Economic Analysis

Risk of a sharp drop in public revenue in 2020

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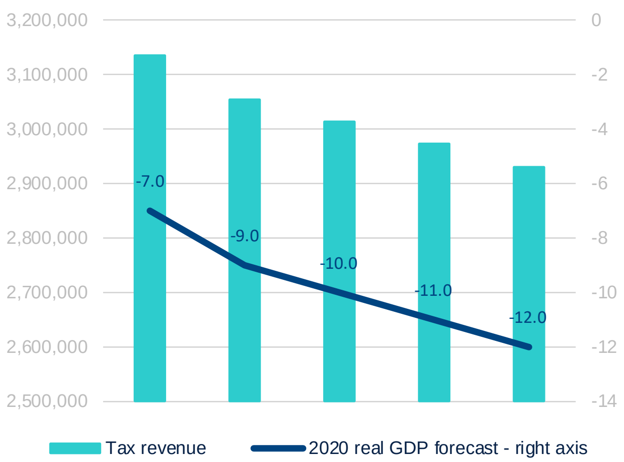
- **Annual falls in real GDP ranging between 7.0% and 12.0% in 2020 would be detrimental to tax revenue, implying a real annual contraction in public revenue ranging between 9.4% and 13.1%**
- **For the same real GDP annual contraction range, the estimated tax revenue published by the Ministry of Finance in the 2021 General Economic Policy Preliminary Guidelines could decrease between MXN 216 billion and MXN 421 billion in 2020**
- **Lower tax revenue would lead to a higher primary deficit (*ceteris paribus*). To meet the primary deficit target of 0.4% of GDP for 2020 under the aforementioned contraction range, the federal government would need to cut down public expenditure by MXN 209 billion and MXN 418 billion in 2020, respectively**

While public revenue showed a real annual growth of 9.2% in the first quarter of the year mainly due to the favorable performance of tax revenue (as we think it was supported by government efforts to fight tax evasion), the significant economic contraction anticipated for 2020 is likely to reverse the positive trend of this kind of revenue. This is because tax revenue is relatively more sensitive to local economic growth than other sources of public income. To get a clearer notion of the tax revenue sensitivity to nominal GDP growth, we estimated the year-on-year percentage increase in quarterly tax revenue corresponding to one percentage point year-on-year growth in quarterly nominal GDP. For this purpose, we used data ranging between the first quarter of 2016 and the fourth quarter of 2019, given that the tax reform that came into force in 2014 might have led to a structural change in this sensitivity.

In the 2021 General Economic Policy Preliminary Guidelines, the SHCP estimated that tax revenue in 2020 would be MXN 3.351 trillion. It should be noted that all estimates of official public finance figures for this year contained in such document were based on an economic growth forecast of -3.0%. Given the very high probability that the economic contraction will be deeper in 2020 (the worst economic effects of the pandemic had not yet been felt and the annualized fall in the first quarter of the year was 4.9%), we consider it important to have estimates of tax revenue corresponding to higher reductions in GDP. Figure 1 shows the different scenarios for such revenue corresponding to several forecasts for real GDP contraction in 2020. For a GDP growth range between -7.0% and -12.0%, tax revenue could fall between MXN 216 billion and MXN 421 billion in 2020 relative to the amount estimated by the SHCP.

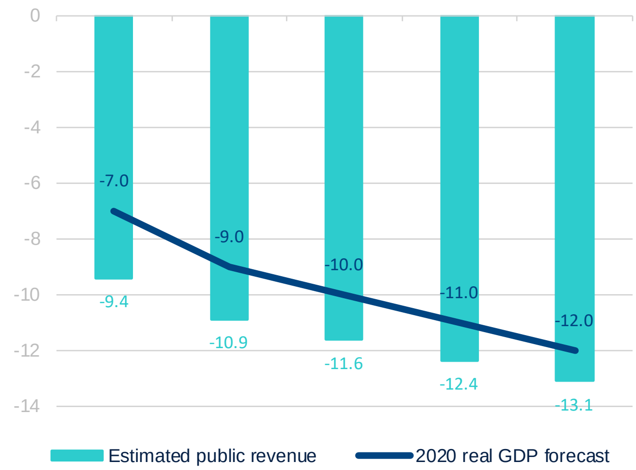
Tax revenue accounted for 59.5% of total public revenue in 2019. Consequently, the dynamism of the former is key to the strength and sustainability of public finances in the medium- and long-term. By taking into account the different estimates of tax revenue corresponding to GDP forecast falls of more than 3.0% (*ceteris paribus*), total public revenue could show real annual contractions ranging between 9.4% and 13.1% in 2020. Figure 2 shows estimates of real annual declines in total public income corresponding to some economic contraction scenarios for this year. It is worth mentioning that the falls in total public revenue only reflect the loss of tax revenue in such scenarios. In other words, what might happen to other types of public revenue is outside the scope of this analysis.

