Chapter 3

Fiscal Policy to Support Inclusiveness

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Mexico's public finances are sound, but do not permit a smooth financing of social or growth-enhancing policies. For fiscal policy to support better, more sustainable and inclusive growth, serious reforms are needed – starting with reforms to strengthen the delivery of quality public services. Though innovative programmes have been developed to address poverty, social expenditure remains low and less well directed than needed to substantially reduce inequality. Spending efficiency could also be improved. Large subsidies on energy consumption and many substantial tax expenditures still need to be withdrawn. Although tax policies have been reformed, the tax base needs to be broadened and distortions removed. Increasing states' revenues and fiscal responsibilities, combined with sufficient fiscal equalisation, is another key challenge that would make the fiscal system sounder and help reduce regional disparities.

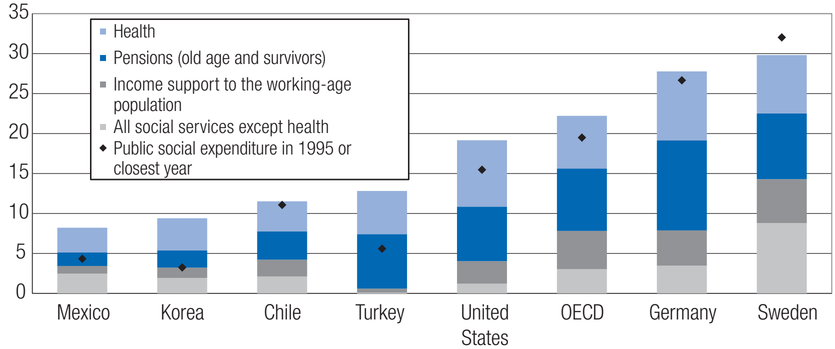
Fiscal policy has a major role to play in supporting the rise in living standards in Mexico. Higher spending on infrastructure, education, public health, social programmes, innovation and support to SMEs could enhance productivity growth, make growth more inclusive, and further reduce widespread poverty. This, however, will require major fiscal reforms in order to improve the efficiency and inclusiveness of public spending and make the revenue base broader and more stable. President Peña Nieto inaugural Message to the Nation included decisions related to fiscal accountability, as well as austerity measures in the public expenditures. Such plans have been supported and further developed in the Pact for Mexico, a national agreement signed by the three main political parties that envisions an efficient and fair fiscal reform which can operate as a lever for development.

Public finances are sound but do not permit a smooth financing of social and pro-growth policies

To further dent poverty, Mexico needs to continue increasing social spending, which remains low as a share of GDP relative to most OECD countries (Figure 3.1). More transfers targeted to the poorest population are especially needed (see Chapter 2 on combating poverty and inequality). While *Oportunidades* has been very successful, the social assistance system could be further enhanced to complement *Oportunidades* and better protect Mexican households and the economy against shocks. Mexico already has been rapidly extending health insurance coverage to workers not covered by social security through a largely tax-financed scheme, *Seguro Popular*. More needs to be done, however. For instance, Mexico is the only OECD country without a system of unemployment benefits, a situation that contributes to informality and inequality (see Chapter 5 on improving access to formal employment). The Pact for Mexico mentioned above (hereafter the Pact) envisions the creation of a public unemployment insurance scheme (commitment 4).

Moreover, population ageing will put additional pressure on social expenditure going forward, and notably on the states' defined benefit pension systems and health care programmes of the federal social security institutes (IMSS and ISSSTE). IMSS is currently drawing down its financial reserves to

Figure 3.1. **Mexico's social spending (excluding education) is low as a share of GDP, 2009**



