Who's Afraid Of Fiscal Reform in Mexico?

Enrique Pino Hidalgo*

Convinced that he will maintain the broad public support he received in last year's elections, Mexico's President Vicente Fox presented an ambitious tax reform bill to the Chamber of Deputies, a bill that will put the political capabilities of the entire cabinet to the test. This reform will be a strategic battle that will mark the way forward for his administration. The bill confirms his economic orientation, marked by the continuity of a neoliberal, privatizing model that the country has followed since the beginning of the 1980s.

Among the measures Fox is proposing are extending the 15 percent value added tax (VAT) to food, medicine, books, school tuition and public transportation; reducing income tax (ISR) on wages, honoraria and corporate earnings from 35 and 40 percent to 32 percent;[1] cutting special taxes in some sectors of production and services, particularly on alcoholic beverages and cigarettes. He is also proposing to modify preferential treatment for agricultural activities, fishing and trucking.

The bill has been criticized and rejected by the political opposition, including some people from Fox's own National Action Party (PAN). On May Day, thousands of workers from independent unions and the old, official unionism demonstrated against levying VAT on basic consumer items while exempting financial profits from taxes and postponing the collection of U.S.$47 billion in back taxes from private banks.

Mexico's tax earnings are less than the average for South American countries.

President Fox assures that his tax program is the fulfillment of a "campaign promise" to the public. To emphasize his administration's financial difficulties because of the loss of oil income, he announced a "very broad economic package" that will generate 30 billion pesos (more than U.S.$3 billion) in "savings to society." This money will come from massive firings included in the "voluntary retirement" programs for tens of thousands of public employees and the sale of a few parastate companies like the Hidalgo Insurance Company. Meanwhile, the Mexican economy will experience a frank retreat in the third and fourth quarters limiting growth to one percent, in the best of cases.

In this article, I will examine the content and effects of President Fox's proposed fiscal reform, as well as reactions from society, political parties and Mexico's social organizations. I will also formulate a few predictions about negotiations and the outcome of the administration's bill. The entire process will put the new government's policy orientations to the test vis-à-vis the public's general expectations of positive economic and political change, expectations expressed in last year's presidential elections.

Mexico's Tax System

The Impact of Public Debt on the Crisis in Public Finances

Mexico's tax system is inefficient, inequitable and vulnerable. Tax earnings represent 10.4 percent of the gross domestic product (GDP), a very low proportion compared to the 26-percent average for members of the Organization for Economic Cooperation and Development (OECD). In Latin America, Mexico's tax earnings are less than the average for South American countries; Brazil, for example, takes in the equivalent of 13.2 percent of its GDP in taxes.

With current structuring of VAT, the Mexican system's potential earnings should be equivalent to 5 percent of GDP, but only 3.3 percent actually comes in. This inefficiency is confirmed by real revenues for the category of tax

* Economist, researcher and professor at the Autonomous Metropolitan University (UAM), Iztapalapa campus.

TABLE 1
TAX REVENUES OF NAFTA COUNTRIES 1980-1995 (PERCENT OF GDP)

Year	Canada				United States				Mexico			
	Total	Direct	Indirect*	S.S. Payments**	Total	Direct	Indirect*	S.S. Payments**	Total	Direct	Indirect*	S.S. Payments**
1980	31.6	17.8	10.4	3.4	26.9	16.3	4.7	5.9	15.9	5.3	8.3	2.3
1985	32.7	17.7	10.5	4.5	26.1	14.6	4.9	6.6	17.0	4.1	11.0	1.9
1990	35.6	21.1	9.3	5.2	26.6	15.1	4.6	6.9	17.1	5.2	9.6	2.3
1995	35.5	20.6	9.0	5.9	27.9	15.9	5.0	7.0	16.3	4.6	9.0	2.7

Indirect taxes.*
Social security payments.**
Source: Nafinsa, *Mercado de valores* (Mexico City), July 1999.

on income and earnings (ISR) coming to only 4.7 percent out of the potential 8 percent. Efficient collection of both taxes would bring in an additional income of 5 percent of GDP. In Mexico, for each peso the public pays in VAT, the government only actually sees 59 cents; the other 41 cents remain in the commercial sector that charges the tax. This practice, a kind of tax fraud, means that of the 250 billion pesos that the Treasury should receive for VAT, it only receives 135 billion (just over U.S.$13.5 billion).

