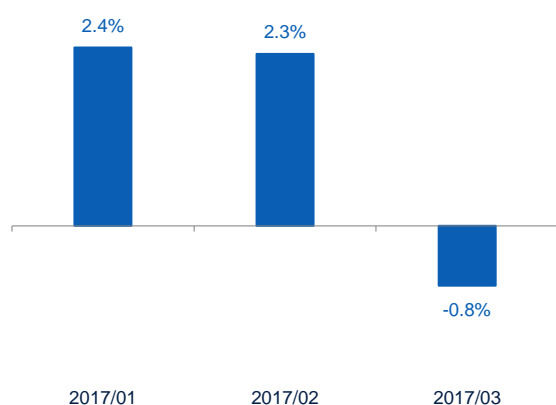


### 3. Temporary weakness in 3Q17 deriving from the negative impact of natural phenomena

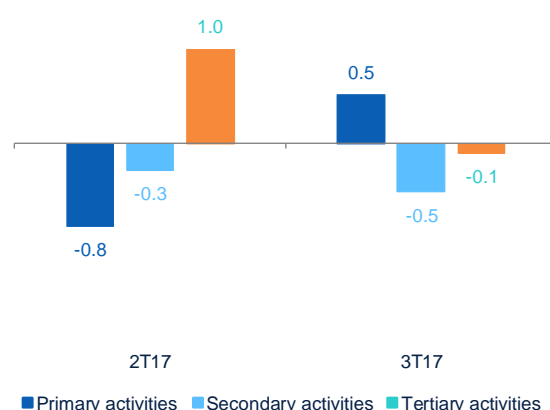
In the third quarter of the year the country's economy contracted by 0.2% relative to the previous quarter (0.8% annualised, SWDA) as a result of declines in the manufacturing, trade and services sectors. In particular, economic activity suffered the effects of the earthquakes and hurricanes that hit the coasts of the Gulf of Mexico on both the Mexican and US sides. In 3Q17 secondary activities declined by 0.5%, tertiary activities by 0.1%, while primary activities increased by 0.5%. We expect the lack of dynamism of GDP in 3Q17 to be short-lived, and economic activity in 4Q17 to be boosted by consumption of goods and services resulting from purchases to assist victims, and going forward improved performance of construction as a result of the rebuilding work made necessary by the September earthquakes.

**Figure 3.1** GDP. Growth rate (QoQ, SA)



Source: BBVA Research based on information from INEGI (National Statistics and Geographical Institute)

**Figure 3.2** GDP by major sector of economic activity. Growth rate (QoQ, SA)



Source: BBVA Research based on information from INEGI

Within industrial activities (30% of GDP) the biggest fall was in the mining sector (5% of GDP), including oil, which according to the Total Economic Activity Index (IGAE in the Spanish initials) declined by -1.5% MoM in July and -2% MoM in August. In September, crude oil output fell by 10.4% MoM, a fall 7.6 pp larger than that seen in August and the largest posted in the past few years, as a result of the negative impact of Hurricane Harvey on US demand for Mexican oil, to which was added the effect of the hurricanes that hit Mexico, which also had negative effects on output.

Like mining, the construction sector (7% of GDP) also had two consecutive months of declines (1.5% and 0.1% in July and August respectively (IGAE, MoM). Also, primary activities (3% of GDP) posted falls of 2.2% and 1.5% in the same months (IGAE, MoM), although their small contribution to GDP limits the negative effects of this on the overall performance of the economy.

Within the tertiary sector (63% of GDP), trade (17% of GDP) showed mixed performances over the course of 3Q17. Retail trade (9% of GDP) posted a fall of 4.6% in July and an increase of 0.9% in August (IGAE, MoM), while wholesale

trade (8% of GDP) saw a fall of 0.4% and an increase of 4.2% in those same months. For its part, the retail sales indicator showed moderate but positive growth in July and August (0.2%, IGAE, MoM). We estimate that the figures for September will show weakening of this sector as a result of the earthquakes, which led to the closure of shops and services for several days, with a subsequent uptick in 4Q17 due to purchases to provide assistance to the victims.

Temporary accommodation and food and beverage preparation services (2% of GDP) also showed mixed performances over the course of the quarter, contracting by 0.6% in July and growing by 0.6% in August. We estimate that growth of this sector in September will be affected negatively by the closure of establishments in the last few days of the month following the earthquakes that hit Mexico City, Morelos, Puebla, Oaxaca and, in particular, Chiapas. Confidence indicators for this sector (right time to invest, and business confidence) already show falls in September, of 0.8% and 0.4% respectively (MoM, SA). According to the INEGI, the States with the greatest incidence of temporary suspension of activity were Morelos (55.2% of its establishments), Mexico City (48.9%) and Puebla (47.5%); on average 52 of every 100 establishments that suspended activities in those States did so for more than one day.<sup>3</sup>

Although the loss of human life caused by these natural disasters is an irreversible tragedy, in terms of the country's productive capacity (public and private infrastructure), the damage was not significant, and did not alter the potential growth of the economy. The main effect was the loss of private property, basically homes, and was concentrated locally. As previously mentioned, in the next few quarters we expect an uptick in economic activity as a result of the increase in construction as the lost capital is gradually replaced, and this, together with increased public spending and private donations, the payment of insurance claims and the use of the government's emergency fund for natural disasters (FONDEN) introduces an upward bias to our growth forecasts for the next few months. Commercial business opinion indicators are already showing a recovery in October, with monthly variations of 10.4% (right time to invest, SA) and 0.6% (business confidence, SA).

