Research

Economic Analysis

Tapping emergency funds in 2020 will cause greater vulnerability going forward

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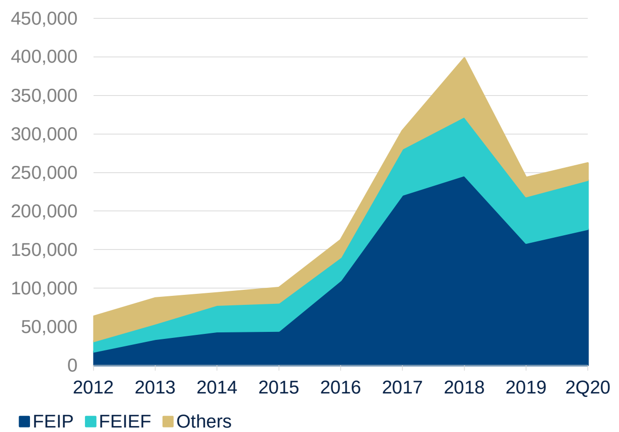
August 20, 2020

- **The sharp annual drop in public revenue as of April, which is very likely to continue until March of 2021, will make the Ministry of Finance tap the main emergency funds for budgetary stabilization (FEIP and FEIF) to avoid more public spending cuts**
- **We anticipate that the devastating economic crisis derived from the pandemic will be reflected on both a real GDP contraction between 9% and 12% YoY and tax revenue losses between MXN 297,836 million and MXN 420,855 million. These amounts would represent between 8.9% and 12.6% of the tax revenue and between 5.7% and 8.1% of the total public revenue figures published in the 2021 General Economic Policy Preliminary Guidelines**
- **We expect the federal government to use at least MXN 100 billion from the FEIP to partially offset the expected loss in tax revenue mentioned above**
- **It is very likely that FEIF transfers to state governments will continue in the next months to compensate for the reduction in federal revenue-sharing with those governments**
- **The expected drastic reduction in the balances of both funds will increase the vulnerability of public finances and will make the need for tax reform more evident**

To deal with the drop in public revenue caused by the current economic crisis, Mexico has various budgetary stabilization funds. The most notable funds, owing to their size, are the FEIP (*Fondo de Estabilización de los Ingresos Presupuestarios* — Budgetary Revenue Stabilization Fund) and the FEIEF (*Fondo de Estabilización de los Ingresos de las Entidades Federativas* — States' Income Stabilization Fund). At the close of the second quarter, the balance of these funds had risen to MXN 176,964 million (0.9% of GDP) and MXN 63,633 million (0.3% of GDP), respectively (see Figure 1). This amounted to a rise of MXN 18,420 million and MXN 3,173 million, respectively, since the end of 2019. Nevertheless, the sharp annual drop in public revenue as of April, which is likely to continue until March 2021, will cause the SHCP (*Secretaría de Hacienda y Crédito Público* — Ministry of Finance and Public Credit) to tap these funds to avoid further cuts in public expenditure.

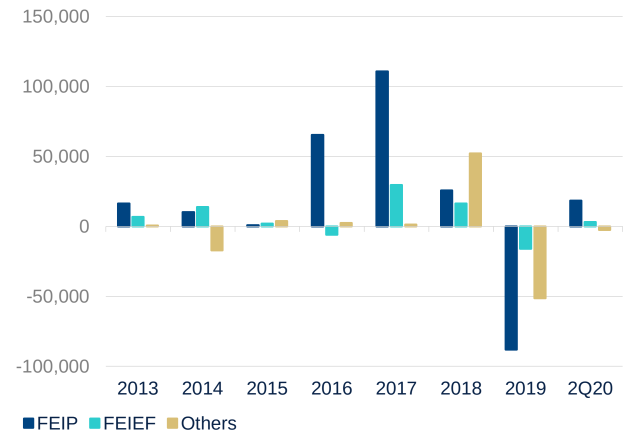
Last year, the FEIP and FEIEF balances decreased by MXN 88,147 million and MXN 15,888 million, respectively (see Figure 2). The activation of both funds was mainly due to lower oil revenue and the impact that the economic slowdown had on tax revenue. In the case of the FEIP, the federal government used approximately MXN 125,000 million in 2019. The FEIEF mechanism was activated in May 2019 as a measure to offset last year's reduced federal tax revenue-sharing with states.

Figure 1. **FEIP AND FEIEF BALANCES (IN MILLIONS OF PESOS)**



Source: BBVA Research based on SHCP data

Figure 2. **CHANGES IN FEIP AND FEIEF BALANCES (IN MILLIONS OF PESOS)**



Source: BBVA Research based on SHCP data

At the end of January, Gabriel Yorio, Deputy Secretary of the Treasury, said that MXN 80,000 million could be used from the FEIP in the event that economic growth was lower than the federal government's 2.0% forecast for 2020. Nevertheless, we expect the severe economic crisis caused by the pandemic to be reflected in a 10% drop in real GDP and a tax revenue loss of MXN 338,842 million compared to the tax revenue figures forecast in the 2021 General Economic Policy Pre-criteria document. This is a much more negative scenario than could have been expected when the Deputy Secretary made those statements.

According to the operation rules of the FEIP, the federal government has set up a reserve amounting to MXN 102,235 million by the end of 2Q20. It should be noted that for this year the maximum annual fund reduction amount allowed is MXN 156,745 million.[1] Given that the FEIP reserve was MXN 93,154 million by the end of 4Q19, the federal government could leave a positive balance in the reserve if it used less than MXN 102,235 million to offset lower budget revenue. We expect the federal government to tap at least MXN 100,000 million from this fund to partially offset the expected loss in tax revenue mentioned above. Moreover, the SHCP reported that it had transferred MXN 20,000 million from the FEIEF to the 32 states in early July. We expect these transfers to continue in the coming months to offset the lower federal revenue-sharing with such states.

[1] According to the agreement that sets out the rules for the operation of the FEIP, the reduction of the reserve at the end of the year compared to the balance on the last day of the previous year must not exceed 50% of the maximum limit set out in Article 19 of the Mexican Federal Law on Budget and Fiscal Responsibility. To our understanding, the maximum limit is calculated by multiplying 0.08 by the sum of the amounts estimated in Article 1 of the Mexican Revenue Law, under the terms for total taxes and transfers from the Mexican Petroleum Fund.

Conclusions

The federal government is facing a very complicated public finance scenario for 2020 and 2021. The activation of the FEIP and FEIEF in the face of lower tax and oil revenues this year will cause both funds to see a drastic drop in their balances. This will leave public finances more vulnerable to external or internal shocks that affect public revenue performance in 2021. While lower tax revenue is expected to continue into next year, it is likely that the Bank of Mexico's operating surplus will be significantly higher than the historical average due to the depreciation of the peso in 2020. The increased fragility of public accounts makes more evident the need for tax reform to help mitigate the risk of further downgrades to the sovereign credit rating. Moreover, the current budgetary challenges that are affecting states could be seen as an opportunity for them to increase their own revenue through mechanisms that make automobile, property and payroll taxes more efficient to collect.

We believe that, going forward, the operation of these emergency funds needs to be reconsidered. These funds have accumulated resources in years in which the federal government has run a deficit. In other words, the government has gone into debt in order to save. This would only make financial sense if you could be certain that the returns on these funds' investments were higher than the cost of issuing sovereign debt. If this is not the case, then the operation of these funds has to be reconsidered. Up until now, emergency funds have been used to offset lower-than-estimated income. We believe that the government should redesign the funds to make them have a countercyclical purpose, so that they can only be used during periods of economic contraction.