ELUSIVE TAX REFORM IN MEXICO

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Introduction

Over the last two decades the Mexican tax structure has been transformed into a more equitable, efficient and modern system. However, there are still many flaws to correct, and a lot of modifications remain to be completed. Tax collection is markedly lower than in other countries while public expenditure has to be strengthened in order to satisfy public needs, and a higher primary surplus is required in order to avoid sustainability problems.

Since 1980 the Mexican tax system has experienced a number of reforms, which guided it towards more efficient, fair and neutral ways of obtaining resources in order to finance public needs. To implement these reforms, the fiscal authority faced non-negligible challenges. In particular, there were two important facts that restricted its choices. The first was adverse macroeconomic conditions: economic crises called for careful use of fiscal policy. Accordingly, every implemented tax reform took into account the constraints imposed by an urgent need of healthy public finances. Second, as a small open economy, tax design cannot ignore international dependence and interactions among tax systems. These facts have grown in importance as the Mexican economy has broadened its commercial relationships with other countries. International competition considerations affect how tax bases are defined and the viability of the level of tax rates.[1]

The efforts undertaken by fiscal authorities during these years can be broadly summarized in three major stages.[2] In the first period (1980-87) the whole structure of the tax system was modified. Among the outstanding reforms of the income tax was the substitution of a schedular scheme of the personal income tax for one that taxed income on a global basis. In addition, the corporate and personal income taxes were integrated in order to avoid double taxation. Regarding indirect taxes, more than 30 federal excise taxes and more than 300 state taxes were eliminated to introduce a value added tax, a tax on specific goods and services (excise taxes), and a tax on new automobiles. Besides the efficiency gains provided by a tax system with a well-integrated small number of taxes, these modifications represented a significant reduction in the administrative cost of collection.

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* Banco de México. The views expressed herein are those of the author and not necessarily represent those of Banco de México. Mariana A. Torán and Alejandrina Salcedo provided valuable research assistance.

1 Gil Diaz (1987).

2 The classification is made only for simplicity of exposition. As such, it does not reflect the richness in detail of yearly modifications. A more specific review of the evolution of the Mexican tax system can be found in Gil and Thrisk (1997) and Amieva (2002).

During the second stage (1987-94) one of the goals of the reforms was the full indexation of the tax system. For the corporate income tax, assets, liabilities, and capital were adjusted for inflation. In 1989 a minimum corporate income tax was introduced. Its aim was to catch the firms that managed to evade income tax through transfer prices and other fiscal manipulations. In 1991 a simplified regime was adopted; it allowed firms as well as individuals in agriculture, livestock, forestry, fishery and land transportation activities to compute the tax on a cash flow basis. Regarding the personal income tax, the schedule of income brackets was also adjusted for inflation. Additionally, a fiscal subsidy inversely related to fringe benefits provided by employers was established. These reforms avoided both the inflationary erosion of the tax base and distortions on the financial structure of firms. They also prevented an increment in the tax burden of low-income taxpayers (because the progressiveness of the tax rates was maintained).

Finally, in the third stage (1995-2000) investment incentives as well as measures to reduce evasion practices were implemented. The accelerated depreciation of fixed assets was allowed and later substituted by a differential tax rate on profits, where reinvested profits were subject to a lower rate. Tax bases were enlarged for both income tax and VAT. In the first case, all financial institutions were included in the corporate tax base. Also, in order to cover some activities of the informal sector, a regime for small taxpayers was introduced within the personal income tax structure. Under this regime, individuals whose unique source of income are entrepreneurial activities must pay a low tax rate (less than 3 per cent) on gross income. In the case of the VAT, interest paid on consumption credits and credit cards was taxed. Additionally, fines to evaders were increased, and new administrative procedures were required in order to improve the monitoring of taxpayers.

In spite of these important steps, tax revenues are still far from raising at the same pace as the requirements of a growing population. Nowadays, no study related to the tax system in Mexico can avoid stressing the fact that tax collection is notably lower than in other countries, either OECD or Latin American, even though the tax system is considered correctly designed overall and one of the most neutral. This is a clear signal that the Mexican tax system is not working properly. The usual indicators of total tax revenues or revenues from specific taxes (such as income or value added taxes) show poor results. The low outcomes are evident in international comparisons such as the one presented in Table 1. Moreover the differences are not due to discrepancies in tax rates given that the value added and top marginal income tax rates are similar to those of other countries.

Fiscal analysts attribute these poor results in revenue terms to exemptions, special regimes, and a number of fiscal benefits that, due to their magnitude, absorbed the positive effects of a tax system grounded in a small number of taxes with a broad tax base.[3] Over time, special economic circumstances have forced the government to introduce preferential treatments. This has led to the computation of

[3] Ruiz (1999) and World Bank (2002).

Table 1

Tax Revenues, 1997-2001 Average
(percent of GDP)

Countries	Tax Revenue	Tax on Income, Profits and Capital Gains	Value Added Tax	Excise Tax
Australia	30.76*	17.83	0.89	2.57
Austria	44.45	13.05	8.30	2.67
Belgium	45.45	17.78	7.10	2.34
Canada	36.02	17.53	2.56	1.84
Czech Republic	38.86	8.84	7.07	3.72
Denmark	49.78	29.47	9.71	5.36
Finland	46.47	19.33	8.22	4.51
France	45.36	10.50	7.62	2.88
Germany	37.24	10.81	6.77	2.77
Greece	36.88	10.20	7.87	4.27
Hungary	38.92	9.15	8.30	4.07
Iceland	35.19	13.79	9.79	3.56
Ireland	31.09	13.18	5.45	3.55
Italy	42.72	14.59	6.00	2.74
Japan	23.68	8.41	2.24	1.81
Republic of Korea	24.57	6.71	4.25	3.50
Luxembourg	41.12	15.38	5.41	4.84
Netherlands	40.90	10.59	7.07	3.34
New Zealand	35.06	20.42	8.87	1.96
Norway	42.51	16.81	8.61	4.79
Poland	36.40	10.84	7.81	3.93
Portugal	33.65	9.79	7.96	4.46
Slovak Republic	35.30*	8.02	7.55	3.08
Spain	34.57	9.84	5.88	2.69
Sweden	52.41	21.85	7.04	3.52
Switzerland	34.57	12.87	3.78	1.92
United Kingdom	31.33	14.12	6.80	3.87
United States	36.61	14.31	0.00	1.41
Chile	17.18	3.98	7.85	2.15
Brazil	24.80*	4.50	8.47	
Argentina	13.67	3.34	6.60	0.26
Mexico	**17.61**	**4.93**	**3.31**	**1.89**

* Average 97-99.
This figure differs from the 10.7 per cent that is normally considered in Mexico because the OECD comparison includes social security contributions (2.96 per cent), taxes on payroll and workforce (0.16 per cent), taxes on property (0.2 per cent), and duties (oil fees and others) (3.17 per cent).

Source: OECD, except Brazil (FMI), Chile and Argentina (Ministry of Finance).

the income tax according to economic sector or income type and, in the case of VAT, according to the type of good. These small but recurrent changes have not only seriously eroded the tax base, but they have also generated a complex tax system, difficult to administer and with a number of opportunities to elude payments. Consequently, a tax reform that reverses such negative loopholes cannot be postponed.

Besides special regimes, administration problems are another important reason for very low collection. Among the most important flaws are high compliance costs, complexity of the code, inconsistency of the applications of the code by tax collectors, and insufficient information and misuse of the available one. Evasion problems are also very deep: estimates indicate that it is higher than 40 per cent.[4] A recent diagnosis of the World Bank (2002) points out that "with weak and sometimes corrupt enforcement, evaders are rarely caught and even more rarely punished, especially large taxpayers. This seriously reduces revenue collection, makes tax burdens inequitable, and increases resistance to paying taxes that are seen as unfair." Although evasion and inadequate tax administration are among the main problems of the Mexican tax system, this document focuses specifically on tax system design.

