Mexico

Economic Watch

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2011 Budget, continuity: maintaining fiscal stability, but not confronting medium-term challenges

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The draft 2011 Budget presented by the executive to the national Parliament represents a continuation of the budget agreed in 2010, as it maintains fiscal stability, but does not confront medium-term weaknesses.

The relationship between growth and projected revenues is reasonable by historic standards and for the current stage of the cycle in Mexico; however, the economic background to the budget has greater downside than upside uncertainty, representing a risk on the same side for forecast fiscal revenues.

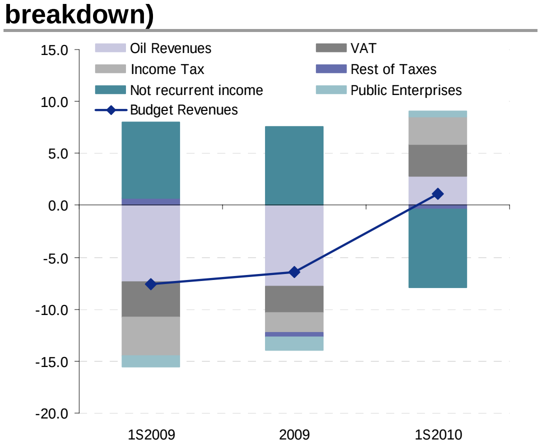
In this context, it is difficult to understand the Parliament's proposal to remove last year's one percentage point sales tax increase. The direct impact of this measure would be 0.4 pp of GDP (2.4% of non-oil revenues), which is meager by international standards, and this would further limit the ability to finance public assets. The lack of a large fiscal base and dependency on oil revenues are factors which the ratings agencies have repeatedly noted as weaknesses in Mexican budget policy.

The forecast deficit is 2.3% of GDP (budget amount), which equates to 2.7% on the widest measurement (PSBR). The deficit has to be complied with by law, but with downside risks to revenues, it might be necessary to resort to stabilization funds and/or to cut spending.

Medium-term consolidation of public debt depends on financing costs and growth in the economy. Beyond maintaining a path of primary surpluses, relatively small changes in the outlook for growth or interest rates affect the stock of debt; progress therefore has to be made in reforms to boost revenues and ensure more efficient spending aimed at increasing the economy's growth potential.

Chart 1

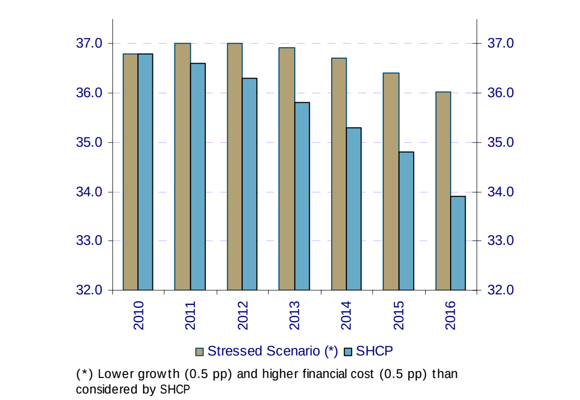
Budget revenues (% change y/y and breakdown)



Source: SHCP and BBVA Research.

Chart 2

Debt (Historic PSBR), alternative scenarios (% share of GDP)



Source: SHCP and BBVA Research

1. General Economic Policy Criteria for 2011: optimism in the economic outlook and oil production which is not falling, unlike recent years

The General Economic Policy Criteria contain the SHCP's view of the economic outlook for 2011. These assumptions are relevant for preparing forecasts of the revenue that will be received in the coming year and, as a result, the availability of funds for spending to meet the deficit committed to in the 2010 budget. The 2010 budget agreed a transitional deficit of 0.7% of GDP for 2010, which will fall to 0.3% (40,000 million pesos approx.) in 2011; as a result, budget balance (not taking into account Pemex investment) will be reestablished relatively quickly following the crisis.

