The Limits of the Fiscal Reform

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Protests against charging VAT for food and medicine.

Mexico's lack of resources for economic growth has been a constant and is the context for the debate on tax reform.

Amidst the economic recession that has characterized the first nine months of President Vicente Fox's administration, the greatest challenge that our incipient democracy faces is regaining the path of sustained economic growth lost for almost three consecutive presidential terms.[1] Our economy, which depends mainly on manufacturing exports, has been adversely affected by the deceleration of the U.S. economy and growth expectations have dropped from 7 percent to 0.5 percent.[2]

Under current conditions, to grow again, we need to reactivate investment in production and reorient the economy toward increasing the domestic market. The administration wants the fiscal reform to be the instrument that will allow the state to achieve higher revenues and stimulate economic growth.

The federal executive has sent the Chamber of Deputies a tax reform bill whose main objective is strengthening state finances by increasing revenues by 117 billion pesos (over U.S.$12 billion). It also sets oft-repeated general goals: fighting tax evasion, simplifying accounting procedures and mechanisms for tax collection, redistributing income more fairly and equitably, increasing investment in production, making public spending more transparent, etc.

Even though the proposed fiscal reform's objectives are acceptable and all the political forces in the country concur that they should be achieved, analysts agree that the proposal is limited both because of its practical applicability and because the real possibility of increasing taxes is very slim.

It would be very complex and costly to exercise control over taxes paid by small-scale itinerant salespeople who sell agricultural items like limes, onions and apples on the street. It would be

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equally difficult to establish just what the income of taxi or mini-bus drivers is.

On the other hand, tax collection is concentrated among a small number of companies and individuals who currently bear the brunt of the burden, and these would in fact end up paying the increased taxes proposed in the fiscal reform. This group also has the most resources and means to make their protests heard.

The current balance of forces in the Chamber of Deputies —where the president's National Action Party (PAN) does not have a majority and where presidentialism no longer operates— makes it possible to predict that the executive's proposal to apply the value added tax (VAT) to basic foodstuffs, medicine for chronic illnesses and basic health care, books and public transportation will be rejected. Some processed foods are considered luxury items and certain products are passed off as medicine when they are actually cosmetic treatments; no one will oppose the VAT being applied to them. But it will be very difficult to get approval for eliminating the tax exemption on basic foods and most medicine, books and public transport. The exemption is considered a victory of the poor, and deputies would find themselves very hard put to explain to their constituents why they had voted to eliminate it.

Concentrated Tax Revenues

We should ask ourselves two questions. Up to what point can large companies, who consider themselves the target of the tax hike —since they are a captive tax base that provides most tax revenues— really absorb the increase? And, would they really be willing to be —in solidarity— a part of this project?

Because of the concentration of income, the country's large companies play an important role in public finances. One percent of companies provide 75 percent of federal government tax revenues: according to Finance Ministry figures, of the 3,130,714 registered companies, 31,307 supply 75 percent of tax income (income and corporate earnings tax [ISR], VAT and others).[3]

On the other hand, tax revenues from the other 99 percent of companies are very disperse because in the main they are small firms over which the Finance Ministry's administrative infrastructure (which is shrinking) has less control. In this category are many companies who only manage to subsist by evading taxes.

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Currently, 20 percent of tax revenues from foreign trade, which has increased its fiscal contribution in recent years, comes from tariffs, a figure unlikely to increase. Although Mexico has signed free trade agreements with the European Community and several countries in Central and South America, and although talks are underway to establish future agreements with Japan and other countries, the trend in free trade is precisely to suppress tariffs.

Mexican income tax (ISR), the single largest source of federal tax revenues, is also highly concentrated. A mere 5,000 companies contribute almost half of this kind of taxes. This shows the high concentration of income and the difficulty in increasing the rate in this category, where the bill stipulates a maximum of 32 percent.[4]

Oil-Based Finances

Pemex, the country's largest company and the federal government's largest taxpayer, contributed 37 percent of all tax revenues in the year 2000.[5] The company predicts a reduction of its contribution, both because oil prices are dropping and because Pemex growth requires large investments put off during the period of so-called "neoliberalism," the last three administrations. Some of these investments are for maintenance and cannot be postponed; this means that if tax monies are not freed up to do it, debt will have to be incurred.

Until now, public finances have been maintained by taxing oil income, but the fiscal reform aims to give the company room to grow by encouraging investment. Of the estimated 289 billion pesos (over U.S.$31 billion) in tax monies that Pemex should generate in 2001, 109 billion (U.S.$11.8 billion) are needed for reinvestment in production and maintenance work that has been postponed over the years.[6]

Personal Income Tax

There is also little room for maneuvering around the proposal to increase personal income tax. On the one hand, among high-income groups, the top 10 percent of families concentrate 40 percent of all income; these people pay 88 percent of all personal income tax and oppose an increase even though they have the ability to pay. On the other extreme of the spectrum are the 60 percent of poorest homes with absolutely no capability of paying taxes. It is important to mention here that they pay no taxes on their personal incomes because doing so would reduce considerably their ability to purchase basic foodstuffs and medicine and use public transportation.[7]

