

A NEW FISCAL AND TAX POLICY FOR MEXICO

A POLICY BRIEF

Prepared by

The Economics Department

and

The Centre for Tax Policy and Administration - OECD

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This note draws on a range of work related to Mexico that has been undertaken by the OECD, particularly the OECD *Economic Survey of Mexico*, 2005. It is provided to the new Government of Mexico to assist in their upcoming policy debate.

This can be seen as a first element in a process of OECD assistance to Mexico in this area. It is proposed that follow-up action could follow two paths:

I. TAKING FORWARD THE POLITICAL DIALOGUE

A dialogue between the OECD and senior Mexican policy-makers and parliamentarians on how to develop the recommendations in this note into a specific legislative programme for Mexico. This could include meetings in Mexico and/or Paris between members of the government, of Congress and of the OECD Secretariat.

II. IMPLEMENTATION

In many ways the key challenge facing the new government once it has decided on the reforms will be how to implement them. This will require time and the OECD believes that it is well placed to help in 3 areas:

1. A 3 year programme to improve the effectiveness of the Tax Administration.
2. A 2 year programme to help modernise property taxes.
3. A programme to modernise the VAT system with the aim of increasing the relative importance of this source of revenue.

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Background

Mexico has shown responsibility in fiscal policy. Budget deficit targets are attained and its headline fiscal position is good. Even the wider definition of the deficit has come down to around 2% of GDP (Figure 1). The structure of the public debt has been strengthened, by a reduction of foreign indebtedness and lengthening of average maturity of debt instruments.

However, the underlying situation of public finances is weak, because of the heavy reliance of the budget on oil revenue, part of which is volatile. Mexico's tax/GDP ratio is one of the lowest in the OECD (Figure 2). Non-oil revenue is low relative to GDP; even with oil-related revenue¹ (about a third of the total), it is at the low end. The problem is that the tax base is narrow, reflecting numerous tax exemptions and special regimes and there is a high level of informality.

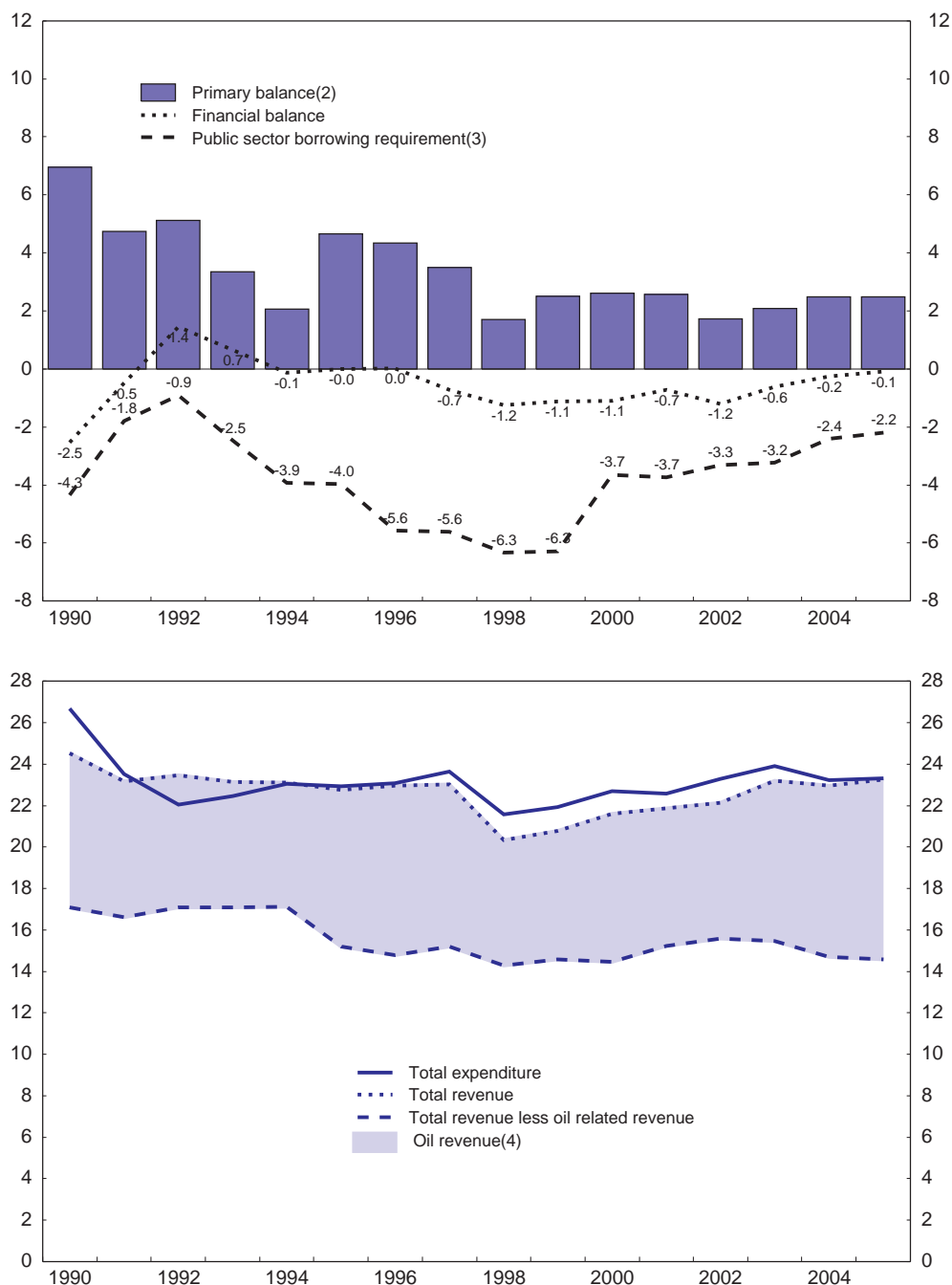
In addition part of oil-revenue is volatile. As a consequence, fiscal policy is heavily influenced by the oil cycle (and it makes it difficult to use fiscal policy to smooth the cycle). Furthermore, development priorities, including basic infrastructure, basic health, education, poverty alleviation do not have matching long-term stable financing.

