Mexico

Economic Watch

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Fiscal proposal: a nice melody in need of more lyrics

Evaluation of the PRI Fiscal Reform Proposal

Economic Analysis

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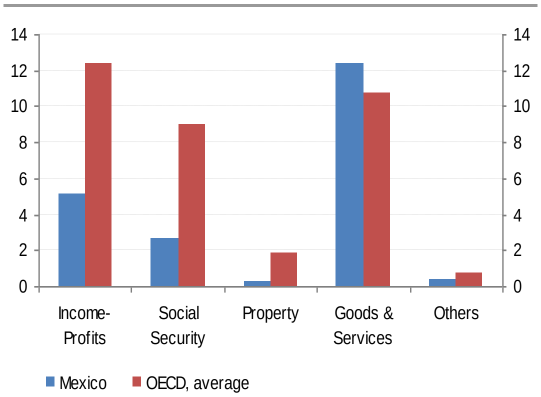
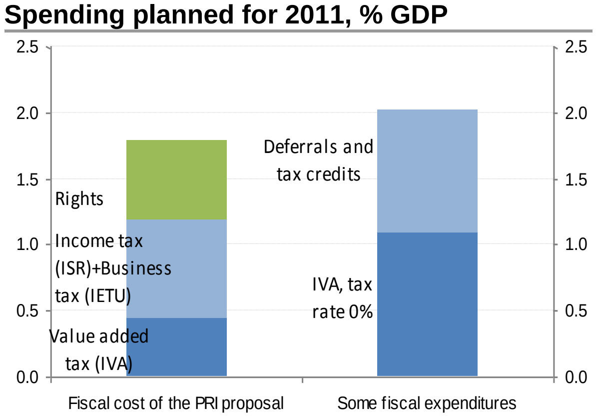
- **The principles of the proposal are well-founded inasmuch as they are focused on achieving sufficient revenue for the public administration by extending the taxable base**
- **However, the lack of information on the implementation of the proposal generates uncertainty with regard to the achievement of the objective of increased collection**
- **No in-depth reforms of the current system are being proposed to increase the tax base, which added to the decreases foreseen in sales and income taxes as well as in petrol royalties revenue could lead to a fall in collection amounting to up to 1.8% of GDP. This percentage would be decreased to the degree that the taxable base is extended, a slow process if the current public spending regime is not adjusted**
- **One of the strength of the Mexican economy is its commitment to fiscal stability. Any sign that this stability is being shaken, such as debates lacking in sufficient information for detailed analysis, would be a negative factor with regard to the credit rating of the public debt, which would determine financing costs and therefore the capacity to generate activity and employment**
- **These uncertainties would be reduced if more information were available on the proposal, which if it is to be applied should be applied gradually, for example with regard to the elimination of the flat rate tax on business operation (IETU), so as to analyze impacts on collection**
- **In any case, it is necessary to have a wide and complete view of existing possibilities in fiscal policy with regard to potential measures to be adopted from both the revenue and spending perspectives**

Chart 1
Public Revenue, % GDP



Source: OCDE

Chart 2
Collection Cost of the PRI Proposal and Fiscal Spending planned for 2011, % GDP



Source: SHCP and BBVA Research

The proposal is in keeping with the principles of sufficient tax collection

The tax reform proposal document presented in the Senate by the PRI[1] establishes that it aims to:

1. Extend the taxpayer base
2. Diminish tax rates for the lower income levels
3. End tax avoidance and evasion
4. Raise collection levels to address spending requirements that will need to be reformed so that their efficiency, transparency, and accountability may be increased

The review of the proposals presented by various institutions over time[2] unequivocally reveals agreement with these objectives, in keeping with the principles of an appropriate tax policy:

- sufficient collection to achieve: effective protection of fundamental rights, physical and human capital, and a reaction capacity in the face of economic ups and downs;
- without distorting decisions regarding income, spending, investment and savings by companies and families.

Implementation of the proposal generates uncertainty with regard to the achievement of the objective of increasing tax collection

The PRI calculates that its reform proposal would make it possible to increase collection with respect to GDP by 1.5%, as a result of combining the specific measures being proposed to the indirect and positive impact of the campaign against tax avoidance and evasion as well as the promotion of formality[3].

Success in simultaneously increasing collection while lowering rates and including eliminating taxes can only be achieved by sufficiently increasing the tax base, the goods, and the services taxed, in the case of VAT and taxed earnings in the case of income tax. However, as detailed in the attached table, an immediate reduction in collection would occur that could amount, according to our calculations, to up to 2% of GDP if the reform is applied all at once[4].

The year ending can be considered to be high ranking with respect to the direct tax cost of the proposal, not only because of the accumulation in one year of the entry into effect of the measures but also because the criteria considered in evaluating some of them, maximums in some cases[5]. In addition, two of the proposed measures have not been evaluated given the lack of information necessary to do it. This is the new optional Simple Contribution Regime for income tax and the Cash Flow Regime. The first should have a moderating impact on the tax collection cost given that it aims to increase the taxable base and not allow entry into the latter by those who already are in special fiscal regimes. The first, according to the evaluation published by the SHCP, would have a very reduced impact[6].

In the case of VAT, based on the available information, greater collection from the increase of taxed new products and from the regional standardization of the general rate far from compensates lower revenue due to the reimbursement of three percentage point of the sixteen of the general rate. The two measures together, considering available data, imply a collection reduction close to 0.4% of GDP, approximately 10% less than collection forecast for 2011.

[1] Available on the Internet in the Senate Gazette.
[2] For example, see
- OECD, OECD Economic Survey: Mexico 2007.
- BBVA Bancomer, Serie Propuestas Enero 2006. Available on the Internet at BBVA Research.

