Three Keys to Understand the 2015 Budget Debate in Mexico

By Christopher Wilson and Pedro Valenzuela

Each fall, Mexico's Congress debates the administration's budget proposal. It was sent to Congress by the Peña Nieto administration in September, and a final version must be passed no later than the end of October to authorize revenue streams and by November 15 to detail expenditures. This is the first budget debate since Mexico's 2013 fiscal reform was implemented, offering an important opportunity to analyze the impact of the tax policy changes on public income, and consequently, also on expenditures. The administration's proposal represents a real increase of 1.2%, which, according to the government, will provide the funds to implement the structural reforms and fund new infrastructure and social programs.[1] As a result of the increased spending and a dip in petroleum revenue, the government will continue to run a deficit, and Mexico's public debt will continue to grow. Each of these three issues—tax collection, public expenditure, and the national debt—are explored in this article, all in the context of Mexico's structural reforms and brightening yet somewhat volatile economic prospects.

At the time of publication, the revenue proposal, which must be passed by both houses of congress, had been approved by the Chamber of Deputies and was in committee in the Senate. The Senate is expected to move the bill to the floor and approve the final version during the last week of October.[2] The Chamber of Deputies made moderate changes to the executive proposal, including an increase in the expected exchange rate from 13 to 13.4 pesos per U.S. dollar and a drop in the expected reference price for oil from \$82 to \$81 dollars per barrel.[3] After the *ley de ingresos*, or revenue law, is passed, attention will turn to the *ley de egresos*, the budget of expenditures, which only needs to be approved by simple majority in the lower house.

[1] Presidencia de la República (September 5 2014). Presentación de la Propuesta del Paquete Económico 2015. Retrieved from http://bit.ly/1yg6TNx

[2] -, (2014, October 21). El Senado aprobaría minuta de Ley de Ingresos sin cambios. *El Economista*. Retrieved from: http://bit.ly/1FD7mOL

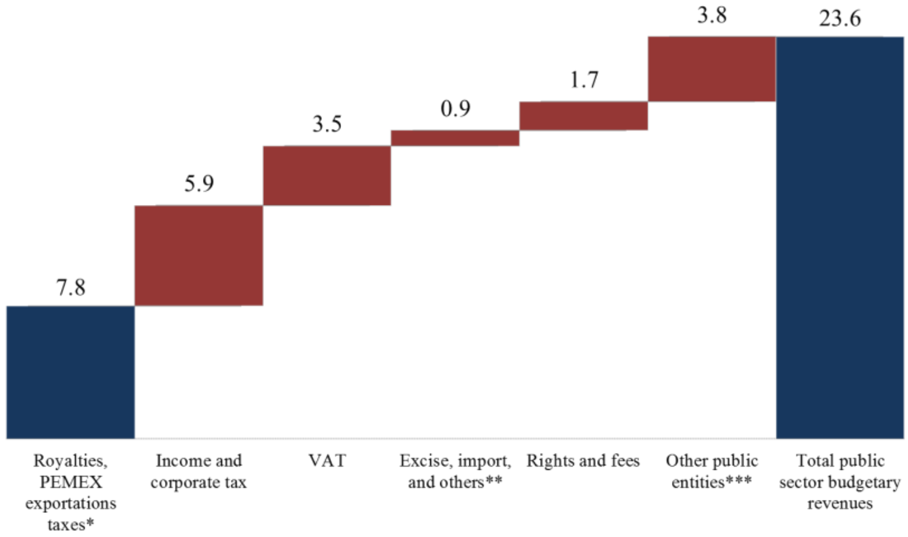
[3] -, (2014, October 17). Envían al Senado la Ley de Ingresos. *Excelsior*. Retrieved from: http://bit.ly/1sPyDH1

Issues to Follow During the 2015 Budget Debate in Mexico

1. Effects of fiscal reform. Beginning this year, Mexico implemented the new tax rules that were passed in last year's fiscal reform. The main objective of the reform was to increase tax collection and close loopholes and exceptions. If effective in increasing the tax take, the fiscal reform could help fund increased government spending on infrastructure, human capital, and the implementation of the other reforms.

