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MANAGING MEDIUM-TERM FISCAL CHALLENGES

EXECUTIVE SUMMARY

Message 1. Mexico needs a comprehensive fiscal reform to alleviate the looming medium-term pressures on its budget. The country's fiscal accounts rely heavily on oil revenue (about a third of total public revenue). But falling oil revenue and an expected increase in spending (aging-related spending, public investment, and social spending to reduce poverty and inequality) will put pressure on its public finances. This calls for a greater tax revenue collection effort, increased efficiency and improved targeting of public spending, and more accurate measurement of medium-term spending and revenue trends.

Message 2. Mexico's fiscal agenda needs a revenue-enhancing tax reform. The country's tax collection effort is low by international standards (nonoil tax revenue amounts to about 10 percent of GDP). Adopting an integral fiscal-reform strategy that broadens the tax base, simplifies the tax system by eliminating tax loopholes, and reduces tax expenditures could bolster revenue substantially.

Message 3. Mexico needs energy pricing reform and budget stabilization measures as part of its fiscal reform. Energy subsidies are estimated at nearly 2 percent of GDP. Removing these subsidies could help the country raise revenues, avoid distorted price signals, and reach its climate change mitigation goals. Institutionalizing the oil-price hedge, lifting the stabilization fund caps, and adopting a structural balance rule could all strengthen budget stability.

Message 4. Mexico's fiscal reform agenda should include a careful evaluation of the distributive impacts of the full range of proposed measures. The loss in household purchasing power resulting from increased tax collection and the removal of energy subsidies must be evaluated in parallel with an increase in public spending capacity for more targeted programs.

OBJECTIVE

This policy note contributes to the debate on Mexico's looming fiscal challenges. The country's fiscal framework, centered on the 2006 Budget and Fiscal Responsibility Law, and prudent fiscal risk management has helped maintain short-term budget stability and a fairly stable public debt path, even in times of economic volatility. However, Mexico faces serious longer term fiscal challenges that are not always recognized, measured, and addressed in policy debates, which tend to focus on approving the annual budget. And though Mexico has adopted several policies to mitigate oil-price volatility on the budget, oil production has fallen substantially over the past few years, drawing renewed attention to the longer term challenge of replacing part of the oil-related public revenue base with other, more permanent sources of revenue. Further, spending pressures associated with increasing aging-related spending, public investment, and social spending needs call for a discussion of the fiscal implications of additional impending outlays.

KEY CHALLENGES

Mexico's falling oil revenue and rising public spending needs over the medium term require increased tax revenue and more efficient and better targeted public spending. Even if greater economic growth and lower real interest rates provide some space for deficit financing without endangering the sustainability of public debt, the onus on fiscal adjustment is likely to rest on raising the country's public revenue collection effort. An integral revenue-enhancing

fiscal reform that broadens the tax base, reduces the scope of special regimes and preferential rates, and generates information flows on economic transactions that facilitate tax compliance and administration could boost tax revenue substantially. Reducing public subsidies, especially prevalent for energy, would also increase public revenue.

Mexico's public finance depends heavily on oil revenue, with recent high oil prices masking a decline in oil production. In 2011, public revenue reached more than 3 trillion pesos (21.7 percent of GDP),[1] a third of it oil-related. Crude oil production and exports have declined steadily following a peak in 2004. The government estimates that production will stabilize at 2.5 million barrels a day over 2011–15, but after years of decline, these estimates are highly uncertain. Even if production were to stabilize, a growing economy would cause oil revenue to fall as a percentage of GDP. In addition, a greater share of oil revenue is being cycled back to PEMEX and thus is not reaching government coffers, due to greater needs in oil investment and higher extraction costs. If current macroeconomic parameters, including average annual economic growth of 3.3 percent, remain constant—and the real price of oil remains stable—oil revenues would fall by 2.5 percent of GDP over 2011–30.[2] And if oil prices remain constant in nominal terms, revenues would fall by 4 percent of GDP over the same period.

Mexico's long-term spending pressures are related to its demographics. The country's increasing life expectancy and declining birth rates have led to an unprecedented demographic shift toward a rapidly aging population. Since 1990, life expectancy has risen 8.3 percent for men and 6.0 percent for women, and the increase is projected to continue. At the same time, Mexico's fertility has declined steadily, from an average of seven children per woman in 1960 to just more than two today. And the population older than age 65, 6.2 percent in 2010, is projected to double to an estimated 12.5 percent by 2030. The aging population is adding to public spending on health, long-term care, and pensions.