In the recent years, there has been extra oil revenue because oil prices have been rising above the reference price. As a non-renewable resource, oil wealth should be used for investment (including human capital formation) to enhance growth potential.

Fiscal policy was prudent. Rules were established (in 2005 in particular) to ensure that extra revenue would be spent wisely or saved. This objective has been broadly achieved. Some of the extra revenue created by high oil prices in 2005 and 2006 was distributed to the oil stabilisation fund, to PEMEX for investment and to states and local governments for infrastructure projects. But there are concerns about the actual use of resources transferred to sub-national governments.

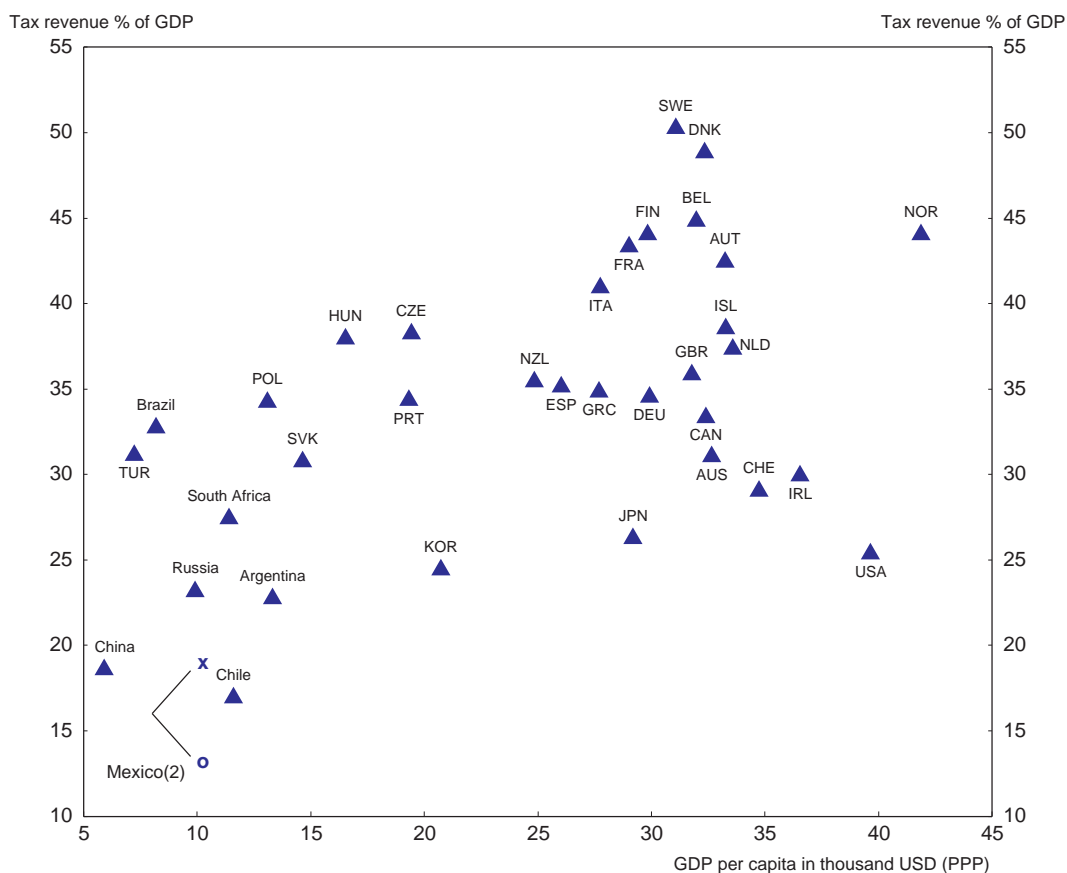
¹ It should be noted that some 'oil-related revenue' would still be collected even if Mexico stopped production of oil. In particular, VAT and excise duties on the sale of oil products to consumers would be collected even if all oil were imported.

Figure 1. Public sector budget aggregates¹
Per cent of GDP



1. The public sector comprises federal government and public enterprises under budgetary control (such as PEMEX). Financial intermediation by development banks is not included.
 2. The primary balance is the financial balance less net interest payments.
 3. Public sector borrowing requirement (PSBR) includes net costs of "PIDIREGAS", inflation adjustment to indexed bonds, imputed interest on bank-restructuring and debtor-support programmes and financial requirements to development banks. Non-recurrent revenues (privatisation) are not included. Further adjustment to include the net non-recurrent capital costs of the financial sector.
 4. Includes oil extraction royalties, VAT and excise taxes on oil products.
- Source: Ministry of Finance; Banco de México; OECD, Economic Outlook database 80.

Figure 2. Tax revenue and the level of income in comparison¹



1. 2004 or nearest year available. Government revenue including social security contributions. Unweighted average for OECD. Public sector for Brazil. Central government only for Chile.
2. Government revenue (including social security): with oil revenues of the federal government (x) and without this component (o).