Given the major cyclical performance of tax revenues, growth forecasts are essential for assessing the reasonableness of the budget scenario. Taking into consideration the degree of economic integration between the USA and Mexico, the SHCP makes explicit forecasts in both areas (*Blue Chip Economic Indicators* are used as the source for US growth). The economic scenario for the 2011 budget is optimistic if it is compared to the BBVA Research forecast or the consensus view among analysts of the Mexican economy. As a result, it would appear that the document does not take account of the full scope of the risks mentioned in the budget document itself: 1) Uncertainty over the world economy, whether resulting from a slowdown in the USA or other developed countries; 2) Potential periods of uncertainty in financial markets, which might result from fiscal problems in some European countries.

In order to estimate oil revenues[1], the SHCP calculates the oil price based on two legally-established formulas; this is a robust procedure which eliminates discretionality and incorporates both the observed long-term trend as well as medium-term expectations of the oil market. This is also a prudent focus as the result is reduced by 15% to give room for maneuver in the event of unexpected price falls. This results in the SHCP estimating an average price for the Mexican oil mix of 63 dollars per barrel. This information is completed by combining it with the Secretary of State for Energy's oil production forecasts , which is oil production of 2.55 million barrels per day. Obviously, the government has more in-depth knowledge of possible production levels for 2011; however, the estimates used for 2008 and 2009 are infamous for being higher than actual production, at 419 mbd and 148 mbd respectively. Therefore, we consider that increasing the forecast for output by 50 mbd compared to the estimate for this year is risky, despite the stabilization seen in 2010.

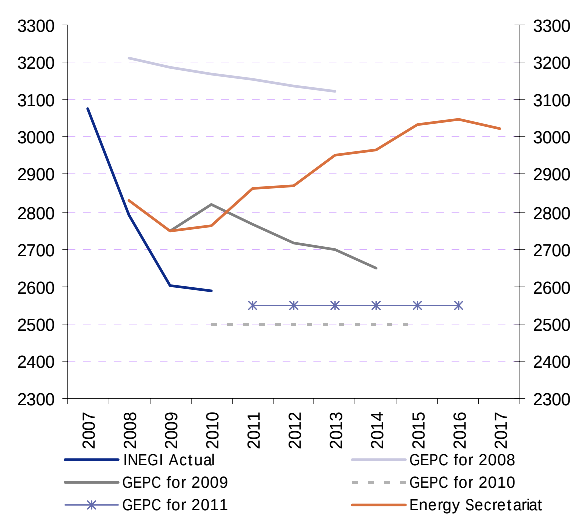
Table 1
Macroeconomic background

	2011 SHCP	2011 Possible Bias
GDP (% real annual)		↓
Real Growth (% annual)	3.8	
Inflation (eop)	3.0	↑
Nominal Exchange Rate (ppd, average)	12.9	↓
Interest Rates (%, Cetes 28d)		
eop	5.5	↓
average	5.0	
Current Account Balance (% GDP)	-1.2	↑
GDP USA (% real annual)	2.8	↓
Inflation USA (% anual promedio)	1.6	↑
Oil (mexican mix)		
Price (bpd)/1	63.0	
Oil exports (thousands daily)	1149	↓
Oil Production (thousands daily)	2550	

*Estimates don´t consider possible changes due to fiscal changes.
/1There's high certainty about oil prices becouse of the availability

Source: SHCP and BBVA Research

Chart 3
Estimated and observed average monthly oil production (mdb)



Source: INEGI, SHCP and SENER

[1] It is interesting to note that over the last two financial years, the SHCP has acquired oil price hedges, and this has contributed to offsetting the effect of the relative uncertainty of the crude price on the budget. It is likely that this will also occur in 2011.

