Fiscal Reform and Public Finance The Economy Continues To Stagnate

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Finance Minister Agustín Carstens at a Chamber of Deputies hearing.

On September 13, Mexico's Chamber of Deputies passed the fiscal reform. The entire package, with its amendments to the Constitution and different pieces of legislation, plus the creation of completely new laws, originated with the administration's June 20 proposal titled "Comprehensive Reform of Public Finance." *Stricto sensu*, the Chamber of Deputies passed one bill amending the Constitution and six more bills concerning different laws. All the bills were immediately discussed and passed by the Senate, and the constitutional reforms were sent to the state legislatures for ratification.

The proposals were widely debated in the weeks prior to Congress's decision, but as a result of the political situation and different business groups' lobbying efforts, what was finally passed is different from the administration's proposal. In addition, the fiscal and electoral reforms were discussed and passed at the same time. The electoral reform was modified in the Senate, while the deputies passed it one day after having passed the changes on fiscal issues. I am emphasizing this fact because it was a specific moment that will not be repeated under the current administration.

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Congress's opposition parties accepted discussing and deciding about fiscal matters as part of a complex negotiation about what has been called the reform of the state. The agenda agreed upon by Congress includes new legislation about the media, particularly radio and television, and about different aspects of government, like the reelection of congressional deputies, a second round of balloting in presidential elections and other issues like federalism, human rights and social guarantees. With regard to fiscal issues, the parties that openly pushed for the reform tried very hard not to get behind any bill that would imply new taxes and to show that they came to the discussion with proposals and bills that took into account all aspects of public finance and would create better conditions for public sector operations. For instance, the Institutional Revolutionary Party (PRI) distanced itself from the proposal of increasing the price of gasoline and diesel fuel, insisting that it was the sole responsibility of Felipe Calderón and Finance Minister Carstens, or in any case, of the National Action Party (PAN). The executive, for its part, with the president's active participation, maintains that the proposal came from the National Conference of Governors, where the PRI has a majority.

The political situation is such that the interests of almost all the political parties with congressional caucuses and the federal administration coincide: the discussion and passage of reforms in different areas of the organization of the state, including fiscal issues, are necessary. If only for that reason, it is difficult to foresee a new opportunity for discussion of a reform in this area during this presidential term. The immediate precedent was the failed proposal presented under the Vicente Fox administration, considered still on the agenda particularly by business groups, financial bodies and international cooperation agencies like the International Monetary Fund (IMF), the World Bank and the Organization for Economic Cooperation and Development (OECD).

Therefore, when evaluating the changes Congress made, the difficulty of reaching agreements on these issues should be taken into account, as well as the sheer size of the resources the public sector requires and the activities that must be considered part of public finance. From that perspective, the fiscal reform is insufficient. It maintains loopholes and uneven treatment of taxpayers, and does not take into account the conditions to positively link public spending with economic performance.

PUBLIC SPENDING AND THE CONTRIBUTION OF TAXES

Since the 1960s, there has been talk about the need to increase government tax revenues. Under the administration of Luis Echeverría (1970-1976), attempts were made to forge a fiscal reform. In the years following that, it was not possible to increase tax earnings as a proportion of the gross domestic product (GDP), nor were measures taken to somewhat decentralize tax collection. Therefore, in addition to a low taxation coefficient, states and municipalities receive most of their resources through agreements and different regimens established by the Finance Ministry.

