

Fiscal Reform in Mexico

Some Issues under Discussion

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This article presents an overall perspective on fiscal reform as currently debated in Mexico. First, it reviews the objectives of fiscal reform based on a summarized diagnosis of the dismal straits of Mexico's fiscal structure; and then it describes and assesses some of the main proposed fiscal instruments in relation to the alleged main beneficiaries. Finally it concludes with thoughts about the timing and feasibility of the proposed reform, as well as the short- and medium-term contradictory effects of using the available instruments.

CURRENT SITUATION

Total 1999 federal tax revenues represented an estimated 9.4 percent of the gross domestic product (GDP). This compares unfavorably to the 1992-1994 period when tax revenues represented a yearly average of 10.1 percent of GDP. Mexico's low revenues fare even worse when compared with other countries: according to the World Bank, in 1999, Italy's total tax revenues were 42.2 percent of GDP; United States', 19.8 percent; and Chile's, 18.9 per-

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cent. Even in relatively poorer countries like Venezuela, revenues reached 17.5 percent of GDP; in Bolivia, 15 percent; and in Argentina, 11.2 percent. Paradoxically the maximum income tax rate in Mexico appears to be rather high when compared with more or less similar economies:¹ in Mexico, it is currently 34 percent, while in Korea it is 28 percent and in Brazil, 25 percent. Other, more developed countries have higher maximum rates: France, 53 percent, and Sweden 50 percent. In terms of the value added tax (VAT) revenue, while 92 percent of all consumption is taxed in Chile and 75 percent in Bolivia, in Mexico it comes to a mere 55 percent. This VAT situation is particularly relevant, since the short-term actions of the proposed fiscal reform are cen-

tered on changing its structure. I will come back to this point.

In addition to the low revenue base, the structure is also quite fragile because it is highly concentrated: Petróleos Mexicanos (Pemex), through a host of specially tailored taxes, including an excise tax —also charged on alcoholic beverages and tobacco— contributed with almost 23 percent of total government tax revenues² (when international oil prices fell in 1994 this percentage fell to less than 20 percent). Pemex's tax burden may have been too heavy since the company's capital expenditures are lagging behind demand, at least in production and distribution of natural gas and gasoline, currently imported in order to cover for insufficient domestic supply.

Although it is extremely difficult to pinpoint the main reasons for such low tax revenues, several deep-rooted weaknesses in the tax law and revenue collection system can be identified if not quantified. The income tax structure tends to be neutral (as opposed to progressive) and includes a host of special tax provisions and exemptions. The VAT stipulates notable exemptions or zero-rate structures (also significantly regressive); local taxes are insignificant (92 percent of local government expenditures are financed with federal tax transfers); corruption and evasion are

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rampant; and an inefficient tax collection system seems rather expensive and burdensome for both taxpayers and the tax authorities.

In contrast with this tight situation, there appears to be practically a national consensus that the country's tax base should increase significantly and rapidly. All political parties and public opinion makers are also supporting fiscal reform, demanding it be discussed, designed and implemented in the short term. The widespread opinion is that the timing for reform is ripe, considering that Fox's democratically elected government (which ousted the Institutional Revolutionary Party, or PRI) is at the peak of its legitimacy and popularity, and also that it is imperative to address the gigantic social backlash of the economic growth model pursued over the last few decades.

Although as yet there is no full-fledged proposal for fiscal reform, administration officials have been publicly arguing in favor of certain areas of reform. Political parties and other interested groups have also been actively debating, insisting (perhaps more loudly than the government) that any fiscal strategy must include revamping and updating the government's institutional framework and expenditure mechanisms.

THE STATED OBJECTIVES OF FISCAL REFORM

Most actors on the Mexican political scene consider that expenditures are the flip side of the coin to fiscal reform. To many advocates, each additional percentage point of tax revenue should be tagged—in advance—to particular social expenditure and investment programs.

To others, especially officials who have gradually been ousted from positions of power they held in previous governments, fiscal reform should also be part of the renewed government instruments of short-term macro-economic management; this vision has quietly gone out of fashion in recent months.

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crease the resources available for education, infrastructure and social expenditure. A by-product should be a fiscal system that induces savings and investments instead of consumption, and which is based on fairness. However, it seems that a concern for social justice, supposedly the guiding objective of overall policy, is less frequently heard in most financial and economic circles.

Although less noted in the media, one objective of fiscal reform mentioned by local and state representatives is the federalization of taxes. They argue that revenues would increase significantly if only they were more local tax-related. Local tax authorities, the argument goes, are more likely to monitor and control tax collection closer to the actual taxpayers.