An improvement in the design of the tax system is not only necessary to address efficiency concerns, a tax reform is required in order to handle increasing fiscal pressures. That is, the reform is not needed to have a technically flawless tax system *per se*, but to strengthen the system with the aim of providing public services satisfactorily while keeping healthy public finances. Regarding the supply of public services, an increase in certain expenditures cannot be deferred for very long. Education, for example, does not receive enough public investment: public education as percentage of GDP is very low compared to other countries. However, the proportion of expenses in education to total public expenditures is high. This points out that such low expenses are not related to a small effort by the government (Figure 1). Several studies insist on the need for more investment in infrastructure, education and health services and agree that they have been delayed because of low revenues.[5] More public spending that enhances human as well as physical capital is not only desirable, but also imperative.

The tax reform is also essential to cope with probable fiscal sustainability problems. Total net public sector debt amounted to 40.21 per cent of GDP in 2002 (Table 2) without taking into consideration contingent liabilities that the government will have to face in the future, like those related to the pension system.[6] Studies on the sustainability of public finances (Santaella, 2001) indicate that the government is bound to maintain a primary surplus of 3.5 per cent of GDP in order to keep healthy

4 Approximations indicate that only 5.5 million people are inscribed in the taxpayer roll compared to the total economically active population of 34 million (Bours, 1999).

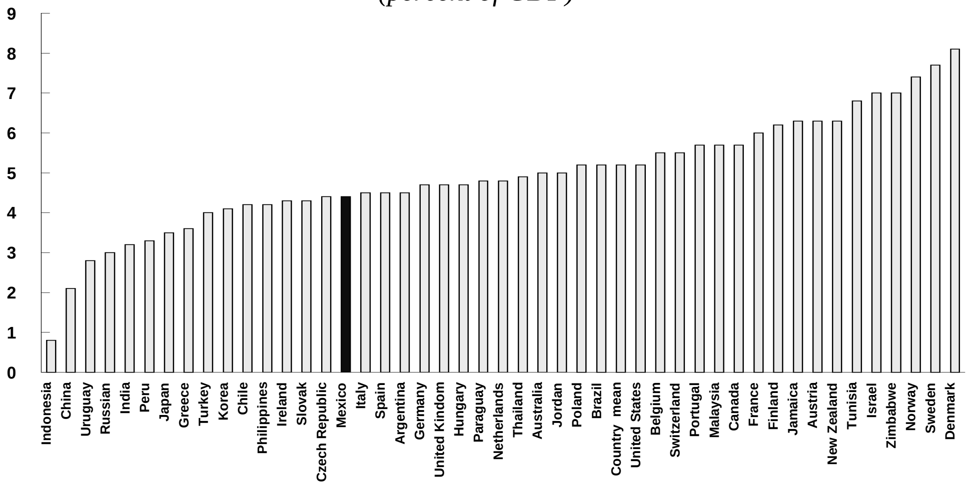
5 Dalsgaard (2000), Ruiz (1999).

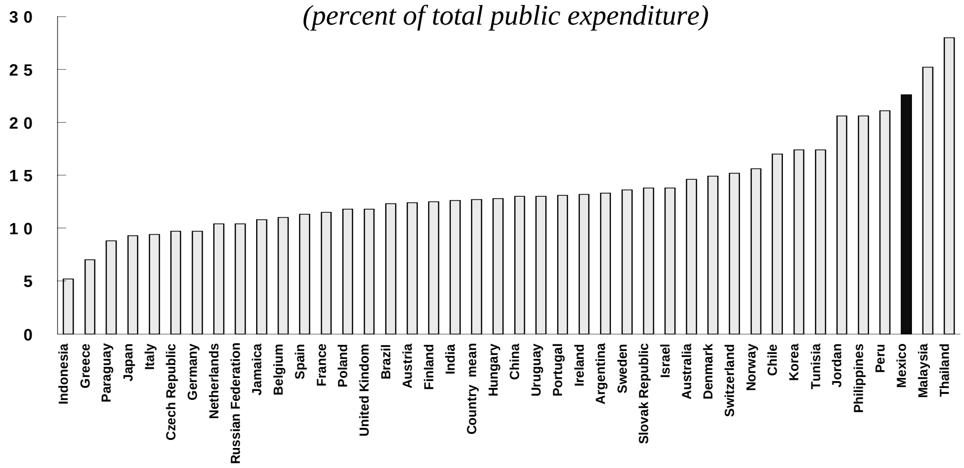
6 Liabilities of IMSS and ISSSTE for 1999 were estimated at 45 and 33.8 per cent of GDP respectively (Santaella, 2001).

Figure 1

Public Expenditure on Education, 1999

(percent of GDP)





Source: Education at a glance, OECD Indicators 2002.

public finances once contingent liabilities (normally not included in the debt to GDP measurement) are considered. Given that the average primary surplus of the last five years is 2.2 per cent of GDP, a fiscal effort of 1.3 per cent is required to avoid any possible sustainability problems.

The only way of reconciling higher public expenditure with higher levels of primary balance is by raising tax revenues. Thus, a tax reform is crucial to

Table 2

Total Net Public Sector Debt
(percent of GDP)

	1994	1995	1996	1997	1998	1999	2000	2001	2002*
a. Net Broad Economic Debt	**32.31**	**37.00**	**27.55**	**22.08**	**24.52**	**21.87**	**20.74**	**20.05**	**22.78**
Domestic	4.20	0.61	2.77	2.61	3.89	5.70	7.83	8.30	10.32
Foreign	28.11	36.39	24.78	19.47	20.63	16.17	12.90	11.76	12.45
b. Contigent Items	**1.15**	**5.11**	**9.27**	**13.73**	**14.16**	**17.51**	**16.15**	**16.54**	**17.43**
1. IPAB	1.15	5.08	8.36	10.49	9.82	11.68	10.31	10.70	10.41
2. FARAC	-	-	-	1.90	1.91	1.97	1.92	2.09	2.29
3. UDIs Restructuring Programs	-	-	0.60	0.48	0.54	0.67	0.64	0.72	0.68
4. Direct PIDIREGAS	-	-	0.11	0.38	1.26	2.34	2.76	2.72	3.94
5. Debtor Suppor Programs	-	0.03	0.20	0.48	0.63	0.85	0.52	0.31	0.11
c. Total Net Public Sector Debt (a+b)	**33.46**	**42.11**	**36.82**	**35.81**	**38.68**	**39.38**	**36.89**	**36.59**	**40.21**
Domestic	5.35	5.72	11.93	15.96	16.79	20.87	21.22	22.12	23.81
Foreign	28.11	36.39	24.89	19.85	21.89	18.51	15.66	14.48	16.39
d. Consolidated with the Central Bank	32.32	40.84	35.03	34.44	36.75	38.51	36.22	36.74	39.52
Domestic	5.35	4.43	12.07	19.63	20.89	25.67	26.69	29.28	31.70
Foreign	26.97	36.41	22.96	14.81	15.86	12.84	9.53	7.45	7.82
Memorandum:									
Total Gross Public Sector Debt	65.1	65.6	56.0	58.4	59.5	65.2	58.4	53.7	57.9
Total Public Sector Debt Net of Liquid Assets	45.2	48.9	36.6	31.5	34.7	47.2	42.8	42.6	46.6

* Preliminary figures.

Source: Banco de México.

strengthen the fiscal position without further damaging the supply of public services.[7]

Furthermore, oil revenues have financed a high proportion of public expenditure. Around 30 per cent of total revenues are related to oil (Figure 2), which during 2002 amounted to 6.65 per cent of GDP.[8] The volatility of the oil price is evidently transferred to public revenues and consequently to expenses as can be seen in Figure 3 where the behavior of oil-related duties and excise taxes against the oil price are shown.

In order to stabilize revenues, it may be desirable to increase taxes not related to oil so that the proportion of oil revenues decreases and with it, the uncertainty on total revenues. Moreover, some authors (e.g. Fernández and Trigueros, 2001) have argued that oil reserves are an asset and as such only the financial gains should be spent, instead of considering all oil revenues as available to finance current expenses.