2. Budget revenues, leveraged with favorable outlook

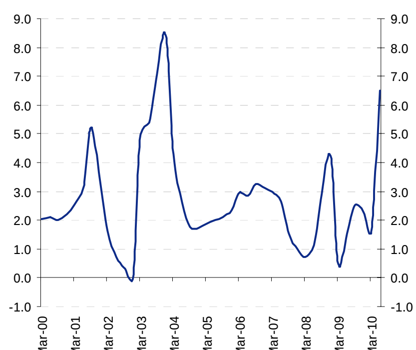
A 3% real increase in Budget Revenues is forecast, based on higher oil revenue (up 2%); a 7.3% increase in tax revenues; a 3.2% increase from directly controlled bodies (e.g. the IMSS social security agency); and a 37.2% fall in non-oil, non-tax revenues.

Growth in oil revenues is based on budgets about which there is a high degree of uncertainty. The estimated 2011 oil price is below the 65 dpb in the 2010 budget, and estimated output at 2550 is lower than that expected at the end of 2010 (2576). As a result, the expectation of higher oil revenues is based on increased weight of domestic sales, carrying a higher tax load, and an average exchange rate estimated at 12.9 pesos to the dollar for 2011, which is lower than in 2010. The scenario is certainly consistent with a gradual depreciation in the exchange rate resulting from productivity and inflation differentials between the USA and Mexico; however, uncertainty about exchange rate forecasts is much higher than for other variables.

Expectations of 7.3% growth in tax revenues are consistent with the scenario proposed by the SHCP, as to a large extent they imply that the economy will continue recovering, leading for the first time since the start of the crisis to a conjunction of stronger internal demand and the 2009 increases in tax rates. The implicit elasticity in growth in both income tax and sales tax –which jointly represent 84% of tax revenues- at 2.4 and 1.9 respectively[2], appear reasonable in relation to the cyclical comparisons estimated by BBVA Research[3] of 2.3 and 1.1. Whilst the cyclical elasticity of sales tax is lower than that presented by the SHCP for 2011, the ratio in the first half of 2010 was 3.5; this gives an idea of the impact of the change produced by a one percentage point increase in the tax rate. As a result, against the background of a gradually narrowing output gap, a return to average historic elasticity seems reasonable.

In terms of non-tax, non-oil revenues, which accounted for 13.6% of total revenues in 2009, it is estimated that these will contract by 37.2% providing that no extraordinary non-recurrent revenues –such as those in April 2009 for the remainder of the Banxico operation- are expected. It is estimated that revenues from Non-Oil Bodies and Companies (i.e. IMSS) -15% of the total- will increase by 3.2%; this is a moderate increase and consistent with an implicit elasticity of 0.84, which is very close to the cyclical elasticity for such revenues of 0.82. It is reasonable to think that revenues for companies and bodies will experience a moderate recovery, as a large share of these comes from the sale of goods and services and contributions and payments by workers to both the IMSS and the ISSSTE social security agency for state workers. As a result, as salaries gradually rise, it is unlikely that we will see a recovery with transitory elasticities in excess of historic rates. In addition, the inertia in the costs for these bodies is very high and this will make it necessary for them to receive subsidies from the federal government or to borrow.

Chart 4
Implicit sales tax-GDP elasticity, growth ratio (Quarterly PM4)



Source: BBVA Research

Table 2
Implicit elasticities in the draft Revenues Law and BBVA cyclical elasticities

	SHCP CGPE 2011	Cyclical elasticity estimated by BBVA
VAT	1.89	1.07
Income Tax	2.36	2.3
Icome from enterprises & organisms	0.84	0.82

Source: SHCP and BBVA, Mexico Situation 3Q10

[2] The ratio of estimated revenue growth for the treasury for each of these tax types and for the economy for 2011.
[3] See Box 2 *"Public finances, in tune with the cycle for the first time"* in Mexico Situation, for the third quarter of 2010, BBVA Research, July 2010

The proposal to reduce sales tax rates by 1 percentage point: an unnecessary risk