With regard to tax revenues, the difference between Mexico and many countries with similar economic conditions is noteworthy. The Finance Ministry's fiscal reform proposal maintains that in the last 18 years, tax revenues, excluding oil-related taxes, products and duties, averaged 9.5 percent of GDP. The same document points out that this is low compared to other countries with degrees of development or per capita income similar to Mexico's. In the Czech Republic, tax revenues as a percentage of GDP are 21.6 percent; in Poland, 18.8 percent; in Hungary, 25.7 percent; in South Korea, 16.7 percent; and in Latin American countries like Venezuela, 21.4 percent; Chile, 20.4 percent, Brazil, 17.5 percent; Argentina, 15.5 percent; Uruguay, 18.4 percent; and Costa Rica, 12.3 percent. Mexico's tax revenues as a percentage of GDP are lower than Bolivia's (13.8 percent) and Honduras (13.7 percent). Only Haiti and Panama's are lower than Mexico's. In 2006, tax revenues in Mexico were the equivalent of 11 percent of GDP. Using this parameter, the federal, state and municipal governments would have to almost double their tax income to reach the economic conditions of similar countries. The increase in tax collection as a result of the reforms passed will be very far from those eight or nine GDP points.

And there is another problem: the low total income of the public sector. That is, low tax revenues are complemented only by small sums from other sources, including those from oil. In this, there is a big distance between Mexico and the other OECD countries or the larger economies of Latin America. Among OECD members, the average fiscal income was 36.9 percent of GDP in 2004. According to Economic Commission for Latin America and the Caribbean (ECLAC) information, in 2004, Brazil's was over 35 percent, and Argentina and Uruguay's was 29 percent and 27 percent respectively. In Mexico, total 2006 fiscal income, taking into account all revenues, including those derived from oil, came to 18 percent of GDP. Some Latin American countries adopt measures to increase public sector income through taxes or change certain fiscal rules to get investment to grow.

The ECLAC's *Estudio económico de América Latina 2006-2007* (Economic Survey of Latin America and the Caribbean 2006-2007) spotlights the reform of Uruguay's tax system, whose main component is the creation of a dual income tax system for individual taxpayers. Brazil, meanwhile, established the Accelerated Growth Program, whose main objective is to increase investment through two fiscal rules to be applied over a long period of time, that directly influence more than one-third of total primary federal spending, making it possible to increase investment expenditures. In Mexico, the main change is the passage of the Single Rate Business Tax (IETU), which will bring with it a very slim increase in tax revenues for the public sector.

THE CURRENT FISCAL REFORM: THE FIGURES

The proposal the Finance Ministry presented to Congress estimates an increase of 1.5 percent in fiscal revenues as a percentage of GDP for 2008. Most of those monies would come from the new IETU. In following years, revenues would grow by almost three points of the GDP. What Congress passed includes three new taxes, the elimination of another and changes in the name and rates or amounts applicable to the taxes agreed upon. Nevertheless, estimates of the overall increase in public revenues remain unchanged. Several of the bills passed stipulate that by the end of the current presidential term, revenues will increase three percentage points of GDP, one percent of which would be spent by the states and municipalities and two percent by the federal government.

The 2008 Law of Public Sector Revenues, the bill presented by the Finance Ministry, estimates that if the fiscal reform were approved, it would generate 115 billion pesos, or something like U.S.$10 billion, in additional revenues. That figure is slightly more than one percent of GDP. Other estimates come up with similar numbers, in large part a result of the IETU, one of the two most sweeping budget reforms passed. The rate established in the IETU Law is 16.5 percent for 2008, which will increase by half a point a year over subsequent years until reaching 17.5 percent.

The basis for calculating the IETU is established by subtracting company spending in inputs, equipment, installations, physical construction and real estate acquisitions from its earnings. Wages are also deducted, but not all fringe benefits. The tax would be paid only if the result of this calculation is higher than the payment of income or corporate tax (ISR), and the taxpayer would pay the difference between the two. Specific calculation methods are set out for, among others, the cases of self-service stores, banks and other financial institutions. Impact on firms will differ greatly, and it will not eliminate or substantially lessen the use of loopholes. Some of those who already regularly pay taxes on their profits will pay more, which is inequitable. This may be the case of small and medium-sized firms, the majority of the country's companies, which provide most of the nation's jobs.