As for the sectors evolving favourably in 3Q17, the secondary sector, manufacturing (16% of GDP) posted moderate but positive growth in July and August (0.4% and 0.6%, IGAE, MoM) although not enough to offset the reduced dynamism in oil extraction and construction. We expect September figures to continue to show modest but favourable performance for this sector, as pointed to by business opinion indicators for manufacturing (right time to invest and business confidence), which rose by 1.2% and 0.8% respectively in September. Added to this is the increased dynamism shown by the US manufacturing sector at the end of 3Q17, with a monthly percentage change of 0.1% in September, 0.3 pp more than in August and 0.5 pp more than in July.

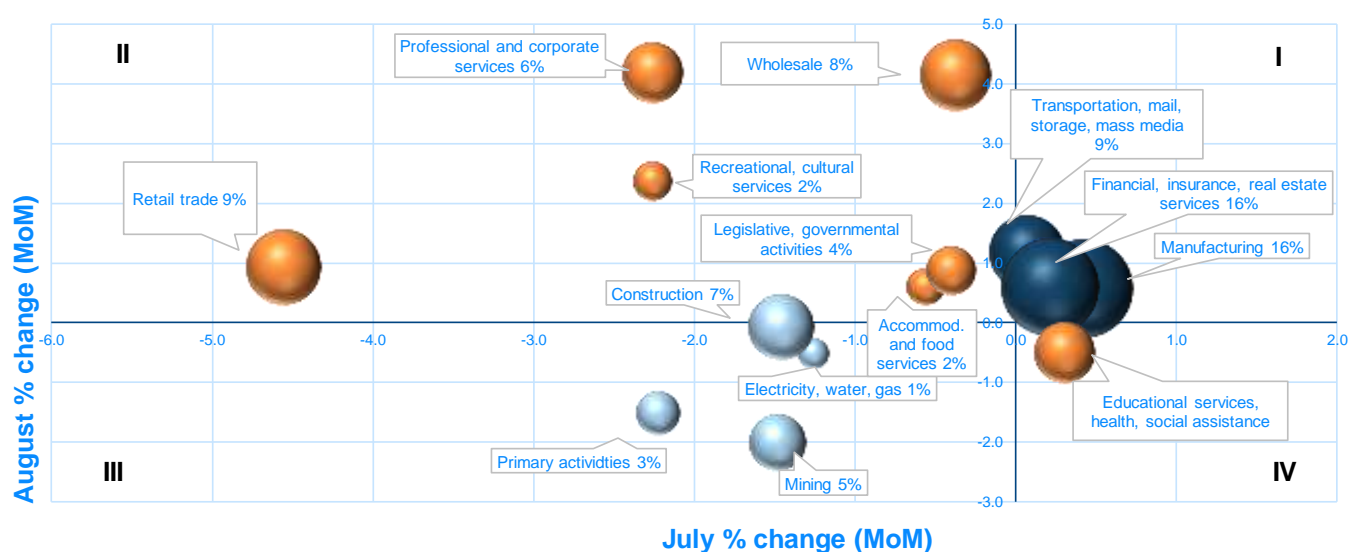
In the tertiary sector, only financial, real estate and rental services (16% of GDP) showed positive growth in July and August (0.2% and 0.6% respectively), after posting falls in the last months of 2Q17.

Figure 3.3 shows the monthly growth of the IGAE (SA) of all the country's economic sectors; the horizontal axis represents the growth of each sector in July and the vertical one that of August. Thus the economics sectors in quadrant I showed positive changes in both months, whereas those in quadrant III showed negative changes in both. The sectors

3: The survey was carried out in the eight States that were most affected by the earthquakes of 7 and 19 September (Chiapas, Mexico City, Guerrero, México, Morelos, Oaxaca, Puebla and Tlaxcala). The sectors covered were service, trading and manufacturing and the sample represented all the economic units of the States and sectors referred to above.

with mixed variations are in quadrants II and IV. The size of the bubbles represents the proportional contribution of each sector to GDP. The economic sectors with negative growth in both months are shown in light blue; those with positive growth in both are in dark blue; and those with mixed performances in orange. Figure 3.3 thus gives us a picture of the performance by the various sectors in 3Q, with information for July and August.