Source: OECD, Revenue Statistics database; OECD, National Accounts; Mexico, Ministry of Finance; World Bank.

Key issues

The main fiscal policy challenge is about preparing for the future. There are several areas of concern related to the large dependency of the budget on oil revenue. Oil revenue has been increasing, with large volatility, over recent years. But additional resources from high oil revenue are not necessarily permanent.

How large will oil-related revenue be in the longer run?

There are two sets of uncertainties prevailing. Typically, uncertainties were related to oil price levels. How durable is the high price environment? What is the appropriate reference price level for the budget? But the speed of depletion of Mexico's oil reserves has now become an issue. Oil production largely depends on the development of new projects.

The budget is not only vulnerable to changes in oil prices, but also to the sustainability of oil production. Production from the main fields already on stream has started to shrink. This has several implications. New production fields will have to be exploited, which requires new technology and the application of best practices. Measures to reduce the dependency of the budget on oil revenue cannot be

postponed. Advertising prospects of a depletion of proven oil reserves could help the public understand underlying public finances weaknesses.

The formula to establish the oil reference price in the Budget Law initiative is an improvement in principle. It should allow some smoothing over time. But stricter guidelines might be needed to prevent persistently high oil revenue from translating into (incompressible) higher current spending. Once a prudent long-term oil price reference has been established – and it might be appropriate to maintain it over several years - extra revenues arising from prices above the reference (*i.e.* revenue of a persistent but not permanent nature) should be used in ways that improve public sector net worth: capitalising the Oil Stabilisation Fund, reducing the public-sector debt, financing pressing infrastructure needs at the federal, state and local government levels as well as PEMEX. (This is more or less achieved with the fiscal rules now in place). If additional resources are required to finance higher spending of a recurrent nature (basic education and health for instance), these should be obtained through a revenue-enhancing tax reform. This last point remains valid whether the decline in oil revenue comes from a decline in oil prices or from a decline in Mexico's oil production.

Large-scale investment in PEMEX exploration and production is needed

Oil revenue has been extracted from PEMEX in a manner that is reducing the long-term return from this revenue source. Until now, raising investment in the oil sector has meant either fiscal policy tightening or issuance of public debt - through the PIDIREGAS. The new fiscal regime is an improvement and according to new fiscal rules, PEMEX will get a larger share of revenue windfalls. But more should be done. PEMEX should be fully separated from the budget and existing constraints on the way PEMEX is run should be modified, in particular to avoid Government's participation in the day-to-day management of the company. Restrictions on PEMEX entering into joint ventures should be eased. This is important for the company to access the technology it needs and to help manage better risk exposure. In sum, the medium-term health of Mexico's fiscal position requires a complete overhaul of the way PEMEX is run and introducing a tax reform that enhances revenue (by widening the tax base) and reduces distortions.

Efficiency gains in public spending are required

Efficiency gains in delivering services at all levels of the public sector can go part of the way to limiting new funding needs. They would also contribute to improving the quality of services. Every OECD country is seeking ways of getting more value for money. There is an on-going project in the OECD Economics Department aimed at drawing cross-country comparisons of efficiency in the provision of public services. This project also attempts relating institutional and policy settings with higher efficiency of public spending. Two areas for reform on the spending side come to mind in the case of Mexico: *i)* the education sector, in particular, where measures are needed to increase efficiency (see Chapter 6 below); and *ii)* subsidies, which are in place in many areas: water, electricity and gasoline (where price at the pump did not rise in 2005 and 2006 with crude oil prices). Subsidies distort incentives and are costly for public finances; they are usually regressive. They also are detrimental for the environment and long-term energy efficiency of the economy.

Removing subsidies and using part of these funds for direct cash transfers to the poor would achieve several policy goals simultaneously by: helping to reduce distortions in the economy and encourage investment in areas of vital importance for growth and living standards, including water and electricity infrastructure; helping to reduce poverty by directly augmenting the incomes of the poor; improving income distribution by increasing the progressivity of public policy; enhancing the fiscal position by reducing overall expenditure; and increasing incentives for consumers to be more efficient.

The need for a tax reform

Beyond what can be achieved to release some additional revenue through efficiency gains on the spending side, a tax reform is needed to both reduce distortions and increase revenue. Higher tax revenue is

indeed required to provide stable financing for spending already committed and incompressible (e.g. increasing cohorts enrolled in secondary education, "social insurance" in health care, amortization of infrastructure projects already built). All political parties are aware of the need for a tax reform that widens the tax base and increases revenue. Various options exist. The main issue has been, and still is, how to gather a consensus for the appropriate tax reform. The following points are relevant, and they can help to build a consensus on the tax reform needed.

There are incompressible spending needs – present and prospective

There are development priorities in basic education, health, infrastructure, poverty alleviation. These recurrent spending needs have to be financed by permanent sources of revenue that are not affected by the volatility of oil prices. Spending for poverty alleviation for instance needs to continue on a large scale and its source of financing has to be stable. There is a long list of areas where additional spending is required, some of it having already been committed. The tax system does not seem to be robust enough to meet prospective financing needs. Efficiency gains in delivering services at all levels of the public sector can go part of the way to limiting new funding needs. They would also contribute to improving the quality of services. However, beyond what can be achieved through efficiency gains, there are increasing demands made on the budget, including the following:

- In education more children have to be enrolled and basic investment shortages need to be addressed.
- In health, implementation of the new "seguro popular" (system for social protection in health) has a substantial budget cost.
- There are pressures from population ageing, resulting from government employees at both the federal and state levels.
- Even under the IMSS regime for private sector employees, the minimum guaranteed pension has a budget cost.
- The cost of amortising long-term infrastructure projects built under the PIDIREGAS schemes is already substantial and is likely to remain so for some time.