Increasing health costs associated with the aging population, and an epidemiologic transition, will gradually put pressure on government spending. Mexico spends nearly 6 percent of GDP on health, approximately 2.7 percent of it public spending. Public and private health spending will gradually trend toward the OECD average of 8.9 percent of GDP, in parallel with Mexico's demographic and epidemiologic transition. Public health spending will likely outpace private health spending, due to the low base and expansion of *Seguro Popular*, a noncontributory public health subsystem that provides health insurance for people without social security.[3]

Transition costs from pension reform are higher than estimated. Though the switch to a defined-contribution pension system for most formal-sector workers improved long-term fiscal sustainability, public spending has risen, as worker contributions no longer fund defined-benefit pensions granted to the current and transition generation of retirees. Government transfers to finance existing contributory pension programs doubled from 1.2 percent of GDP in 1999 to 2.4 percent of GDP in 2010. Transfers to the Mexican Social Security Institute (*Instituto Mexicano del Seguro Social*, or IMSS) reached 1.2 percent of GDP in 2009–10, far earlier than estimated.

High labor informality and the associated low contributory pension coverage generate significant contingent liabilities. Many Mexicans lack pension benefits because they are employed informally or because they shift between formal and informal employment and are thus unable to meet the minimum contributory pension requirements. Low contributory pension

coverage has released the pent up demand for noncontributory pensions, reflected in the recent expansion of the program 70-plus (70 y Más) to urban areas.[4] Providing a basic pension in 2012 for everyone age 70 and older without an IMSS or Institute for Social Security and Services for State Workers (*Instituto de Seguridad y Servicios de los Trabajadores del Estado*, or ISSSTE) pension would cost the government approximately 0.2 percent of GDP.[5]

Looking more closely at these medium- and long-term revenue and spending trends and publishing a medium-term budget outlook would allow for long-term budget planning. The government produces a National Development Plan (or *Plan Nacional de Desarrollo*) every six years and includes a section on fiscal risks in its annual budget presentation,[6] but a more dynamic, strategic, and effective medium-term budget plan is needed. Projecting federal spending and revenues over the coming decades under multiple scenarios would help identify and evaluate upcoming budget pressures earlier than before—and promote the proposal of mitigation measures and analysis of their budgetary impacts.

POLICY OPTIONS

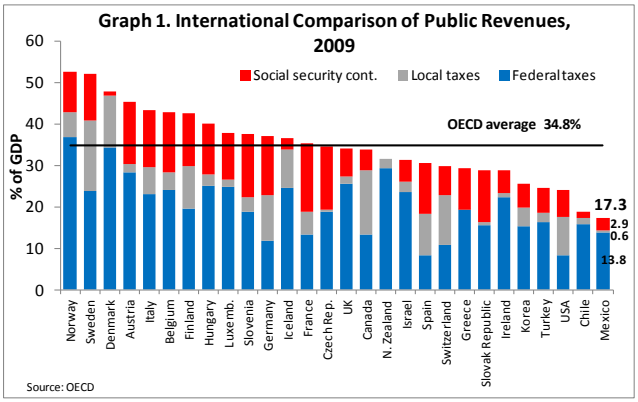
Adopting a revenue-enhancing tax reform

Mexico's tax collection effort is low by international standards. And though its federal tax collection (13.8 percent)[7] is well below the OECD average (19.2 percent), it is above that of Canada, Spain, and the United States. When local taxes and social security contributions are included, however, Mexico drops to last place among its OECD peers (figure 1). And while Mexico's social security contributions amount to 2.9 percent of GDP and local government tax collection to 0.6 percent of GDP, those averages for the OECD are 8.6 percent and 6 percent, respectively. The property tax is an important revenue generator for local governments in other countries but in Mexico amounts to just 0.2 percent of GDP.

The general features and statutory rates of Mexico's tax system compare favorably with those of other OECD countries.[8] But a large informal economy and a complex tax system with loopholes and exemptions lower the tax revenues collected and the productivity of most tax categories.[9] In addition, preferential corporate and individual tax regimes, value added tax (VAT) exceptions, and multiple rates limit collection, facilitate noncompliance, and further complicate the tax system. These exemptions, deductions, and credits (known as tax expenditures) generate substantial revenue losses, have the same effect on the budget as government spending (like subsidies), and alter the tax system's horizontal and vertical equity.