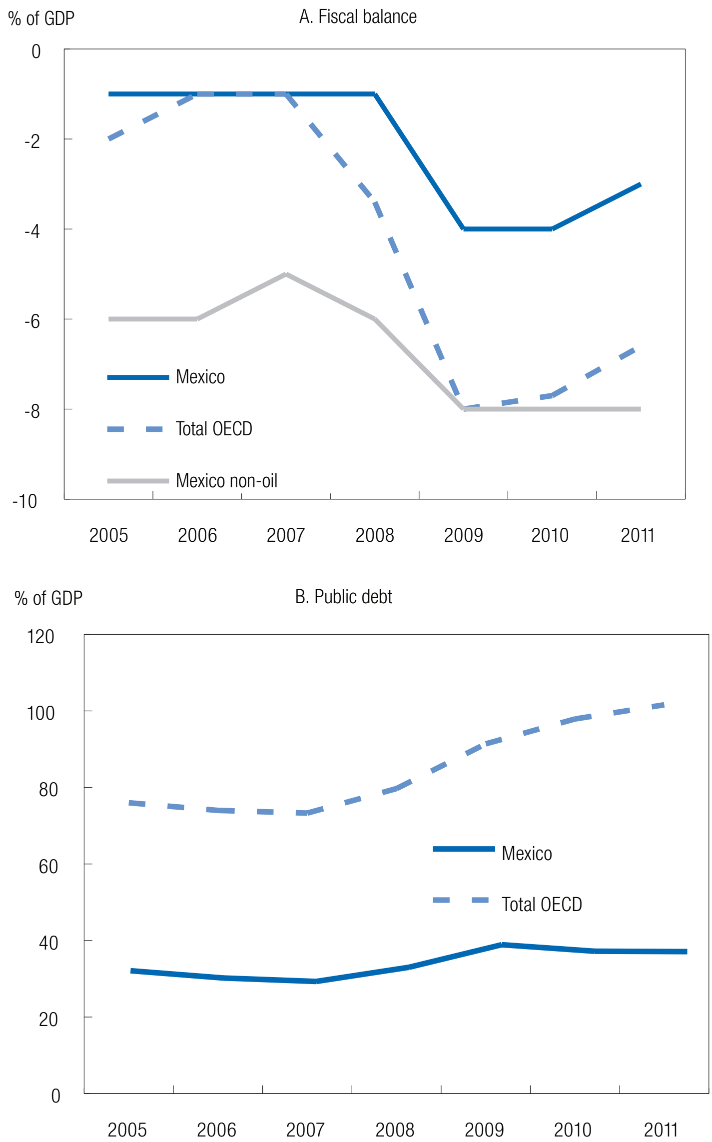
Source: OECD Social Expenditure database, 2012.

cover operational deficits of its health accounts – endangering sustainability of a number of its schemes– even though some of its other schemes are running surpluses (see Chapter 7 on health challenges). The Pact commits to reforms to integrate disparate health care schemes at the federal level, but the sustainability issues of IMSS and state-level pension systems will also need to be dealt with directly.

Supporting stronger and more inclusive growth will also require further investment in human capital (see Chapter 6 on education) and support to SMEs (see Chapter 10 on SMEs and entrepreneurship). Such investments, also included in the Pact for Mexico, are essential to complement ongoing reform of the business environment and the functioning of the labour market in reducing informality. Beyond these reforms, considerable scope for growth-enhancing infrastructure investment exists as well (OECD, 2009b).

However, as the Pact for Mexico recognises, the fiscal situation does not allow for the higher spending needed to make growth both stronger and more inclusive. Mexico has pursued a prudent fiscal policy that has kept a lid on the public debt deficit; this policy course should continue. After the global economic crisis in 2009, the government tightened its policy stance, raising taxes and containing expenditure growth. The broad measure of the deficit was brought down to 3% of GDP in 2012 (Figure 3.2). Limiting spending growth would further reduce the deficit to 2.4% of GDP in 2013. The deficit is set to close by 2014 based on the government's nonstandard definition that excludes PEMEX investment but includes a number of financial operations. If the recovery unfolds as projected, the government should implement its consolidation plans in full to avoid eroding market confidence in Mexico's fiscal policy. In this context, the room for higher expenditure is limited without a full-fledged tax reform.

Figure 3.2. **Mexico's fiscal balance and gross debt**

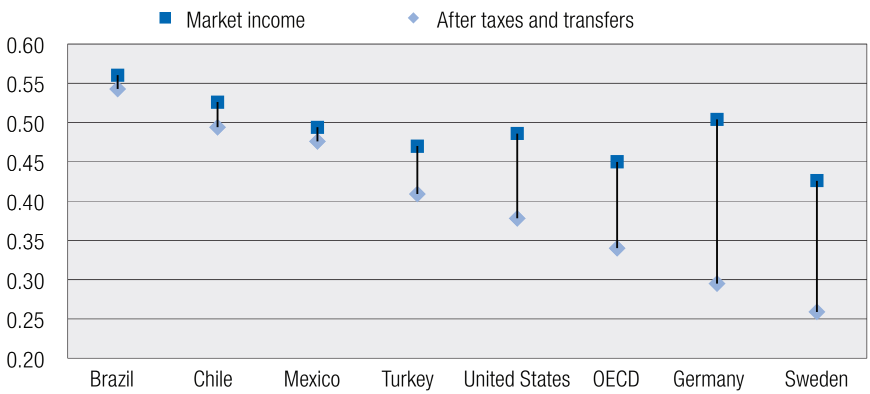


Notes: The fiscal balance is the public sector net borrowing requirement, including the borrowing requirements of the central government and of public enterprises as a percentage of nominal GDP. Gross debt is the historical balance of the public sector net borrowing requirement, including the borrowing requirements of the central government and of public enterprises, as a percentage of nominal GDP.