Mexico's taxes in comparison with other OECD countries

Table 1 provides some comparisons of the Mexican tax system with those in other OECD countries. In 2004, Sweden had the highest tax-to-GDP ratio (50%) in the OECD and Mexico the lowest at 19%, a number that would fall to about 15% if oil revenues were excluded. Mexico's tax-to-GDP ratio is well below that of the United States (25%) and the OECD average (36%).

Table 1. How Mexico's tax system compares with other OECD economies

	TAX / GDP	% OF TOTAL TAX REVENUES			TOP PIT RATE	CIT RATE	TAX WEDGE	TOP RATE ON DIVIDENDS	STANDARD VAT RATE
		% PIT	% CIT	% CONSUMPTION					
	2004	2004	2004	2004	2005	2006	2005	2006	2006
Canada	33.5	35.1	10.3	25.9	46.4	36.1	31.5	50.9	7
United States	25.5	34.7	8.7	18.3	41.4	39.3	29.2	48.7	0
Australia	31.2	40.2	18.2	28.5	48.5	30.0	28.4	46.5	10
Japan	26.4	17.8	14.2	20.0	50.0	39.5	27.7	45.6	5
Korea	24.6	13.6	14.3	36.3	38.5	27.5	17.2	48.7	10
New Zealand	35.6	41.0	15.5	33.8	39.0	33.0	20.5	39.0	12.5
France	43.4	17.0	6.3	25.6	55.9	34.4	50.1	55.9	19.6
Germany	34.7	22.8	4.5	29.2	45.2	38.9	51.9	52.4	16
Italy	41.1	25.4	6.9	26.4	44.1	33.0	45.4	44.8	20
Spain	34.8	17.7	9.8	28.0	45.0	35.0	39	50.0	16
United Kingdom	36	28.7	8.1	32.0	40.0	30.0	33.5	47.5	17.5
Mexico	19		24.6	55.5	30.0	29.0	18.2	29.0	15

Notes: Mexico reports a combined share of PIT+CIT

VAT rate for Canada is the Federal Government Rate. Some provinces also levy a VAT

PIT is personal income tax

CIT is corporate income tax

The tax wedge is the difference between the costs to an employer of employing an unmarried worker with no children and the net wage that the worker receives after tax, as a percentage of the employer's costs.

Since 1980 (the earliest year for which the OECD has tax data for Mexico), Mexico's tax-to-GDP ratio has grown by about three percentage points, in comparison to an increase of the OECD average of nearly four percentage points. The growth in the OECD average, however, covers wide variations from a decrease of about five percentage points (the Netherlands) to an increase of about twelve percentage points (Spain). The United States has experienced a reduction of about one percentage point since 1980. Even if Mexico is compared with other significant countries in Latin America (such as Brazil, Argentina and Chile) its tax-to-GDP ratio is still low.

In terms of tax mix, Mexico has a relatively low reliance on personal and corporate income taxes (25% of revenue in comparison to 34% for the OECD average and 43% for the United States in 2004). It also has a low reliance on social security contributions (17% as against the OECD average of 26% and a US figure of 26%). To balance this, it has a particularly high reliance on taxes on goods and services – 55% of total revenue, the highest in the OECD – compared to 32% for the OECD average and 18% for the United States. This is mainly due to the inclusion of oil revenues in this category. Looking at VAT/general sales taxes only, the ratio for Mexico is 19%, about the same as the OECD average but still well above the US figure of 8%. The comparison with other significant Latin American countries is somewhat different. They have an even lower share of income taxes, but similar shares of taxes on goods and services.

Much of the tax reform debate in OECD countries is focused on the top personal and corporate tax rates. In 2005, Mexico's top rate of personal income tax (30%) was lower than average for OECD countries (many of which have top rates of more than 40%) although the Slovak Republic had a rate of 19%. In 2006, Mexico's corporate income tax rate of 29% was at the middle of the range for OECD countries, which varied from 12.5% (Ireland) to 39% (Germany, Japan and the United States).

It is also useful to look at the taxes that apply to average workers: personal income tax and both employer and employee social security contributions. Average workers in Mexico paid a lower proportion of their income in personal income tax (8%) than any other OECD country in 2005 (OECD average 26%, US 24%). When employer and employee social security contributions are added, the Mexican 'tax wedge'

in per cent of gross labour costs becomes 18%, second-lowest to Korea (17%) and well below the OECD average (37%) and the US (29%).

VAT has swept through the tax world with 29 of the 30 OECD countries now having VAT (136 countries worldwide). Mexico's VAT rate of 15% is somewhat below the OECD average but Japan (5%), Switzerland (7.6%), Korea (10%), Australia (10%) and New Zealand (12.5%) have lower rates.² Other OECD countries (with the exception of the US, which does not have a VAT) have rates of up to 25%. Equally important, Mexico has the narrowest VAT base in the OECD, with tax paid on only 30% of consumption expenditures. This contrasts with figures of over 50% for most OECD countries and 96% for New Zealand. VAT has proved to be a buoyant source of tax revenues for governments and most have been able to deal with the perceived regressivity of the tax by means of multiple rate schedules (lower rates being applied to basic necessities such as food and clothing) or by using the revenues generated by the VAT to provide social benefits to the lower income groups. The comparison of Mexico with major Latin American countries in terms of statutory rates is similar: these countries have, on average, slightly higher statutory rates but it is only for VAT that Mexico is the lowest rate country.

