Business Climate Legal & Institutional Reform

Best Practices for the Business Environment

June 2006

Issue 8

Reforming Taxes in a Multi-Party Democracy
Lessons from Mexico

This Best Practice was adapted from "*Doing Business 2007*: How to Reform Case Study: Tax Reform in Mexico," prepared by Booz Allen Hamilton in cooperation with USAID for the World Bank Group's 2007 Doing Business Reformers Club Conference.

Executive Summary:

Until 2000, Mexico had largely been a single-party political system for over 70 years. In such an environment, the requirements of cooperation and consensus building in policy reform are limited. However, with the rise of Vicente Fox and the ***Partido Acción Nacional*** *(PAN), a multi-party Mexico forced the reform minded government to learn the tools of legislating in a multi-party democracy. Several of these lessons were the need to incorporate broad, internationally focused, "neutral" policy levers; remain flexible in the face of opposition; and realize that political parties are often driven purely by short-term political objectives. Keeping these and other lessons in mind, Mexico was able to drive tax reform.*

Introduction

This report is the story of a developed country confronting a looming fiscal crisis while at the same time emerging from over a half century of one-party rule. Faced with mounting public obligations and meager tax revenues, Mexico, at the opening of the current millennium, needed a solution. Complicating matters was the simultaneous rise of a newly unleashed and vibrant multiparty democracy that in the beginning struggled to find its legs. The challenges faced and successes won by Mexico in reforming its failing tax regime provide instructive insight into how similar goals elsewhere and under similar conditions might be achieved.

Context

Mexico has historically suffered from low tax revenue, a situation that has left its government less able to cushion economic shock, promote systemic change, and care for the country's most needy. As of June 2006 Mexico had the lowest fiscal-efficiency level, defined as total tax revenue vis-a-vis GDP, among Organization for Economic Co-operation and Development (OECD) members. Its tax revenues were only 11.8 percent of its GDP—low compared with other countries in Latin America such as Argentina (13.9 percent) and Chile (15.2 percent). Low tax revenue had been a problem in Mexico for some years and such was the situation at the beginning of the millennium.

The *Partido Revolucionario Institucional* (PRI) fell from power with the victory of Vicente Fox of the PAN in the 2000 presidential election. For the first time in 71 years, the Mexican political system began to move from what was essentially a single-party state to a more democratic multiparty regime.

Mexico's tax universe had been historically volatile. It was not unusual in Mexico for the government to change several tax structures, procedures, systems, and approaches on a yearly basis—largely because it could. The PRI had held the presidency and dominated the national legislature, and as a result, broad substantive change could be rapidly enacted without the hindrance of debate, political opposition, and compromise.

Since the political sea change of 2000, the means of passing legislation at the nation-

USAID FROM THE AMERICAN PEOPLE

al level has become vastly more complex and somewhat more transparent. The administration must now present its tax-related legislative initiatives to Congress for consideration before the Lower House, and then the administration, the myriad political parties, and constituencies must negotiate and compromise to reach consensus.

Approach

President Fox presented his first wide-ranging tax reform proposal in 2001. His two goals were to extend the value-added tax (VAT) to food and medication and to reduce income tax rates. Facing opposition for the first time, the PRI, joined by the left-wing-populist PRD, worked tirelessly to defeat the initiative. The administration's inexperience, coupled with intense lobbying never before experienced in Mexico, doomed the reform.

By 2003, the Mexican government had regrouped and put forth a broad tax reform package designed to achieve the following objectives:

- Broaden the tax base by bringing informal businesses into the formal sector;
- Simplify tax collection mechanisms (in particular for common consumption taxes since such taxes are hard to avoid even with a large informal economy); and
- Establish international (OECD) tax standards in order to encourage foreign investment.

Unlike the prior efforts, this second tax reform plan was developed through a joint effort led by the Fox administration and supported by the state governors and key members of the political parties. Despite these multiparty origins, however, the plan, as packaged, was defeated by a Mexican Congress that feared that passage would give too much political momentum to President Fox and PAN leading up to the 2006 presidential election.