**Figure 3.3** IGAE. IGAE. Monthly growth rate (SA), July and August



Source: BBVA Research based on information from INEGI

## Change of base year from 2008 to 2013 in Mexico's National Accounts System

On 31 October the INEGI announced a change in the base year of the National Accounts System, from 2008 to 2013, which led to differences in observed GDP growth rates relative to those published previously, in particular average growth for the period 2013-2016 went up by 0.5 pp, from 2.1% to 2.6%, while that of the previous period, 2007-2012, went down by 0.4 pp, from 2.1% to 1.7% (Table 1).

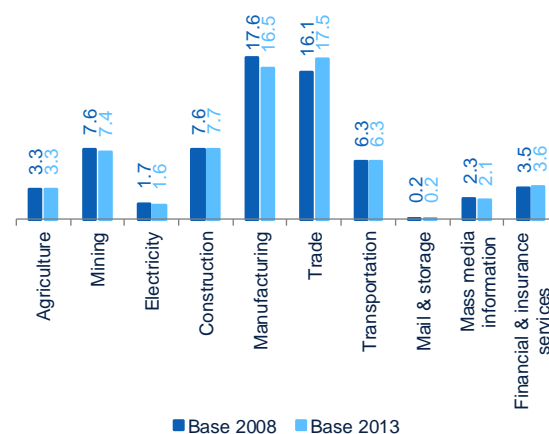
One of the main changes relative to 2008 is a variation in the weight of the sectors of the economy with the biggest contributions to GDP: manufacturing and trade. With the change of base year the percentage contribution of manufacturing in gross value added (GVA) falls by 1.1 pp (from 17.6% to 16.5%), while that of trade increases by 1.4 pp (from 16.1% to 17.5%) (Figure 3.4). This change is significant, because trade has shown much greater growth than manufacturing in the past few years (0.9% compared with 2.9% with 2008 as the base and 0.6% as against 2.8% using 2013, average figure 2007-2016). In short, the change of base year gives greater weighting to the trade sector, which has grown more than the other significant sectors of the economy.<sup>4</sup>

4: GVA 2013. Source: INEGI

**Table 3.1** GDP (YoY 5 change, SA)

	1995- 2000	2001- 2006	2007- 2012	2013- 2016
Base 1993	3.5	2.3		
Base 2003	3.5	2.1	1.9	
Base 2008	3.4	2.3	2.1	2.1
Base 2013	3.3	2	1.7	2.6
Difference 2003 vs. 1993	0	-0.2		
Difference 2008 vs. 2003	-0.2	0.2	0.2	
Difference 2013 vs. 2008	0	-0.3	-0.4	0.5

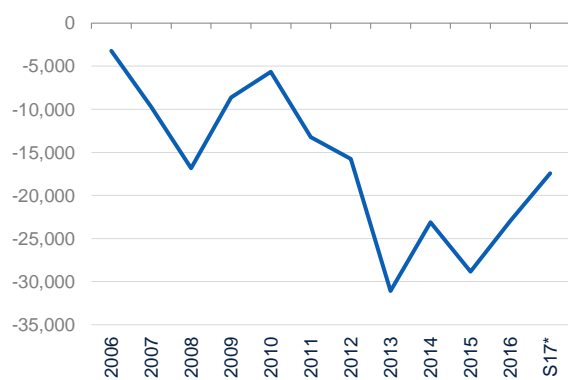
Source: BBVA Research based on information from INEGI

**Figure 3.4** Composition of GVA. 2013


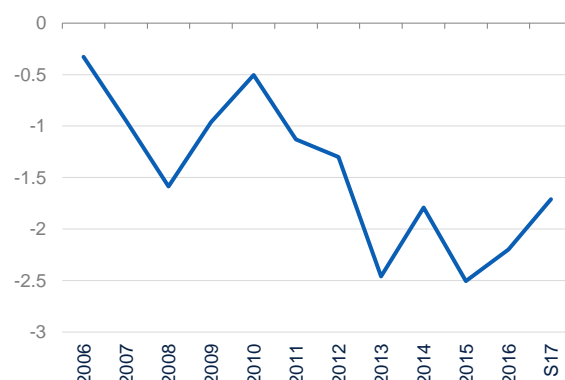
Source: BBVA Research based on information from INEGI

## Current account: the deficit declined significantly in the second quarter of 2017 in response to a more positive balance of non-oil goods and a smaller deficit in primary revenues

After exceeding US\$30 billion in 2013, the current account deficit has gradually shrunk to US\$17.4 billion with annualised data in the second half of 2017 (Figure 3.5). In GDP terms, the current account deficit went from 2.5% to 1.7% over the same period (Figure 3.6). Although we are still awaiting the information for the second half of 2017, we expect the current account deficit to come in at 2.4% of GDP for 2017. Our forecast implies that the current account deficit will have increased to 3.0% of GDP in the second half of 2017, partly because of the expected slowdown in exports of manufactured goods. For its part, the forecast for the current account deficit in 2018 is 2.3% of GDP.