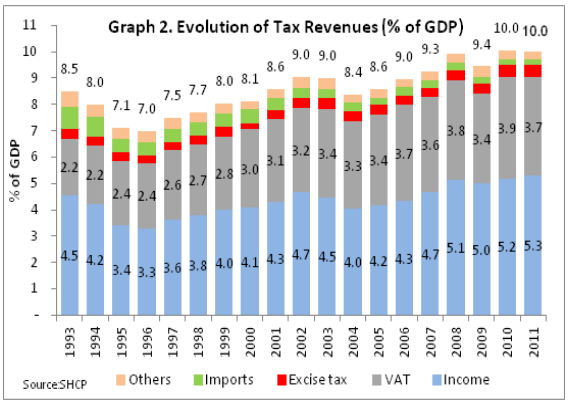
Adopting an integral reform that simplifies the tax system and broadens the tax base could boost revenue substantially. Recent reforms, including a higher VAT, the introduction of an alternative minimum tax on business income, a tax on cash deposits, and a temporary increase in the corporate tax rate and marginal personal income tax[10] have not boosted tax revenues sufficiently (figure 2). A more comprehensive reform strategy is needed to close the projected fiscal gap and guarantee that public services are provided in a sustainable manner. Spending on social security and social services, so critical for developing human capital and unlocking growth, is constrained by limited revenues.

Figure 1. International comparison of public revenues



Source: OECD 2011.

Figure 2. Evolution of tax revenues (% of GDP)



Source: SHCP and INEGI

Reducing or withdrawing tax expenditures would broaden the tax base and increase revenues. Foregone tax revenues due to tax expenditures are substantial. Tax expenditures not only lower revenues but also ease noncompliance through tax evasion. Withdrawing these expenditures would raise revenue, simplify the tax system, reduce tax evasion, and provide useful information for tax authorities. Revenue foregone due to differential tax rates, tax exemptions, and subsidies are estimated at nearly 5.1 percent of GDP for 2011. There is a growing international consensus that differential VAT rates on goods and services may be a poor way of achieving income distribution objectives. Transition to a broad-based single-rate VAT system, the best policy option, would minimize compliance costs and thus increase efficiency and revenues. But if over the short term removing VAT exemptions and zero rating is not politically viable, an exemption or lower rate could initially be retained on a small basket of staple goods. There seems to be no rationale for reduced VAT rates in border areas, so border rates should be increased to the standard rate. The tortilla subsidy's 1990s elimination in favor of a cash transfer to lower income levels demonstrates the possibility of reforming politically difficult fiscal benefits.

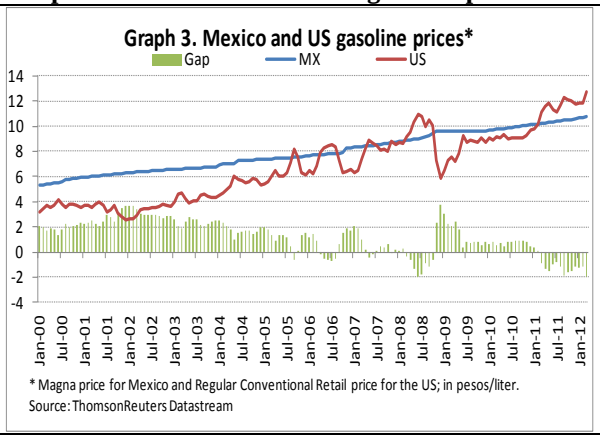
Adopting energy pricing reform and budget stabilization measures

Mexico's energy subsidies are high and have increased substantially over the last few years. Domestic energy prices, set by the Ministry of Finance and Public Credit (*Secretaría de Hacienda y Crédito Público*, or SHCP), are considered subsidized if their price is below a reference price representing the opportunity cost (for tradable goods, such as fuel) or representing the cost of production (for non-tradable goods or services, such as electricity). There is no explicit budget appropriation; rather, subsidies show up as lower revenue to the federal government or its state-owned companies.

