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President Felipe Calderon Announces Tax Reform Proposal

by LADB Staff
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President Felipe Calderon has unveiled a tax-reform plan that proposes several innovative solutions to Mexico's outdated fiscal system, but the measure faces strong opposition from at least some of the business community.

Unlike earlier plans offered by the conservative Partido Accion Nacional (PAN), the initiative leaves out the controversial plan to impose a value-added tax (Impuesto al Valor Agregado, IVA) on food and medicines (see SourceMex, 2000-10-11, 2003-01-17, and 2004-08-25).

Instead, Calderon's plan proposes to close corporate loopholes and impose a tax on some bank deposits, putting the president at odds with some of the big corporations that supported his presidential candidacy.

Plan seeks to reduce reliance on oil-export revenues

The centerpiece of Calderon's tax proposal is a flat tax (Contribucion Empresarial a Tasa Unica, CETU) of 19%, which would be introduced gradually. Under the plan, companies would either pay the CETU or their normal income tax (Impuesto sobre la Renta, ISR) of 28%, according to a formula included in the proposal.

Other major elements of the plan include a 2% tax on monthly bank cash deposits over 20,000 pesos (US$1,850), an IVA on winnings from private lotteries and similar types of contests, and a provision allowing states to impose an IVA on tobacco, alcohol, and gasoline. The administration says its proposal would increase revenues from sources other than oil exports. "This reform would allow us to generate by 2012...almost 30% more tax revenues than we do at the moment," Calderon said in a speech announcing the plan.

Mexico has struggled for many years to reduce its dependence on oil-export revenues to fund the treasury, primarily by reforming the tax system. At present, Mexico's tax collections are the equivalent of 10% of GDP, the second-lowest rate in Latin America after Guatemala. "There are countries much poorer than Mexico that have revenue streams relative to GDP higher than ours," Finance Secretary Agustin Carstens told reporters in Washington, DC.

The need for Mexico to wean itself from oil-export revenue is more urgent than ever, as supplies at its primary source of crude, the Cantarell oil field, are dwindling rapidly. Reserves at Cantarell, which accounts for more than half of Mexico's crude-oil production, are falling at a much faster rate than projected (see SourceMex, 2007-03-07).

The state-run oil company PEMEX has discovered new reserves in the deep waters of the Gulf of Mexico, but these are expensive to extract and would not be available for a very long time (see SourceMex, 2006-03-22). The overreliance on oil-export revenue has left the Mexican budget at the

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mercy of the global oil market both during times of boom (see SourceMex, 1999-09-08, 2000-09-27, 2002-09-11) and times of bust (see SourceMex, 1999-03-10).

Administration officials say diversifying revenues is an important step to reduce the Mexican economy's vulnerability to oil-market fluctuations. "We have a very important challenge before us, which is to enact a very broad tax reform," said deputy finance secretary Alejandro Werner. Taxes would increase on corporations Some aspects of the Calderon proposal are more controversial than others, namely the decision to create the CETU.

Still, private analysts agree that the new tax could go a long way toward eliminating some of the tax-avoidance tactics used by the private sector. "Basically, this reduces maneuvering room for companies that look for tax loopholes," said economist Miguel Gaitan of Bursametrica consulting company in Mexico City.

Some critics say, however, that the proposal could end up hurting small and medium-sized businesses, including some companies in the services sector that depend on labor rather than capital. "These companies are being treated almost in the same league as the big guys," said economist Rogelio Ramirez de la O, who served as economic adviser during the presidential campaign of center-left candidate Andres Manuel Lopez Obrador.

The Asociacion Mexicana de Franquicias (AMF) has come out against the tax plan, particularly the CETU, arguing that it would inhibit investment in franchises. "Rather than expanding the tax base and simplifying the system, the new proposal would hurt small and medium-sized enterprises, which generate many jobs for the economy," said AMF president Carlos Roberts. Others agreed that the flat tax could be counterproductive.

"The CETU could discourage investment," said Luis Linero, a specialist at the Mexico City consulting company Deloitte. He noted that many companies are going to devote some of their earnings to paying the tax rather than investing the funds. There is also concern that the tax could have a negative effect on small-scale agricultural producers.

But proponents say the tax will overwhelmingly affect the large agricultural operations and transport companies. "The big companies in the agricultural sector, the big exporters of tomatoes and limes, would have to pay more taxes," said Deputy Jorge Estefan Chidiac, chair of the finance committee (Camara de Hacienda) in the lower house. "It's not going to affect the small producers." Estefan is a member of the opposition Partido Revolucionario Institucional (PRI).