Firms that need to invest in assets or that have a high capital/product ratio are in a position to decrease the tax base on which the IETU will be applied. Not all companies continually renovate assets because of the kind of firms they are, the way they operate or the characteristics of the sector they are in. But, in addition, by approving the IETU, the assets tax was eliminated, which operated with a diametrically opposed logic. The assets tax has a minimum rate of 2 percent, but an increase in investment implies a larger base upon which to apply it.

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Principles of equity and proportionality are part of the basis of the income and corporate tax (ISR). The tax is levied on the economic result of each firm's activity, without taking into account the kind of business it is to determine the tax base. The exceptions have limited the principle of universality implicit in the ISR, which explains the undersized revenues accruing to the government from it. Simply eliminating the exceptions and loopholes would have made for a substantive fiscal reform.

The revenues to be expected from the new tax on cash bank deposits will be marginal and complicate both individuals and companies' preparing their tax returns. The other source of increases in fiscal revenues is the result of a change in the Law on the Special Tax on Production and Services to introduce a federal tax on the final sale of gasoline and diesel fuel. The new tax stipulates a monthly increase of 2 cents per liter on Magna gasoline; 2.44 cents on Premium; and 1.66 cents on diesel, every month until all fuel prices have risen 5 percent. This is in addition to other hikes like monthly increases of the price of natural gas, liquefied petroleum gas, electricity and other fuels. This reinforces a policy that makes public revenues dependent on the public's consumption, particularly of hydrocarbons.

The Fiscal Reform, Public Spending And Economic Growth

With the fiscal reform, the government estimated 3.7 percent GDP growth in 2008. Without it, growth would be 3.5 percent. Except for an increase in the balance of payments current account, no other differences are pointed out. The passage of the reform does not change the country's economic trends. Estimated average growth at the end of the Fox administration for 2007-2012 was 3.6 percent. The new taxes and other modifications do not bring substantial changes with them, but they also do not alter the composition of public spending. Financed public works (investments by the private sector in infrastructure to be paid back by the government at some future date) will continue to be the main way of investing in infrastructure, with the increase of the public sector debt listed on the books under the item of Pidiregas.[1]

The change in the Mexican Petroleum Company (Pemex) fiscal regime does not fundamentally alter the company's finances. Congress approved decreasing the ordinary duty rate on hydrocarbons from 79 percent to 74 percent in 2008, and dropping it further each year until it reaches 71.5 percent in 2012. However, the law itself stipulates that in the period from 1998 to 2005, federal government resource requests forced Pemex to pay out 110 to 140 percent of its balance. This meant that it paid out all its profits in taxes and even borrowed to pay taxes. The changes agreed upon do not guarantee that Pemex's financial situation will be corrected. What is more, the increase in gas and diesel prices is what finances the change, at least in part. The resources that will no longer come from Pemex will come from taxes on fuel and will be used for spending in the states, up to the equivalent of 1 percent of GDP.

In short, the composition and size of public spending will remain the same. The government's infrastructure program for 2007-2012 confirms that increases in public investment in this area are not expected. Most of the resources will come from financed public works, partly debt contracted abroad. Capital formation will grow at similar rates to that of previous years, with a gross capital formation to GDP ratio fluctuating between 20 percent and 21 percent; the same will happen to the main macroeconomic variables. The one factor that could change this is less growth of the U.S. economy, particularly in some of its sectors that involve most of Mexico's foreign trade. This would lead to lower GDP growth in the country, or even recession. Therefore, with the fiscal reform, the growth of the economy will continue to be weak, and, considering the increase in the population, it will continue to tend to stagnate.

Notes

[1] Pidiregas is the acronym for "Differed-Impact Projects in Spending," a term coined by the Finance Ministry in 1996 to describe private investments in priority, long-term infrastructure projects, with the government assuming the corresponding liabilities. See "Pidiregas, situación actual y perspectivas" at http://www. energiaadebate.com.mx/Articulos/oct-nov-2005/victor_manuel_garcia_dela_vega.htm. [Editor's Note.]