What kind of tax reform is needed in Mexico?

The comparison of Mexico with other OECD countries shows that its tax-to-GDP ratio is well below other countries while its statutory tax rates are simply towards the low end of the range. The picture is fairly similar in comparison to other major Latin American countries. This suggests that the bases on which Mexico's taxes are levied are significantly narrower than in other OECD countries, either because the legal definition of the base is smaller or because of weakness in tax administration. The tax reform should therefore increase revenue, concentrating on broadening the base and further strengthening the tax administration. The main concerns are the preferential regimes and deficiencies in tax administration (which are closely related). The preferential regimes, besides diluting revenue and complicating administration *per se*, create significant loopholes, distort economic activity and facilitate evasion. They also create a perception of unfairness, which reduces the willingness to pay taxes.

An important element of any process to remove inappropriate tax preferences is tax expenditure reporting, so that the costs of the preferences (whether they are exemptions of fringe benefits from the income tax or the zero-rating of particular goods) can be made clear to decision-makers. This encourages a rational discussion of whether any possible benefits of each tax preference is worth the cost, bearing in mind the other public expenditure demands. Mexico should, therefore, develop tax expenditure reporting into a standard part of the budget-making process.

Income taxes

Regarding income taxes, measures have been taken in recent years to eliminate various preferential regimes both for corporate and individual tax payers. The corporate income tax rate has been cut and the top marginal rate of individual income tax is reduced (as well as the number of brackets). The reform of 2002-03 has made some improvement under the personal income tax regime, as income from all sources has become subject to the same tax rate. However the scope of tax expenditure has been broadened, and there are still exemptions, tax deductions and preferential regimes on a range of economic activities that create uneven incentives and complicate tax administration.

Value Added Tax (VAT)

Regarding VAT, it has not yet been possible to broaden the tax base. Numerous exemptions and a large proportion of zero-rated goods and services in the VAT system imply that only a small part of the

² Comparisons of standard VAT rates are available in OECD *Consumption tax trends*, 2006.

potential base is actually being taxed. It also contributes to low VAT compliance, as some transactions are falsely attributed to the zero-rated base.

Each OECD country has a specific mix of rates, exemptions, thresholds. Among the wide diversity of ways in which OECD countries are implementing the VAT, Mexico stands out as the country with the lowest revenue raising capacity from VAT. An indicator of the performance of the VAT in raising revenue is the share of VAT revenue to national consumption as a ratio to the average VAT rate. A high ratio points to VAT bearing uniformly on a broad range of consumption combined with effective tax collection. The average ratio for the OECD is just above 50. Several OECD countries, including Canada, Japan, Korea, Luxembourg, New Zealand and Switzerland have ratios higher than 65. In that group Japan in particular has a high ratio with a low standard rate and no zero rate on domestic goods. The five other countries have a relatively low standard rate and a zero rate. Mexico at the other extreme has the lowest VAT efficiency (a ratio about 30 in 2003), probably reflecting the narrow tax base and poor collection capacity, while the standard tax rate is not particularly low. OECD experience shows that the complexity of VAT creates administrative burdens and reduces the compliance of taxpayers. Getting rid of exemptions³ and zero-rating would bring in substantial additional revenue and reduce the scope for tax evasion. For example, increasing VAT efficiency to the OECD average would increase VAT revenues by more than 50% (around 2% of GDP).⁴

A key issue is the impact that a broadening of the VAT base would have on the progressivity of the tax system. Although zero rating and exemptions under VAT are often perceived as a way of reducing inequality, it is actually the most affluent households that gain most from them as they buy more goods in general, including goods that are zero rated. Given the distribution by income deciles, high-income households are actually heavily subsidised by the non-taxation of many consumption goods.⁵ Calculations for 2005 show that the highest two deciles together capture close to 35% of the value of the implicit subsidy, while the lowest two receive less than 10 per cent, although as a percent of income the subsidy is highest for low-income brackets (Figure 3).

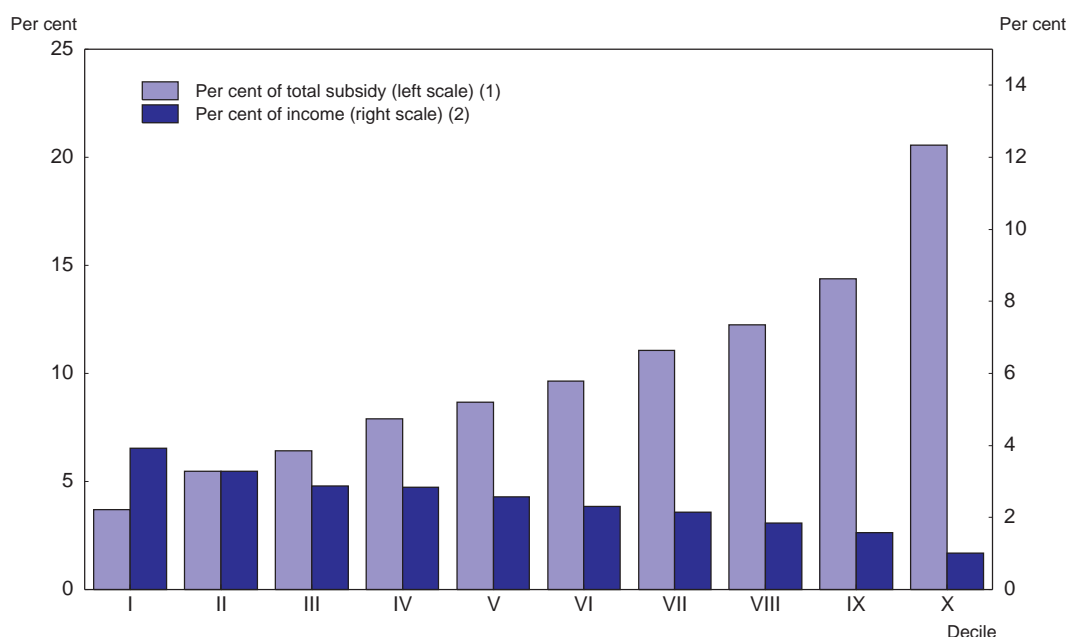
It is important to note that about half of the increase in revenue from base broadening would come from the higher income categories (the 3 highest income deciles as illustrated by Figure 3)). If some of this revenue was redistributed to the 3 lowest deciles, it would more than compensate them for the loss of subsidy on their food consumption and there would still be extra revenue to spend on social programmes. There are many options available to compensate the poorest categories, including direct income transfers, which have been used successfully by other countries.