For the last 10 years, income from Mexico's oil production have represented an average of 31.5 percent of all public revenues. This dependence makes public finances very vulnerable to rapid changes in international oil prices and world demand. The crises of 1982, 1998 and 1999 have confirmed the risks of this structural fragility of public finances and therefore, of the Mexican economy itself.

President Fox's administration has left out a key factor in the current fiscal crisis in defending his bill: the financial obligations linked to the U.S.$290-billion public debt. An important part of these financial obligations stems from the bank bail-out when the government's Savings Protection Bank Fund-Bank Savings Protection Institute (Fobaproa-IPAB) purchased overdue loan portfolios. The basic problem of public finances is the year 2001 budgetary difficulties in paying the interest on government debt. Almost U.S.$30 billion is lacking, representing a fiscal deficit of 5 percent of GDP. The monies that the tax reform would generate would be earmarked to finance the interest on the debt and decrease the deficit. According to the Fox administration tax reform, the additional funds from levying VAT on food, medicine, books and transport would represent between 120 and 140 billion pesos that would cover the inefficiency of the tax system. The new "redistributional fiscal finances" would not correct structural failures; they only broaden out the collecting mechanisms that will weigh in against the middle- and low-income sectors of the population.

THE ADMINISTRATION'S "NEW PUBLIC FINANCES"

At the end of last March, President Fox presented his bill to the Chamber of Deputies under the suggestive title of "The New Public Finances, A Shared Commitment." The proposal was publicized as a reform that would have a "distributional" effect, a reform that would help build "a Mexico with fewer inequalities." In its argumentation, the federal government emphasizes the need to strengthen the tax base, which in Mexico represents only a modest 10.4 percent of GDP, saying that the increase in tax revenues would make it possible to finance economic growth and increase social spending in education, health and economic and social infrastructure.

During his six-year administration, President Fox hopes to achieve a goal of increasing tax revenues by 5 percentage points of GDP (two from VAT and three points by fighting tax evasion).

His proposed fiscal guidelines include the following measures:

Regarding value added tax (VAT):

1) Levying a 15 percent VAT on food, medicine, school tuition, public transportation, books, etc.;
2) Levying the 15 percent tax on employee benefits like supermarket and gasoline vouchers, important wage supplements;

Regarding income tax (ISR):

3) Reducing the maximum rate on company and personal income (ISR) to 32 percent (currently, the maximums are 35 and 40 percent);
4) Changing the tax credit applied to wages and the differentiated income rate, as well as exempting personal incomes equivalent to four times the minimum wage (60,000 pesos, or slightly over U.S.$6,000, a year) or less from ISR;
5) Exempting stock-market and fiscally consolidated corporations' profits from tax payments;
6) Eliminating the existing 5-percent tax on dividends to corporate stockholders;
7) Eliminating special categories as well as the ISR exemption on activities in agriculture, animal husbandry, fishing, silviculture and publishing;
8) Encouraging investment by eliminating taxes on company earnings of up to 4 million pesos a year (U.S.$435,000);
9) Reducing rates of the Special Tax on Production and Services on alcoholic beverages, beers and cigarettes;
10) Eliminating invoices and registering bank statements;

Regarding the environment:

11) Charging for water rights now under the aegis of municipal governments;
12) Differential treatment in the application of ecological taxes on "clean" and "dirty" automobiles.[2]

Actually, Fox's fiscal proposal is part of a broader project that includes other financial and budgetary reforms.[3] What is being called "The New Public Finances" includes 13 bills that deal with issues as diverse as the opening of branches of foreign banks, limiting the right to banking secrecy, the review of different kinds of mortgage plans, reforms to stock exchange activities, etc.[4] According to government plans, the central aim of the financial reform is to consolidate, foster and make transparent the activity of financial intermediaries, extending their services to broader sectors of society, and to increase domestic savings. It also proposes to increase supervision and regulation of financial intermediaries; for example, with regard to the stock exchange, it plans stricter sanctions for undue use of privileged information and measures for the creation of an equities clearing house.