Still, there appears to be some support among members of the private sector for the Calderon plan. The Centro de Estudios Economicos del Sector Privado (CEESP) endorsed the measure, calling it "politically correct" because it takes a bold step to boost Mexico's non-oil revenues. The Confederacion Patronal de la Republica Mexicana (COPARMEX), an organization that represents employers, opposed the proposal when it was originally announced. But COPARMEX president Ricardo Gonzalez Sada later had a change of heart, calling the plan a "responsible and honest effort" on the part of the executive.

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Finance Secretary Carstens said most companies would not be paying much more than their current rate. Rather, the plan affects the companies "that are using elusive practices or are not paying enough because of exemptions," he said.

Proposal also offers plan to tax informal economy

Other aspects of the tax reform are also slightly controversial. The plan to impose a 2% tax on bank deposits of 20,000 pesos (US$1,850) or more is intended partly to tax some of the transactions in the informal economy. The measure presumably would not affect small-scale street vendors who make little or no use of the banking system. Rather, administration officials say, the proposal would create a mechanism to collect revenues from the large operators in the black market.

Detractors complain that the bank tax could punish small-scale operations such as small hair salons, auto-body shops, and other enterprises that are considered part of the formal economy. Another concern is that the bank tax could potentially affect the remittances sent by expatriates.

Administration officials said, however, that the law would include exemptions for electronic transfers from overseas. In contrast, the proposal to allow states to impose taxes on gasoline, diesel, cigarettes, and beer appears to have broad support. The tax, which would be separate from the federal Impuesto Especial sobre Produccion y Servicios (IEPS), would require reforms to Article 73 of the Mexican Constitution. "What this proposal is seeking is to give states the right to charge a tax [for these products] that is in addition to the one already charged at the federal level," said PAN Deputy Carlos Madrazo Limon.

The proposal to tax winnings from private lotteries has generated some minor controversy, with critics questioning the administration's decision to exempt the national lottery (Loteria Nacional). Revenues obtained from the public lottery are used to fund some social programs, in contrast to private lotteries conducted by television network Televisa and other private entities, which do not have the same social function, said the Secretaria de Hacienda y Credito Publico (SHCP).

Some economists contend the new package does not go far enough in widening the tax base. "From what I have seen so far these are very superficial reforms," said Cesar Castro, chief analyst at Mexican investment consulting company Capem. "To diversify income sources they would have had to change IVA, which is being left as is."

Plan leaves out controversial tax on food, medicines

The president's decision to leave out the IVA on food and medicines, however, gives the plan at least a fighting chance to gain broad support in the Congress. The tax plan is "politically palatable" to most legislators, said Pamela Starr, an analyst for the Eurasia Group in Washington. "Calderon is actually going out and seeking and creating cross-party agreement," said private analyst Phillip Blackwood.

The Calderon government said it views its proposal as a means to begin to address poverty. "We are aware that the government has a social debt to those who are poorest in our country," said Interior Secretary Francisco Ramirez Acuna. Ultimately, the tax-reform package could look different than the one Calderon presented, depending on what changes the various political parties promote.

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The president is pushing for Congress to approve the measure by this summer so that the changes could be incorporated into the 2008 budget. The problem is that the Congress is in recess until September, and, as of late June, legislators had not officially called for a special session to consider the tax reform. PAN congressional leaders said they were confident that such a special session could be scheduled for the end of July, but other parties had yet to make a commitment. The center-left Partido de la Revolucion Democratica (PRD) has hinted it would support a special session if a discussion of changes to the telecommunications law were also included (see SourceMex, 2007-06-20).

Even with the uncertainty about a special session, the Congress has already begun some discussions. Legislative committees dealing with budget (Comision de Hacienda y Credito Publico) and constitutional matters (Comision de Puntos Constitucionales) in the Chamber of Deputies started to dissect the president's proposal in late June. Members of both committees promised to seek the input of financial experts, businesses, labor unions, and state governors to determine how the proposal could be "enriched."

PRI says plan should include PEMEX tax reforms

The major opposition parties have already spelled out some provisions they would like to see in the tax-reform law. For example, the PRI would like to see major reforms to the tax structure of the state-run oil company PEMEX as part of the overall tax reform. At present, the government gains control of PEMEX revenues by imposing a tax on the company.