**Figure 3.5** Current account (US\$ million)


\* The current account deficit for the first half of 2017 has been annualized  
Source: BBVA Research with information from Banxico

**Figure 3.6** Current account (% of GDP)


Source: BBVA Research with information from Banxico

On analysing the behaviour of the current account deficit in the second quarter of 2017, we see that it declined relative to the first quarter (Table 3.2). This was due mainly to the significant contraction in the deficit in primary revenues and the greater surplus in non-oil goods. This surplus was largely driven by exports of manufactured goods.

When we compare the behaviour of the current account deficit in the first half of 2017 with the same period of last year, we see that the decline of US\$5.4 billion was due mainly to the significant reversal of the balance of trade in non-oil goods, which went from a deficit of US\$1.7 billion to a surplus of US\$5.3 billion. Without doubt this came from increased external demand deriving mainly from the recovery of US manufacturing output in the first half of 2017.

**Table 3.2** Cuenta corriente y sus componentes en los primeros dos trimestres de 2017 (Millones de USD)

	(A)	(B)	(B-A)
<b>Current account</b>	<b>-8,397.9</b>	<b>-321.2</b>	<b>8,076.7</b>
Trade bal. goods & services	-4,877.8	-2,373.8	2,504.0
Trade bal. goods	-2,743.5	-132.8	2,610.7
Trade bal. oil products	-4,375.9	-3,823.6	552.3
Trade bal. non-oil goods	1,600.9	3,688.8	2,087.9
Bal. of goods acquired in port by carriers	31.5	2.0	-29.5
Trade bal. services	-2,134.3	-2,241.0	-106.7
Bal. of primary revenues	-10,009.7	-5,140.2	4,869.5
Bal. of secondary revenues	6,489.6	7,192.8	703.2

Bal = Balance

Source: BBVA Research with information from Banxico

**Table 3.3** Cuenta corriente y sus componentes en el primer semestre de 2016 y 2017 (Millones de USD)

	Ene-Jun 16 (A)	Ene-Jun 17 (B)	Diferencia (B-A)
<b>Current account</b>	<b>-14,128.0</b>	<b>-8,720.0</b>	<b>5,408.0</b>
Trade bal. goods & services	-10,294.0	-7,252.0	3,042.0
Trade bal. goods	-7,022.0	-2,876.0	4,146.0
Trade bal. oil products	-5,373.0	-8,200.0	-2,827.0
Trade bal. non-oil goods	-1,681.0	5,290.0	6,971.0
Bal. of goods acquired in port by carriers	31.0	33.0	2.0
Trade bal. services	-3,272.0	-4,375.0	-1,103.0
Bal. of primary revenues	-16,767.0	-15,150.0	1,617.0
Bal. of secondary revenues	12,933.0	13,682.0	749.0

Bal = Balance

Source: BBVA Research with information from Banxico

## Public finances: non-tax revenues sustained the increase in total budget revenue for the public sector in the first nine months of 2017, while cuts to programmable spending shrank total expenditure

Total public sector budget revenue showed real annual growth of 1.8% in the first nine months of 2017. Importantly, this year-on-year comparison includes the amount of 321.7 billion pesos from the Banco de México operating surplus. If we excluded this component from budget revenue for the period, the real annual rate would have been a negative 6.9%.

If we break down total budgetary revenues into components, non-tax income (including the federal government's petroleum revenues) showed real annual growth of 23.6% in the first three quarters of 2017. Excluding the central bank's operating surplus would imply an increase of 25.8% in this component in real annual terms. There was a 1.0% real annual increase in tax revenues in this period. Although this figure reflects lacklustre annual growth in tax revenues, we have seen a recovery in these revenues, since they had increased by just 0.1% in real annual terms in the first half of 2017.

Income tax is an important component of tax revenues due to its weight in their overall structure (54.5% in the period January to September 2017). It showed a real annual variation of 5.3% in that period, which compares unfavourably with the real annual growth of 11.6% observed in the first three quarters of 2016.

Public sector oil revenues accounted for 15.5% of total budget revenues from January to September 2017 (17.7% during the same period in 2016). It is important to note that this revenue item fell in annual terms, with a negative real growth rate of 11.0% in the first nine months of 2017.