In an effort to save some aspects of the tax reform plan, the Fox administration changed its strategy and refocused the discussion on how such reforms would improve Mexico's competitiveness in the global economy. While income tax and VAT reform remained key objectives, the overall plan was tailored to better achieve international standards. The opposition quickly found its voice and rose up against proposed administration programs that would require additional tax revenues to implement. Without the creation of such programs, they argued, there would be less need for government funding and requisite tax revenue. Support, then, for sweeping tax reform was largely decried by the opposition as being unnecessary.

Results

Despite the public battle, the Fox government could nonetheless claim partial and significant victory on the tax reform front by the beginning of 2006. This section describes what Mexico accomplished during those years and discusses the impacts on business, the forces behind the reforms, and the negotiations that led to these amendments.

Income Tax

From 2000 to 2006, the income tax rate was lowered from 32 percent to 28 percent. The administration pushed this reform ostensibly to comply with Mexico's commitments to the OECD to reach internationally competitive tax rates, but also in an effort to shrink the informal sector and thus raise total social security tax contributions. The rate reduction was supported by all of the private sector, primarily through the Consejo Coordinador de Empresarial (CCE), an umbrella organization for all private sector organizations in the country.

The government further hoped that the income tax rate reduction could then be coupled with a law to allow broader taxation of social welfare benefits (many employer-provided social welfare benefits such as food and housing allowances were not be included as part of taxable income). When the Fox administration proposed this change, however, both employees and their employers opposed it. Employees feared that higher taxes on their wages would not be covered by an accordant wage increase. On the back of strong opposition from worker's unions and from the private sector, especially the *maquiladora* industry lobby, Congress did not approve this part of the reform.

Tax Deduction for Employee Profit Sharing

Until 2004, Mexico's well-known mandatory profit sharing for employees—10 percent of taxable corporate profits—had always been an item that was not tax-deductible for corporations. In effect, the profit sharing was an additional tax on businesses that already had to pay a 28 percent corporate income tax. The Fox administration proposed an amendment to the income tax law that would make employee profit sharing deductible for businesses and achieve a total "tax" burden rate reduction from 43 percent to 35 percent.

Private sector organizations, such as chambers of industry and commerce, strongly supported and lobbied for the proposal during congressional hearings and testimony throughout Mexico. The amendment passed without opposition.

Amendments to Tax Deduction System

To soften the impact of seasonal fluctuations of business income tax collections and conform to OECD standards, the administration returned to the cost-of-sales tax deduction system, replacing the cost-of-acquisition system that had been established to protect against high inflation.

Foreign investors lobbied for the change, as they desired that Mexico meet OECD standards, making it better for investment. However, the cost-of-sales system was very heavily criticized by domestic private sector organizations, especially construction companies (represented by *Cámara Nacional de Desarrollo de Vivienda* (CANADEVI)), breweries (represented by *Cámara Nacional de la Industria de Cerveza y Malta* (CNICM)), and supermarket chains (represented by *Asociación Nacional de Tiendas de Autoservicio y Departamentales* (ANTAD)) who enjoyed the protection of the previous system. Among the opposing organizations, the breweries and CNICM were the most aggressive, filing an avalanche of constitutional challenges (*amparos*) in the federal courts. They alleged that the reforms would cause inequities in tax collection, thus violating constitutional principles that guarantee equitable taxation. These *amparos* were eventually considered by the Supreme Court and dismissed.

State Income Tax

In the past, the corporate income tax had been under the exclusive power of the federal government and had featured one-sided "tax sharing agreements" with the states. This system worked when the PRI had absolute control over Mexico. However, when the Fox administration took over, state governors realized they could no longer simply depend on federal generosity. A group of state governors formed the *Conferencia Nacional de Gobernadores* (CONAGO), which eventually included all governors, regardless of political party. Since their first meeting in the summer of 2001, the states and CONAGO have fought to obtain a higher percentage of the national tax "pie" and to gain greater tax authority.

Under pressure from various Mexican states, the Congress amended the Federal Law on Fiscal Coordination to grant to the states the right to enact business taxes of up to 3 percent. Many states, however, have not yet imposed higher business income taxes because of the political stress that results from constant federal, state, and municipal elections occurring throughout the country.