It is also proposing a Popular Savings and Credit Law and the creation of new kinds of mutual funds for managing private pension funds as well as the creation of the National Mortgage Society that would support housing programs. The text of the budgetary reform offers to reorient public spending "focusing on results," subjecting the budget to a formal measurement of performance and rigorous accountability for the funds spent. It also proposes setting up guidelines under which Congress will be able to modify the budget proposals (both for revenues and for spending) known as the "economic package." For example, if Congress and the president do not agree on an economic program, the president could use his right to veto. Also, any additional spending proposed by the legislature would have to be accompanied by proposals of funding mechanisms. Mr. Fox's project aims to limit the legislative branch's attributions with regard to the budget, broadening those of the executive.[5]

> The new "redistributional fiscal finances" would not correct structural failures; they only broaden out the collecting mechanisms.

Economic and Social Effects Of the Fiscal Reform

In preliminary reviews of the negative and positive impact of the fiscal reform, analysts have pointed to the following. First of all, the new income it would generate would help reduce the government's fiscal deficit, as well as its financial dependence on oil earnings. It would probably also facilitate Standard & Poors' granting Mexico's public foreign debt "investment grade," confirming the economic stability favorable to investment and employment. Interest rates would continue their des-

TABLE 2
SOURCES OF MEXICAN TAX REVENUE (1997)

Tax	Percentage of tax revenue
Income and corporate earnings tax	34
Tax on oil (does not include proceedings from direct sale)	35
Value added tax	20
Special tax on production and services*	2
Import duties	5
Others (tax on new autos and vehicle registration)	4
Total	100

* Applied to alcoholic beverages, tobacco, beer and soft drinks.
Source: Secretaría de Hacienda y Crédito Público, Mexico City, 1998.

cent, which would hopefully stimulate the demand for loans and their repayment. In addition, a decrease in the ISR, which benefits both individuals and companies, and the immediate investment deduction would also have positive effects in high-income categories.

In a climate of stability and confidence, the entry of new capital would strengthen the peso vis-à-vis the dollar. And finally, stock prices would increase because of high expectations. These are some of the positive effects most often cited in defense of the Fox administration's fiscal project.

Among the negative effects is, in the first place, an 8- to 9.5 percent inflation rate due to price hikes stemming from the application of the VAT to food and medicine; according to the National Statistics Institute, food and medicine represent 27 percent of the consumer price index. This price increase would more severely affect the over 50 percent of the population who have low incomes since they earmark more of their earnings for basic goods and services. As a result, disposable income among these sectors would drop. The government would have to broaden out and strengthen compensatory programs to avoid greater impoverishment.

Increased taxes would inevitably weaken the domestic market and with that accentuate the difficulties faced by small and medium-sized firms, important sources of employment. The new fiscal arrangement could even stimulate further the informal economy. Preliminary estimates of the Scotiabank-Inverlat Brokerage indicate that the fiscal reforms could cause a temporary reduction in domestic consumption, with effects differentiated according to sector of economic activity. For example, the industries whose sales would be most affected would be textiles, beverages, food and commerce.[6] In general, all companies linked to the production and commercialization of wage-goods would be affected.

Interest rates would stay at current levels, at least during the period in which prices increase due to taxes. The currency would increasingly be over-valued because of the influx of new capital.

SOCIETY AND THE POLITICAL PARTIES RESPOND

The administration's proposal has caused an uproar and an intense debate in political and business circles and among social organizations. The media has paid particular attention to this debate, whose initial results did not favor the Fox administration. The fiscal reform proposal has not achieved consensus among the public, but in the end, it will be the Chamber of Deputies that will make the decision.