Source: OECD Economic Outlook 92 database and OECD (2012c), Restoring Public Finances: 2012 Update, OECD Paris.

Figure 3.3. **Income inequality could be reduced further with taxes and transfers**

Gini coefficients



Source: OECD Income Distribution and Poverty database.

Moreover, the budget has become increasingly dependent on oil revenues rather than on more sustainable sources, making it vulnerable to changes in market conditions. More than one-third of fiscal revenues depend on oil, covering a large part of budget expenditure – as evidenced by the non-oil budget balance that has improved at a slower pace than the headline balance. en though oil production has stabilised since mid-2009, maintaining current production levels beyond a 10-year period will require continued substantial investments in high-cost exploration and new discoveries. Mexico launched a reform in 2008 to improve the governance of the state-owned oil company, PEMEX, which has stepped up its exploration of new oil fields (see Chapter 11 on energy policy). The government has taken initial steps to provide more flexibility in PEMEX's contracting mechanisms in order to enable it to operate more like its peers, and the Pact commits to more flexibility still (commitments 55-57). But the outlook remains uncertain, and a strategy to strengthen non-oil tax revenues is urgently needed.

Output volatility has also been higher in Mexico than in most other OECD countries – including during the recent crisis, though the economy recovered quickly from the global recession. Such large fluctuations of activity and employment, against which Mexico has not been able to create effective buffers, can inflict large costs on individuals and companies.

Lastly, compared to other OECD countries, Mexico's tax and transfer systems have a very limited impact in reducing income inequality, which remains very high (Figure 3.3). While education and labour market reforms to ensure better opportunities for all play a major role in tackling these inequalities, the tax and transfer systems could contribute to that goal to a much greater extent.

Addressing these challenges requires fiscal reforms in several directions, to: improve the fiscal framework; improve budgeting and strengthen the efficiency of public administration; improve the efficiency and targeting of public expenditure; broaden the tax base; and strengthen fiscal federalism.

Improving the fiscal framework

To offer a fiscal buffer against volatile oil prices and output, the Mexican government could adopt a structural fiscal rule that takes account of the cyclical nature of tax and oil revenues, such as Chile's. Such a rule would be more effective if government accounts were presented according to international standards for national accounts. It is currently difficult to identify strictly transitory income (such as oil price hedging) since some financing operations are reported as income. The revenue surpluses accruing during economic upswings or periods of high oil prices should be accumulated in a stabilisation fund. Simple and transparent rules on savings and withdrawals would in turn enhance the transparency of oil revenue management. A system of revenue stabilisation funds already exists in Mexico, but the rules on savings and withdrawals are complex and the ceilings imposed on these funds are moderate. That has resulted in the accumulation of reserves worth less than 2% of GDP, even with periods of high oil prices. In Chile, the structural budget surplus rule of 1% of GDP permitted the accumulation of reserves, between 2001 and 2007, amounting to 20% of GDP. Thus at the start of the crisis in 2008, they could be used to provide a major fiscal stimulus. As a first step towards the establishment of a full-fledged economic stabilisation fund, temporary lifting of the limits on accumulated assets in the oil stabilisation funds (in 2010-11) should be made permanent.

Such improvements to the fiscal framework will nonetheless need to be completed by further reforms in the tax and oil sectors. This would make the budget less dependent on oil revenues, thus strengthening budgetary sustainability.

Improving the efficiency and targeting of public spending

Over the past few years, Mexico has introduced a wide range of reforms aimed at making the public administration more efficient and increasing the impact of spending policies. These reforms have included increased fiscal responsibility and transparency in budgeting; better public procurement mechanisms; improved human resource management; and measures to avoid corruption. Although many of these reforms are in place, strong and consistent political support is needed for the new legislation to gain traction and generate real savings and productivity gains (see Chapter 4 on strengthening governance at all levels of government).

Further improving budget processes

Further progress is needed to better link budgeting decisions to performance. This could be achieved by moving towards a more interactive budget process informed by performance evaluations and related tools such as efficiency or strategic spending reviews. These tools can be mainstreamed into the regular budget process as a mechanism to generate fiscal space. While the initiative should come from the executive branch, Congress – and more particularly, the Budget and Public Accounts Committee – should be encouraged to make more use of evaluations during the budget approval stage and oversight of budget implementation. Indeed, Congress provided the initial push for performance evaluations when it wrote a requirement that social spending be evaluated annually into the 1998 social development law; however, these evaluations were not widely used. Subsequently, the 2006 Budget and Fiscal Responsibility Law (BFRL) and the 2007 Integral Fiscal Reform (IFR) elaborated a framework for evaluations and enlarged the volume of performance information that the executive must present to Congress – for example, through its quarterly reports.