**Table 3.4** Total public sector budgetary revenues from January to September (billions of pesos)

	2016	2017	Real % chge.	Struc. %
<b>Total</b>	<b>3,501.2</b>	<b>3,773.0</b>	<b>1.8</b>	<b>100.0</b>
Federal Government	2,655.4	2,986.3	6.2	79.2
Tax	2,041.5	2,182.7	1.0	57.8
Income tax	1,066.0	1,188.6	5.3	31.5
VAT	586.0	637.6	2.8	16.9
Non-tax	613.9	803.6	23.6	21.3
Agencies & companies budg	245.4	266.7	2.6	7.1
State enterprise	600.4	520.0	-18.2	13.8
Pemex	382.6	255.1	-37.0	6.8
CFE	217.8	264.9	14.9	7.0
<b>Total</b>	<b>3,501.2</b>	<b>3,773.0</b>	<b>1.8</b>	<b>100.0</b>
Oil revenues	621.1	584.9	-11.0	15.5
Non-oil revenues	2,880.2	3,188.1	4.6	84.5

Source: BBVA Research with Ministry of Finance (SHCP) information

**Table 3.5** Net expenditure paid by the public sector in January-September (billions of pesos)

	2016	2017	Real % chge.	Struc. %
<b>Total</b>	<b>3,764.1</b>	<b>3,731.0</b>	<b>-6.4</b>	<b>100.0</b>
Programmable expenditure	2,903.0	2,744.5	-10.7	73.6
Current expenditure	2,111.9	2,201.9	-1.5	59.0
Capital expenditure	791.1	542.7	-35.2	14.5
Non-programmable	861.1	986.4	8.2	26.4
Contributions to states	531.9	607.3	7.9	16.3
Financial costs	305.1	359.3	11.2	9.6
Adefas* and others	24.0	19.8	-22.1	0.5

Adefas: Spanish acronym for 'debit balance from prior fiscal years'.  
Source: BBVA Research with Ministry of Finance information

As far as net public sector spending in the first nine months of 2017 is concerned, it registered a real annual decrease of 6.4%. This was mainly due to programmable spending (accounting for 73.6% of total net public sector spending in that period), with a real annual contraction of 10.7% in the period. Within programmable expenditure, capital expenditure showed a real annual decline of 35.2%. Current expenditure meanwhile recorded a reduction of 1.5% in real annual terms in the same period.

It is important to acknowledge that federal payments, public pensions, and the financial cost of public debt continued to pressure public finances in the period January to September 2017. Our own calculations show that without financial investment and the expenditure headings referred to, other spending was kept in check to a greater extent, with a real YoY reduction of 8.5% over the period.

The real annualised reductions in this more limited item of expenditure show the federal government's efforts to maintain some measure of financial discipline in the items more directly under its control. The federal government will have to continue these efforts to rein in spending during the last part of 2017 to reach the targets of a primary surplus of 0.4% and a public sector debt stock of 48.0% of GDP.

**Table 3.6** Indicators of public expenditure in the period January-September (billions of pesos)

	2016 Nominal	2016 Nominal	2017 Real	2017 Real % chge.
<b>Total net expenditure</b>	<b>3,764.1</b>	<b>3,731.0</b>	<b>3,524.7</b>	<b>-6.4</b>
Without financial investment	3,509.9	3,619.6	3,419.4	-2.6
Without financial investment and state funding	2,978.0	3,012.3	2,845.7	-4.4
Without financial investment, state funding and pensions	2,507.0	2,491.1	2,353.3	-6.1
Without financial investment, state funding, pensions and financial cost	2,201.9	2,131.8	2,013.9	-8.5

Source: BBVA Research with Ministry of Finance information

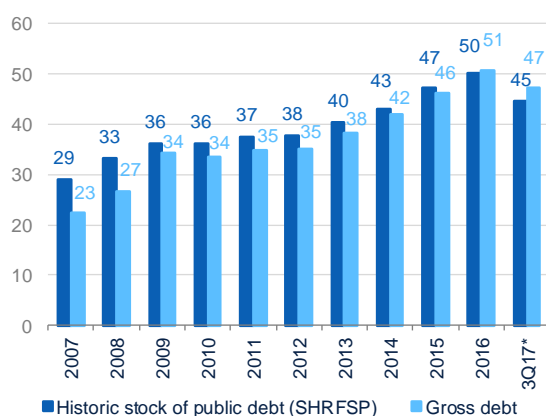
**Table 3.7** Financial situation of the public sector January to September (billions of pesos)

	2016	2017	Real % chge.
Public balance	-251.3	63.2	n.s.
Public bal. without prod. invt.	129.9	319.9	132.7
Budgetary balance	-262.9	42.0	n.s.
Budget revenues	3,501.2	3,773.0	1.8
Net expenditure paid	3,764.1	3,731.0	-6.4
Federal Government Balance	-300.0	75.7	n.s.
Bal. agencies & companies	37.1	-33.7	n.s.
Primary balance	59.1	416.0	564.7
Budgetary balance	42.2	401.3	797.9
Federal Government	-79.1	336.1	n.s.
Agencies and companies	121.3	65.2	-49.2
Pemex	15.0	-33.9	n.s.
Other entities	106.4	99.1	-12.0
Entities under indirect control	16.9	14.7	-18.0