The energy subsidies also mask resource costs, are inefficient in alleviating poverty, and are highly regressive. Subsidies for electricity, gasoline, diesel, and liquefied petroleum were more than 1.5 percent of GDP on average each year over 2005–09, according to government estimates. Electricity subsidies in Mexico—though harder to quantify because the reference cost of production is based on an administratively set rate of return of capital and also may include inefficiencies in the state-owned power utility—are prevalent in the rate structure for electricity

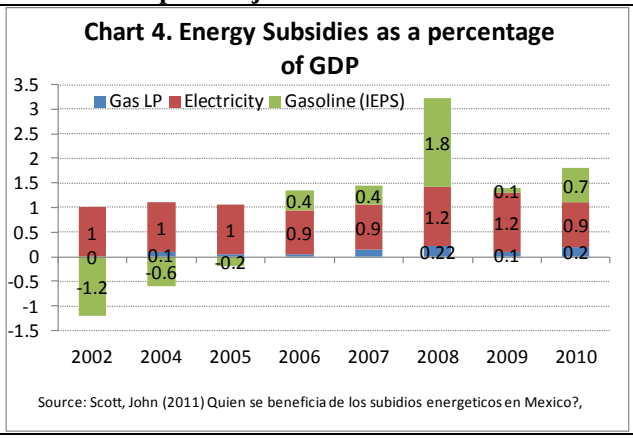
use in housing and agriculture and are considered among the largest in the world. Subsidizing domestic energy consumption both encourages wastefulness and discourages investment in energy efficiency. And despite being a net gasoline importer, Mexico sells gasoline domestically at a much lower price than do most OECD and Latin American countries (figures 3 and 4).

Figure 3. Mexico does not fully pass through the sharp increases in international gasoline prices



Source: ThomsonReuters Datastream

Figure 4. Subsidies have increased as a result of the domestic fuel-price adjustments



Source: Scott 2011.

Domestic fuel-price adjustments have not kept up with international price increases. Mexico for years followed a fuel-pricing policy of monthly price adjustments that until 2009 aligned with expected inflation. But today, prices are adjusted at an accelerated pace, to close the growing price gap between domestic and international prices. The difference between the sales price to the public and the (international) reference price is made up by a variable excise tax that turned negative following the sharp rise in oil prices over the past few years. A negative excise tax equals a subsidy of the same size.

Fuel-pricing policies have served economic and fiscal stabilization purposes in the past, but today there are better alternatives. Predictable, monthly price adjustments avoid the impact that international oil- and fuel-price volatility has on inflation elsewhere. This may have been important when monetary authorities were still battling to bring inflation down to levels in line with overall economic stability. With inflation within the target range established by the monetary authorities, the artificial suppression of fuel-price volatility may no longer be needed, given the moderate impact on overall inflation and inflation expectations. Similarly, the monthly fuel-price adjustment has moderated the impact of oil-price volatility on public finances. Higher oil prices add oil export revenue, but do not lead to higher domestic sales revenue. At the same time, a sudden drop in oil prices and export revenue is not accompanied by lower domestic sales revenue.

Removing energy subsidies would help Mexico raise revenues, avoid distorted price signals, and reach its climate change mitigation goals. The added revenue from the withdrawal of subsidies for electricity use in housing and agriculture—along with the adoption of a positive fixed excise tax on fuel— could be used in part to mitigate the effect of higher energy prices on lower income households. Additional transfers to beneficiaries of the *Oportunidades* program to compensate for higher energy prices in 2008 could be an efficient mitigation tool. Because reducing fuel subsidies at a time of high oil prices would be politically difficult, a temporary

option could be to accelerate the price-smoothing mechanism for gasoline and diesel, to quickly align them with international prices. Once a target excise tax on fuel has been reached, fuel prices should be allowed to fluctuate with international price movements.

A fixed excise tax on fuel would increase the sensitivity of government revenues to energy price fluctuations and in turn, the importance of a strong stabilization mechanism. Budget stability and transparency would benefit from institutionalizing the oil-price hedge and lifting the stabilization fund caps. Lifting the caps would create a more effective fiscal buffer against large negative shocks, by promoting greater savings during economic upturns and periods of high oil prices. Further, greater energy-related savings could help protect future generations instead of financing current government consumption. The best solution would be to reform the stabilization funds so that they not only protect and stabilize the budget and the economy from excess volatility but also increase savings for future generations. Institutionalizing the oil price hedge would reduce the pressure to use these funds for other needs, such as to meet budget shortfalls.

Adopting a structural balance rule could help reduce the procyclicality of public spending under the current rule. The obligation to target the nominal balance and reserve fund caps imply that public spending rises and falls with revenue fluctuations linked to economic growth and oil revenue. This results in a close correlation between changes in expenditures from one year to another and changes in nonoil tax and oil revenues. A structural balance rule would also further smooth spending patterns. A structural budget would allow for an endogenous response to changes in revenue deriving from the economic cycle while promoting fiscal discipline and sustainability of the deficit and debt levels.