Congress has access to robust analytical capacity through both the Centre for Public Finance Studies (*Centro de Estudios de las Finanzas Públicas*, CEFP) and the Supreme Audit Department of the Federation (*Auditoría Superior de la Federación*, ASF). The former, created by Congress in 1988 ahead of many OECD countries that have since followed suit, is mandated to provide objective, non-partisan and timely analysis of public finances. More specifically, CEFP is charged with analysing i) the executive's quarterly reports; ii) the annual report on implementation of the National Development Plan; and iii) the fiscal implications of new legislation. Its analysis is facilitate by its formal agreement to exchange information and methodologies with the National Council for the Evaluation of Social Policy (CONEVAL). The ASF has been empowered since 2008 to carry out performance audits and include them in its report on the final accounts, which is presented to Congress (and also available for public scrutiny on the Internet).

Another useful measure would be to limit or discontinue congressionally earmarked spending (especially earmarks directed at a particular organisation or project in individual constituencies), focusing the attention of legislators on ensuring the key objectives of sustainability, fairness and efficiency.

In addition, Mexico needs to develop a longer-term, multi-year budget approach that aligns spending and funding with the government's plans and goals for different sectors, and prepares better for eventual challenges such as declining oil revenues and changing demographics.

Improving the efficiency of public expenditure

Mexico's total public spending is only about half of the OECD area average. There is room to improve the quality and targeting of spending in many areas, including social policies and education (see Chapters 2, 6 and 7). Important efficiency gains could notably come from improvement in public procurement, which forms a key part of public spending (see Chapter 4).

Improving the efficiency of social services would free up financing for higher spending, but could also contribute to reducing informality (see Chapter 5). A better quality of social security services and their value for workers could indeed create more incentives to join the formal sector. In particular, efforts to further restructure the social security package and integrate key benefits with other schemes would increase the incentives of low-income and rural workers to move to the formal sector.

Addressing the challenges posed by population ageing will require in-depth reforms of the pension and health care system, such as converting the remaining defined benefit pension systems to defined contribution systems; adopting a stronger focus on prevention in health care; and taking measures to make the social security agencies more efficient.

Removing energy subsidies

Mexico spends significant sums on subsidies for electricity, gasoline, diesel and liquefied petroleum gas, which together on average accounted for more than 1.5% of GDP each year over 2005-09. While intended to help the poor, energy subsidies are inefficient as a poverty alleviation tool: much of their value is captured by higher-income groups, to the extent that they do not reduce inequality (see Chapter 11 on green growth). Moreover, energy subsidies create incentives to consume more energy and invest less in energy efficiency, thereby reducing energy security and raising greenhouse gas emissions. This is inconsistent with Mexico's ambitious target to cut national greenhouse gas emissions by 50% by 2050, compared to 2000 (see chapter on green growth). Since these subsidies cost more than twice what is spent on anti-poverty programmes, they should be replaced by direct social spending with a much greater benefit targeted more directly to the poor, through either an expansion of *Oportunidades* or introduction of an income-based social assistance benefit. This would also help further improve the progressivity of the Mexican tax-and-transfer system. While a reduction of such subsidies for the wealthy is envisioned in the Pact (commitment 73), it would be far preferable to withdraw all distortive subsidies and make unconditional cash transfers for the poor.

An administrative price-smoothing mechanism for gasoline and diesel can yield additional revenues in times of declining oil prices, but result in large implicit subsidies in times of rising oil prices. Since 2005, gasoline prices in Mexico have been below those observed in major trading partners' countries. Mexico should enable gasoline prices to follow their international reference by abolishing the price-smoothing mechanism, and it should consider levying an excise tax.