"[PEMEX] has always been looted by the federal treasury to finance our country's lack of financial resources," said Sen. Manlio Fabio Beltrones, who coordinates the PRI delegation in the upper house. "In fact, PEMEX had to take out a loan two years ago just so it could pay its taxes to the federal government."

Some financial experts, such as Moody's Investor Services, agree that a comprehensive tax reform would be less effective without accompanying changes to the energy sector. They said PEMEX should be given more resources to conduct exploration and other activities that would help boost reserves. "It is very important that the state-run oil company have sufficient economic resources to make the necessary investments to boost production and increase reserve levels," said Mauro Leos, Moody's Latin America vice president for sovereign risk.

The Congress did approve some reforms to PEMEX's tax structure in 2005, which have increased its earnings significantly (see SourceMex, 2005-07-20). But some legislators, including PAN Sen. Gustavo Madero, say any additional changes to the PEMEX structure would have to be comprehensive. "We have to look at governance, accounting, efficiency of expenditures," said Madero, who chairs the Senate finance committee (Comision de Hacienda). "This is not a matter of just giving more resources to PEMEX."

The Calderon administration has endorsed tax changes to PEMEX. "There is not going to be a reform that doesn't include a true effort to give PEMEX more autonomy," said Carstens. PRD wants

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proposal to include spending transparency The PRD is trying to present a united front, but there are diverse voices on how to proceed.

Former presidential candidate Lopez Obrador has rejected the Calderon plan outright as simply a "tax increase for the majority of the Mexican people." He criticized Calderon for going back on his campaign promises to reduce costs for electricity, gasoline, and heating oil. The tax increases will make these services more costly, he said, calling on the PRD and its allied parties in the center-left coalition (Frente Amplio Progresista, FAP) to reject the government's plan. While the president did not propose an IVA on food and medicines, Lopez Obrador said the people, particularly the middle class, would still be punished by this tax policy because they would have to pay higher costs for other services.

Calderon's plan to boost taxes on the earnings of the large corporations, however, appears to be in line with the PRD's rhetoric during the presidential election. "One of the points that the PRD presented during its campaign was the need for a tax reform that would target the profits of the large companies," said the Mexico City daily newspaper Excelsior. "Even though they pay taxes, these are not equivalent proportionally to the ones paid by Mexican workers." Lopez Obrador has said that the Calderon administration could save a significant amount of money by implementing austerity measures, such as cutting back on bureaucracy and reducing personal expenses for officials.

While Lopez Obrador remains an important voice in the debate, the final decision on the center-left position on tax reform will be made by the legislative delegations of the PRD and its allies, the Partido del Trabajo (PT) and Partido Convergencia por la Democracia (PCD). "The issue will be discussed by the PRD national council and by the deputies and senators of the FAP," said Jesus Ortega, who heads the PRD's Nueva Izquierda faction. The PRD's national council will offer its position on the Calderon tax-reform plan and offer its own proposals following its meeting in early July, said party president Leonel Montano.

Some PRD legislators have already hinted at the types of issues they will press during negotiations. Sen. Hector Miguel Bautista Lopez said the party would push for a mechanism to account for the way in which tax revenues are spent. For example, he cited programs such as those managed by the Secretaria de Desarrollo Social (SEDESOL). "We do not know who benefits from these programs," said Bautista. While the prospects for a fairly broad agreement on a tax-reform package appear good now, other political considerations have the potential to sink cooperation between the executive and the various parties in Congress.

As recently as April, the PRI accused the administration of meddling in the gubernatorial election in Yucatan and said it would not cooperate with the administration on tax reform or any other important issue. This became a moot point when PRI candidate Ivonne Ortega won the gubernatorial race over PAN rival Xavier Abreu in May (see SourceMex, 2007-05-23).

Other political disputes of importance to the PRI have emerged, including charges that the PAN exerted influence on the electoral court in Baja California to disqualify PRI gubernatorial candidate Jorge Hank Rhon (see other article in this issue of SourceMex). PRI legislators said, however, they

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would not use the Baja California situation to hold the tax-reform discussions hostage. "We will not use this issue to create pressure on the negotiations," said Deputy Emilio Gamboa Patron, head of the PRI delegation in the lower house. "It would be unprofessional for us to engage in political games." [Note: Peso-dollar conversions in this article are based on the Interbank rate in effect on June 27, reported at 10.81 pesos per US$1.00]

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