Historically, Mexico has had low levels of tax collection; in 2013 government revenues equaled 23.6% of GDP, but less than half of that (only 10.2% of GDP) came from tax revenue (See Figure 1), with another 7.8% derived from Pemex petroleum and derivatives sales.[4]

Figure 1. 2013 Mexico's Federal Public Sector Budgetary Revenues as % of GDP



Notes:
* Include all the oil-related revenues that the Mexican government collects.
** Include taxes to products such as alcohol, tobacco, new vehicle, vehicle ownership, and export taxes.
*** Include all the revenues collected by social security agencies: *Instituto Mexicano del Seguro Social* (IMSS) and *Instituto de Seguridad y Servicios Sociales de los Trabajadores del Estado* (ISSSTE) plus the Federal Electricity Commission (CFE).
Source: Secretaría de Hacienda y Crédito Público. Estadísticas Oportunas de Finanzas Públicas.

The fiscal reform included, among others, measures that limit corporate deductions; eliminate taxes on cash deposits; establish a 10% tax on dividends; increase the income tax rate for the highest earners; harmonize the value added tax throughout the country –by eliminating the special discounted rate for the border zones–; establish special tax rates (excise taxes) for sugary drinks and snacks; and impose additional taxes on the mining industry.

[4] Secretaría de Hacienda y Crédito Público. (2014). Estadísticas Oportunas de Finanzas Públicas. Retrieved from: http://bit.ly/1ta9cRX

The Ministry of Finance reports[5] a 2.6% increase in total budget revenue in Jan.-Aug. 2014 compared to the same period during the previous year, but that figure conceals a much higher 6.3% increase in tax revenue, which is equivalent to 0.69% of GDP. As shown in Table 1, the growth was driven by special taxes (mainly the excise tax on sugary foods), the value added tax increase in the border regions, and the corporate and income tax, which suggests the fiscal reform was the main cause of increased revenue.

Table 1. Mexico's Federal Public Sector Budgetary Revenues (in Mexican pesos).

Concept	Jan-Aug		Real % Change
	2013	2014	
Total federal revenue	$ 2,387,493.2	$ 2,545,125.1	2.6%
Tax collection	$ 1,111,334.4	$ 1,228,292.7	**6.3%**
Corporate and Income Tax	$ 620,714.10	$ 676,579.70	4.9%
VAT	$ 362,978.10	$ 445,949.40	18.2%
Special Taxes	$ 53,718.70	$ 81,601.80	46.2%

Source: Secretaría de Hacienda. Información de Finanzas Públicas y Deuda Pública, Enero-Agosto de 2014.

While such an increase in tax collection does create space for a more expansionary fiscal policy, it has also been the target of a great deal of private sector discontent. Throughout the year, many have complained that rising taxes have been a constraint to economic growth and a source of inflation.

The federal government estimates that next year tax collection will continue to increase and that by 2018, it will be up by 3.5% of GDP.[6] Some analysts have questioned these projections, and it certainly still remains to be seen if they are reached. Nonetheless, the tax collection growth seen during the first part of 2014 has been largely in line with what the government promised, raising the probability that future goals will also be reached.