n.s. = not significant

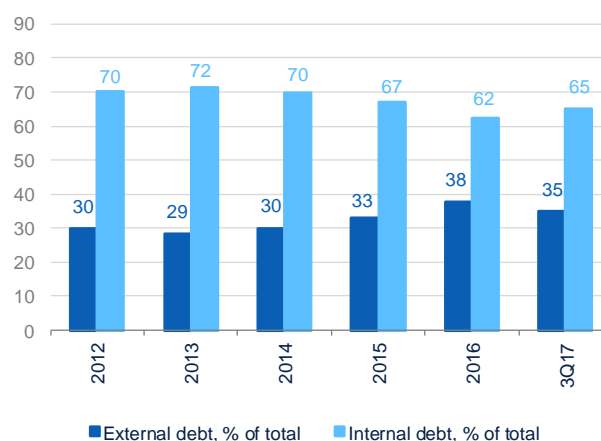
Source: BBVA Research with Ministry of Finance information

The primary public sector balance showed significant improvement in the first nine months of 2017, coming in at MXN 416.0 billion as against MXN 59.1 billion in the same period of 2016. The increase in the primary surplus was largely due to the federal government balance and, to a lesser extent, those of the IMSS (social security) and the CFE (state-owned electricity utility). If this disciplined management of the finances of the federal government and other state-owned enterprises continues for the rest of 2017, the target of 0.4% of GDP for the entire public sector primary surplus in 2017 will be attained.

**Figure 3.7** Gross debt and public sector financing requirement\* (as % of GDP)


\* To calculate the SHRFSP (stock of public debt) and public debt we used the Ministry of Finance's nominal GDP forecast for 2017.

Source: BBVA Research based on Ministry of Finance and INEGI data

**Figure 3.8** Percentage structure of internal and external public sector debt (% of the total debt)


Source: BBVA Research based on Ministry of Finance data

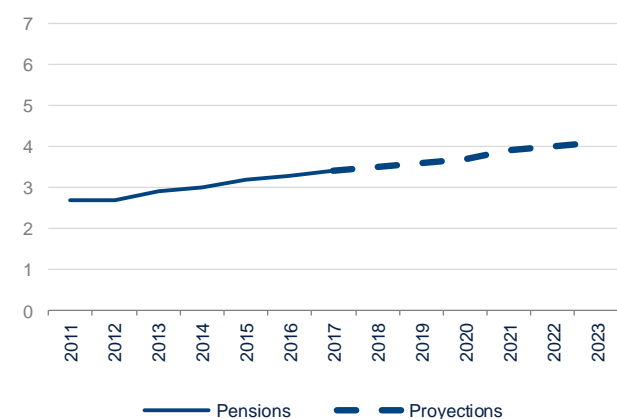


Gross public debt stood at 47.3% of GDP at the end of the third quarter of 2017. The debt level is 3.5 percentage points lower than the ratio of public debt to GDP seen at the close of 2016. As regards the breakdown of this debt into domestic and external components, external debt went from 37.8% in 2016 to 34.9% at the end of the third quarter of 2017. The appreciation of the Mexican peso against the dollar so far this year was clearly a prime factor in both the reduced proportion of gross external debt and the lower ratio of gross debt to GDP.

In the third quarter of 2017, the stock of public debt (SHRFSP) was 15.4 pp of GDP higher than its level in 2007. As far as 2017 is concerned, the Ministry of Finance expects the balance to be reduced to 48% of GDP from 50.1% in 2016 with the support of the central bank's operating surplus. To reach this balance, it should be remembered that the annual deficit in the public sector financing requirement would have to reach a level of 1.4% of GDP by 2017 (after 4.1% and 2.9% of GDP in 2015 and 2016, respectively).

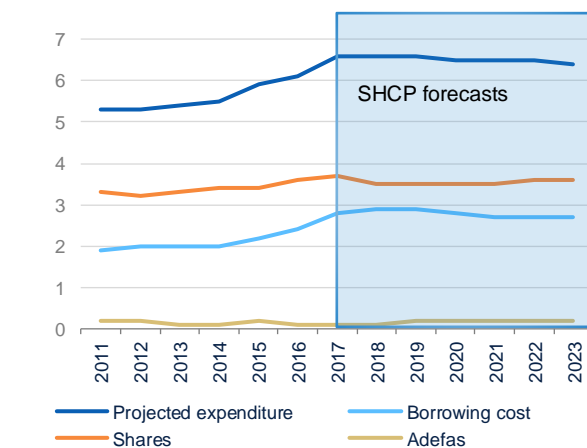
As for the medium-term outlook for the public finances, the Ministry of Finance envisages public sector pensions, federal contributions to the states and the financial cost of the public debt continuing to be a significant source of pressure on the public sector's net spending. This will require the federal government to maintain financial discipline in the expenditure items more directly under its control. It would be desirable for the cuts in current spending to be deeper and for public sector capital expenditure to gradually recover so as to underpin the country's economic growth.

