Mexico's Fiscal Reform Earns Mixed Reviews

By Jesus Cañas

Mexico historically has had one of the lowest tax-to-gross-domestic-product (GDP) rates in Latin America and by far the lowest among Organization for Economic Cooperation and Development (OECD) nations.

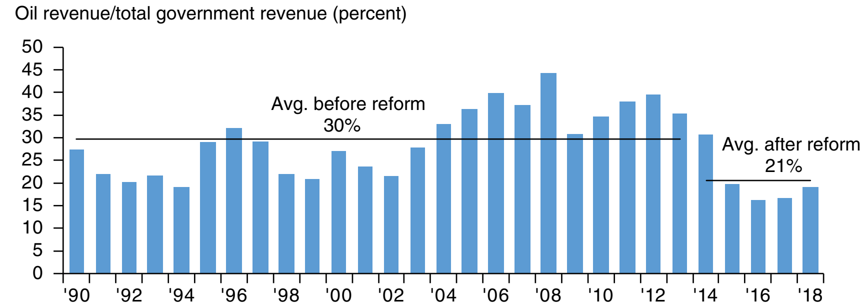
To compensate for the lack of tax collection to fund government, Mexico has depended heavily on its state-owned oil company, Pemex. Thus, when oil production began declining in 2004, fiscal reform gained urgency.

The Mexican government, seeking to put public sector finances on a sustainable path, adopted a major tax overhaul in 2013. It sought to broaden the tax base and increase tax rates.

The reform included higher tax rates on certain products and services—junk food, sugary drinks and private school tuition—and on certain groups, such as higher-income households. It also unified the value-added tax throughout the country, ending lower sales tax rates in border regions (a change recently reversed).

The revised rules also imposed a 10 percent capital gains tax on profits from shares traded on the Mexican stock exchange and offered incentives to bring the more than 5 million informal-sector businesses into the formal sector, where their operations could be overseen and taxed.[1]

CHART 1 Mexico Reduces Oil Dependence After Fiscal Reform



SOURCES: Secretaría de Hacienda y Crédito Público (Mexico Secretariat of Finance and Public Credit).

Independence from Oil

The fiscal reform succeeded in reducing Mexico's dependence on oil revenue *(Chart 1)*. Its share of total government revenue declined from 35 percent in 2013 to 19 percent in 2018. The overhaul also succeeded in raising Mexico's non-oil tax-to-GDP ratio from 15 percent in 2013 to 18 percent in 2018, putting it on par with Colombia but still behind Chile and El Salvador.[2]

The major contributors to the increase in non-oil revenue collection have been the middle class and the corporate sector—accounting for 1.3 percentage points of the increase. Higher taxes on gasoline and diesel brought in another 1.5 percentage points of the gain.

Tax Receipts Still Lag

Mexico's total government revenue as a share of GDP was 22 percent in 2018, close to the 23 percent average in Latin America and the Caribbean, but still the lowest among OECD members, who average 34 percent.[3]

As a result, Mexico spends a relatively small amount on public services. While low taxes are generally a positive for growth, the limited public outlays restrain expenditures for education, health and infrastructure. Mexico's education spending fell 2.2 percent annually between 2014 and 2018, while health expenditures declined 2.9 percent annually during the period. Government investment, including infrastructure, has fallen over the past 10 years.

While Mexico's recently elected government canceled a new $13 billion Mexico City airport, it has announced plans for other infrastructure projects, among them a Maya train linking five states in southeast Mexico and ultimately connecting the Pacific Ocean and the Gulf of Mexico.

Additional plans include paving 300 roads in the southern state of Oaxaca, providing nationwide internet coverage with free access in schools, hospitals and public spaces, building 100 public universities and construction of an $8 billion refinery. Realization of these projects is uncertain given the new government has also declared a firm commitment to fiscal discipline.

Mexico's deficits have averaged 2.4 percent of GDP since the fiscal reform, and national debt has been stable at 47 percent of GDP. (By comparison, the U.S. debt-to-GDP ratio exceeds 105 percent.)

Near-term concerns include the still-precarious position of Pemex's impact on the overall economy. Oil production continues to fall, and the state-owned oil company has considerable debt and pension obligations. The major debt-rating agencies have downgraded Pemex debt, putting pressure on Mexico's sovereign debt outlook.

Notes

[1] "Mexico Tax Reform Bill Approved for 2014," International Tax Review, December 2013, www.internationaltaxreview.com/Article/3348483/Mexico-Tax-Reform-Bill-approved-for-2014.html?ArticleId=3348483.

[2] Total tax-to-GDP ratio, including oil revenues, fell from 23 percent in 2013 to 22 percent in 2018 mainly due to falling oil production and lower oil prices.

[3] "Economic Survey of Mexico," Organization for Economic Cooperation and Development, May 2019, www.oecd.org/economy/mexico-economic-snapshot/.