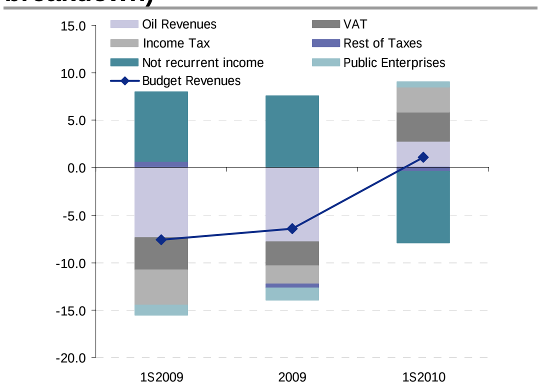
In addition to the Budget for Revenues submitted by the Federal Executive, a proposal has been presented in Parliament[4] to reduce sales tax from 16% to 15% in non-frontier areas; and from 11% to 10% in the frontier area. The reasons given in the proposal document are basically that the sales tax increase has not achieved the proposed revenue objectives, and that at the same time it is suppressing spending. In place of the tax increase, the document proposes more decisive action against tax evasion and a restructuring of the federal government apparatus.

As can be seen from the accompanying chart, which compares the changes in the main tax collection headings, sales tax and income tax have recorded the largest increases, resulting from increased economic activity and the one percentage point increase in the tax rate. With regards to the fight against tax evasion, this is a path that has to continue to be pursued and which should in the coming years offset the expected reduction in income tax rates so as not to reduce tax revenues. Finally, with regard to expenditure, in addition to underspending that may arise from the impact of the calendar on progress with work (there is no reason for the annual budget cycle and multi-year investment to coincide), the effectiveness and appropriateness of all components of expenditure needs to be examined, not only for current federal expenditure, which, for example, displays greater adjustment that the shares allotted to states and municipalities. In this sense, an assessment should be made of whether the relative automatic nature of growth in the shares does not act as a disincentive to the search for other funds and more efficient use thereof by the states and municipalities, particularly when the budget presented includes a fall in capital spending in 2011.

Mexico's tax structure has wide scope for improvement and the reduction of weaknesses, as it is highly dependent on oil, and because of its intensive involvement in the revenue, spending and investment decisions of economic agents, whilst lacking a general and transparent structure, and featuring a plethora of specific tax regimes, exceptions and zero rates. Backtracking on the 2009 agreement to increase indirect taxes is a risk, as the rating agencies –which influence the financing costs of Mexico's public and private sectors- have repeatedly pointed to the lack of a large tax base and dependence on oil as issues to be corrected. In this regard, tax revenues in Mexico are between 10 and 20 points below normal rates for benchmark countries in the region in terms of GDP[5].

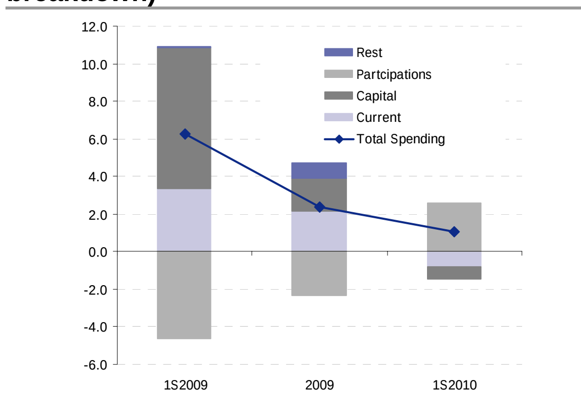
If, against such a background, the public sector opts for the budget restrictions proposed last year –which imply a deficit of 0.3% of GDP in 2011- in adverse conditions, this would probably result in having to resort to drawing on stabilization funds and subsequently reducing expenditure, which would aggravate the effects of any slowdown. In our view, any fiscal proposal implemented will have to: take into account the risk of dependence on oil revenues; propose measures to increase the tax base and increase the efficiency of tax collection.

Chart 5
Budget revenues ((% change y/y and breakdown)



Source: BBVA Research with SHCP data

Chart 6
Budget expenditure ((% change y/y and breakdown)



Source: BBVA Research with SHCP data

[4] "Amending and adding various provisions to the Sales Tax Law". Tabled by the member of parliament Rubén Ignacio Moreira Valdez, PRI. Sent to the Commission for Finance and Public Credit. Official Parliamentary Gazette, number 3092-IV, Tuesday 7 September 2010. (1163)
[5] OECD, International fiscal comparisons. Available on the Internet.