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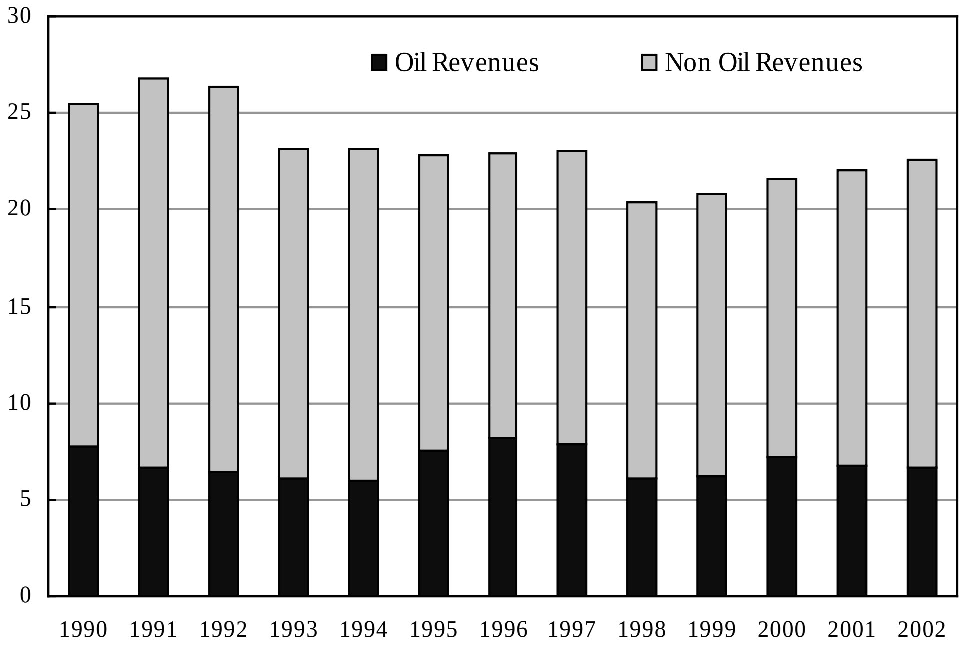
7 So far in Mexico, when a fiscal adjustment has been imperative it has been implemented through expenditure cuts. For example, in 2001 when the oil price fell sharply, the government decided to cut expenses in order to reach the public balance goal.

8 Thirty four per cent of these revenues were linked to duties and 27 per cent to excise taxes on fuel.

Figure 2

Public Revenues: Oil and Non-Oil Revenues
(percent of GDP)



Source: Ministry of Finance.

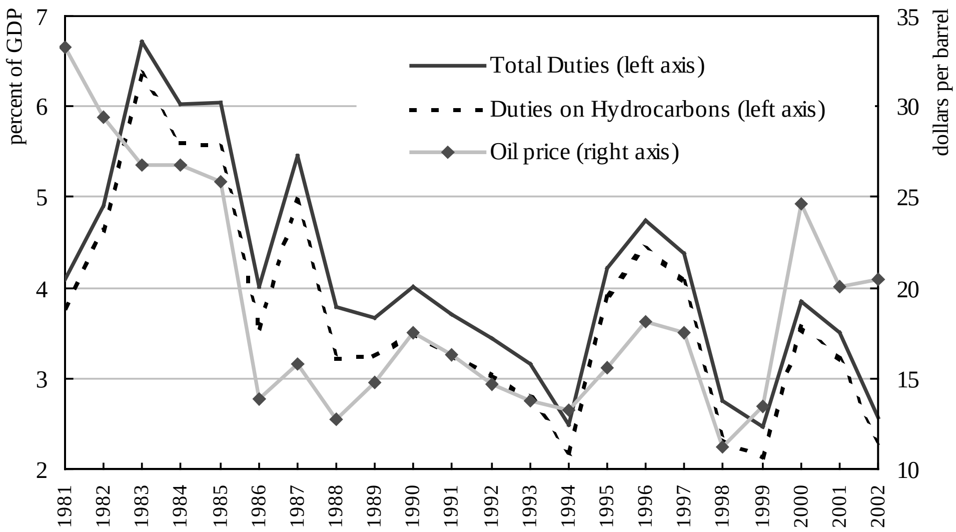
In conclusion, whether to improve the efficiency and fairness of the system, to raise public expenditures, to avoid sustainability problems or to decrease oil price dependency, there is a consensus that a tax reform is needed. There is also an agreement regarding the steps that should be taken in order for the reform to be successful. In particular, well identified causes of low collection such as evasion, narrow tax bases, preferential regimes, and exemptions must be tackled.

In April 2001, the incoming administration, conscious of the limitations of the tax system, presented to Congress a package of fiscal initiatives. It was argued that the fiscal reform was intended to strengthen the government's fiscal stance and to reduce the public sector's borrowing requirements; increase social expenditures in key areas such as education, health and infrastructure; and foster an environment of low interest rates.[9] The fiscal package was designed as a comprehensive modification of the tax system. It suggested measures to increase tax revenues as well as mechanisms to compensate those taxpayers who would be adversely affected by the reform.

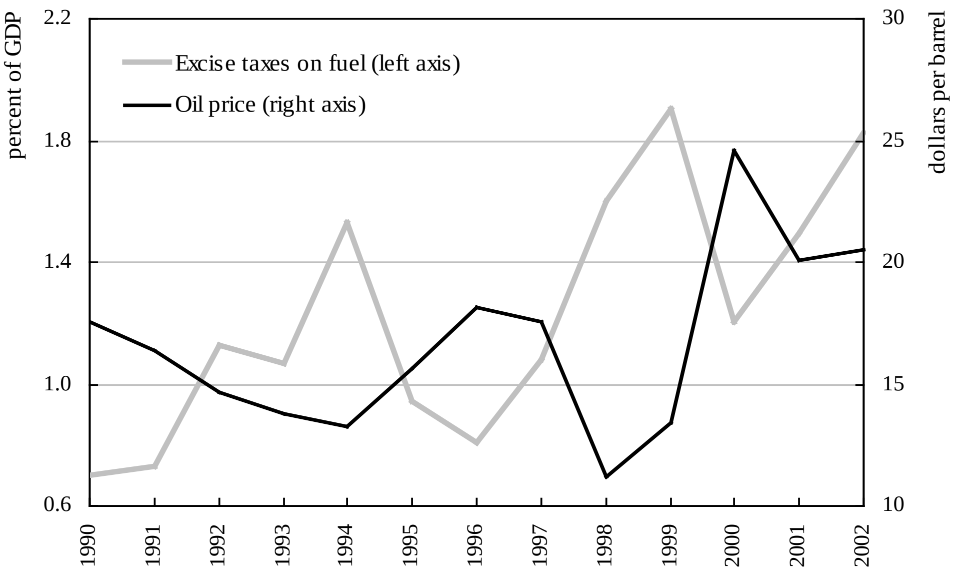
9 SHCP, 2001a.

Figure 3

Duties and Excise Taxes on Fuels



Correlation coefficient	Oil price
Total Duties	0.58
Duties on Hydrocarbons	0.62



Correlation coefficient	–0.35

Source: Ministry of Finance and Pemex.

In broad terms, the proposal aimed at eliminating preferential regimes and exemptions. It suggested a uniform VAT tax rate of 15 per cent except in the border; a reduction of the top marginal income tax rate together with less tax brackets and higher wage credits. A uniform tax rate of 32 per cent (3 points lower than the prevailing) was proposed for the corporate income tax, simultaneously with the elimination of preferential schemes and taxes on dividends. Initiatives were also presented for excise taxes and taxes on new cars. Finally, a series of measures geared towards improving tax administration and collection were suggested such as payments via electronic transfers and internet procedures.