³ In addition to standard exemptions for "social" purposes – education, health and charities – in practice in the majority of OECD countries, Mexico has exemptions for specific sectors: public transportation of passengers by land; agriculture, forestry and fishing activities (cf. OECD *Consumption tax trends* 2006).

⁴ Additional revenue could be expected from having a less complex regime to administer, hence closing loopholes that facilitate evasion.

⁵ Zero-rated goods include all non-processed food, which is also the case in a few other OECD countries. For instance, caviar and smoked salmon are under zero rating. Cf. details in OECD, *Consumption tax trends*, 2006.

Figure 3. Distribution of implicit VAT "subsidy", 2005



1. The implicit VAT subsidy at each income decile is estimated by the corresponding expenditure on food multiplied by the standard VAT rate of 15 per cent.
2. The consumption of food and household income per decile (referring to total income) are based on the INEGI 2005 Household Survey.

Source : INEGI, "Encuesta nacional de ingresos y gastos de los hogares 2005"; OECD calculations.

Taxing the affluent more

Another potential area for reform would be the real-estate tax, which is administered by the municipalities. The real estate tax, which has many attractive features as a sub-national tax, accounts for the bulk of municipalities own tax revenues (59% in 2004). However its proceeds - at 0.2% of GDP in 2004 - are much lower than in most other OECD countries (the OECD average is 0.9% of GDP, ratios of 3.3% for the United Kingdom and 2.8% for both Canada and the United States). Real estate taxes are less easy to evade than taxes on financial assets and are generally regarded as having little distortionary effect. A main limitation has been the outdated land register (leading to undervaluation of property) and lax local administration and enforcement of collection. Upgrading the land register would allow to increase tax revenues in a fair way and it would increase taxing powers of sub-national governments. With a sufficiently high lower limit, it would be possible to achieve a progressive profile, thereby contributing to taxing the highest-income individuals more heavily, as rich people usually hold a substantial proportion of their wealth in the form of housing.

Related issues in fiscal federalism

Fiscal relations across levels of government can be improved. Two of the recommendations made by the OECD in its 2005 *Economic Survey of Mexico*⁶ are particularly relevant to the discussion above. First, on the revenue side, it is important that States and local governments share in the effort to raise more revenue nationwide; they should raise taxes to finance part of the new spending, so that the direct users face some of the costs. This would increase responsibility. Second, on the spending side, there is little control on how the recent additional resources transferred to sub-national governments for investment are

⁶ See also Joumard (2005), "Getting the most out of public sector decentralisation in Mexico, *Economics Department Working Paper*, No. 453, OECD, Paris.

being used. Because the amounts transferred are substantial, increasing accountability at the sub-national level has become all the more important. It could help if taxpayers (hence voters) were better informed about the responsibilities (and accountability) of the various levels of government in the provision of public services.

Tax administration: further improvements are possible

Today's tax administrations face many challenges. In addition to implementing Government reforms, there are the day-to-day requirements of helping to achieve budget revenue targets and providing adequate services to taxpayers, against a backdrop of globalization and technological impacts, significant and diverse tax non-compliance issues, (for many) declining budgets, and the on-going challenge of developing a competent and trustworthy workforce, information technology services, and internal financial management). In some countries, tax administrations are being given a range of non-tax roles, which only adds to the pressures of managing an organization performing a critical government function.

Mexico faces some additional (but not unique) challenges. Tax revenue collection is seriously affected by weak compliance, even in the formal sector, and the existence of a large informal sector. The tax administration's own estimates of tax non-compliance suggest overall revenue leakage equivalent to almost half the statutory revenue base. Related to this, the number of individuals registered with the tax administration is equivalent to less than 20% of the labour force, complicating the identification of citizens who should be, but are not, registered for tax purposes. At the same time, Mexico has only one member of the tax administration for every 1,600 members of the labour force, as compared to the OECD average of about one to 600. Audit activities, which in many countries represent the primary response to tax non-compliance, are relatively small in scale; and they have been on a declining trend in recent years. A related issue is the significant level of unpaid tax debts which, in relative terms, is very high compared to most OECD countries (over 50% of annual revenues, in comparison to less than 10% for Brazil and Spain and about 13% for Hungary).