The most polemical proposals are the ones imposing VAT on food, medicine and other items that were previously exempt and the elimination of tax breaks on agricultural, fishing, transportation and publishing activities. This puts the fiscal reform at risk because the two measures are at the center of the administration's proposal given its urgent need for income.

One of the most frequently repeated criticisms is that the fiscal reform is not equitable and that therefore the new proposed tax system cannot fulfill its aim of redistributing income. The VAT will negatively affect more than half the population who earn under twice the minimum wage. The administration proposes setting up a compensatory program that consists of distributing 108 pesos a month —it has been debated whether this would actually cover the VAT a family of five would pay out— to 5.3 million families, barely half the poor families affected. The case of Mexico City is a significant example: it has 3 million poor inhabitants who are not part of the federal government Progresa compensatory programs and therefore would receive no compensation at all.[7]

The fiscal reform is inequitable because it taxes these sectors' consumption at the same time that the federal government has decided not to charge the country's banks back taxes owed to the tune of 45 billion pesos (U.S.$4.5 billion). If Mexico's bankers paid 15 percent of their back taxes, the federal government would take in 6.7 billion pesos, the equivalent of all the income expected from the VAT applied to medicine and books.

After five months of debates and analysis, the administration's fiscal project has not achieved an affirmative answer or consensus in society. Quite to the contrary, the main reactions have been disapproval and rejection. Unions and peasant confederations have stated that the fiscal reform injures people's basic rights to food, health and education.

With the exception of the powerful Bankers Association of Mexico, the chambers of commerce and industry have also expressed their skepticism regarding the government's project. The National Chamber of Publishers called applying VAT to books an "attack on culture" that would accelerate the sector's already existing crisis. The Business Coordinating Council, one of the country's most influential business organizations, said that the reduction of the ISR to 32 percent would only benefit the rich and the poor, leaving the middle class without any form of government support that would compensate for the negative effects of applying VAT to more goods.[8]

In this atmosphere of disagreement, the changes to and eventual rejection or approval of the new tax laws will be decided by Congress, in particular the deputies of Mexico's three main political parties: the governing National Action Party (PAN), the former governing Institutional Revolutionary Party (PRI) and the center-left Party of the Democratic Revolution (PRD).

A Probable New PAN-PRI Congressional Majority

It is a fact that the Mexican economy has stagnated as a result of the recession in the United States and the impact of governmental budget cuts that have slowed investment and domestic consumption.

The 200,000 new jobs the administration had planned to create from January to March did not materialize, meaning it will not reach its goal of 700,000 new jobs this year (1,200,000 new people enter the work force yearly). In addition, the economy will only grow one percent this year.

This is the social and economic context in which the Chamber of Deputies, where none of the three largest parties has a majority, will discuss the proposed fiscal reform and have to come to some kind of a decision.

> Increased taxes would inevitably weaken the domestic market and accentuate difficulties faced by small and medium-sized firms.

During an economic recession, the fiscal reform will also put the legislative branch to a rigorous test as a counterweight to the executive branch, particularly the political parties and deputies as elected officials.

The final outcome will be a good estimation of the level of independence that the legislature has vis-à-vis the executive. The public will be able to measure the truth of Fox's statement during his inaugural address that "the president proposes and the Congress decides."

The PAN's congressional caucus supports the bill in general terms but has strong objections to some of the proposals about levying VAT on more products. The caucus does not have a majority and will have to negotiate the terms of the compromise proposal with the PRI and the PRD, and even with the executive branch itself. The terms of that negotiation seem to be clearly outlined by the fact that the PAN caucus has 207 votes and needs only 44 votes more to have a majority in the Chamber of Deputies. Those 44 votes could come from the PRI (which has a plurality of 209 votes) or even from the sector of the PRD (with 51 votes) headed up by its president, Amalia García, who has proposed a conciliatory policy toward the Fox administration.