The initiative designed by the government echoed some of the most important proposals of fiscal specialist about ways to increase tax collection, reduce evasion, and improve efficiency. Nevertheless, Congress did not approve it. Instead, the fiscal reform transited from a comprehensive tax reform to a partial modification of the existing taxes, the introduction of new ones and several administrative measures.

The purpose of this paper is to provide a review of the new administration's attempt to implement a tax reform in Mexico. The structure of the most important taxes (in terms of their revenue raising capacity) is described in order to highlight their flaws as a rationale for the proposed reform. The initiative of the Ministry of Finance is analyzed as well as other proposals. Since the tax reform was once more eluded, the approved fiscal package for 2002 is described as well as the changes made in 2003 in order to amend it.

1. Structure and recent changes on the Mexican tax system

The review of the Mexican tax system presented in this section focuses only on three taxes, VAT, excise taxes and income tax as they stand for more than ninety per cent of total tax revenues. The first two are indirect taxes, while the third is the unique direct tax. Other federal levies are taxes on imports, which have been diminishing due to trade liberalization; tax on assets, which is treated as part of the income tax; tax on new automobiles, and an annual registration fee for vehicles. Local taxes, which will not be discussed in this document, comprise payroll and property taxes.[10]

1.1 Indirect taxes

1.1.1 Value added tax

The Value Added Tax (VAT) was introduced in 1980, but it has suffered several changes in rates and administration. The Mexican VAT belongs to the

[10] Although the subject is not treated deeply enough in this document, a comprehensive fiscal reform should include a revision of local taxes and its relation with federal transfers and the level of local expenditures. States expenditures have been increasing, but local authorities take little responsibility for tax collection. The Federal Government cannot afford to transfer taxes to local government without reducing transfers.

consumption variant (gross investment expenditure is excluded from the tax base), it is based on the destination principle, and it is computed through the credit-invoice method. When it was first implemented, there were three different rates: a standard rate (10 per cent), special rate for border regions (6 per cent), and a zero rate (for some agricultural goods and for some basic foodstuffs). Over the last 20 years the need to reduce budget deficits in times of adverse macroeconomic conditions called for adjustments of the rate schedule. In each case, in order to make an increment in the standard rate politically palatable, some goods were classified as zero rated or exempted, while others were classified as luxuries and taxed at a rate higher than the standard one (Table 3). These changes undermined the simplicity, neutrality and revenue potential of the tax. It is estimated nowadays that the VAT tax base includes

Table 3

Value Added Tax Rates

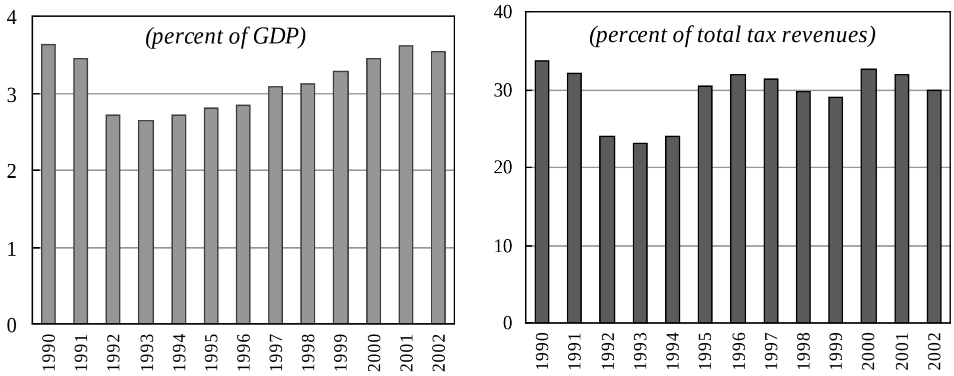
Rates/Goods and Services	1980	1981-1982	1983-1987	1988-1991	1992-1994	1995-2001
Standard rate	10	10	15	15	10 (1)	15 (2)
Border tax	6	6	6 (3)	6	10	10
Luxury goods and services	-	-	20	20	-	-
Basic Food	0	0	0	0	0	0
Processed food	10	0	R	0	0	0
Medical Care	X	X	X	X	X	X
Medicines	10	10	R	0	0	0
Education	X	X	X	X	X	X
Dwelling house	X	X	X	X	X	X
Books	X	X	X	X	X	X
Newspapers and magazines	X	X	X	X	X	X
Recreative services(4)	X	X	X	X	X	X
Financial services(5)	X	X	X	X	X	X
Agriculture	0	0	0	0	0	0

(1) Since November 11th, 1991.
(2) Since April 1st, 1995.
(3) The standard tax rate is levied on services, vehicles, sale and leasing of property, fuels, lubricants, extracts from oil and petrochemicals, and on all goods subject to excise taxes (softdrinks, wine, beer, fermented alcoholic beverages, alcoholic beverages, turbosine, tobacco, cigarettes, insurance (until 1990), telephone services (until 1989) and fuels).
(4) Public shows and museum entrances.
(5) Agriculture and life insurance.
X Exempted goods and services.
0 Zero rated goods and services.
R Special rate.

Source: Ministry of Finance.

Figure 4

VAT Revenues



Source: Ministry of Finance.

only 50 per cent of total consumption.[11] Additionally, VAT compliance is very low. In Mexico it is around 63 per cent while in Canada is 77, in Portugal 86, in New Zealand 95, in Argentina 69, and in Chile 77 per cent.[12]

The VAT represents revenues of around 3 per cent of GDP (Figure 4). For 2002 total collection was 3.5 per cent of GDP, which amounted to 30 per cent of total tax revenues and 16 per cent of total public revenues. VAT collection as a percentage of GDP had been increasing since 1994, however in 2002 it diminished. It was argued that the low economic activity was responsible for the result of such year's performance. On the contrary, after reaching a maximum in 2000, revenues from VAT as percentage of total tax revenues have decreased.

In 2001 the VAT regime established a 15 per cent rate, except for the border regions where it was 10 per cent. Nevertheless, as it is shown in Table 3 and in more detail in Table 4, there were several goods and services (which represent a large proportion of total consumption) exempted or zero-rated. Besides eroding the tax base, such differential rates encourage evasion, and as a result revenues are diminished. Furthermore, businesses with sales under a certain threshold were also exempted from VAT payment. Because of such exemptions, collection from VAT is such as if the rate were only 5 per cent.[13] Apart from the problem of exemptions and

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[11] Fernández and Trigueros (2001), Dalsgaard (2000). The involvement of states in the collection task, justified by their supposed knowledge on the local situation, is not functioning, because incentives related to federal transfers are not correctly designed.

[12] Dalsgaard (2000).

[13] World Bank (2002). This study also points out that: "the zero rating for food cuts out a lager proportion of total consumption expenditures in Mexico than a similar exclusion would in other OECD countries because Mexico is poorer".

Table 4

VAT Exempted and Zero Rated Goods and Services

Departures from standard exemptions[1]		Coverage of lower rates	
Exemptions other than "standard exemptions"	Taxation of "standard exemptions"	Zero rate	Lower rates
– books – newspapers – magazines – gold and silver coins – equity – foreign currency – gold bullion – authors rights – public transport of passengers by land – agriculture, forestry and fishing activities	– postal service – insurance services (except life and agricultural) – the letting of commercial buildings – financial services for consumer credits and personal loans	– non processed animals and vegetables except rubber – patented medicines – milk, water and ice – food except smoked salmon and caviar – agricultural equipment and machinery – fishing boats – the wholesale of gold, gold bullion and jewellery – some agricultural and fishing services – the letting of some agricultural machinery and equipment – the export of goods and service	The sale of goods and services in the border regions. Rate = 10%

(1) Standard exemptions are the following: postal services; transport of sick/injured persons; hospitals and medical care; human blood, tissues and organ; dental care; charitable work; education; non-commercial activities and non-profit making organization insurance and reinsurance; letting of immovable property; financial services; betting; lotteries and gambling; supply of land and buildings; certain fund raising events.

Source: Consumption Tax Trends, OECD 2001.

a lower rate at the border, collection is highly affected by evasion and low enforcement.