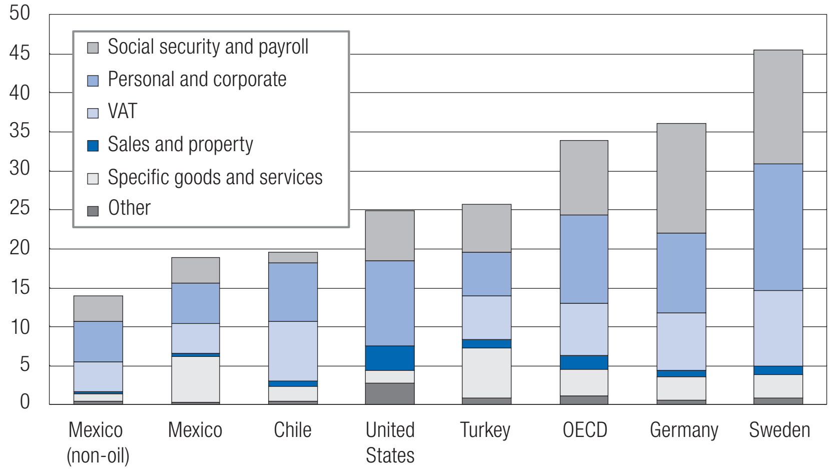
Better targeting of energy subsidies to bring prices more in line with costs is one of Mexico's declared goals in its energy strategy. The government has begun to implement a new cash transfer scheme connected to *Oportunidades* to help poor households cover their energy needs with fewer distortions than under the current system. Mexico has also started an interesting pilot programme to replace electricity subsidies for pumping irrigation water with direct cash transfers in some states, thus removing the price distortion (see chapter on making water reform happen). However, more needs to be done to bring energy prices more in line with costs. Despite welcome efforts to gradually increase gasoline, diesel and LP gas prices, the subsidies remain in place and are likely to increase further when international prices rise. Little has been done to remove electricity subsidies.

Working towards better productive efficiency – and thus lower prices and higher quality – in the electricity sector would attenuate the effect of lower electricity subsidies on consumer (see Chapter 11). The government recently closed *Luz y Fuerza del Centro* (LyFC), a highly inefficient state-owned electricity company; this is a step in the right direction. The right strategy to lower prices for consumers would be to improve the efficiency of the remaining state-run company and allow more competition in the sector in the long run, all the while ensuring high-quality regulation.

Reforming the tax system to make it broader and simpler

While there is potential to improve expenditure efficiency, given current and emerging spending pressure, Mexico should further pursue its significant efforts to increase tax revenues. Mexico's tax revenue is low relative to many other countries (Figure 3.4), even though some of its statutory tax rates are not. The main reason for low revenues is the narrow tax base, which reflects high tax expenditures (accounting for almost 4% of GDP, or around 20% of actual government revenues). Low revenues also result from weaknesses in tax enforcement that must be addressed to increase the fairness and transparency of the tax system. Therefore, a combination of a broader tax base and improved tax administration could help increase revenues and reduce the deadweight burdens of the tax system. Mexico should also take advantage of the move towards a more transparent international tax environment, to launch an effective campaign against tax evasion and erosion.

Figure 3.4. **Mexico's tax revenue is low as a share of GDP, 2010**



Source: OECD *Revenue Statistics* database 2012.

Informality also undermines the tax base but its root causes go beyond taxation, as overall labour taxes in Mexico are moderate. While regressive social charges – reflecting a fixed base contribution to the health care system – make for a high burden on the lowest wages, this effect is partly compensated by the *subsidio para el empleo*. A careful evaluation of this programme is needed, however (see below). The new *Programa de Primer Empleo* will provide cost reductions for firms that hire workers who are registered with the federal social security agencies for the first time. Tackling informality will therefore require major structural reforms, including education and training to help low-productivity workers and enterprises succeed in the formal economy, and to reduce the costs of being in the formal sector. These policies, described in the other chapters of this report, will play a major role not only in boosting productivity and reducing income inequality, but also in broadening the tax base and bringing in higher tax revenues, as the capacity of low-productivity firms and workers to generate income is strengthened.

Reassessing tax expenditures and various special regimes

In addition to revenue losses, tax expenditures complicate the tax system, leaving ample room for aggressive tax planning and evasion, *e.g.* through false declaration of income under categories that receive favourable treatment. Eliminating inefficient tax expenditures would broaden the tax base and make the system simpler to administer and more transparent. In the Pact, the government has in fact committed to broadening the tax base and reducing tax expenditures (commitments 69 and 72).

The costs of tax expenditures in the VAT system are particularly high. There are zero rates for food and medicines; exemptions, such as for education and medical services; and reduced rates at the border. Altogether this lowers tax revenues by around 2% of GDP. The magnitude of tax expenditures is also evidenced by the VAT revenue ratio; this measure indicates actual VAT revenues as a percentage of potential revenues that could be obtained if the standard VAT rate applied to all final consumption. At around 30% this ratio, which is a measure of the combined effects of tax expenditures, weak administration and evasion, is lower in Mexico than in any other OECD country. As in the case of energy subsidies, VAT tax expenditures are inefficient as a poverty alleviation mechanism, because higher-income households capture the largest part of the benefits in absolute terms.

It would be desirable to gradually withdraw zero rates and exemptions within the VAT system and address social concerns with targeted cash transfers, as lower-income households spend a larger proportion of their income on food. This would result in higher net revenues, as the costs of (in effect) subsidising higher-income households would be avoided. However, attempts to broaden the tax base by taxing zero-rated and VAT-exempted goods have proved politically difficult. Past government proposals to tax all consumption goods while at the same time increasing the benefits of *Oportunidades* were rejected by Congress. Nonetheless, given the advantages of such a reform package, further efforts to broaden benefits are warranted. An expanded cash transfer system to compensate lower-income households, through *Oportunidades* or complementary schemes, would be a more efficient poverty alleviation instrument than VAT exemptions or other consumption subsidies, such as for energy.

