.757	31.868	40.891	41.461	40.858	40.570
Debt service	10.692	17.191	21.227	20.178	18.257	17.484
Banks' rescue charges	0.000	2.489	6.390	4.276	4.502	2.816
States' sharing of revenue	8.289	14.715	18.811	21.130	21.997	21.527

Note: In U.S. dollars, with average exchange rates, Ecanal estimates for 2003.

Source: Ministry of Treasury, Mexico.