**Figure 3.9** Pensions and retirement benefits paid by the public sector (% of GDP)



Source: BBVA Research with Ministry of Finance information

**Figure 3.10** Non-programmable expenditure and its components (% of GDP)



Source: BBVA Research with Ministry of Finance information

## Mexico would still be more competitive than the US as a manufacturing base, even if the US cut its corporation tax rate from 35% to 20%

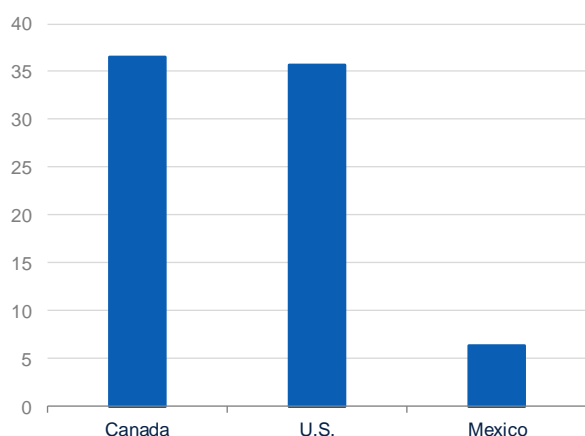
The proposed tax reform currently being discussed in the US envisages a cut in the rate of corporation tax from 35% to 20%. In Mexico this rate is 30%. Two pertinent questions arise in this respect: What effect will it have on US FDI into Mexico? Should the Mexican government respond by cutting its corporation tax rate too?



As for the first question, our estimates indicate that even if this tax cut were to be implemented in the US, Mexico would still be a more competitive manufacturing base. Consequently FDI should not be substantially affected. And this for the following reasons: las siguientes razones:

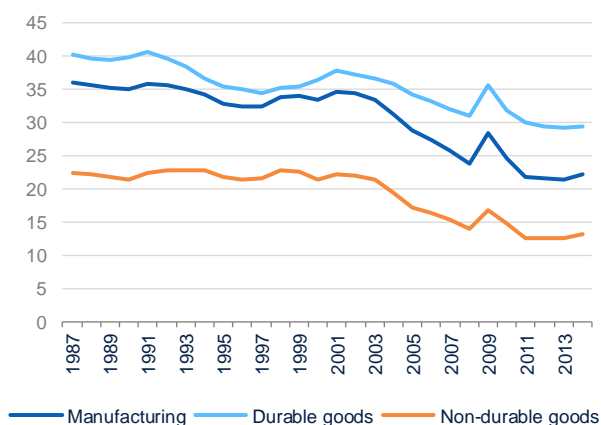
- i) Manufacturing labour costs in the US are on average nearly six times higher than in Mexico (Figure 3.11). At the same time in the US manufacturing labour costs as a percentage of total industry revenues in 2014, the latest figures available, were 22.1%. We have carried out a calculation to determine whether this differential would offset the US tax cut and in which country it would be cheaper to produce if the US tax rate were to be cut to 20%, ten pp lower than Mexico's. We find that the difference in labour costs alone is a sufficient factor for Mexico to still be more competitive than the US (Table 3.8). In other words Mexico would lose some of its competitive advantage over the US but would still have a clear advantage.

**Figure 3.11** Labour compensation per hour in manufacturing industry in 2012 (USD)



Source: BBVA Research with information from the BLS

**Figure 3.12** Labour costs as a percentage of nominal revenues in manufacturing industry in the US (% of nominal income)



Source: BBVA Research with information from the BLS

- ii) We also have to bear in mind that the peso's depreciation of more than 10% since April 2016 (associated with the Trump risk) would almost offset the US tax cut. This depreciation also means that Mexico would still be more competitive than the US even if the tax cut were to take place.
- iii) We must also take into account the fact that the Federal corporation tax is not the only tax faced by US firms; 44 states and Washington D.C. Also have state taxes ranging from 3% to 12%. If in addition to the proposed federal tax of 20% we take account of the average tax of the 50 states and Washington D.C. (6%), Mexico's comparative advantage in terms of post-tax profit widens further (Table 3.8).

Due to these factors, if the US does cut its federal corporate income tax rate to 20%, it will still be cheaper to produce manufactured goods in Mexico - at least 20% more profitable than in the US.

Apart from this, the analysis should consider the tax rates actually paid, not the standard rates laid down in the law. Effective tax rates are usually lower due to deduction, consolidation and other mechanisms. According to the US

Congress Budget Office (CBO), the effective corporate income tax rate in Mexico is 11.9%, whereas in the US it is 18.6%. In other words tax is paid at a significantly lower rate in Mexico. In fact when we look at effective rates, Mexico is not among the countries with the highest rates. This means that when effective rates of corporation tax are taken into account Mexico is more competitive than the US by a bigger margin than an analysis of nominal tax rates would suggest.