Improving the distributional impact of fiscal policy

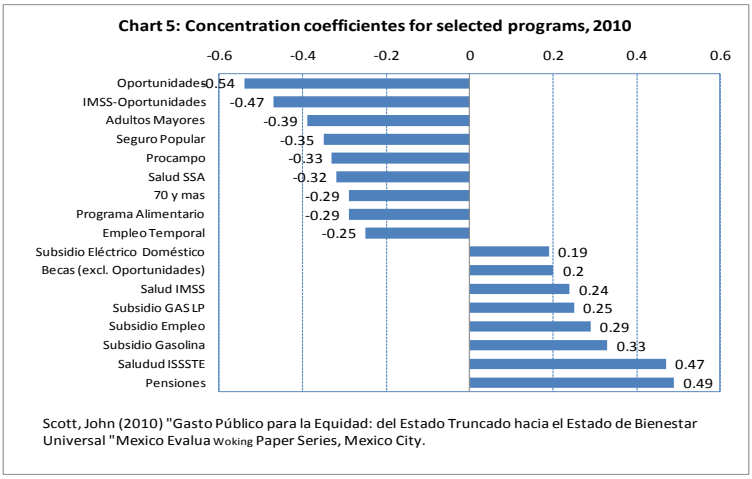
Mexico's tax-benefit system does not improve income equality as much as in other OECD countries. While taxes lower income inequality in almost all OECD countries, Mexico's Gini coefficient falls only slightly, from 0.515 before taxes to 0.509 after. It falls a bit more, to 0.465, when including targeted social spending. For an average EU country, however, the Gini coefficient falls from 0.46 before taxes and transfers to 0.34 after, largely through transfers.[11]

High inequality in Mexico is due partly to the failure of fiscal policy to perform its redistributive function. While income taxes are generally progressive, high informality and high poverty reduce the share of income tax in the overall tax base.[12] Easier-to-collect indirect taxes, such as VAT, are largely regressive. But using multiple VAT rates can achieve some progressivity, despite increasing skepticism about their effectiveness in achieving redistribution objectives. (See Annex 1 for a discussion on progressivity.)

Despite better targeting of social spending, some programs in Mexico disproportionally benefit the higher income population deciles and worsen inequality. Some programs are very progressive, as the per capita public transfer falls with higher income levels (as shown in a negative concentration coefficient). Others are less so, as the per capita public transfer *rises* with higher income levels (as shown in a positive concentration coefficient; figure 5). As long as the concentration coefficient is below the market income Gini coefficient, these transfers are only moderately redistributive. Like energy subsidies, VAT exemptions and zero rating are in effect nontargeted consumption subsidies. The amount of the subsidy obtained depends on household

spending on the subsidized products, which tends to rise with income. Devoting a larger share of public spending (including tax expenditures) to programs with a negative concentration coefficient (or a small positive one) would help make the tax-benefit system more progressive[13].

Figure 5. Concentration coefficients for selected programs, 2010



Source: Scott 2010.

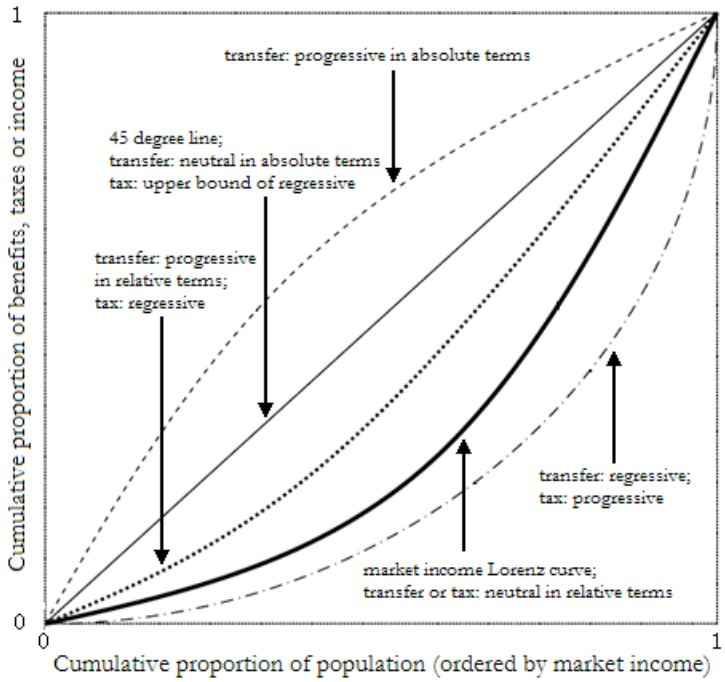
The distributional incidence of individual fiscal interventions should be less of a concern than the overall distributional incidence of the tax-benefit system. The loss in purchasing power generated from higher levels of tax collection and a removal of energy subsidies must be evaluated in parallel to an increase in public spending capacity for more targeted spending programs. Eliminating subsidies and preferential tax regimes, along with a compensation mechanism for lower income households, could lead to a net benefit in the income redistribution function of the tax-benefit system. A communication strategy for fiscal reform is needed to show the costs and benefits of the suggested policy options and to build political consensus.