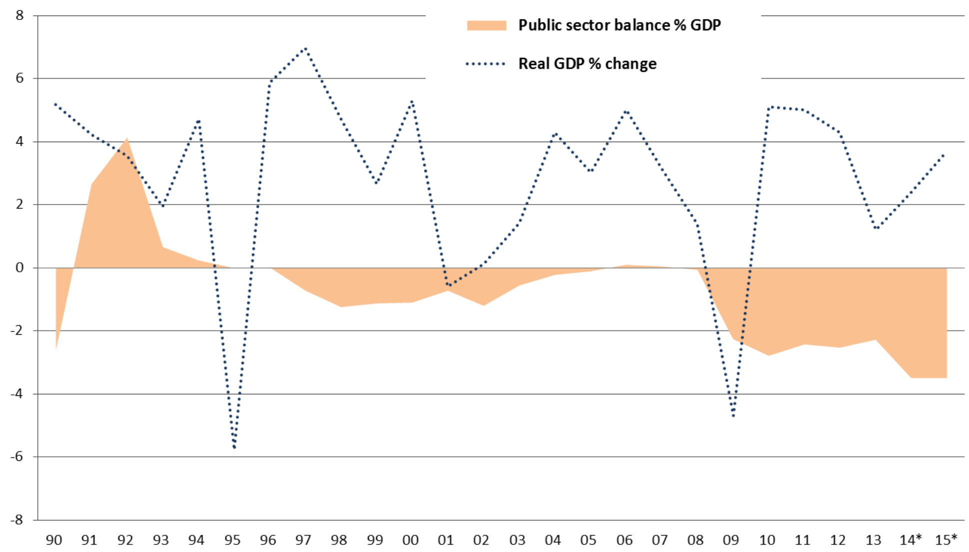
2. Fiscal burden of the reforms and new federal programs. While the major reforms passed in recent years represent a probable positive change in the long-term for the country, many will require increased public spending, either temporarily or permanently, in their implementation. Proposed infrastructure investments, such as those named in the National Infrastructure Plan and the recently announced new airport to be built for Mexico City, have significant costs. The anti-poverty program '*Oportunidades*' is being rebranded '*Prospera*,' which will maintain current benefits but also expand the number and length of scholarships extended to young people, a measure likely to cause a long-term growth in the cost of the program.

[5] Secretaría de Hacienda (September 30, 2014). *Información de Finanzas Públicas y Deuda Pública, Enero-Agosto de 2014*. Retrieved from: http://bit.ly/1w3O2at
[6] -, (2013, December 30). Economía crecerá 5.3% en 2018 por reformas estructurales: SHCP. *La Crónica*. Retrieved from: http://bit.ly/1s3GkW4

Even the energy reform, which is expected to bring in significant additional investment, raise oil production, and thereby eventually increase federal revenue, will likely lead to a decrease in revenue in the short term as a result of new rules that allow Pemex to reinvest a larger portion of its profits.[7] The energy reform also mandates the creation of stabilization funds that will strengthen the country's ability to exercise countercyclical fiscal policy, but the strength of these funds will for the next several years depend significantly on the price of oil. Finally, federal spending on pensions is sure to rise, in part due to promises made long ago but also as a result of changes to the universal pension for older adults, and pensions for the unions of PEMEX and the Federal Electricity Commission made through the recent reforms.

3. Increasing public debt. Since 2008, the total public debt[8] of Mexico has grown each year, rising from 21.1% in 2008 to 35.5% of GDP in 2013. Beginning during the recession of 2009, Mexico has run a steady deficit in the range of 2% to 4% of GDP. The public sector deficit reached 3.6% of GDP in 2014 (See Figure 2) and is expected to stay at the same level for 2015. By not including infrastructure spending, the federal government also presents an alternate deficit estimate of 1% of GDP for 2015. On the other side, some outside analysts include additional expenses, such as debt service obligations, which raise the figure to as high as 4%.

Figure 2. Public sector balance and GDP Growth for Mexico (1990-2015)



* Estimates
Notes: The data for 2014 and 2015 was taken from Secretaría de Hacienda.
Source: Institute of International Finance and Secretaría de Hacienda y Crédito Público, 2014.

Compared to many countries, Mexico still has a low and healthy level of total debt (See Figure 3), which creates the space for continued deficit spending without raising concerns of default. On the contrary, Mexico's sound macroeconomics and prospects for growth have led the three major ratings agencies to upgrade Mexico over the past two years, and government bond yields are at historic lows.

