BTMU LATIN AMERICA TOPICS

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MEXICO: VIEWS ON THE PROPOSED FISCAL REFORM

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The government presents its fiscal reform

We were in Mexico last week on a business trip that coincided with the unveiling of the anticipated fiscal reform proposal. The recommended reform was presented to congress along with the 2014 budget on Sunday, September 8th by President Enrique Peña Nieto (EPN) and Finance Minister Luis Videgaray. Below, we outline the key points to consider.

The fiscal reform is the final structural reform initiated since November 2012 by the EPN administration, which has pursued an ambitious reform agenda this year to take advantage of the favorable climate of political cooperation (established by the Pact for Mexico) and the window of opportunity that is present before the 2015 mid-term legislative elections.

Fiscal reform is a central part of the reform agenda since Mexico's public accounts have limited flexibility. Mexico has the lowest total and non-oil tax collection rates among OECD countries, and one-third of its revenue comes from state-owned oil company PEMEX. (Figures 1 and 2.) Congress is now reviewing the key energy and fiscal reforms during its ordinary session spanning September-December.

Less bold than expected, but it encourages progress in the broader reform agenda

The proposed fiscal reform is less bold than originally anticipated at the start of the year. This is because the government adjusted its proposal to the deceleration of economic activity and the noisier political climate, which has seen protests from teachers over the secondary laws pertaining to the education reform.

In this context, the government opted for a pragmatic proposal that has a high chance of being approved by Congress and supports the progress of the broader reform agenda. Emphasis is placed on social reform through the introduction of a universal pension scheme and unemployment insurance. Focus on these social needs will help President Peña Nieto's PRI party obtain the support of the opposition PAN and PRD parties to pass the reform, allowing for more in-depth negotiations on the energy reform (which requires constitutional change).

The fiscal reform takes needed steps to deliver in raising total and non-oil tax revenue. Yet, at the same time, it temporarily widens the deficit in 2013 and 2014. We are of the view that this mix elevates the importance of raising non-oil revenue and monitoring the evolution of fiscal developments in the medium-term.

Proposed reform raises non-oil revenue

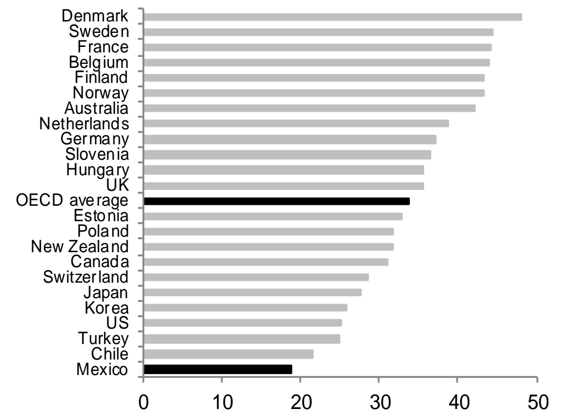
The fiscal reform simplifies the tax code and takes steps to deliver structural progress in two areas: 1) raising total tax collection and 2) increasing non-oil revenue. It aims to boost revenue by 1.4% of GDP in 2014 and 3% of GDP by 2018 via progressive measures which include:

- Increase to personal income tax from 30% to 32% for annual income exceeding MXN500,000 (approximately USD40,000), and limitation of deductions.
- Limitation of exemptions and special regimes for the corporate tax, which stays at 30%.
- Repeal of flat tax (IETU) on corporations and tax on cash deposits.
- Standardization of the value-added tax (VAT) in US-border states from 11% to 16%.
- Shifting several expenditure types (ie, private school tuition, home rents, mortgage interest payments, and home sales) to the general VAT rate of 16% from the previous exemption. As the VAT on education could face resistance in congress, it will be important to see if the revenue will be made up from another source, or if expenditures will be cut.
- Implementation of a 10% tax on capital gains and dividends earned through investments in the Mexican stock exchange. (Pension fund investments are exempt.)
- Implementation of an excise tax on artificially-sweetened beverages of MXN1 per liter.

The reform does not widen the VAT to food and medicine—a measure which was expected to enhance non-oil income by as much as 1% of GDP— in response to slower GDP growth.