3. Draft Revenue Budget: inertia and no boost to the economy's growth potential

The draft proposes to increase net budget expenditure by 2.1%, 2.3% including Pemex investment. Within this, programmable expenditure would increase by 1.2% as a result of a 2.1% real increase in current expenditure and a 1.8% decrease in capital expenditure. Non-programmable expenditure would increase by 5.9%, due to a 6.8% increase in transfers to states, which implicitly implies a smaller increase in financial costs.

The forecast composition of programmable expenditure shows a 2.1% real increase in the current component; this marginal increase would be driven by a 1.2% increase in spending on personal services; a 4.2% increase in spending on pensions; and a 5.5% increase in operating costs. At the same time, expenditure on subsidies and capital would fall by 2.2% and 1.8% respectively. This breakdown could be reflecting the fact that, in an absence of higher revenues from bodies and companies such as the IMSS and ISSSTE, the Federal Government has to make substantial transfers to these bodies to keep them operational and to enable them to meet their pension commitments. Furthermore, the budgets for the Ministries of National Defense, the Navy and Public Safety will increase by 10.3%, 9.9% and 5.9% respectively, to strengthen public safety policy. The impossibility of continuing increases in capital expenditure and transfers, and the shortfall of social security resources, will not help to improve the growth capacity of the economy or help it to face up to the challenge of meeting increasing commitments resulting from ageing of the population.

A 5.9% real increase in non-programmable expenditure is expected which will be driven by marginal 2.4% growth in public sector financing costs; this figure demonstrates that the costs of the country's indebtedness are under control due to the country's good debt management. Transfers to states will increase by 6.8%, and it is expected that they will reach 459 billion pesos, the highest ever total.

Table 3

Net budget expenditure 2011, billion pesos and % real y/y change

	Amount	Real y/y % chg.
Total with investment in Pemex	3,351.3	2.3
Total without inverstment in Pemex	3,065.0	2.1
Programmable Paid	2,524.3	1.2
Programmable Paid w/o Investment in Pemex	2,237.9	0.7
Differed Payments	-27.0	0.0
Due	2,551.3	1.1
Due w/o investment in Pemex	2,265.0	0.7
Not Proggramable	827.0	5.9
Financial Cost	315.0	2.4
Participations	490.4	6.8
Debits from past exercises (ADEFAS)	21.6	56.1

Source: SHCP

Table 4

Estimated programmable expenditure 2011, billion pesos and % real y/y change

	Monto	Var. % a/a Real est.
Total	2,551.3	1.1
Current Expenditure	1,954.3	2.1
Personal Services	847.9	1.2
Pensions	331.6	4.2
Subsidies	318.0	-2.2
Operation Expenditures	456.8	5.5
Capital Expenditures	597.0	-1.8

Source: SHCP

4. Public Deficit and Debt

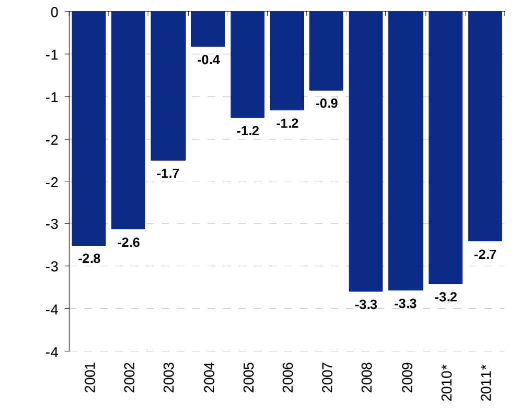
The Traditional Public Sector Balance (budget revenues minus budget expenditure) for 2011 is estimated at -2.3% of GDP, composed of a budget deficit of -0.3% and -2.0% relating to public investment in Pemex. The widest measure of the deficit, the PSBR[6], would be almost 0.5 pp higher than the traditional deficit, resulting in a public sector financing requirement of 2.7% GDP, 0.5% lower than the estimate for 2010 and in line with the budget set then. As a result, it is estimated that the measurement of debt corresponding to these requirements will reduce marginally by 0.2% of GDP to 36.6%.