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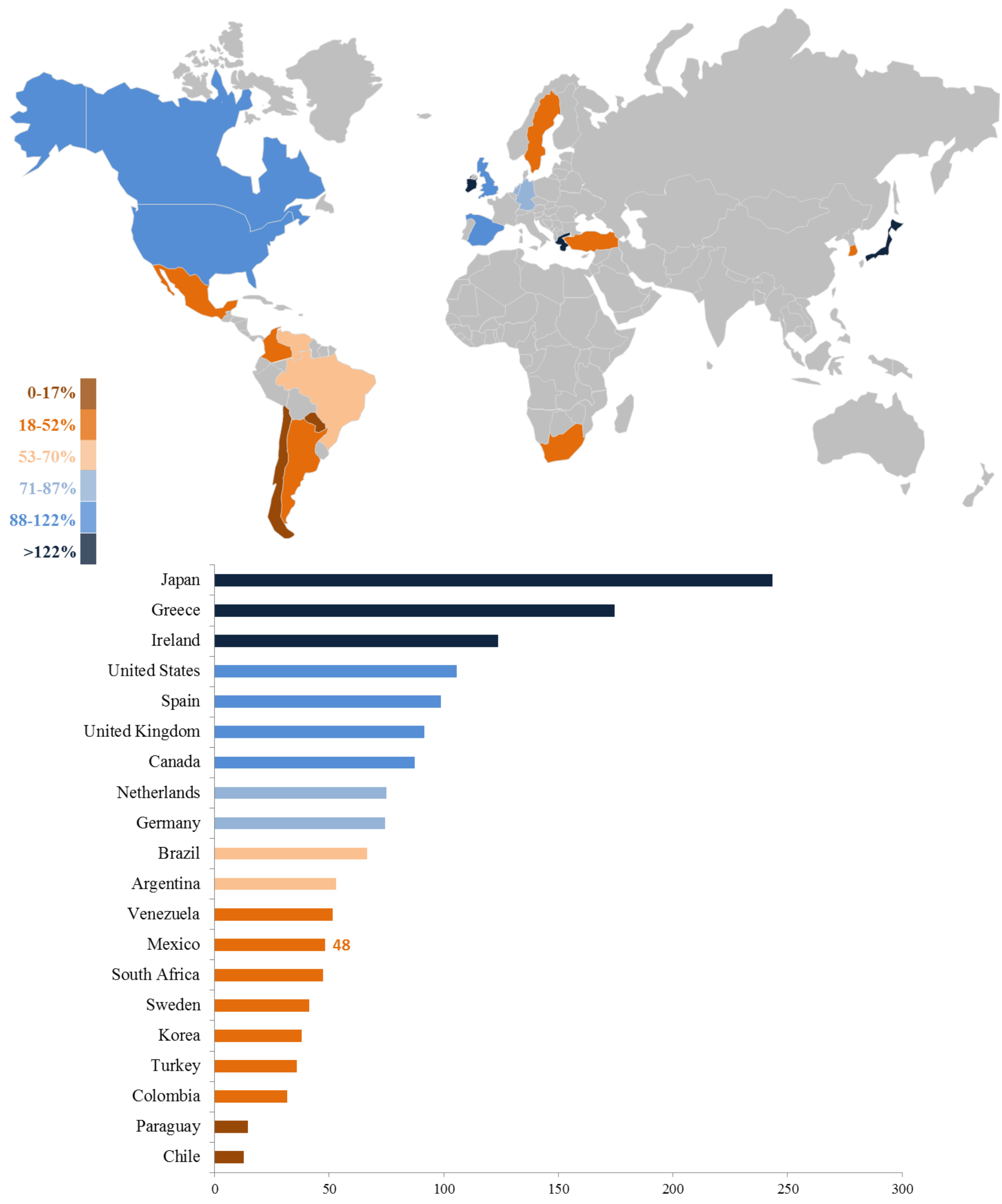
[7] Negroponte, Diana (August 14, 2014). Mexico's Energy Reforms Become Law. *Brookings Institution*. Retrieved from: http://bit.ly/1oqLyAF

[8] Total de Deuda Neta in Secretaría de Hacienda y Crédito Público. (2014). Estadísticas Oportunas de Finanzas Públicas. Retrieved from: http://bit.ly/1ta9cRX

Figure 3. 2013 General Government Gross Debt as a % of GDP for selected countries



Notes: According to the IMF, General Government Gross Debt consists of all liabilities that require payment or payments of interest and/or principal by the debtor to the creditor at a date or dates in the future.
Source: World Economic Outlook Database, IMF, 2014.

