Economic Analysis

Fiscal reform in the United States: No significant effects yet for Mexico

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Effective from January 1, 2018, President Trump's fiscal reform enforced, among other aspects, a reduction of the federal corporate income tax rate from 35% to 20%. As soon as discussions on the reform began, concerns started to arise in Mexico regarding its possible impact on investment in our country. The fear was that, given Mexico's corporate income tax rate of 30%, companies could choose to invest more in the United States and benefit from reduced taxation. This fear lingers on. In the early days, many called for a reduction in the corporate income tax rate in Mexico to mitigate the threat.

When the Trump reform was being discussed, I argued on this site that it would not result in a significant decrease in investment, and that, therefore, it was not advisable at the time to lower the corporate rate, since this would result in a significant decrease in tax revenue; an issue that the country could not (and still cannot) allow given its limited fiscal space. This does not mean that it is not desirable to consider profound fiscal reform to reduce corporate income tax while increasing goods and services tax and the tax base, so that the decline in corporate income tax does not result in lower tax revenue.

As I explained at the time, even with the decrease of taxes within the US, Mexico would still have a competitive advantage over the US for the manufacturing industry thanks to the following factors: (i) labor costs in Mexico are just a sixth of those in the US; (ii) companies in the US are subject to a state corporate tax, averaging 6%, in addition to the federal tax; iii) the real exchange-rate depreciation of the peso means that Mexico is more competitive than it was before 2014 when the depreciation began; iv) tax rates are not the sole or primary determining factor in a company's decision about where to invest — if it were, we would see all investment in the United States directed to Wyoming (which has no income tax) instead of California, where it is 9%.

A little more than one year on, we are now in a position to make a first assessment of the effects of Trump's reform. Has investment migrated from Mexico to the United States? There are various ways to answer this question. One (inaccurate) way is by using anecdotal evidence. We have not heard, from press reports, of any large companies deciding to move their production from Mexico to the US as a result of this reform. Another is to analyze Foreign Direct Investment (FDI) data. This is also inaccurate because FDI statistics are strongly affected by corporate accounting decisions, such as profit sharing.

To analyze whether Mexico is losing physical investment, the best thing to do is to look at the capital account component of the balance of payments. For this, we can observe current account development (which is the counterpart to the financial account). The current account deficit at the close of 2017 was 1.7% of the GDP, but at the close of 2018 it was 1.8%. This indicates that, up to now, there has not been any significant real investment withdrawal from Mexico, if there has been any at all. To my mind, this shows that the government acted correctly last year in not reacting and lowering the corporate income tax rate. I believe that in order to attract more investment, we need to work harder to improve the legal framework, provide greater legal certainty, and improve the infrastructure for exporting goods to the United States.

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