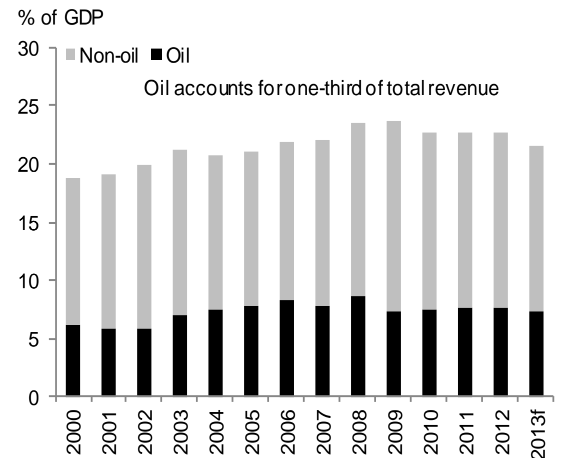
Also, the large size of the informal sector—accounting for 60% of total employment—remains a major obstacle to boosting non-oil fiscal revenues. The reform encourages the transition of the informal economy to the formal economy through a gradual incorporation into the taxation regime, but a stricter treatment of informality and tax evasion could eventually be needed.

Figure 1- Total tax revenues as percent of GDP



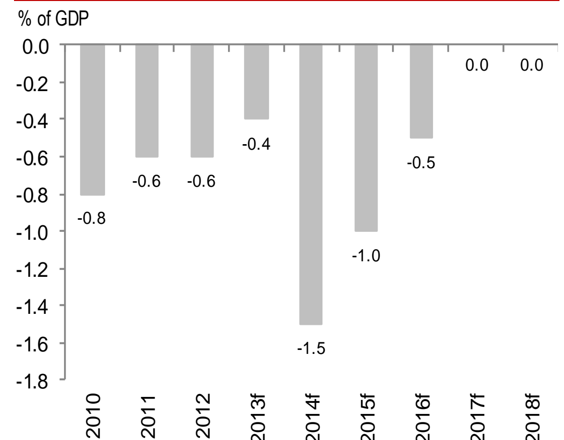
Source: OECD; Ministry of Finance; BTMU Economic Research.

Figure 2- Government revenue sources



Source: Ministry of Finance; BTMU Economic Research.

Figure 3- Primary public sector balance (excl. PEMEX)



Source: Ministry of Finance (forecasts); BTMU Economic Research.

Grants desired budget autonomy for PEMEX, but oil income will remain important revenue source

A favorable aspect of the reform is that it grants budgetary independence to PEMEX, which would be taxed as a regular company starting from 2015. Currently, the company's budget is determined by the Ministry of Finance.

- Per the proposal, PEMEX's tax burden would be reduced. It would be levied the standard corporate tax rate, royalties, and shared profit taxes.
- Aside from the freeing up of resources directed to the government, PEMEX would also have the desired autonomy to decide on investment expenditures.

It also proposes large—though temporary—increase the fiscal deficit

Despite higher revenues, the government's proposal also calls for a temporary widening of the fiscal deficit to 0.4% of GDP in 2013 (from a zero balance target set at the start of 2013) and 1.5% of 2014. (Figure 3.) The deficits—which would be financed by debt—are cited by the government as transitory, owed to the expectation of lower oil prices and cyclical spending increases to support growth. The government is proposing to close the deficit by 2017.

- The 2014 budget is working with an average oil price of USD81 per barrel, versus USD86 in 2013.
- The government wants to provide a cyclical spending boost to the slowed pace of economic growth in 2013.

In our view, the widening of the deficit to 1.5% of GDP in 2014 seems sharp, especially considering that the government is still expecting stronger GDP growth on the back of the advancement of structural reforms to boost competitiveness. Moreover, not all expenditure increases will be cyclical, particularly the proposed universal pension and higher social program spending commitments. There is the possibility that fiscal balances could be weakened. In this regard, we see that it will be essential to raise non-oil revenue and monitor how medium-term expenditure developments play out for fiscal sustainability.

Thinking longer-term: Structural rule commits the government to save

Among the more forward-thinking features of the reform proposal, in our view, is the establishment of a structural fiscal rule and sovereign wealth fund to support counter-cyclical policy. If this component is suitably designed and implemented, the government would be required by law to save during good times (determined in the proposal as years of "above-potential growth"), thus permitting coveted fiscal flexibility to spend during periods of GDP growth deceleration.