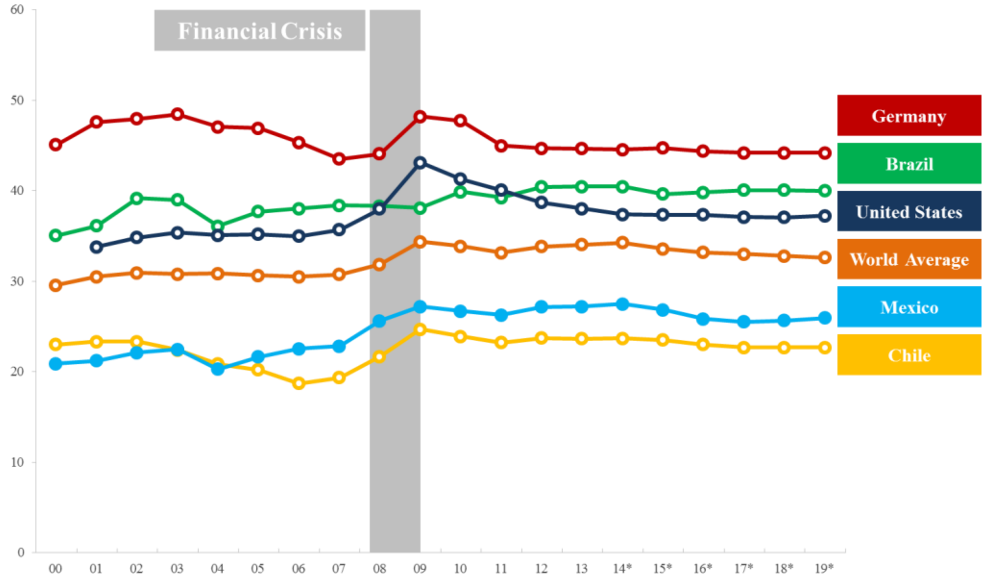
Nonetheless, it is important to take into account some factors that could put pressure on the public sector budget over the next year or so. *i)* In recent months, oil prices have fallen, with the cost of Mexican crude decreasing more than 20%. If this trend continues, it could lead to a change in the reference price that is being used to estimate the 2015 budget –in the proposal submitted to the Senate, the estimate for the Mexican crude oil is 81 dollars per barrel.[9] Currently, the international price is around 77 for Mexican crude.[10] If next year's actual oil prices end up being less than those projected in the budget, the deficit and debt could rise. *ii)* After the 2008-2009 crisis, Mexico became quite attractive for international investors, with the low interest rates in the United States economy driving those looking for higher yields yet still relatively low levels of risk to incorporate Mexican government bonds into their portfolio. However, this could change somewhat next year if, as is expected, the Federal Reserve raises benchmark interest rates, which could pull investments back to the United States from emerging economies like Mexico. *iii)* Economic growth is still low. Although the Mexican economy is expected to grow at a moderate but healthy 3.5% in 2015, it is also true that in recent years that indicator has been revised downwards due to both internal and external factors. Recent signs have been positive, but given Mexico's economic openness, uncertainties in the global economy could eat away at some of the optimism generated through the economic reforms. Lower than expected growth would, of course, weaken tax revenue and thereby necessitate increased debt levels.

Context

Decisions on public spending are decisions about the size and role of government in a society. Creating the budget requires a careful balancing of specific spending priorities within a broader balancing act involving macroeconomic concerns. According to the International Monetary Fund, in 2013 government spending in Mexico reached 27.1% of GDP (in 2000 it was 20.9%). As a portion of GDP, the country is spending more than Chile (23.6%) and less than Brazil (40.4%), Germany (44.6%), and the United States (38%).

[9] -, (2014, October 17). Ley de Ingresos 2015 avanza al Senado. *El Economista*. Retrieved from: http://bit.ly/1s3GkW4.
[10] Petróleos Mexicanos. (2014). Seguimiento Diario del Precio del Petróleo. Retrieved from: http://bit.ly/1s3GkW4

Figure 4. Public spending as a percentage of GDP
(2000-2019, selected countries)



* Estimates
Notes: Estimates start after 2013.
Source: World Economic Outlook Database, IMF, 2014.