THE FISCAL REFORM INSTRUMENTS

There are several areas of discussion around fiscal reform, particularly regarding changes in three key instruments: income tax, VAT and the expenditure-side mechanisms of reform. All proposals and discussions seem to concur that reform necessarily means streamlining the complexity and procedural red tape that currently pervades the tax system. Other areas of consensus are the reduction and abolition of existing loopholes and special tax provisions and exemptions in the income tax base and the need for stronger executive and judicial instruments against corruption and evasion. Aside from these, the remaining proposals are still under debate.

With reference to income tax, administration officials and most other proponents have been publicly discussing the reduction of the maximum tax rate from 34 percent to 30 percent (in several fora 32 percent has been mentioned), coupled with significant changes in tax provisions regarding the tax base itself—in relation to taxing consumption—and several other aspects that distort how the tax base affects the financial performance of companies. Another idea put forward (albeit less strongly) is dumping the entire income tax structure and applying a flat-tax.³ Here, the implicit argument is that income tax in Mexico has not had the expected progressive nature, and thus a flat tax would arguably have the same neutral effect but would be more efficient.

A hotly debated idea is the "Pardon for the Past" proposal made by the finance minister as soon as he took office. The idea is to swiftly forgive any misdeeds or underpayments of previous years as long as the 2000 income tax

return is properly submitted; the logic behind this is that it is wiser and more profitable to bring in as many taxpayers as possible now, rather than betting on being able to bring them to justice—and collect—for past underpayments. Debate around this idea will probably continue during the next few months.

Arguably, the most important part of the debate is the reform of the VAT. Currently, medicine, food and other minor articles are exempt from VAT. The administration's proposal is to include the most significant goods among these items—namely medicine and durable foodstuffs—into the VAT structure at the 15 percent rate currently charged for most other goods. Although a new stream of revenue would almost instantly come from this, the measure's potential side effects are substantial. From the government's point of view, enlarging the VAT tax base would set Mexico in the right direction in relation to other countries; furthermore, the finance ministry holds that evasion is positively correlated to the variance in VAT rates, and that there is no other available instrument as expedient. Finally, officials contend that greater fiscal policing has only a limited short-term effect. Articles assessing the VAT proposal⁴ conclude that it would have a "relatively regressive" impact, burdening the poor more heavily than the rich. The administration recognizes the effect and has emphasized that the excess revenue would be channeled to education, infrastructure and social expenditure.

CONCLUDING REMARKS

It is rather difficult to envisage a better political environment for badly needed

fiscal reform. Given this, Mexico must make sure that fiscal policy is based on a clear medium-term strategy that assures expansion of both the overall tax base and income tax revenues (with a socially progressive outcome). If revenue collection is to be increased in the short term, however, it seems that rigidities in the overall economic and political environment will very likely mean a tax reform with a neutral or

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non-progressive—if not regressive—fiscal reform. If consumption-related tax provisions are adopted (if for no other reason than their feasibility when compared to other more desirable but unrealistic ones in the short term), they should be counterbalanced with additional targeted expenditures and investment for the poor. Unfortunately, on this front Mexico's system of inequality seems to reproduce itself. Public spending on education and health are also of a neutral/proportional nature (similar amounts are spent for the poorest 20 percent of the population and for the richest 20 percent).⁵

A must of fiscal reform will be addressing the changes required for better and more clearly targeted social expenditure. Although several social

programs exist (with varying degrees of perceived success), there is neither a benchmark nor quantifiable goals that would allow for an assessment of their efficiency. Without measurable targets, social expenditure funded with new fiscal resources may well prove to be a worthless effort. The stronger commitment to public accountability of both government and civil society will be put to the test precisely when the additional resources from fiscal reform become available. Mexicans must make sure that, this time, the funds are both efficiently and almost completely channeled to the poor. **MM**

NOTES

¹ Maximum income rates can be tricky to estimate because there are several instances of double taxation. This is the case, for example, of taxes on dividends; in Mexico once income tax has been paid by a company, personal income tax on dividends paid by the company to shareholders only generates a 5 percent rate. In other countries, like the United States, dividends are fully added up and accrue a 33 percent rate. Thus, comparisons should be regarded more as rough estimates.

² In 1998, according to Banco de México, "Economic and Financial Developments in 1998 and Policies for 1999," Banco de México (1999). (<http://www.banxico.org.mx>)

³ A flat tax is a tax rate applied to all levels of income. It is often discussed as an alternative to a progressive tax.

⁴ An excellent, short and substantial analysis of the VAT effects and expenditure elements is to be found in Fausto Hernández Trillo et al., "La reforma hacendaria integral: algunos retos," *Este País. Tendencias y opiniones* (Mexico City), February 2001.

⁵ Fausto Hernández Trillo, *op. cit.*