The proposed reforms for 2002 were intended to take advantage of the revenue potential of VAT. Thus, the main suggestions focused on eliminating preferential treatments, *i.e.* to obtain a rate schedule as uniform as possible. The Ministry of Finance proposed a unique tax rate of 15 per cent for all goods and services except for exports which would be taxed at a zero-rate and border regions that would be levied at a 10 per cent rate. Consequently, all goods and services that were exempted or zero-rated up to 2001 would be taxed at 15 per cent rate. Estimates of tax expenditures computed by the Ministry of Finance indicate that the total cost of the special regimes associated to VAT (zero rates and exemptions) amounts to 1.69 per cent of GDP. The highest loss in collection is related to food, and it totals 1.13 per cent of GDP (Table 5). Furthermore, it is important to recall that additional collection was expected due to the fact that evasion opportunities are weakened in a scheme with less special regimes.

Fernández and Trigueros (2001), agreed in the homologation of the VAT rate by means of a reduction of exempted and zero rated items, but suggested also a reduction in the standard rate. In this way, revenues would be augmented while the

Table 5

Value Added Tax Expenditures, Estimated for 2002
(percent of GDP)

Concept	percent of GDP
Total	1.6960
Zero Rate	1.3390
Food	1.1330
Medicines	0.1000
Books, newspapers and magazines 1	0.0860
Other products	0.0200
Exemptions	0.2330
Medical care	0.0220
Education services	0.1030
Public transportation of persons by land	0.0890
Household water services 1	0.0120
Others	0.0070
10% border rate	0.1240

(1) Includes the exemption granted through Presidential Decree.

Source: Ministry of Finance.

neutrality of the tax regarding saving and investment decisions would be enhanced. In their suggestion only corn staples (flour, nixtamal, and tortilla) and exports would be taxed at a zero rate, while exemptions would only apply to vegetables, fruits, cereal, and leguminous in natural state. The standard rate for the rest of goods and services would be 12 per cent even in border regions. In addition, local governments would have the option to increase the tax rate and to keep the supplementary revenues. To set the right incentives, this measure would tie local collection to federal transfers. In order to avoid an excessive tax burden on consumers, part of the local tax could be credited against the federal tax. Their estimates indicate that VAT revenues would be increased by 2.1 per cent of GDP if the federal standard rate were established at 12 per cent together with a local 3 per cent rate. If no local tax were adopted, the increase in collection would be only one per cent of GDP.[14]

The World Bank (2002) considers that apart from eliminating exemptions and zero rating, the preferential rate in border areas should also be removed.[15] With these

[14] These estimations consider 30 per cent of evasion, which is lower than the 40 per cent estimated for the regime in 2001.

[15] This study indicates that no other OECD country, except for limited exceptions, has such preferential rates.

reforms, the system would become slightly regressive, contrary to the prevailing progressive system, so that subsidies to the poor should be increased through expenditure programs. The sales threshold under which business are exempted is judged to be too high, so the proposal is to lower it.

In spite of the proposal presented to the Congress by the Federal Government, there were no major reforms approved to the VAT structure. The main administrative modification established that the VAT will be charged on a cash flow and not on an accrued basis. Regarding tax rates, a voluntary local tax was introduced for local governments of a maximum of 3 per cent on the value of the good. Nevertheless, no local government chose the option because political costs were high and there were no incentives since the amount of federal transfers remained unchanged. Apart from this rate, there were no other changes in the number of rates or the composition of goods or services subject to taxation.

In an attempt to compensate the revenue loss expected due to the rejection of the original proposal, a tax on luxury goods and services was introduced. The tax rate was set at 5 per cent. The goods and services that qualified for this luxury tax are described in Table 6. It can be noticed that those goods and services are such that the tax could be easily evaded.

The collection from this tax was only 1,853 million pesos, even though it was estimated at 8,751.4 million pesos. As a result, for the 2003 fiscal package this levy was derogated.

1.1.2 Excise taxes[16]

Excise taxes are structured as the VAT, but up to the wholesale level. As a result, they are charged on a small number of taxpayers who are easily supervised. These taxes have to be paid only after goods are released for final sale. These goods are also subject to the VAT, which is calculated upon the value of the good including the excise tax.

In 2001, excise taxes comprised fuels, alcoholic beverages, tobacco, and motor vehicles. They represented 17 per cent of total tax revenues, while in 2002 they amounted to 18.7 per cent. In terms of GDP, in 2002 they increased with respect to 2001 from 1.9 to 2.2 per cent. More than 80 per cent of the collection of these taxes is related to oil revenues; they are paid by Pemex for fuel sales (Figure 5).[17] So, even if this is an effective tax in terms of collection and neutral in

[16] In Mexico this regime is known as the Special Tax on Production and Services.

[17] Excise taxes are not the only way Pemex transfers part of its revenues to the Federal Government. Oil revenues of the Federal Government amount to around 4 to 5 per cent of GDP, of which only around 1 to 2 per cent of GDP correspond to the excise taxes analysed in this section. The Mexican Ministry of Finance considers the rest of the revenues as non tax revenues, and as such, are not examined in this document.

Table 6

Luxury Goods and Services

Goods	
○ Caviar ○ Smoked salmon ○ Elvers ○ Motorcycles with cylinders over 350 cubic centimeters of potency ○ Motorized water ski ○ Aquatic motorcycles ○ Motorized surf boards ○ Special automobile parts (magnesium rims, sun roofs and sports equipment) ○ Aircraft, except fumigation airplanes ○ Perfumes ○ Fire arms ○ Camping equipment ○ Automobiles with capacity for up to 15 passengers with a price above 250,000 pesos	○ Silk or leather clothing items, except for shoes ○ Watches with a value over 5,000 pesos ○ Televisions with screens over 25 inches ○ Flat screen monitors or televisions ○ Sound equipment with a price above 5,000 pesos ○ Computing and auxiliary equipment with a price above 25,000 pesos ○ Electronic agendas ○ Videocameras ○ Compact disc format video players ○ Audio and video playing equipment with a price above 5,000 pesos ○ Gold, jewelry, gold or silver work, crafts or ornaments with a price above 10,000 pesos ○ Ingots, memorial medals and coins that have a minimum gold content of 80 per cent

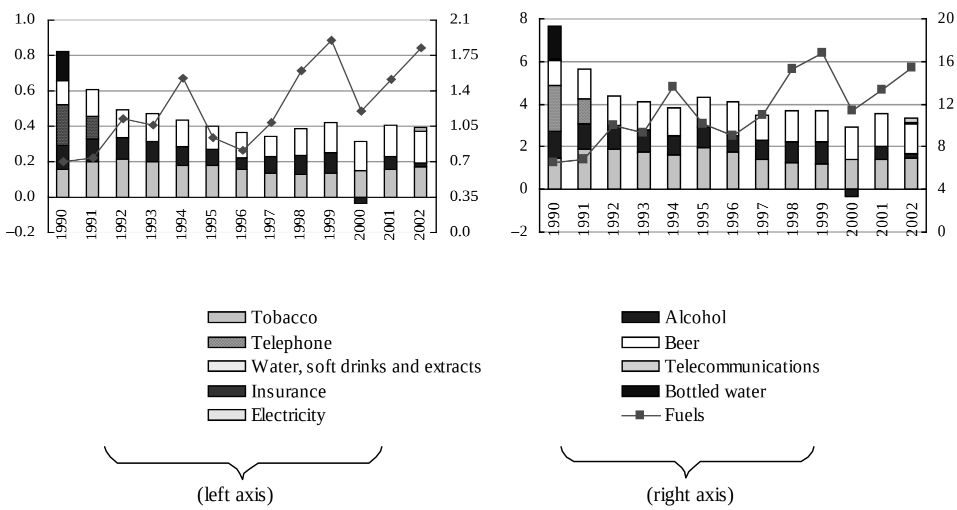
Services

- Those that enable the practice of golf, horseback riding, motor car racing or water sports.
- The membership fees for restaurants, night clubs or bars with restricted access.
- Bars, cabarets, discotheques, as well as restaurants in which alcoholic beverages are served (except beer and table wine).