At the end of the day, tax policies stand or fall on the efficacy of their administration. Yet, for many countries, tax administration tends to be the Cinderella of tax reform. It should go without saying that administrative feasibility is an essential feature of any reform program. Across the OECD, tax administrations supported by their Governments have responded in a variety of ways but a number of common threads to tax administration reform over recent years can be identified:

- Establishing institutional arrangements for revenue administration that provide adequate autonomy and strengthened governance arrangements.
- Strengthening the organizational framework for tax administration through the creation of a single revenue body to collect both direct and indirect taxes - and increasingly social contributions - typically, these bodies are organized principally on a functional basis but with a dedicated organizational unit responsible for the administration of its most important taxpayers (i.e. large businesses and non-profit bodies). Unlike in Mexico, there is no trend to administer tax and customs from within a single agency, only 6 of 30 OECD countries adopt such an approach (with Canada deciding in 2003 to separate the administration of tax and customs).
- Improving risk management and the management of audits.
- Setting the thresholds for VAT registration at a level which enables the tax administration to concentrate its efforts on collecting worthwhile amounts of revenue.
- Strengthening the legislative framework for tax administration in order to provide adequate powers for the conduct of compliance-checking functions and enforced tax debt collection, and appropriate sanctions for tax offences.

- Adopting wider public sector reforms to strengthen organizational planning and accountability, including the preparation of a multi-year business plan that provides a clear articulation of agency mission, vision, goals, strategies, and key performance indicators, and an end-of-fiscal period performance report that describes achievements against the plan.
- For strategic and operational planning purposes, a strong focus on the individual needs and behaviours of different segments of taxpayers/ clients (e.g. large businesses, small and medium-sized enterprises) through the increasing application of risk management techniques to identify major compliance risk areas (e.g. the informal sector) and to assist the formulation of a balanced set of responses (i.e. service and enforcement).
- Increasing the use of modern technology for the delivery of services to taxpayers (e.g. information provision to taxpayers, electronic filing of tax returns, and the collection of tax payments, as well as for operational risk profiling purposes (e.g. for audit case selection and debt collection).
- Intensifying efforts to increase staff competencies.

Mexico's tax administration has taken some steps in these directions but there is considerable scope for further progress.

How to gather a consensus for the appropriate tax reform

The fact that there has been "generous" oil-related revenue over recent years (higher-than-budgeted oil prices every year from 2000 to 2006) reduced the pressure to raise more tax revenue. The recent decline of oil prices could help, but overall prices remain higher than a few years ago. A closer examination of Mexico's oil sector - with backlogs in investment, insufficient production and refinery capacity; low quality of the Mexican oil export mix, and incipient decline in oil production - does not allow complacency on future trends in oil revenue.

The experiences of other OECD countries suggest the following approach:

- A strong communication effort is required to promote a revenue-enhancing tax reform, including an explanation of its effects on progressivity.
- The reform must be based on clear and well articulated principles so that taxpayers can understand what government is trying to achieve.
- There must be a package approach: reform must encompass income taxes, VAT and other taxes, and with the gains and pains intricately linked. This makes it more difficult for lobbyists to cherry-pick.
- The government should demonstrate that it is improving efficiency of spending before requiring the public to pay higher taxes. This could increase the public's willingness to pay higher taxes.
- It should raise awareness on a number of concerns mentioned above: i) the need to meet commitments for the development of education, health care and pensions; ii) the depletion of Mexico's oil reserves. It should stress that no new spending can be considered with the existing weak revenue base.

Lessons on VAT reform from other countries

All tax reforms are politically difficult, except for those that reduce the overall tax-to-GDP ratio, because the losers will always be more vocal than the gainers. It is even more difficult if the tax reform is

expected to raise additional revenue. Therefore, considerable thought has to be put into how the reform can be made acceptable, and the experience of other countries can be useful in deciding an appropriate strategy. Some of these lessons are outlined in the section above. This section deals with what appears to be the most difficult area of tax reform in Mexico – the broadening of the VAT base.

It should be noted that Mexico is not alone in finding it difficult to broaden the base of VAT. Although many OECD countries have increased their rates of VAT over the past thirty years, there are very few cases in which countries have broadened its base. This is partly due to the political difficulties that would arise, as is shown by one of the few examples of a country increasing its VAT base: the UK's extension of the VAT to include supply of electricity and gas. The UK government planned to increase the VAT rate on electricity and gas from zero to the standard rate in two steps: first a move to about half the standard rate, and then a later move to the standard rate. It managed the first step by a very narrow majority in parliament in the face of widespread opposition, but failed to get a majority to implement the second step. The reason why the government failed is that it did not manage to convince the population that its scheme to compensate people who would be most affected by the price increase would be sufficient to meet all cases of real need.

Despite this lack of experience of broadening VAT bases, there is considerable experience of countries broadening the base of their indirect taxes: mainly in the process of adopting a VAT. As this process involves the same issue as broadening the VAT base, the concern that poor people would lose from extending taxation to goods that are seen as necessities, it also provides lessons that are relevant to Mexico's efforts to broaden its VAT base.

In many cases, countries have adopted VAT because of some over-riding political necessity. In the case of Chile, the VAT was imposed under a military dictatorship and so people had few opportunities to protest. In a more democratic context, many countries in central and Eastern Europe have accepted the VAT as the necessary price of joining the European Union, despite its perceived adverse effect on inequality. Clearly, if the Mexican government can create a view that Mexico's development depends on the broadening of the VAT base (because of the unreliability of oil revenue and the need for greater expenditures), this would help overcome the objections. Many economies in transition and developing countries have adopted VAT systems because they are seen as the only way of raising sufficient revenues to finance development.