This concentration of income can also be observed in wages: of the 14.5 million wage-earners registered as taxpayers, 60 percent earn the equivalent of three times the minimum wage or less and therefore, by law, pay no ISR. On the other end of the spectrum are the top-earning nine percent (1,305,000 wage earners) who earn over ten times the minimum wage and who contribute 93 percent of wage-earners' ISR. This is the segment where taxes could be raised, but if the crisis continues, there will be fewer earnings to tax because in the first eight months of the year, almost half a million workers have lost their jobs.[8]

Value Added Tax

The Fox administration hopes to increase tax revenues by 117 billion pesos (over U.S.$12 billion) by applying VAT to new products. This amount would have to be adjusted down with any changes that Congress might make to the bill. After the adjustments, analysts estimate that between 30 and 40 percent of the goal could actually be collected. Current VAT revenues, which represent 30 percent of government revenues, also come from a relatively small number of people. The 20 percent of the population with the highest incomes pays 64 percent of all the VAT collected, while the other 80 percent only contributes 36 percent.[9]

The Informal Economy

The informal economy, which includes all unregistered economic activities carried out in units of under five persons, is responsible for the largest amount of tax evasion of any sector. A mechanism has to be created to integrate the informal economy into the formal sector and, of course, levy taxes on it. This is necessary because, measuring by its size and economic resources, it represents an equivalent of 8 percent of the GDP that is simply not counted in national accounts. In addition, during the current recession, it is the most dynamic part of the national economy. This sector's very rapid development is attributable to excessive regulation, the lack of job opportunities and the relative simplicity with which the unemployed of the formal sector turn into itinerant salespeople with high profit rates because they pay no taxes.

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According to National Statistics Institute studies, more than 8 million people work in the "underground economy," that is 21.7 percent of the economically active population, which generates 40 percent of the GDP in sales.

This is the sector with the greatest potential for increasing tax revenues because this is where the most tax evasion is occurring. According to the Chamber of Deputies' Finance Commission, tax evasion may amount to about 138 billion pesos (over U.S.$14.8 billion), more than the entire increase in tax revenues Fox hopes for from his fiscal reform.

Conclusions

Regardless of whether we accept the aims of the fiscal reform, the real possibilities of increasing revenues are limited because high-income groups already pay relatively high taxes, and it will be very difficult to justify an increase.

To be able to incorporate the informal economy into the formal economy and increase taxes paid by people with middle-class incomes, the state machine will have to be expanded, which represents a cost that may not be justified.

If the government opted for increasing the price of fuel, given the difficulties in increasing taxes, it would be the high-income sector that would end up paying for the increase.

To be able to negotiate the fiscal reform, all sectors of society would have to come together to reach a national accord, with long-term objectives. They would have to start by making the state viable, through the appropriate functioning of an economy in sustained growth based on three premises:

1) An overall fiscal reform that would include the basic guidelines for the federal budget (with regard to both revenues and spending) so as to avoid what happens now, which is that every year, Congress has a rushed debate and ends up establishing a series of transitory measures in the part of the bill called "Miscellanea."
2) Establishing bankruptcy and guarantees legislation to ensure legal security for investments and to allow the operation of the entire business system.
3) Restructuring the whole banking and financial system to reincorporate it into the productive sector.

The Modern State

This national accord has projects that could immediately be put into effect to reactivate the economy based on investments that would have a repercussion on the country's domestic economy:

a) The construction of Mexico City's new airport;
b) Private investment in petrochemicals;
c) Private investment in electricity generation;
d) The construction of a railroad network that would connect nearby cities to Mexico City's metropolitan area.

The new administration will have to face the task of making the Mexican state both strong and smaller than it is today, but more efficient and with a greater ability to fulfill its obligations to society. It must be a solid state based on an economy in sustained growth that would foster job creation to ensure employment to most people of working age. That is, a state in which paying taxes is not an unwarranted burden on anyone. VM

Notes

1 According to Central Bank figures, gross domestic product (GDP) growth from 1982 to 1994 surpassed that of population growth only five times, and Finance Ministry data puts GDP growth per inhabitant at only 4.77 percent for the entire period between 1994 and 1999.

2 Compare Vicente Fox's campaign proposals and recent declarations of Guillermo Ortiz, the governor of the Central Bank.

3 Interview with José Guzmán, head administrator of foreign trade, *Reforma* (Mexico City), 19 May 2000.

4 Interview with Fernando Pérez Noriega (PAN) and Jorge Chávez Presa (PRI), members of the congressional Finance Commission, *El Universal* (Mexico City), 31 July 2001.

5 *Reforma* (Mexico City), 27 August 2001.

6 Ibid.

7 Instituto Nacional de Estadística, Geografía e Informática, *Encuesta de ingresos y gastos* (Mexico City: INEGI, 1998).

8 Figures from the Mexican Social Security Institute (IMSS) about workers who lost their jobs taken off the rolls.

9 Interview with Deputies Fernando Pérez Noriega (PAN) and Jorge Chávez Presa (PRI), members of the congressional Finance Commission, *El Universal* (Mexico City), 31 August 2001.