Matrix of short- and medium-term policy reform options*

Reform area	Short-term options	Medium-term options
Fiscal reform Tax reform	• Implement revenue-enhancing tax reform that broadens the tax base, simplifies tax filing, reduces tax expenditures, and eliminates special regimes and preferential rates. (LR)	
Energy pricing reform	• Accelerate price adjustment for domestic fuel sales to align with international prices (LR) . • Reduce subsidies on electricity for use in housing and agriculture (LR)	• Adopt a fixed excise tax on domestic fuel sales and allow prices to fluctuate with international price movements (LR)
Measures to improve distributional impacts of tax and energy pricing reforms	• Compensatory programs: provide compensation for lower income households negatively affected by tax and energy pricing reform (LR).	• Strengthen capacity to estimate overall distributional incidence of the tax-benefit system (AR).
Budget stabilization measures	• Institutionalize oil-price hedge and remove caps on stabilization funds (LR).	• Adopt a structural balance rule (LR).
Improved measurement of medium-term revenue and expenditure trends	• Prepare medium- and long-term budget projections and analyze fiscal reform options (AR).	• Maintain and publish annually medium- and long-term budget projections. (AR)

* LR= Legal reform; AR= Administrative Reform. Preliminary classification.

Annex 1. Fiscal policy and income redistribution: absolute versus relative progressivity



Analyzing the distributional impact of a tax or benefit on per capita income is essential for comparing policy options. If a government's goal is to improve income distribution (lower inequality and poverty), it should allocate the largest share of spending to programs that are progressive in absolute terms.

Transfers are progressive in absolute terms when their per capita value declines with market income. In the figure above, absolute progressive transfers are those above the 45-degree perfect-equity line. Cash-transfer programs, such as *Oportunidades*, are progressive in absolute terms, as the poor receive more transfers than the nonpoor in absolute terms. Transfers are regressive in absolute terms but progressive in relative terms when their per capita value increases with market income, while their value relative to the market income declines. Examples of these transfers, for which the concentration coefficient is positive but smaller than the market income Gini coefficient (reflected in the graph by a curve between the market-income Lorenz curve and the 45-degree line), are value added tax exemptions and zero rating on food and energy subsidies, as well as public spending on tertiary education.

Taxes are called progressive and transfers regressive in absolute and relative terms when their relative value with respect to market income goes up. In this case, the line reflecting the distribution of the tax or transfer is below the market-income Lorenz curve (and the concentration coefficient is higher than the market income Gini coefficient).

Source: Lustig and others 2011.

NOTES

[1] This amount reflects the budgetary public sector, including revenues generated by state-owned enterprises in energy and social security.

[2] IMF, 2011, 2011 Article IV Consultation, p 32.

[3] Seguro Popular was introduced in 2001 as a health insurance program for low-income households not covered by social security. In 2012, the government claimed full coverage of the population without social security.

[4] The expansion of 70-plus also followed the creation of universal pension systems by a number of states and Mexico City.

[5] Assuming 3.6 million people age 70 and older without a pension and a basic pension of 500 pesos a month.

[6] See Criterios Generales de Política Económica (2012).

[7] To compare Mexico's tax base with that of other countries, the OECD includes transfers by PEMEX to the federal government, because if the oil company were a private enterprise, it would pay the equivalent in royalties.

[8] However, tax rates are toward the lower end of the international spectrum.

[9] Mexico's Tax Administration Service (Servicio de Administración Tributaria) estimates that approximately 77 percent of income tax due on nonsalary income is not paid and that VAT tax evasion is estimated at 35 percent.

[10] The individual maximum marginal rate was temporarily increased from 28 percent in 2010 to 30 percent in 2012 but will fall to 29 percent in 2013.

[11] OECD, 2011. Economic Surveys: Mexico

[12] The two richest income deciles pay almost 80 percent of income taxes and, as a result of an in-work tax credit, the three poorest income deciles pay negative income taxes on average.

[13] Birdsall, Lustig, and McLeod 2011.

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