Figure 5

Excise Taxes Revenues

(percent of GDP) *(percent of total tax revenues)*



Source: Ministry of Finance.

Table 7

Tax Rates for Excise Taxes, 2001

Good	Tax rate
Fermented alcoholic beverages	25% - 60%
Tobacco	20.9% - 100%
Fuels	Based on the difference between the import parity and the regulated final consumer price
Alcoholic beverages	Fixed amount per liter

the sense of imposing few distortions (due to the low demand elasticity of taxed goods), it is dependent on the oil price, which makes it a volatile income.[18]

In 2001, goods subject to excise taxes in Mexico were classified in two broad groups. The first one included fermented alcoholic beverages and tobacco products, which are taxed with a combination of *ad valorem* and specific rates. This group also included fuels (gasoline, diesel and natural gas) that pay a variable *ad valorem* rate. Such rate depends on the difference between the domestic regulated price and the international reference price, so that when the international price is high the rate decreases. This induces a highly volatile implicit tax rate.[19] Nevertheless, as it taxes mainly products with low demand elasticity, it causes relatively few market distortions. The second group included distilled alcoholic beverages, where each different type pays a fixed amount per liter. The tax rates for sales of these goods are displayed in Table 7.

Regarding excise taxes, the Federal Government's initiative sought that all alcoholic beverages be taxed with a combination of *ad valorem* and specific rates. Furthermore, it included increases in the rates of cigarettes and beverages.

Fernández and Trigueros (2001) agreed with the general modifications, but in the case of alcoholic beverages they suggested that the differential burden (specific part of the rate) should be related with the alcoholic degree of each. With respect to fuels, their proposal was to establish a rate of 150 per cent instead of the effective variable rate. These authors point out that although services like electricity, telephone, and water have convenient characteristics to be taxed under this scheme

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18 The relation of the excise taxes related to fuel and the oil price was described in the introductory section (Figure 3).

19 Fernández and Trigeros (2001).

Table 8

Revenue Impact from New Excise Taxes
Estimated for 2002
(million pesos)

Excise taxes	Revenue impact
Telecommunications	3,830.8
Soft drinks	1,374.9
Processed tobacco	85.8
Alcoholic beverages	–170.0
TOTAL	**5,121.5**

Source: Ministry of Finance.

(inelastic demand and easy administration), it is not recommendable to tax them. On one hand, electricity and water are subsidized, and it would be politically unfeasible not only to reduce the subsidy but to tax them. On the other hand, both electric and telephone sectors are under reform, so that it would not be convenient to introduce a new tax on them. Unlike those authors and the Ministry of Finance, the World Bank's (2002) proposed tax reform suggests the conversion of *ad valorem* rates into rates per physical unit.

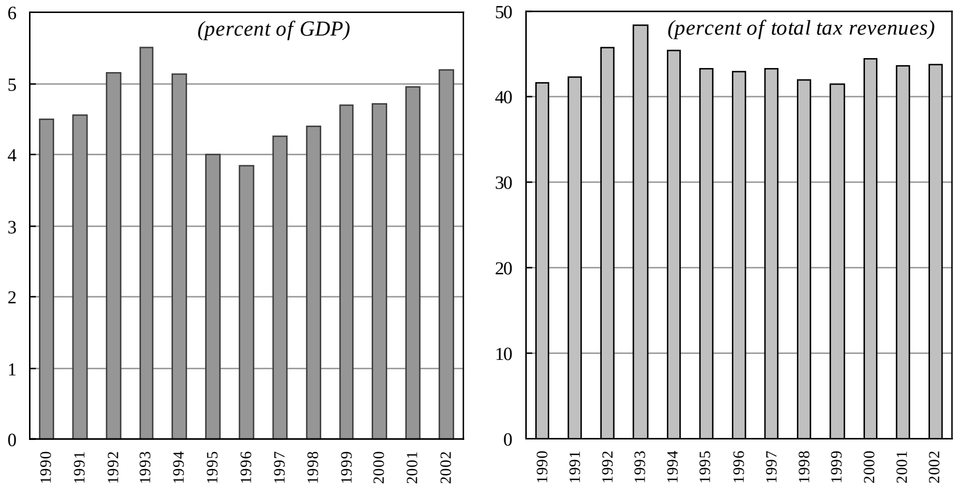
The Congress approved the proposal of taxing alcoholic beverages with a combination of *ad valorem* and specific rates regardless of the process by which they are obtained (fermentation or distillation). New taxes were also introduced. Among them, and despite the aforementioned recommendations, telephone and telecommunications were included. A 10 per cent excise tax on cellular phone, wireless data services, cable and satellite television services was adopted. Residential telephones, cellular services (provided via prepaid cards of up to 200 pesos), domestic and international long distance, emergency services, and web hosting were excluded form the base. This tax was extensively criticized because it opens a lot of possibilities for elusion. Additionally, a 20 per cent tax on natural and mineral bottled water, and on soft drinks and other beverages sweetened with fructose was introduced.[20] Furthermore, rates on cigarettes and alcoholic beverages were adjusted. Approved reforms for 2003 were only for clarification of the previous law.

The revenue impact from these reforms was estimated at 5,121.5 million pesos according to the structure shown in Table 8. Nevertheless, the collection

[20] The tax on soft drinks with fructose was a protectionist measure for the domestic sugar-cane industry.

Figure 6

Income Tax Revenues



Source: Ministry of Finance.

generated from the new excise taxes was not as expected. For example from telecommunications only 1,254.9 million pesos were raised, and for the tax on soft drinks the revenue was only 379.5 m.p.

1.2 Direct taxes

Over the past years, the income tax has experienced a number of changes aimed to broaden and strengthen the tax base, to simplify its structure and to avoid double taxation. To attain these goals, the implemented modifications sought to tax income on a global basis, to index the whole structure for inflation, to flatten the rate schedule and to integrate personal and corporate regimes. Although the tax structure as a whole is considered among the most neutral and progressive within the OECD countries,[21] its low revenue raising capacity is remarkable: it is the lowest from such organization. It is important to stress that the flaws of the income tax scheme are related to fiscal benefits associated with special regimes. Although the government had the intention of eliminating these special regimes, it had to preserve some of them in order to obtain support for the suggested unification of VAT rates.

In 2002 the collection derived from income tax amounted to five per cent of GDP, which is equivalent to 44 per cent of total tax revenues (Since 1996

[21] Dalsgaard (2000).

income tax revenues have increased as a percentage of GDP while as a percentage of total revenues they have remained around 45 per cent.

1.2.1 Corporate income tax

In 2001 the corporate income tax was administered via two modalities: the general regime and the simplified regime. Under the first one, business' taxable income was computed on an accrual basis; under the second, income was calculated on a cash flow basis. The nature of the business activity determined the regime under which the firm would pay taxes. In particular, agriculture, livestock, forestry, fishery and land transportation activities were subject to the simplified regime as long as the firms performing these activities did not act as holding or subsidiary companies. Also, firms with these kind of activities[22] are exempted from the payment of the tax as long as their income does not exceed 20 times the annual minimum wage.

The tax base includes all income received in cash, credit, goods, services or any other form, such as changes in the value of assets and liabilities due to inflation or exchange rate gains and losses. Dividends and profits are exempted as long as they are distributed after the payment of corporate income tax. If profits are distributed, they are taxed at a 35 per cent rate, while if they are reinvested they are subject to a rate of 30 per cent. This differential tax rate was introduced in 1999 as an investment incentive that replaced accelerated depreciation allowances. A discount between 25 and 50 per cent on the general tax rate is applied to firms within the agriculture, livestock, forestry, fishery and publishing industries regardless of the regime to which they belong.

