# Raising Taxes in Mexico

In his inauguration day speech to Mexico's Congress, President Vicente Fox reiterated his administration's commitment to transform "tax collection into an engine of development." The keystone of Fox's ambitious fiscal agenda is a pledge to increase the ratio of total tax revenues to gross domestic product (GDP) from the current 11 percent to as much as 17 percent by 2004. The new Mexican administration hopes to reduce the central government's dependence on oil-related income and to lower real interest rates through fiscal discipline.

Mexico's limited capacity to raise taxes is typical of developing countries but shows marked weakness compared with industrialized economies (*Chart 1*). One of the distinguishing features of developing economies that explains this pattern is the size of the informal sector. The informal sector includes all establishments and self-employed individuals that do not comply with government regulations such as the tax code. Informal employees typically fail to receive government-mandated benefits and may be paid below the minimum wage.

Economists estimate that informal employment accounts for almost half of urban employment in Mexico, while unreported, untaxed economic activities represent over 30 percent of official GDP. As a result, the effective base for income taxation is small. Chart 1 shows that proceeds from income taxation represent a smaller share of official GDP in Latin American nations than in their industrialized counterparts.

Fox plans to increase the base for income taxation by simplifying and improving the administration of taxes and by giving small firms financial incentives to operate in the formal sector. These policy principles appear sensible in light of two leading explanations economists offer for the documented size of the informal sector in Latin America. First, tax enforcement is lax in most Latin American nations as a result of corruption and the limited resources with which tax authorities must operate. Second, the advantages firms can expect to enjoy when they decide to operate formally are greatly reduced by the inefficiency of formal institutions such as the judiciary system. For instance, banks are reluctant to write loan contracts in an environment where property rights are not adequately enforced. As a consequence, small firms in Latin America have little access to formal sources of financing, even if they maintain credible accounting practices.

A scheme of credit subsidies or guarantees for those firms that maintain tax records, or tax breaks contingent upon the taxable income reported by firms, could increase tax revenues by expanding the tax base. Fox has announced the creation of the National Program for Microcredit to give "the poorest people… access to financing, training and technical assistance," with the hope of drawing more workers and small businesses to the formal sector. Deeper reforms aimed at improving the efficiency of legal institutions and fighting corruption, two of Fox's campaign themes, could also increase the formal share of economic activity.

Fox's agenda does not represent Mexico's first attempt at raising tax revenues. Several Mexican governments have promised to reform the tax system, but most have failed to face the associated political costs. A notable exception is the 1978 reform that simplified the tax structure, broadened the base for personal income taxation and introduced a value-added tax in Mexico. Fox plans to reform the tax system, but his projections rely largely on improving compliance. Time will tell whether the president's expectations in this respect are reasonable.

The new administration has delayed spelling out a tax plan until April. The current policy guidelines from the Ministry of Finance contain only vague proposals to "reinforce the administration of the Mexican tax system." To meet his short-term fiscal targets, Fox may have to resort to potentially explosive measures, such as eliminating value-added tax exemptions on food and medicine.

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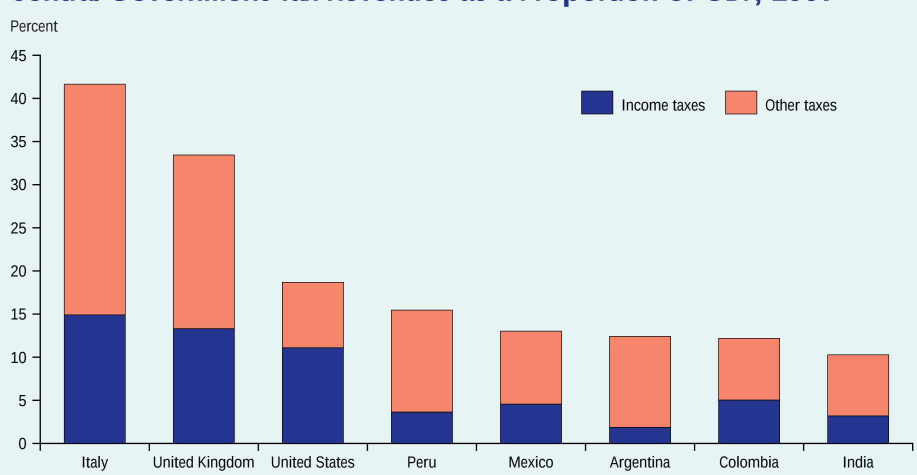
Chart 1

**Central Government Tax Revenues as a Proportion of GDP, 1997**




SOURCE: Government Finance Statistics Yearbook, International Monetary Fund.