For this reason, we consider that Mexico should not respond by cutting its corporation tax rate. In the event that the Mexican government did decide to cut the rate from 30% to 20%, tax revenues would show an annual contraction of 16.9%, equivalent to 1.2% of GDP. Therefore the implementation of this measure in Mexico would put at risk the attainment of the target of 0.9% of GDP for the primary surplus in 2018. Furthermore, it would mean a permanent reduction in tax revenues. This would be irresponsible in the current context in which the government is carrying out a process of fiscal consolidation and above all considering the low historical levels of tax collection seen in Mexico. In short, i) there is no need to react to possible tax changes in the US, since Mexico would still be more competitive, and ii) even if it wanted to react, there is insufficient fiscal room in which to do so.

This does not mean that it is not desirable to achieve a tax reform that reduces taxes on businesses and raises them on consumption. But this is a discussion that needs to be had independently of the tax process in the US and taking care that any change is at least neutral in terms of total revenues.

## Impact of tax reform in the US on net income of manufacturing companies

The following is a simplified example of the effect that a reduction in US corporation tax from 35% to 20% would have on the net income of a US manufacturing company. The exercise assumes that non-labour costs are equal in both countries (X% of revenues) and an average state corporation tax rate of 6% in the US. It also takes account of US tax law which requires taxpayers to pay the standard US tax rate regardless of where the income is generated and show proof of tax paid in other countries.

Of every US\$100 of revenues of a US manufacturing company based in the US, 20% goes to cover labour costs in the US and X% to cover non-labour costs. Thus the company makes a profit of  $100 - 20 - X = 80 - X$  before tax. Of this amount, 35% goes to pay US corporation tax, giving net income of  $(80 - X) \times (0.65) = 52 - 0.65X$ . If we include the average state corporation tax of 6%, total taxation is 41%, leaving the company  $(80 - X) \times 0.59 = 47.2 - 0.59X$ . With the tax reform in the US the rate would be 20%, so net income would be  $59.2 - 0.74X$ .

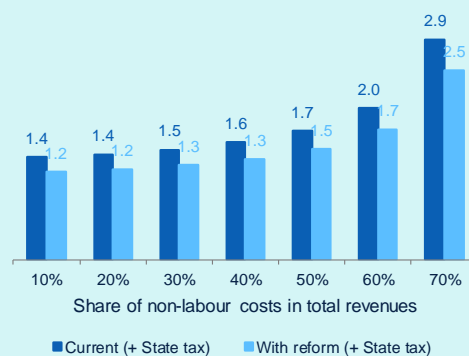
If the company is based in Mexico, out of every US\$100 of revenues, 3.3% goes to pay labour costs in Mexico (1/6 of the 20% that applies in the US.) and X% goes to pay non-labour costs. Thus the company makes a profit of  $100 - 3.3 - X = 96.67 - X$  before tax. Of this amount, 35% goes to pay US corporation tax which the company is obliged to pay as a US Company (showing proof of the 30% paid in Mexico), so the company's net income is  $(96.67 - X) \times 0.65 = 62.84 - 0.65X$ . With the tax reform, the tax paid in Mexico is at the local rate of 30%, so net income would be  $67.69 - 0.7X$ . Table 3.6 illustrates all the calculations.

If non-labour costs represent 10% of the firm's revenues ( $X=10$ ), net profit in Mexico would be 1.4 times that generated in the US under the current US tax regime. If they represent 50% ( $X=50$ ), net profit in Mexico would be 1.7 times that obtained in the US. With the proposed tax reform, the figures would be 1.2 and 1.5; in other words, producing in Mexico would be at least 20% more profitable than in the US. It is clear that Mexico's competitiveness is maintained even after a cut in the rate of tax on corporate profits from 35% to 20% in the US.

**Box 1**
**Table 3.8** Post-tax profit: current rate versus proposed rate

	U.S. company			
	Current		With tax reform	
	Based in the U.S.	Based in Mexico	Based in the U.S.	Based in Mexico
Revenues	100	100	100	100
Labour costs	20%	3.3%	20%	3.3%
Non-labour costs	X%	X%	X%	X%
Federal tax	35%	35%	20%	30%
State tax	6%	-	6%	-
Profit after Federal tax	$(100-20-X)*0.65$ = 52-0.65X	$(100-3.3-X)*0.65$ = 62.84-0.65X	$(100-20-X)*0.80$ = 64-0.80X	$(100-3.3-X)*0.70$ = 67.69-0.70X
Profit after Federal and State tax	$(100-20-X)*0.59$ = 47.2-0.59X	-	$(100-20-X)*0.74$ = 59.2-0.74X	-

Source: BBVA Research

**Figure 3.13** Post-tax profit in Mexico / Post-tax profit in the US. Ratio


Source: BBVA Research

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