Purchases and costs directly related to business activity are deductible when incurred. Inventory valuation is not considered for tax purposes for reasons of accounting simplification. Interest and exchange rate losses are deductible after they are adjusted for inflation. Fixed assets are depreciated at a constant yearly rate using the straight-line method. Taxable income equals gross income less expenses and net losses carried forward from preceding fiscal years.

A tax of 1.8 per cent on total assets complements the corporate income tax as a control to avoid elusion. It was designed as a minimum corporate income tax. The base of this tax is composed of all firm's assets, adjusted for inflation without allowing the deduction of debts. Payments are creditable against the corporate income tax. It does not have an important effect on investment and it is estimated that for every peso collected by the asset tax, 3.5 pesos are collected by the income tax.[23] This tax is creditable against the income tax.[24]

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[22] Excluding land transportation activities.

[23] Amieva (2002).

[24] The income tax measure described in Table 6 includes the asset tax.

The Ministry of Finance proposed several modifications to this tax in the fiscal reform initiative of April 2001. As in the case of the VAT, for the corporate income tax the Federal Government's primary goal was to eliminate preferential treatments. In particular, it suggested the removal of reduced rates granted to agriculture, livestock, forestry, fishery, and publishing.[25] The need to adopt this particular measure was widely recognized not only by national and international studies that assessed the Mexican tax system, but also by private sector analysts.[26] Some studies estimated that the tax expenditure associated with these preferential provisions amounted to approximately 0.33 per cent of GDP[27] without considering the cost associated with elusion opportunities generated by differential fiscal treatments.

The Federal Government suggested additional reforms. In order to encourage investment, accelerated depreciation of fixed assets (other than furniture) was reinstated as long as firms were located in areas outside the three mayor cities of the country. Among the new fiscal benefits were the deduction of social security contributions as well as deposits on housing funds paid by employers and the profit sharing among firm's employees. The tax rate on profits would be unified at 35 per cent in 2002, and it will gradually be reduced one percentage point annually in order to reach 32 per cent by 2005. As a result, there would no longer be a fiscal difference neither between retained and distributed profits nor between the top marginal tax rate for individuals and the rate applied to corporations.

The private sector[28] also proposed a change in the computation method of the corporate income tax base for a cash flow approach (a consumption-based income tax). It was estimated that this modification would provide a 15 per cent increase in corporate tax revenues, in addition to a significant simplification of accounting requirements for firms. A major drawback of this proposal is that it would prevent foreign firms from crediting the taxes paid in Mexico. This change would constitute a pervert incentive for foreign direct investment, since income generated in Mexico would suffer double taxation.

The Congress accepted the proposal related to the deduction from taxable income of mandatory benefits such as social security, deposits to employees' retirement savings accounts and to housing funds. However, the suppression of special fiscal treatments was not achieved. The major advance made in this regard deals with tax reductions. The top marginal rate was unified at 35 per cent in 2002 and the gradual reduction to achieve a tax rate of 32 per cent by 2005 was approved (Table 9). The 50 per cent discount in the tax rate for publishing was diminished to

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[25] It was also proposed the elimination of the exemption for firms related to agriculture, livestock, forestry and fishery.

[26] Gil Diaz (1987), OECD (1999), Ruiz (1999), Bours (1999), Chávez and Gabriel (2000).

[27] SHCP (2001).

[28] Bours (1999).

Table 9

Corporate Income Tax Regimes

	2001			Approved Fiscal Package								
	Computation	Rate	Discount(2)	Computation	Rate (R) / Discount(2) (D)							
					2002		2003		2004		2005	
					R	D	R	D	R	D	R	D
General	Accrual basis	30 / 35 *	50	Accrual basis	35	40	34	30	33	20	32	10
Simplified(1)	Cash flow	30 / 35 *	25-50	Cash flow	35	25-50	34	25-50	33	25-50	32	25-50

(1) Agriculture, livestock, forestry, fishery and transportation services are subject to the simplified regime. Firms are exempted from the payment of the tax as long as their income does not exceed 20 times the annual minimum wage.
(2) For the general regime, the discount applies only to publishing firms.
* The rate is 30 per cent if profits are distributed and 35 per cent if they are reinvested.

40 per cent in 2002, and it was programmed to decrease 10 percentage points annually until 2005. There were also administrative changes to increase collection.

Furthermore, since the need for increasing revenues was obvious and they were not coming from the VAT reform, the Congress introduced, besides the luxury tax, a new tax that would replace the wage credit. Employers had the option of paying the wage credit[29] that was formerly covered by the government or a 3 per cent payroll tax.[30] The government expected a revenue impact of 23,187 million pesos. For 2003 the rate was increased from 3 to 4 per cent.

1.2.2 Personal income tax

In 2001 the personal income tax considered six categories of sources of income:[31] wages and salaries, service fees, leasing, income from sale and purchase of goods (real state), income from entrepreneurial activities and other types of income. For wage and salary earners an annual return form is not mandatory since tax on this income relies heavily on withholding.[32] Income from interests was taxed on a schedular basis.[33]

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[29] As will be explained in the next section, this credit is provided to avoid that taxpayers with incomes slightly above the minimum wage enter into the schedule with a high marginal rate.

[30] Up to 2001 firms paid the wage credit and were allowed to deduce the whole amount from their taxable income. Under the new schemes firms pay either a 3 per cent payroll tax (still deducting the wage credit) or the wage credit (deducting only the difference between the credit and the amount they would pay under the payroll tax).

[31] Each individual is taxed separately, regardless of marital status.

[32] Although individuals with this type of income have the option to fill the annual return form in order to deduce allowed expenses, it is not a common practice. Individuals in this category must fill an annual

(continues)

The main exemptions from this tax are: bequests, fringe benefits (that do not exceed the limits indicated by law), in kind benefits, social security benefits and capital gains in the stock market. Deductions include: medical expenses, school transportation, funeral expenses and (up to a limit) contributions to pension funds and donations made to qualified institutions.

There were ten tax brackets with a minimum rate of 3 per cent and a top rate of 40 per cent. A wage credit equivalent to one minimum wage is provided to avoid that taxpayers with incomes slightly above the minimum wage enter into the schedule with a high marginal rate. The credit decreases as taxable income increases.[34] A tax subsidy is also included in order to partially incorporate fringe benefits not included in the base; the amount of the subsidy is inversely related to the proportion of fringe benefits in total worker's remuneration. Thanks to these special characteristics of the tax structure, individuals with earnings below four minimum wages actually received a refund.[35]

If individuals obtained income solely from entrepreneurial activities, they were taxed under one of three different regimes: a general, a simplified and a small taxpayer regime. Within the first one, individuals computed their taxable income as specified by the relevant corporate tax provisions (they also applied the corporate tax rate). The simplified regime was designed for individuals earning their income from agriculture, livestock, forestry, fishery and transportation services, and it was computed on a cash-flow basis. Taxpayers within this regime paid the same reduced rate as firms devoted to these activities. Finally, in 1998 the regime for small taxpayers was created in an attempt to incorporate individuals with activities in the informal sector. It was applicable to those with entrepreneurial annual income below 2.7 million pesos. The minimum tax rate was cero, the top rate was 2.5 per cent, and it was charged on gross income.

The proposed fiscal reforms for the personal income tax focused on the treatment of fringe benefits. The main concern was that their exclusion from the tax base represents a loss of 0.9 per cent of GDP for the treasury. In particular, it was recommended to tax all recurrent or monetary fringe benefits such as food and gasoline coupons and to exempt all non-recurrent fringe benefits as well as those provided in services such as sport facilities, transportation or maternity benefits.

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return if they obtained income from any other source (except interests) or if their income from wages and salaries was higher than 2.1 million pesos.

33 Interests paid on saving deposits that do not exceed two times the minimum wages and those paid by bonds issued by Federal Government or international credit institutions were exempted. The rest of interest income was taxed at a rate of 2.4 per cent on the first 10 percentage points of paid interest.

