Economic Analysis

Economic recovery in Mexico through a reduction in the income tax rate for low-income taxpayers

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- **Despite the reduced fiscal space, we consider it desirable to boost private consumption and, by the same token, aggregate demand by reducing the target for the 2019 primary balance to 0.5% of GDP**
- **We suggest that this be implemented through a reduction in the income tax rate in such a way that it benefits taxpayers at low-income levels, which have a higher marginal propensity to consume**
- **To avoid that such fiscal stimulus brings about a permanent reduction in the tax revenue derived from income taxes, we suggest public policies aimed at lowering the informal sector's size and thus make it possible to have a significantly broader base of taxpayers in the years to come**

We believe that the economic recovery plan announced by the Ministry of Finance several weeks ago will have a positive marginal impact on economic growth in 2019. This is mainly the case because 66% of the plan's resources are allocated to the provision of loans and guarantees of development banks. Although the plan aims to boost the productive activity of micro-businesses and small and medium-sized enterprises, the full amount of credit granted will depend on these companies' demand for credit and, ultimately, on the demand for the goods and services they produce.

As we estimate there is a low probability that commercial banks apply credit rationing to those companies and in our view the relatively low banking penetration is due to demand and not to supply problems, we believe that there would be relatively low demand for such credits unless credit risk admission standards were relaxed. The latter would result in financial losses for development banks and, in the case where their equity would fall below the minimum level, public finances would be under pressure.

In our view, it would be more effective that the fiscal stimuli package be concentrated on the development of infrastructure projects. This is mainly due to their higher impact on potential economic growth because of the positive externalities that they could produce. For such type of package, we propose the creation of an autonomous institution that oversees the financial and social valuation of public investment projects. Consequently, the risk of approving such projects only because of political considerations would be mitigated. Given that Mexico does not have an institution of this nature, the fiscal stimulus that we will describe next will revolve around paying lower taxes.

As we know, economic growth in Mexico is experiencing a slowdown that has been reflected on the stagnation of productive activity since the fourth quarter of last year. Moreover, the pace at which formal employment is created has been in significant decline from an average annual growth rate of 3.5% in the fourth quarter of 2018 to 2.4% in the second quarter of this year. In the meantime, the figures for the annual variation of the private consumption indicator in the domestic market were 1.4% for the fourth quarter of last year and 0.8% for the months of April and May. Finally, GDP showed an annual growth of 0.3% in the first half of the year. Our annual GDP growth forecast for 2019 is 0.7%.

We believe that, without discussing its structural problems, the Mexican economy is experiencing a sharp slowdown in the growth of aggregate demand. A possible alternative to support it could come from boosting private consumption, which contributes approximately 67% to total GDP. A reduction in the personal income tax rate or in the VAT rate would have a direct and immediate effect on private consumption. However, this would lead to a lower tax revenue and consequently to a lower primary surplus than the MXN 240.2 billion target (1.0% of GDP) for the 2019 primary balance.

Since we acknowledge the need to maintain fiscal discipline (generating a primary surplus and a stable public debt to GDP ratio) due to the risk of a reduction in sovereign credit rating, the stimulus resulting from a lower tax rate that we propose would reduce the target for the primary balance to 0.5% of GDP and put the historical balance of Public Sector Borrowing Requirements at 46.1% vs. our current forecast of 45.6% of GDP for 2019. We strongly believe that financial markets would welcomed such proposal. To this end, through an amendment to article 23 of the Mexican Federal Law of Budget and Fiscal Responsibility, of the approximately MXN 175 billion in resources budgeted for public expenditure that were not spent in the first half of the year, approximately MXN 120 billion might not be spent and instead be used to decrease tax revenue by that amount.[1] In other words, 68.8% of the underspending would be tapped into to compensate for the fall in tax revenue coming from either a lower tax rate levied on personal income or a reduced VAT rate.

Our proposal to boost economic growth by reducing taxes rather than increasing public spending is supported by empirical evidence. Alesina and Ardagna (2009) analyze a sample of OECD countries between 1970 and 2007. These authors find that fiscal stimuli based on tax reductions are more likely to increase economic growth than those based on higher public spending.

Data from the SHCP reveal that revenue from VAT and income taxes was 3.9% and 7.1% of GDP in 2018, respectively. Regarding VAT, using a 16% tax rate, we can infer that each percentage point of the rate collects 0.24% of GDP, which compares unfavorable with the 0.3%–0.4% range of GDP that prevail in OECD countries and Latin America.[2] In terms of income taxes, if we assumed that the weighted average rate was 25%, each percentage point of the rate would collect 0.28% of GDP.

Comparing the alternatives between reducing the VAT rate or lowering the income tax rate to boost private consumption, we suggest the use of the latter for the following five reasons: (i) VAT has only contributed 15% to the 3.4 GDP percentage point increase in tax revenue observed between 2013 and 2018 as income taxes and fuel excise taxes were the main drivers; (ii) reducing the income tax rate would lead to an immediate increase in households' disposable income, which would not be the case for VAT as it would depend on the consumption of the goods and services upon which such tax is levied; (iii) implementing the reduction in the personal income tax rate could be done in such a way that it could benefit taxpayers at low-income levels, which have a higher marginal propensity to consume; (iv) more formal jobs could be created as the labor cost associated with gross wages would be lower; and (v) lowering the VAT rate would be regressive as high-income taxpayers would benefit more from it. Our proposal of reducing income tax rates has low-income taxpayers as its main beneficiaries.

1 We propose that there be no obligation to correct or spend the portions of underspent budgets as we believe that these could compensate for lower-than-predicted public revenues or even be used for the repayment of public debt. Undoubtedly, decisions regarding as to what to do with underspent budgets should be based on rules.

2 To make matters simple, we assume that the revenue intake from VAT behaves in a linear fashion but acknowledge that this could not be the case.

Concluding remarks

In the face of the current economic situation with very low economic growth, we think it is convenient to implement countercyclical public policies that contribute to bolstering economic activity. While we recognize that the fiscal space available for this is very small due to the relatively high level of public debt (% of GDP) and the need to generate primary surpluses in the short and medium-term, private consumption this year could be boosted by allocating a portion of the underspent budget to reducing personal income tax rates (by way of an amendment to article 23 of the Mexican Federal Law on Budget and Fiscal Responsibility). However, this would imply that a fraction of the 1.0% target for the 2019 primary balance would have to be sacrificed to an extent that would not compromise fiscal discipline and would not significantly affect Mexican risky assets.

Our proposal for supporting economic activity could be faster and more effective than any proposal that focus on public expenditure, with the exception of those based on infrastructure development. To avoid that such fiscal stimulus brings about a permanent reduction in the tax revenue derived from income taxes, we suggest public policies aimed at lowering the informal sector's size and thus make it possible to have a significantly broader base of taxpayers in the years to come. However, the reactivation of private investment and the promotion of profitable public investment projects that produce positive externalities will be key to boosting economic growth in the medium and long term.

References

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