Nonetheless, in Mexico many of these fundamental decisions were made in prior decades, and the majority of items in the budget proposal face economic, legal, or political constraints that keep them off the table during congressional negotiations. In a recent study on the politics of creating the budget in Mexico, Luis Carlos Ugalde notes that only between 6-10% of the executive proposal is normally considered for modification during the negotiations in Congress.[11] It is also noteworthy that the federal budget is of paramount importance not only for the federal government but represents about 80% of state budgets.[12] In fact, transfers to the states represent the equivalent of 8.5% of GDP,[13] and the federal government has very limited control over how those funds—which cover vitally important education, health, and security services—are managed.

[11] This refers to the era beginning in 1997 when the PRI first lost control of the Congress. Source: Luis Carlos Ugalde, La Negociación Política del Presupuesto En México 1997-2012, Integralia, 2014, http://integralia.com.mx/publicaciones/resumenejecutivo.pdf.
[12] Revilla, Ernesto (2013). Subnational Debt Management in Mexico: A Tale of Two Crises. In *Until Debt Do Us Apart: Subnational Debt, Insolvency, and Markets* (Pages 145 – 176), World Bank.
[13] Secretaría de Hacienda y Crédito Público. (2014). Estadísticas Oportunas de Finanzas Públicas. Retrieved from: http://bit.ly/1ta9cRX

Conclusion

Regular debt and currency crises during the 70s, 80s, and early 90s led to important changes in the way Mexico manages its fiscal and monetary policy, and since the Tequila Crisis of 1994-1995, the Mexican economy has for years enjoyed a sound and stable macroeconomic foundation, with healthy levels of inflation, reserves, deficit, and debt. In fact, the health of Mexico's fundamentals has been one of the principal factors (the other being the reforms) fueling consistent investor interest in Mexico since the Great Recession drove down interest rates in mature markets. Mexico has taken advantage of low borrowing costs to maintain deficit spending and thereby increase the nation's debt burden.

Despite significant debt growth over the past decade, the overall level of debt is still within a healthy range and is expected to stay so for foreseeable future. This is, however, contingent on the success of the reforms and the implementation of investments in infrastructure and human capital. As suggested in the Ministry projections', the deficit will have to be tamed over the next several years in order to stabilize the debt as a portion of GDP. This will require both increased economic growth and budgetary restraint. The challenge lies in the fact that the global climate and Mexican reforms will have to conspire to create economic momentum strong enough to withstand the challenge of increasing spending on pensions and debt service while reining in the deficit and weaning itself off of oil dependency. If there are unforeseen hiccups at home or abroad, the current projections to successfully walk this line without further taking on significant additional debt may not hold. Mexico thankfully still has space to react to unforeseen events before creditors will need to worry, but that space is not unlimited.

With that in mind, Mexico must make the most out of each peso it spends. Some progress has been made toward increasing transparency and accountability, more so at the federal level but some also at the state and municipal level. Still, much more is needed. On September 4, a group of opinion leaders representing some of the key think tanks in Mexico released 10 proposals to improve the budgeting process,[14] highlighting the need for increased transparency and accountability in infrastructure projects, pensions, and the transferences made to the state- and municipal-level governments. Furthermore, they called to avoid increasing debt at a faster rate than overall economic growth, and to use in a more intensive way results-based budgeting as a strategy to fund the most successful projects and programs. Another analyst, Mauricio Merino come to similar conclusions, recognizing the process Mexico has made in creating the necessary indicators and tools for results-based budgeting, but noting that several poorly performing programs continue to be funded.[15] In sum, the government must prove to its citizens that needed increases in taxes are justified. It must effectively and apolitically implement social programs, infrastructure spending, and the package of economic reforms. From that perspective, the budget debate under way is just the beginning of the process.

[14] México ¿Cómo vamos? (2014). 10 propuestas para un mejor presupuesto 2015. Retrieved from: http://bit.ly/1uFCp3N

[15] Mauricio Merino, "The Second Democratic Transition in Mexico: Efforts, obstacles and challenges to Mexico in the quest for a comprehensive, coordinated, consistent form of accountability," Wilson Center and Consejo Mexicano de Asuntos Internacionales, June, 2013, http://www.wilsoncenter.org/sites/default/files/democratic_transition_merino.pdf.

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