Mexico should also reassess the costs and benefits of its numerous special business tax regimes. There are regimes for export assembly firms (*Maquiladoras*), transport and agricultural firms, co-operatives, small firms and intermediate firms. These benefit from reduced rates, simplified accounting regimes, tax deferral provisions, accelerated depreciation and other forms of tax relief. In addition to the direct loss in revenue, special regimes complicate the tax code and make it easier for firms to engage in aggressive tax planning or in tax evasion, by underreporting or misreporting their revenues. Special regimes may also distort the allocation of resources away from sectors or areas that do not benefit from them. The costs and benefits of all special business tax regimes should be carefully evaluated, and only regimes of proved efficiency should be retained.

In particular, the *Maquiladoras'* (IMMEX) regime should be ring-fenced and evaluated, as some of the tax concessions may have become overly generous. Besides fixing various loopholes in the regime, one option would be to set a sunset time horizon and reconsider the size of tax concessions. However, this should be done soon so that businesses can have greater certainty about potential taxes due. In addition, enlargement of the regime may have opened up some opportunities for abuse, such as VAT carrousel fraud**;** to fix this, VAT should be levied on all imports and prompt refunds given when re-exported. While there may still be justification for keeping such a regime, the original double-taxation problem that existed in the United States is no longer an issue, and Mexico's international cost-competitiveness position has improved. Moreover, import tariff rates have fallen for all types of enterprises.

There is also reason to reassess and to rethink the design of the special regime for small enterprises, *régimen para pequeños contribuyentes* (REPECO), now administered by states. REPECO would also benefit from a forceful graduation mechanism, for example requalification after a couple of years or a sunset clause. While tax relief within REPECO is very generous, firms evade 86% of their tax liability according to a 2010 study by ITESM), indicating that the states need to step up their enforcement efforts. States' incentives to draw on local sources of revenues also need to be strengthened more broadly, an issue discussed below.

The in-work tax credit (*subsidio para el empleo*) was instituted, as in other OECD countries, to help low-wage workers while avoiding major work disincentives. It subsidises around 60% of the formal wage distribution with a tax credit that declines with individual labour income. The government has recently frozen the *subsidio para el empleo* in nominal terms. Although the benefit is progressive relative to formal labour income, the share of the benefit that goes to the poor is relatively small. This is because the in-work tax credit is not targeted to the poorest workers, but subsidises a relatively wide range of formal labour income. By design, the tax credit is not available to informal workers whose income is concentrated at the very lowest wages. Moreover, the tax credit is based on individual income, but some workers with relatively low wages may live in high-income households. A careful evaluation of the tax credit warranted to assess whether it has a positive impact on formal employment and how far it helps increase low-income workers' take-home pay. Such an evaluation could be the basis for reforms. For example, Mexico could consider targeting it more closely to the lowest-income workers who are most likely to move frequently into and out of the formal sector. That might help to promote formal employment.

Many wage elements and fringe benefits are fully or partially tax-exempt for workers, and at the same time can be deducted from companies' tax base. Examples are wages for supplementary hours and bonuses. These elements can in total reach up to 30% of an average worker's wage. This creates incentives for tax planning. At the same time, it contributes to horizontal and vertical inequities: smaller companies are often not able to offer sophisticated salary packages with a substantial contribution of tax-exempt fringe benefits, and higher-income individuals benefit more from tax relief than poorer ones. Mexico should therefore move towards taxing all wage elements at the same rate.

In cases where subsidies are deemed to be warranted, perhaps for childcare facilities, the government could consider direct subsidies instead, as this would be more transparent.

To some extent the issue of tax exemptions and fringe benefits is addressed through the alternative minimum tax on business income (*Impuesto Empresarial a Tasa Unica*, IETU). This flat 17.5% tax on cash flow was introduced in 2008 to limit revenue losses resulting from tax planning within the business tax system. It has to be paid if it is larger than the tax liability of the regular business income tax scheme. IETU has helped limit revenue losses from tax loopholes, and serves as an important backstop to the standard corporate tax. In the long run, it would be ideal to have a uniform and effective business tax system. Therefore, the base of the regular business tax system should be broadened (including through reducing accelerated depreciation provisions which tend to favour established firms compared with new entrants), and enforcement strengthened. Until such reforms are put in practice, however, the IETU should remain in place. Retaining only the IETU is another option Mexico could consider, though this would involve a very different corporate tax system compared to most OECD countries. The advantage is that the tax is broad-based, neutral and relatively easily enforced.