Value-added Tax (VAT)

The government initiative focused on broadening the taxpayer base by lowering the general VAT rate to 8 percent, but would have also eliminated many exemptions on essential items, such as food, prescription drugs, and other medicines. PRI and PRD, the two main opposition parties, defeated President Fox's initiative by arguing that the poor could not afford to pay VAT on those essential items. The administration responded to these allegations by offering to create an offset program that would enhance welfare benefits by including a comprehensive medical assistance package with free medical attention and prescription drugs.

The private sector, especially the food and pharmaceutical industries, opposed the reform through significant lobbying efforts—because of the reform itself as well as the offset program. The pharmaceutical industry resisted the proposal because once enacted, it would have been effective immediately, and this industry was counting on—at a minimum—a gradual transition by category of products.

While general reform in this area escaped the government, some changes to the VAT scheme did occur. In each case, the influence of the maquiladora industry was key to bringing about these reforms:

- Zero percent VAT rate on transfers of products or components from maquiladoras to PITEX companies, final automotive assemblers (OEMs), or other similar regimes (manufactures that import raw materials and components for export purposes).
- Technical adjustments to make the tax basis more rational and to make the VAT crediting system easier.
- Granting taxpayers who have favorable VAT balances (VAT credits) the option to use them to offset to other federal taxes.

Automobile Tax

To advance the objective of reducing pollution and demand on the country's energy resources,

"*Historically, Mexico's tax universe had been volatile. It was not unusual in Mexico for the government to change several tax structures, procedures, systems, and approaches on a yearly basis—largely because it could.*"

Congress approved a reduced tax rate for hybrid cars. This reform was brought about as the result of aggressive lobbying by internationally supported, well-organized environmental groups.

From 2004 to 2006, many companies and individuals filed legal challenges contesting this tax, and in the first half of 2004, the federal courts declared it unconstitutional. After the second half of 2004, however, the federal courts changed their criteria and upheld the tax.

Special Tax on Selected Products and Services

The government also imposed a special tax on specific activities and products, pursuant to its desire to encourage or discourage activities with social impacts, such as alcohol and tobacco consumption. These industries have strong lobbying teams that oppose reforms not advantageous to them. These taxes have not changed recently, except that in some cases companies may now pay a fixed amount instead of a percentage of sales price as the tax.

Conclusions

Mexico's tax reform effort mirrors that of many other developed nations. Mexico has ample subject-matter experts to draft and educate about needed changes. It does not require outside expertise in developing its legal structure, including tax reform, and no such assistance was uncovered during the research for this report. There are numerous parties with the needed political will to put together and support reform—and from all sides of the issue. The challenges that Mexico faces, which are the lessons of its tax reform effort, involve primarily the political arena at all levels of government.

Mexico's tax reform efforts from 2000 to 2006 underscore the importance of achieving political consensus on the tax objective. Depending on the reform sought, this consensus must be broadly reached to include, among others, municipal, state, and federal governments; the private sector; trade and professional associations. It is important to remember that political parties often operate under a short-term, political-opportunity-driven outlook, as their focus is often on what is better for the next election and not for the country in the larger context.

To offset these concerns, Mexico enjoyed some success by incorporating broader, internationally focused, and more "neutral" policy levers into its planning. For example, by using international tax standards from the OECD, the Fox administration created a noncontroversial opening to pursue its reform agenda. Similarly, another strategy that helped the government was to remain flexible in the face of opposition. For example, after two failed tax reform efforts, it changed its approach by reshaping the discussion to that of tax reform being necessary for Mexico to compete on a global scale. The government also showed a willingness to negotiate and compromise.

Last, the power of lobbying and lobbyists—a new and relatively large issue in Mexico—cannot be dismissed. It is incumbent on any interested party seeking reform to ensure it has adequate resources—in terms of finances, political capital, and access to key stakeholders—to see its initiative through successfully.

About BizCLIR:

BizCLIR, or the Business Climate Legal & Institutional Reform Project, is a multi-year initiative of the United States Agency for International Development with the goal of improving the efficiency and impact of assistance programs intended to help developing countries improve their business enabling environments. This series, Best Practices for the Business Environment, represents one of many knowledge management components of the BizCLIR project. The goal of the series is to highlight the known best practices, case studies, lessons learned, and in some cases worst practices, so that the lessons can benefit other practitioners in the field. All issues are available at www.bizclir.com.