As we have already stated, the public sector will become comfortable with this deficit, as under normal conditions it will only require fiscal discipline to maintain it, whilst under less favorable conditions stabilization funds and, if necessary, expenditure cuts can be applied.

In terms of debt, the SHCP is requesting net internal debt of 340 billion pesos for 2011 (2.4% of GDP), and net external debt of up to 5 billion pesos (0.5% of GDP). Net debt in the 2010 budget amounted to 380 billion pesos in internal debt (3% of GDP) and 8 billion pesos in external debt (0.8%).

[6] Includes the financing requirements of the PIDIREGAS (Deferred Investment Projects included in the Expenditure Record), the IPAB (Bank Savings Protection Institute), budget adjustments, the debtor support program, the development bank and development funds.

Chart 7
PSBR as % of GDP



Source: SHCP

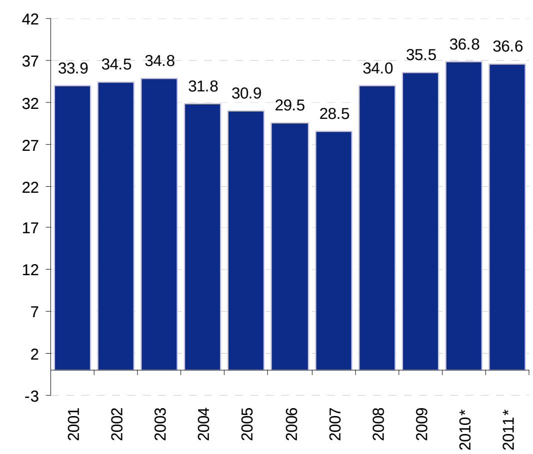
Table 5
Estimated 2010 PSBR and 2011 breakdown (% of GDP)

	2010	2011
I Traditional Balance	**-2.7**	**-2.3**
II Ajustments	**-0.5**	**-0.4**
Requirements From Pidiregas	**-0.1**	**-0.1**
Requirements from IPAB	**-0.2**	**-0.2**
Budget Adecuations	**-0.3**	**-0.2**
Debtors Program	**0**	**0**
Development Banks & Promotion Funds	**0.1**	**-0.1**
III PSBR (I+II)	**-3.2**	**-2.7**

Source: SHCP

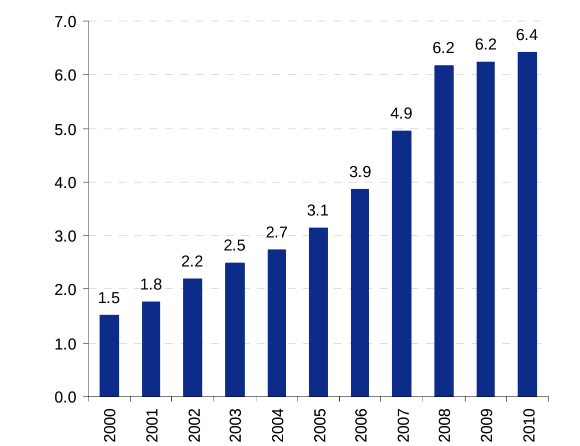
Furthermore, internal debt issuance criteria will aim to strengthen liquidity on the long part of the curve, taking advantage of Mexico joining the WGBI index, in addition to using syndicated placements to accelerate the creation of new products and to deal with bottlenecks that may result from joining the index. As has been achieved in recent years, efforts will be made to lengthen debt maturity and to increase direct placements, so that small and medium savers will have access to a wider range of financial services, and to continue developing the market in “Udibono” bonds with real rates.

Chart 8
Internal and external historic PSBR % of GDP



Source: SHCP

Chart 9
Average maturity of Federal Government debt (years)



Source: BBVA Research with Banxico data