Even when VAT is seen as a necessity, governments have taken steps to minimise any adverse effects that it may have on poor households. In the case of Canada, this was done by introducing a payable tax credit (which the household would receive even if they paid no income tax) into the personal income tax system for households on low incomes. More generally in developed countries, state benefits for the poor, the unemployed and the elderly have been increased to compensate for the price rises produced by VAT. In addition, most OECD countries apply reduced rates and/or exemptions to particularly 'sensitive' goods.

In developing countries, these forms of direct payments have been more difficult to manage because of limited administrative resources and so there has been more emphasis on reduced rates and exemptions. There is a widespread view that, in developing countries, exemption is a better approach than zero-rating (except, of course, for exports). This is because the exemption of sectors such as small-scale agriculture, as was done in Uganda and Zambia, can give favourable tax treatment to food consumed mainly by the poor at the same time as reducing the burden on the tax administration of assessing large numbers of small farmers for VAT. Mexico may wish to consider applying exemption rather than zero-rating to many goods as an intermediate step in broadening the VAT base. It would increase revenues to some extent (as no refunds of input VAT need be paid) and reduce the burden on its hard-pressed tax administration, although it would increase the compliance burden on businesses that produce both exempt and non-exempt goods.

Despite the widespread use of zero-rating and exemptions, research in South Africa⁷ shows that many goods that benefit from reduced taxation give little distributive benefit. This study showed that maize was the only product considered which gave a worthwhile improvement in poverty reduction from reduced taxation, while a study by the 2000 South African Women's Budget convinced the government to introduce zero-rating of paraffin because it is a good on which poor people spend a high proportion of their income, but rich people hardly buy at all. If these tests were applied to the goods that are zero-rated or exempted in Mexico, the experience of South Africa suggests that most of them (not just the smoked salmon and caviar) do not meet the test for providing real distributive benefit: a good that is consumed heavily by the poor but very little by the rich. If Mexico limited its exemptions and zero-rating to goods that passed this test, large amounts of additional revenues could be raised with hardly any cost to the poor, who could be compensated by cash or improved local services from some of the additional revenues.

The Mexican government may wish to set up an independent body to evaluate which goods really deserve preferential VAT treatment on distributional grounds. This would provide a scientific basis for VAT reform and a truly independent body would improve the political acceptability of any reforms it recommended. This would be a variant of the 'tax reform commissions' that several OECD countries have used to provide public advice to the government on tax reforms.

The implementation of a successful reform

What can Mexico learn from other countries about the implementation of tax reform? The OECD has looked at how other countries have succeeded in putting in place sound tax reform. 'Best Practices' include:

First, policy reform must be matched by administrative reform and this is particularly important in Mexico.

Second, it is probably wise not to allow too much time between the initial announcement of the reforms and their implementation, since again, this gives lobbyists too much of an opportunity to undermine the reforms; on the other hand, there must be an intensive and well-resourced effort by the administration to implement the reform.

Third, considerable thought has to be given to the transitional rules.

Fourth, the tax administration must develop a comprehensive communication and education package for taxpayers.

Box 1. Recommendations for strengthening public finances

Medium-term approach to budgeting

Mexico's proven oil reserves are starting to decline, assessing the long-run price of oil is delicate and the costs of adjusting to lower revenue are large. The oil reference price underlying the budget should be based on deliberately prudent projections and remain unchanged over a period of several years (the number of which will have to be defined).

Guidelines for prudent fiscal policy

⁷ See Alderman and del Ninno (1999) 'Poverty issues for zero-rating Value-Added Tax (VAT) in South Africa', *South Africa: Poverty and Inequality Informal Discussion Paper Series 19336*, World Bank, Washington DC.

Oil wealth should be considered as belonging as much to future generations as to present ones. Prudent fiscal management requires that extra resources of a non-recurrent nature should be oriented to non-recurrent spending, to be saved or invested. Guidelines should ensure the following allocation: *i)* capitalising the Oil Stabilisation Fund; *ii)* reducing the public sector debt; *iii)* financing infrastructure investment by the federal government, states and municipalities as well as PEMEX.

Pressures for additional spending:

Over the short to medium term, there are needs for additional funding of core programmes in education and health in particular. Financing should come through durable and predictable revenue increases, *i.e.* as a result of a revenue-enhancing tax reform or a mix of revenue-enhancing solutions.

The public sector employees' pension system

The public sector employees' pension system (ISSSTE) reform should be passed and implemented without delay. The transition cost would be felt for a limited number of years. In the current context of high oil revenue, its financing would not squeeze other important spending. The reform would contribute to strengthen the underlying fiscal position, which is important because oil revenue abundance may not be permanent.

Increasing tax revenue while reducing distortions

Develop tax expenditure reporting into a systematic method of reducing tax preferences as broadening tax bases.

The most promising option for tax reform is to widen the VAT base, so as to reduce distortions and facilitate tax administration. Compensation of low-income categories could be introduced at the same time, either through direct transfers or by retaining zero rating or a preferential tax rate on a few basic staples.

Regarding direct taxation, there are still exemptions, tax deductions and preferential regimes on a range of economic activities that create uneven incentives and complicate tax administration. Their scope should be reduced to improve both efficiency and equity.

A reform of the property tax should be undertaken, with a view to increase tax capacity of municipalities and increase the progressivity of the tax system.

Further improvements in tax administration are needed.

Further reading

OECD *Economic Survey of Mexico*, 2005.

OECD *Consumption tax trends*, 2006.

Guichard (2005), "The education challenge in Mexico: delivering good quality education to all", *Economics Department Working Paper, No. 447, OECD, Paris*.

Joumard (2005), "Getting the most out of public sector decentralisation in Mexico", *Economics Department Working Paper, No. 453, OECD, Paris*.