Figure 1: **Estimated tax revenue and real GDP in 2020**
(Millions of pesos and % change year-on-year)



Source: BBVA Research based on SHCP data

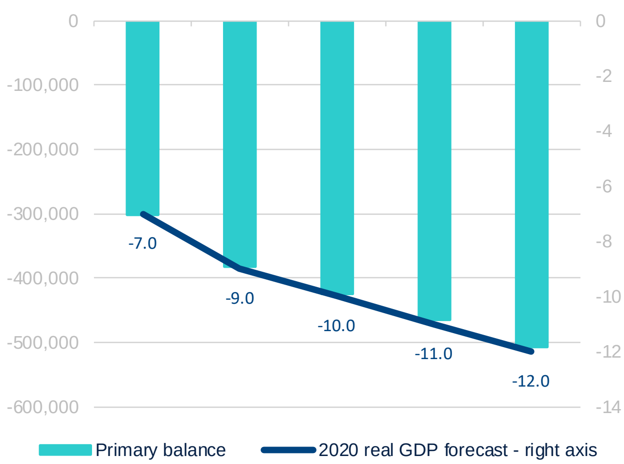
Figure 2: **Estimated public revenue and real GDP in 2020**
(Real % change year-on-year)



Source: BBVA Research based on SHCP data

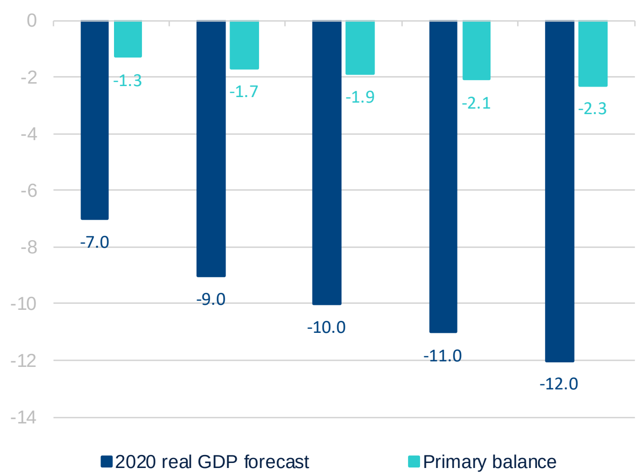
The different forecasts of falls in tax revenue would be reflected on the primary balance if public expenditure were not adjusted. The SHCP's primary deficit target is MXN 85.54 billion (0.4% of GDP) for 2020. For the projected annual GDP contraction range between 7.0% and 12.0% for this year, the primary deficit would range from MXN 301.37 billion (1.3% of GDP) to MXN 506.40 billion (2.3% of GDP) by year-end. This gives us some idea about the cuts in public expenditure (*ceteris paribus*) that the federal government would have to make to meet the primary deficit target of 0.4% of GDP. Given that 0.4% of GDP represents MXN 92.73 billion and MXN 88.07 billion under the scenarios of an annual contraction of GDP of 7.0% and 12%, then the government would have to cut public expenditure by MXN 208.64 billion and MXN 418.33 billion in 2020, respectively. Figure 3 shows the relationship between the primary balance (in millions of pesos) and economic growth forecasts for 2020. Figure 4 also exhibits this relationship, although representing the primary balance as a percentage of GDP.

Figure 3. **Primary balance and real GDP in 2020**
(Millions of pesos and % change year-on-year)



Source: BBVA Research based on SHCP data

Figure 4. **Primary balance and real GDP in 2020**
(% of GDP and annual % change)



Source: BBVA Research based on SHCP data

Conclusions

We anticipate a very complicated economic environment for public revenue in 2020 and 2021. The sharp economic contraction expected for this year will cause significant tax revenue losses despite the federal government's increased efforts to fight tax evasion and fraud. As a result, it would be desirable for the federal government to implement a much broader package of fiscal support and reallocate public expenditure to contain the decline in economic activity. Although we recognize that the government has a limited fiscal space to maneuver when trying to cope with current negative shocks, we believe that fiscal discipline could be maintained by proposing a fiscal reform that would increase tax revenue and come into effect as soon as the health emergency is behind us. This would allow a countercyclical fiscal expansion that we believe could be in the order of up to six percentage points of GDP without affecting the sovereign rating or public debt sustainability. Moreover, a more effective countercyclical fiscal policy would also allow a faster economic recovery that would contribute to the dynamics of tax revenue. We strongly urge the federal government to design a fiscal reform that can help to mitigate the risk of losing the investment grade for the country's sovereign credit rating.

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