[3] Textually, from the proposal presented: *"... The impact calculations and projections for the tax collection total that this initiative concerns demonstrate that the joint effect of the reforms on income tax, in the flat rate tax on business operation, and the value added tax will directly produce a positive effect on the Treasury of the order of one percentage point of GDP. In addition, additional benefits will be obtained, estimated to be equivalent to half a percentage point of the GDP, from greater collection efficiency to the extent that the effects of the reform mature, from the fight against fiscal avoidance and evasion, and from the promotion of formality."* Senate Gazette
[4] The PRI certainly takes into consideration these effects when it proposes that the rates cuts be implemented gradually in a period of up to three years so that the direct impact is reduced by the increase of the taxable base with lower rates.
[5] Specifically, the additional reduction of revenue from PEMEX oil rights reaches the threshold indicated in the PRI proposal.
[6] 0.03% of GDP according to The SHCP Press Release.

It seems very adventurous to consider that the three percentage point discount from the rate will increase the taxable base attracting transactions to formal channels in sufficient amount so as to easily compensate these losses. In addition, although this measure could improve control on some formal companies that evade taxes by way of underreporting their sales, the effect on the vast amount of informal entities will be minimum given the latter's total evasion of taxes and failure to deliver sales receipts. The maximum effect of 3% seems to be too small in order to compensate collection losses resulting from the rest of the measures, even more so given that should this "formalization" take place based on the increased opportunity cost of informality, it would act with a certain delay, jeopardizing the fiscal accounts balance.

Total Revenues of the Federal Government

		Taxes					Other Revenues		Total
		Value Added Tax (IVA)	Income Tax (ISR)	Business Tax (IETU)	Other Taxes	Total Taxes	Oil Rights	Rest	Federal Government
Expected revenues 2011									
	mop	555,677	688,965	60,605	159,052	1,464,300	626,787	88,203.10	2,179,289.60
	% GDP	3.93	4.87	0.43	1.12	10.36	4.43	0.62	15.41
Fiscal cost resulting from the PRI proposal (*)									
Return 3 percentage points in IVA (1)	mop	-104,189	--	--	--	-104,189	--	--	--
	% GDP	-0.74	--	--	--	-0.74	--	--	--
Homologate tariffs across regions (2)	mop	16,931	--	--	--	16,931	--	--	--
	% GDP	0.12	--	--	--	0.12	--	--	--
Taxing processed food (3)	mop	25,504	--	--	--	25,504	--	--	--
	% GDP	0.18	--	--	--	0.18	--	--	--
Reduce tax to firms from 30% to 25%	mop	--	-45,177	--	--	-45,177	--	--	--
	% GDP	--	-0.32	--	--	-0.32	--	--	--
Optional regime of simple taxation (4)	mop	--	??	--	--	??	--	--	--
	% GDP	--	??	--	--	??	--	--	--
Cash flow regime	mop	--	??	--	--	??	--	--	--
	% GDP	--	??	--	--	??	--	--	--
Federal Law of Rights, incentives to Pemex investment (5)	mop	--	--	--	--	--	-84,825	--	--
	% GDP	--	--	--	--	--	-0.60	--	--
Total cost of the proposal	mop	**-61,754**	**-45,177**	**-60,605**	--	-167,536	-84,825	--	**-252,362**
	% GDP	**-0.44**	**-0.32**	**-0.43**	--	**-1.18**	**-0.60**	--	**-1.78**

Source: BBVA Research
(*) The proposal considers a transitional 3-year period beginning in 2013. This exercise considers a one-time impact in 2011.
(1) 3/16 of the government revenues in 2011
(2) Budget of Fiscal Expenditure 2010
(3) Following the National Household Income and Expenditure Survey (ENIGH), it is considered that an additional 20% of the household expenditure in food is taxed, percentage of the fiscal expenditure at zero rate in (2)
(4) Given the available information, it is not possible to quantify the increase in the fiscal base resulting from this new regime.
(5) Maximum deduction of 6.5 USD per barrel and considering the data of oil production of 2009.
mop means millions of pesos

The possibility of a short-term increase in collection resulting from the proposed reforms is uncertain due to the fact that the rates reduction does not seem to be sufficiently compensated by an increase in the taxable base. Indeed, there is an inconsistency between the declared objective of the Proposal to increase collection, and the mention that special regimes have fulfilled their purpose and constitute tax loopholes and evasion opportunities while current regimes are not reformed and new ones are even proposed[7].

With the passage of time, lower tax rates generate an increase in available income that foments investment and employment, increasing the taxable base in a natural way, but it is an impact that arrives with a certain delay before reaching the potential collection gains mentioned in the PRI proposal, for which no estimation method is disclosed.

On the other hand, there is a relevant margin for action on VAT collection through the additional adjustment of the special exemption and zero-rate regimes, which imply a fiscal cost of 1.4% of GDP according to data for 2011 of the Fiscal Expenditures Budget of 2010. If we add to this costs derived from deferrals in fiscal payments and credits on income tax and the flat rate tax on business operation, the margin of increase of the collection will be over 2% of GDP, and it will in addition simplify compliance to tax obligation and avoid the grey areas between regimes, which are a source of avoidance.

This type of measures would require that an all-encompassing tax reform be considered, something that the existing Proposal does not do, to carry out by way of spending and not revenue, as has been the case up to now, the necessary boost to equitability between the various levels of personal income.

[7] Within the Optional Simple Contribution Regime, rural producers with annual incomes under four million pesos would contribute at 3%, two percentage points under the rest. All of this generates border effects that lead to inefficiencies in the assigning of resources by private agents.