- This move follows the disciplined fiscal example pioneered by Chile, which since 2001 has adhered to a structural rule-based fiscal framework. Chilean legislation requires that the structural fiscal balance adjust in line with the long-term (10-year) copper price and potential output. The structural balance must deliver an annual surplus during years when copper prices are above the long-term equilibrium or output is above potential, and excess revenue gains must be saved in the sovereign wealth fund. Conversely, the government can run a target deficit in the case of a fall in copper prices below the 10-year average, or drop in output below its potential.
- Among Latin American countries, Colombia and Peru have also made progress in recent years in establishing fiscal stabilization funds and following a fiscal rule to enhance the flexibility of counter-cyclical policy.
- Mexico currently has a stabilization fund that it is used mainly for the near-term hedging of oil prices and managing of cash. The proposed creation of a sovereign wealth fund would establish longer-term accumulation of savings and facilitate the transition to counter-cyclical fiscal policy.
- It will be interesting to follow how this aspect of the reform component develops into law. To begin, how would this part of the reform coincide or disagree with the government's proposal for widening the fiscal deficit in 2014? Moreover, how will the structural balance and potential output be determined, by whom, and how often? For example, in Chile, two independent expert committees determine each year the estimates for the long-term copper price and potential GDP growth, thereby granting the process independence from politics.

Timeline: With busy months ahead, approval looks set for November

While the labor, education, and telecommunications reforms have been passed, the government is currently working on three reforms: financial, energy, and fiscal. The financial reform was approved by the Chamber of Deputies on September 10th and has advanced to the Senate.

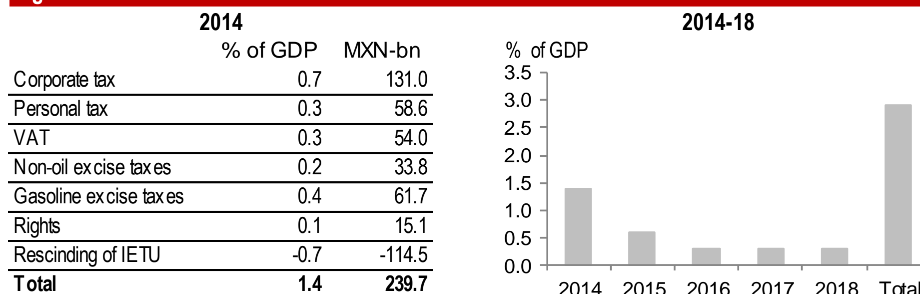
As the revenue component of the government's 2014 budget must be approved by October 31st, and the expenditure component must be approved by November 15th, we are likely to see a steady progression of discussions on the 2014 budget and fiscal reform over the next two months.

Final take-away: Elevated importance on medium-term fiscal developments

The fiscal reform takes steps to deliver needed structural progress—despite the noted surprises—while also preserving support for the passage of other reforms in a politically-sensitive time of decelerated growth. The fiscal reform is expected to be approved with few modifications since it is progressive, does not aim to impose a VAT on food and medicine, proposes social reform, and increases spending to support growth. As a result, this proposal is likely to maintain the near-term political support needed to advance the pending energy reform.

The fiscal reform introduces a stronger foundation for public accounts by increasing non-oil revenues. Along with the proposed structural balance rule, these developments should contribute to enhance the flexibility of fiscal policy. As dependence on oil revenue looks to remain high, a broadening of the tax base would further support fiscal accounts. Given higher expenditure commitments and temporary increase to the fiscal deficit, the reform proposal also elevates the importance of broadening the non-oil tax base and strengthening fiscal developments in the medium-term.

Figure 4- Increase to tax collection efforts in 2014-18



2014

	% of GDP	MXN-bn
Corporate tax	0.7	131.0
Personal tax	0.3	58.6
VAT	0.3	54.0
Non-oil excise taxes	0.2	33.8
Gasoline excise taxes	0.4	61.7
Rights	0.1	15.1
Rescinding of IETU	-0.7	-114.5
Total	**1.4**	**239.7**

Source: Ministry of Finance; BTMU Economic Research.

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For historical data and commentary following BTMU's Economic News Releases, see our website at: http://www.bk.mufg.jp/report/ecolatin2013/index.htm

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