Some of the weaknesses in the corporate income tax system involve complex tax planning issues; certain rule changes may help prevent abuse. One example of such a change – and indeed a reform envisioned in the Pact for Mexico – concerns limitations on consolidation of losses of corporations that are newly purchased; these can be used to offset taxation of profits within company groups. Another example is the deductibility of interest, which could be made dependent on EBITDA (gross earnings before interest, taxes, depreciation and amortization). Deductibility could be limited to debts between affiliated companies when the loan is used by one company to finance an acquisition of shares from another intra-group company. One particularly abusive practice that has become commonplace in Mexico is for large businesses to set up affiliated private airline companies, which only charge business class fares for private jet flights, and run up heavy losses that can then be deducted by the consolidated company.

Improving tax enforcement

Mexico has made important progress in combating tax evasion by enhancing the capacity of the federal tax administration. According to studies commissioned by that body, VAT evasion declined from 23% of potential revenues to 18% between 2000 and 2008. Registration campaigns, the use of risk models to identify taxpayers with a high probability of evasion, and efforts to reduce compliance costs and combat corruption within the administration have contributed to this success. Mexico should refine and extend the use of risk models, step up training of tax administration staff, in particular regarding auditing techniques, and continue to develop attractive pay and career paths. There is also scope to improve the efficiency of the tax collection process – an intention that has been repeated in the commitments of the Pact (commitment 69) and to build on examples of successful efforts to reduce the size of the underground economy. States where progress in enhancing the capacity of tax administrations is very uneven will have to engage in similar efforts.

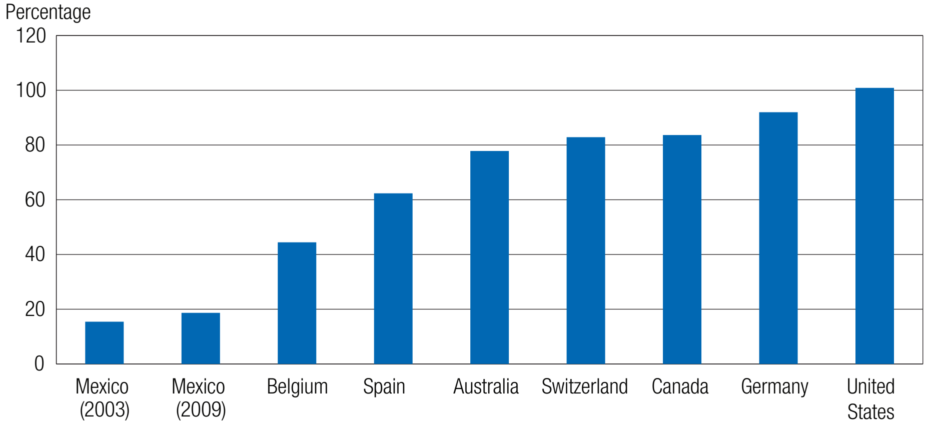
Some reforms would give the federal tax administration greater capacity to address issues that arise with larger taxpayers. Rules that require corporate tax strategies to be disclosed transparently would help the administration to keep up with these complex strategies. Additional reporting obligations would also be warranted, for instance with respect to the intention to claim deductions for certain interest expenses owed to related and non-related foreign parties. Moreover, greater scope should be given to the tax administration to settle with taxpayers in the context of audits. Presently, the Administration is prevented from settling with taxpayers, which encourages litigation. Mechanisms would have to be put in place to prevent tax administrators and taxpayers from colluding. While estimates of evasion of corporate taxes suggest that only about 13% of potential revenue is lost, it is difficult to estimate the full ramifications of many tax planning strategies, especially when there is a lack of transparency.

Mexico is close to many tax havens that offer opportunities for Mexican taxpayers to evade taxes. The recent OECD and G20 initiatives offer the government an opportunity to counter such offshore non-compliance. Mexico has already started to exploit these opportunities by negotiating Tax Information Exchange Agreements (TIEAs) and tax treaties. The country has also signed the Multilateral Convention on Mutual Administrative Assistance in Tax Matters, which provides for full exchange of information. The next steps should be to launch an offshore compliance initiative along the lines of those established by the UK, US and other OECD countries; increase the resources of the competent authorities in the SAT (the national tax authority); develop programmes to train auditors on how to take advantage of this more co-operative environment; and explore the possibility of establishing automatic exchange of information with other countries.