34 By law, individuals with an income equal to the minimum wage cannot be taxed.

35 Fernández and Trigueros (2001) estimated that the cost of these provisions amounted to 0.5 per cent of GDP in 2000. Moreover, only a third of wage earners actually pay some income tax. Due to these provisions it has been argued that incorporating individuals from the informal sector will not contribute to strengthen the revenue capacity of the system since their incomes fall within the three to four minimum wages range.

With respect to the wage credit, some authors[36] proposed a limit in order to provide the exemption only to workers who earn one minimum wage. Since it would be difficult to implement this change, they suggested fixing the nominal amounts of the credit (*i.e.* to eliminate the indexation of this benefit) until they achieve the necessary level to exempt income equal to one minimum wage.

Regarding the fiscal treatment of individuals whose income is solely generated by entrepreneurial activity, the Federal Government proposed the disappearance of the simplified regime.[37] It also suggested the elimination of the schedular regime for interests in addition to the removal of the exemption to interest income from Federal Government bonds. With respect to deductions, it would be possible to subtract from taxable income 20 per cent of tuition payments as well as 100 per cent of medical insurance premia[38] and the mandatory sharing out of firm's profits granted to employees. As in the case of the corporate income tax, the reduction of the top marginal tax rate from 40 to 35 per cent in 2002 was recommended with the same annual reduction of one percentage point until 2005.

The Congress accepted lowering the top marginal tax rate from 40 to 35 per cent in 2002 (Table 10) together with a gradual reduction of one percentage point each year in order to reach a tax rate of 32 per cent in 2005. The number of tax brackets was reduced from ten to eight in 2002 and will diminish one bracket until 2005. Among the new deductions from taxable income the most important are medical insurance premia and mortgage interest payments. In the case of deductions of voluntary contributions to retirement accounts, the modification was to limit the amount that can be deposited in such accounts. In order to increase fiscal control over wage and salary earners it is now compulsory to fill an annual income tax return for those who obtain more than 300 thousand pesos (previously this limit was 2.3 million pesos). It is also required to report non-taxable and/or exempted income.

The regime under which individuals with entrepreneurial activities tribute was also restructured. Individuals whose income comes strictly from these activities pay taxes on a cash flow basis and apply the general progressive rate schedule together with personal deductions allowed for individuals with other types of income. In addition to the small taxpayer regime, an intermediate taxpayer scheme was introduced. The first one is applied to individuals with annual entrepreneurial income below 1.5 million pesos. Under this regime the tax paid on income is one per cent (the progressive schedule is not applied). The intermediate regime includes individuals with annual income between 1.5 and 4 million pesos. The benefit of paying under

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36 Fernández and Trigueros (2001).

37 Fernández and Trigueros (2001) proposed the elimination of the discounts in tax rates. They also suggested the substitution of the small taxpayers regime for the simplified one and to limit the option to pay taxes under this regime to individuals whose earnings were under 600 thousand pesos.

38 These deductions aim at compensating the rise in the VAT rate for these services.

Table 10

Personal Income Tax Rates*

		No. of Tax brackets	Marginal tax rate	
			Minimum	Top
	1995	8	3	35
	1996	8	3	35
	1997	8	3	35
	1998	8	3	35
	1999	10	3	40
	2000	10	3	40
	2001	10	3	40
Approved fiscal package	2002	8	3	35
	2003	7	3	34
	2004	6	3	33
	2005	5	3	32

* Before 2001 these rates were applicable to all taxpayers under the personal income tax regime except those whose income was solely generated by entrepreneurial activities. From 2002, according to the approved fiscal package, the only exclusion is for individuals in the small taxpayers regime.

this regime is that immediate deduction of investments is allowed.[39] The former simplified regime was eliminated.

2. Conclusions

At the time the new administration took office in 2001 there was an overall recognition that a major tax reform was needed to improve the condition of public finances. In the end, the modifications actually approved were last minute changes aimed at reducing the revenue loss generated by the rejection of the original proposal.

It is obvious that the need to implement a major tax reform prevails. It once again should be targeted at strengthening revenues and at consolidating public finances by broadening the tax base and reducing reliance on oil income. Although through previous reforms the Mexican tax system has gained in efficiency, tax collection has not increased due to special regimes and exceptions. Tax evasion is closely related to them, and it will not be easily handled without a comprehensive reform.

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39 Individuals with income above 4 million pesos still deduct physical investments with the option of accelerated depreciation.

Table 11

Personal Income Tax Regimes for Taxpayers With Entrepreneurial Activities Only

	2001			Approved Fiscal Package		
	Computation	Rate	Discount	Computation	Rate	Discount
General	Accrual basis	Corporate tax rate (35%)	0%	Cash flow	Personal progresive tax rate. Min rate: 3%. Top rate: 35% and diminishing 1% each year until 2005.	0%
Simplified(1)	Cash flow	Corporate tax rate (35%)	25% - 50%	Eliminated		
Intermediate (2)	Did not exist			Cash flow	Personal progressive tax rate. Min. rate: 3%. Top rate: 35% and diminishing 1% each year until 2005. (4)	0%
Small (3)	Cash flow	0% - 2%	0%	Cash flow	1%	0%

(1) Agriculture, livestock, forestry, fishery and transportation services are subject to the simplified regime. Firms are exempted from the payment of the tax as long as their income does not exceed 20 times the annual minimum wage.
(2) Entrepreneurial annual income between 1.5 and 4 million pesos, except for agriculture, livestock, forestry, fishery and transportation services where the limits are 1.5 million pesos and 10 million pesos.
(3) Entrepreneurial annual income below 2.7 million pesos in 2001 and below 1.5 million pesos from 2002, except for agriculture, livestock, forestry, fishery and transportation services where the limit is 1.5 million pesos.
(4) The difference with the general regime is the depreciation scheme: contrary to the general regime, in this one immediate deduction is permitted.

Neither the fiscal authorities nor the taxpayers deny the deficiencies of the current tax system. There were several proposals for a comprehensive tax reform that suggested mechanisms to eliminate the special regimes and exemptions and to enhance fiscal administration, thus increasing tax collection and reducing evasion. In 2001, the Ministry of Finance presented to the Congress initiatives for new laws with the aforementioned purposes. Nevertheless, such reform was politically difficult to accept and was therefore rejected by legislators.

It should be noted that the original initiative was comprehensive in that it included reforms in consumption and income taxes that complemented each other. However the reform process favored changes mainly related to fiscal benefits leaving aside those aimed at increasing tax bases. In particular, the proposal to homologate VAT rates was rejected while the compensation measures included in the income tax (designed to lower the distributive impact of the consumption tax reform) were almost completely approved. This has left the fiscal authority with less bargaining power for future modifications.

This last experience regarding the attempt to implement a comprehensive tax reform reassures three already known lessons. Even though the reforms were technically well designed to fix the shortcomings of the tax system, political economy issues to establish a successful bargaining process cannot be ignored in the future. This consideration is particularly relevant given that groups with preferential fiscal treatments will continue to oppose any reform that attempts to increase their tax burden. It should also be taken into consideration that in order to make the acceptance of a broad reform feasible, it might be necessary to introduce well-defined expenditure programs.[40] It is difficult for people to accept higher levies while public goods and services are not seen as a direct consequence of them. In this regard it is also crucial to introduce public accountability and transparency laws. Finally, a generalized disposition to contribute to public expenditures will be very difficult to achieve if evasion problems are not solved.

The process of reform is continuous as long as the fiscal authority faces varying economic scenarios, new restrictions and the constant compromise to satisfy new needs. It is possible to take major steps towards a more efficient and equitable system as was the case of Mexico in the past two decades. Nowadays the major challenge is not to modify the whole structure of the tax system but to tune up the system in order to improve its revenue raising potential. Even after the last proposal made by the Ministry of Finance this particular goal was not achieved: the tax reform continues to be elusive.

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[40] The Federal Government suggested several expenditure programs together with the initiative of tax reform, but they were not seen as a fair compensation for the higher tax burden. The reforms should include benefits to offset increases in the tax burden of the poor; it is better to increase the progressivity of public spending than of the remaining taxes (World Bank, 2002).

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