The new congressional majority will probably be forged between the PAN and some of the more conservative sectors of the PRI itself that have confirmed their agreement with President Fox's neoliberal economic strategy. This kind of an agreement has a precedent in the recent controversial approval of the constitutional amendment about the rights of indigenous peoples. Under these circumstances, President Fox's original proposal would undergo important modifications.

The political-electoral costs of approving Fox's VAT proposal could be considerable for both the PAN and the PRI, whose deputies already approved in 1995 an increase in the VAT tax from 10 percent to 15 percent.

A decision like this could cut short the electoral recovery the PRI has had in the recent state elections in Oaxaca and Tabasco.

The PRD has expressed its overall rejection of Fox's tax proposals. This party, the country's third electoral force, is sharply divided and made a bad showing at the most recent federal elections, despite having retained the Mexico City mayor's office. A congressional agreement between the PAN and sectors of the PRI could once again exclude the PRD from the real process of negotiations about tax reform.

Some Preliminary Conclusions

In the new political context marked by parties alternating in the presidency, an attempt to come to a consensus about tax reform requires first of all a reform of the public administration, guaranteeing transparency and efficiency in the use and assignation of public funds. Otherwise, taxpayers are not going to be very willing to increase their payments or even become part of the fiscal system. This prerequisite has not been guaranteed by the new administration.

A state with weak finances sees its ability to foster economic development seriously restricted. A successful fiscal reform must cover certain minimal bases and clearly defined objectives. First of all, it should guarantee the principle of equality, achieve a consensus among the different economic actors and social sectors and operate in the framework of legal security. Mexico needs a fiscal reform that will eliminate inequalities and inefficiency and strengthen public finances. Only under these conditions will the state be able to fulfill its obligations in financing national development.

In a context of crisis in public finances, passing the fiscal reform bill promoted by the Fox administration is a task of the highest order. However, the characteristics of the bill itself do not fill the expectations of a progressive economic change that broad sectors of the population are waiting for. Its eventual approval without substantial changes would also make the political parties that voted for it very vulnerable politically and electorally.

The Mexican economy has stagnated as a result of the U.S. recession and the impact of federal budget cuts that have slowed investment and domestic consumption. At the same time, unemployment continues to rise. In this difficult social and economic situation, the Chamber of Deputies will negotiate, change and approve a final version of the fiscal, financial and budget reforms.

Negotiations among the main congressional caucuses is inevitable given that none of the three has a majority. Under these circumstances, we should not be surprised if the PAN comes to an agreement with sectors of the PRI since they agree overall on the federal government's neoliberal economic model. VM

Notes

[1] Mexico's income tax (ISR) is applied to different kinds of income both personal and corporate, including wages, honoraria, dividends, interest, and corporate profits. ISR is also applied to rent, real estate purchases and sales and purchases of goods and services.

[2] "Llegó la propuesta; no hubo cambios: SHCP," *El Universal* (Mexico City), 4 April 2001, p. A6.

[3] The broader government proposal includes a new law on earning and value added and reforms to the Special Law on Production and Services and to the Federal Law on Automobile Tax, among others. In the financial realm, the administration is projecting a new national law on mortgages, a law to create the National Savings and Financial Services Bank, reforms to the Law on Credit Institutions and changes to the charters of the National Finance Institution, the Rural Credit Bank, the Foreign Trade Bank, the Army Bank and the Bank of Public Works and Services. With regard to the budget, it is planning amendments of different articles of the Constitution to allow the president to push forward the yearly Expenditures Budget Decree. (Chamber of Deputies, *Gaceta Parlamentaria*, 4 April 2001), Appendices.

[4] Cámara de Diputados, *Gaceta Parlamentaria*, 4 April 2001, Appendices.

[5] Ibid.

[6] "La reforma fiscal reducirá el consumo en general," *Milenio Diario* (Mexico City), 4 June 2001.

[7] "Declaración del jefe de gobierno del Distrito Federal sobre la reforma fiscal," *La Jornada* (Mexico City), 19 April 2001.

[8] "Condiciona la iniciativa privada apoyo a la reforma fiscal," *Milenio Diario* (Mexico City), 5 April 2001.