Strengthening fiscal federalism

Fiscal federalism reforms could provide better incentives for states and municipalities, and also enhance policy co-ordination across levels of government. Two decades ago, Mexico began to decentralise core expenditure responsibilities to local governments, and this decentralisation process is half completed. States have formal responsibilities over major categories of spending, including such key areas as health and education, and account for almost half

Figure 3.5. **Sub-national revenue as a percentage of spending, 2010**



Source: OECD Fiscal Decentralisation database 2012.

of all public expenditure. However, the devolution of spending responsibilities has not been mirrored on the revenue side: states and municipalities are highly dependent on federal transfers (Figure 3.5). This reduces incentives for efficient spending and prudent fiscal management at the sub-national level. Spending assignments across levels of government are poorly defined and often overlap, reducing the efficiency of public spending. Information on the use of sub-national governments' financial resources is scant and there is no homogeneous and standard reporting of sub-national budgets, despite the law mandating that all levels of government adopt a results-based budgeting framework. This reduces transparency and hampers the evaluation of fiscal performance, which is critical for enhancing local government accountability (see Chapter 4).

On the revenue side, sub-national governments' own revenue shares are extremely low by international standards. Payroll taxes account for the largest part of states' own revenues. Although easy to collect, they have the disadvantage of increasing the cost of formal labour. For municipalities, the most important potential source of revenue is property taxes – a comparatively efficient form of taxation – which are underused. This is due to outdated land registers, which lead to undervaluation of property as well as weak incentives to collect higher property taxes. Mayors can only run for a single three-year term, which is insufficient to provide the positive incentives that would permit taking the unpopular step of raising property taxes so as to provide better-quality public goods. The federal government should launch a programme to help municipalities update land registries, as some states already do. because municipalities would then find it easier to attract and train more qualified personnel and establish the required infrastructure, and this could help diffuse the political liability of facilitating such taxes.

The central government has made efforts to increase states' and municipalities' incentives and capacity to collect their own taxes. Incentives were improved by tightening sub-national borrowing rules, discontinuing extraordinary transfers to states, and providing information on federal investment projects. The formulas for various non-earmarked federal transfers now include both the level and increase in sub-national government tax collection to reward states' efforts to collect taxes, though these formulas are not yet fully deployed. States were also offered a chance to levy a sales tax or a surcharge on income taxes, but these new tax powers were not used. This is likely due to incentives remaining weak despite past efforts, as it is easier for states to lobby for higher federal transfers than to step up their tax-raising efforts. Further increases in federal transfers should be limited so that states have more incentives to raise more of their own revenue. Conferring taxing powers for broader tax bases to the states, such as surcharges on personal income taxes, would then meet with more success. This should be combined with a well-functioning and transparent fiscal equalisation mechanism, to ensure that poor states have the necessary resources to strengthen their growth potential and catch-up. The Pact for Mexico already envisions substantial reforms giving stronger taxing powers to the states, supporting the collection of property taxes, and revising the Fiscal Coordination Law to re-equilibrate the relationship between the federal government and the states (commitments 68 and 70). If these reforms are carried out, substantial improvements will have been made to Mexico's system of fiscal federalism.

OECD Key Recommendations

Fiscal framework

- Address revenue volatility by further improving the fiscal policy framework through accumulating fiscal buffers; this could be accomplished using a structural balance rule.
- Improve the governance and operating efficiency of PEMEX, by lifting investment constraints and strengthening accountability.
- Government accounts should be reported using official national accounts standards, to enhance comparability and improve transparency.

Spending

- Design a multi-year budgeting process, with a focus on expenditure performance and effectiveness, and on outcomes in the public sector.

- Increase cash transfers to the poor, for example through *Oportunidades* or by introducing a social assistance scheme.
- Improve government efficiency by professionalising the civil service, taking steps to enhance expenditure quality, and expanding transparency and open government initiatives (see Chapter 4 on strengthening governance).
- Gradually withdraw energy subsidies, and consider an excise tax on oil.

Tax policy

- Increase tax revenues by concentrating on broadening the VAT, personal income and corporate income tax bases. Remove tax expenditures and further strengthen the tax administration. Enhance tax enforcement through extended use of risk models, training, and attractive pay and career paths.
- Move toward greater reliance on the new alternative minimum business flat tax (IETU), possibly with a higher rate, and toward closing gaps in the corporate income tax that allow for aggressive tax planning. Strengthen international tax co-operation and fight the use of tax havens by Mexican taxpayers.
- Review and ring-fence the special tax regimes for *Maquiladoras* and small business, and consider phasing them out.
- Evaluate the in-work tax credit to assess its impact on formal employment, and consider targeting it more at the lowest-income workers.
- Increase fiscal responsibilities of states by limiting federal government transfers and allowing higher marginal revenue retention. Greater use of property taxes should be encouraged with federal support.

Further reading

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