



# **Reforming Mexico's Fiscal Federalism Framework**

**José Antonio González Anaya**  
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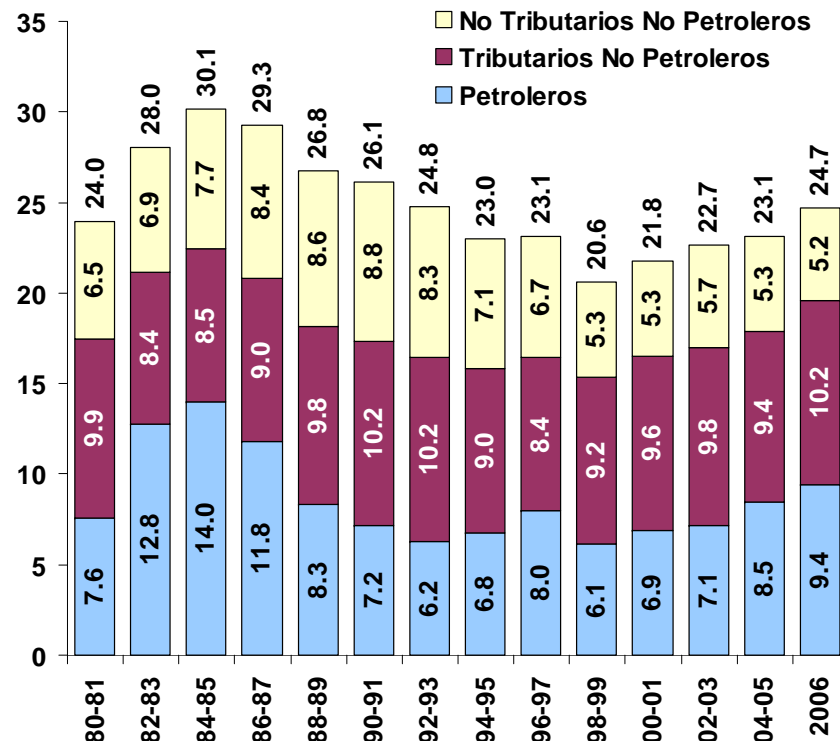
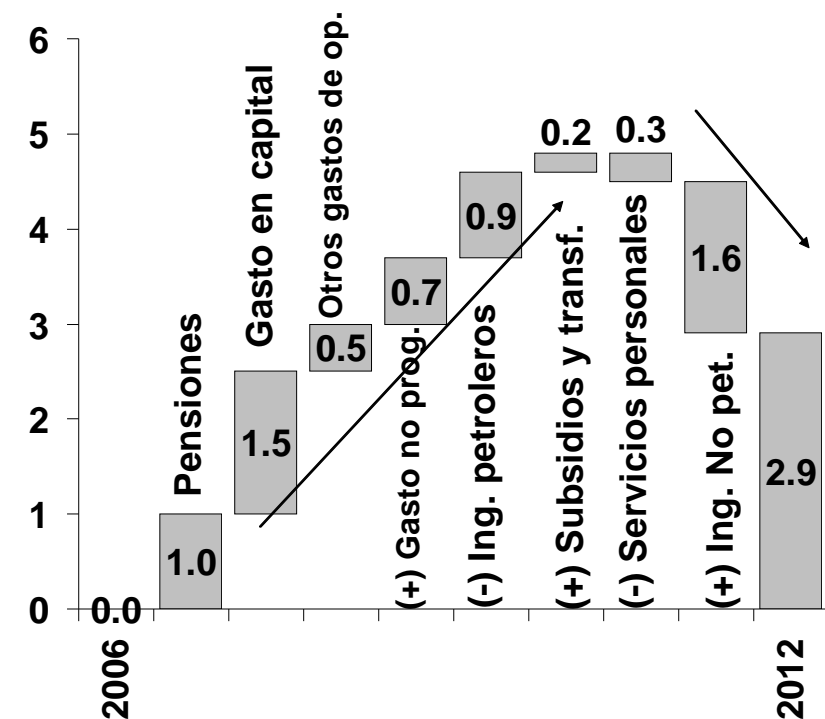
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- The need for a fiscal reform: Mexico's federal public finances.
  - The need to address intergovernmental fiscal relationships: a diagnostic of Mexico's fiscal federalism framework.
  - The Reform: towards a new fiscal pact between the States and the Federation.
  - Conclusions.

# Why did Mexico need a fiscal reform?

- Low levels of expenditure relative to other countries, and especially in light of the needs in infrastructure, social development, and future fiscal pressures.
- In the next few years, federal public finances will face important pressures from pensions as well as from infrastructure and social expenditure needs.

Public Finance Pressures  
(% of GDP)

**Public Sector Revenues in Mexico**  
(% of GDP)



## **Four pillars of Mexico's Public Finance Reform :**

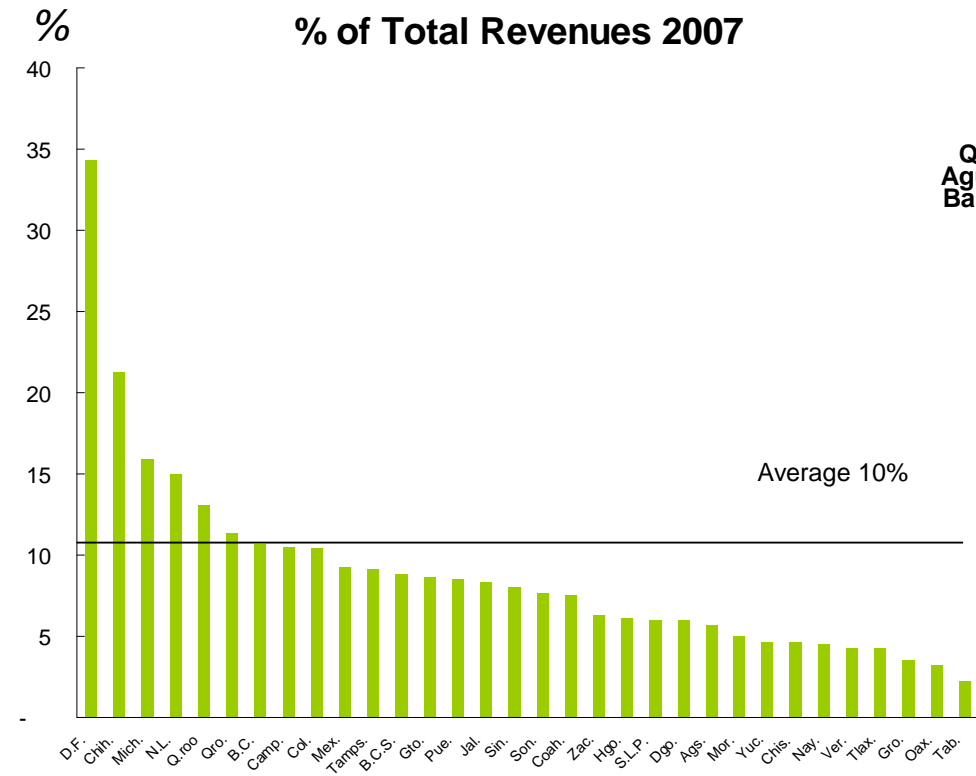
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1. Increase revenues through more flexible and balanced tributary instruments: the New Flat Rate Corporate Tax (IETU).
2. Establish an institutional structure for more efficient and transparent public spending.
3. Improve tax administration.
4. Strengthen Fiscal Federalism.

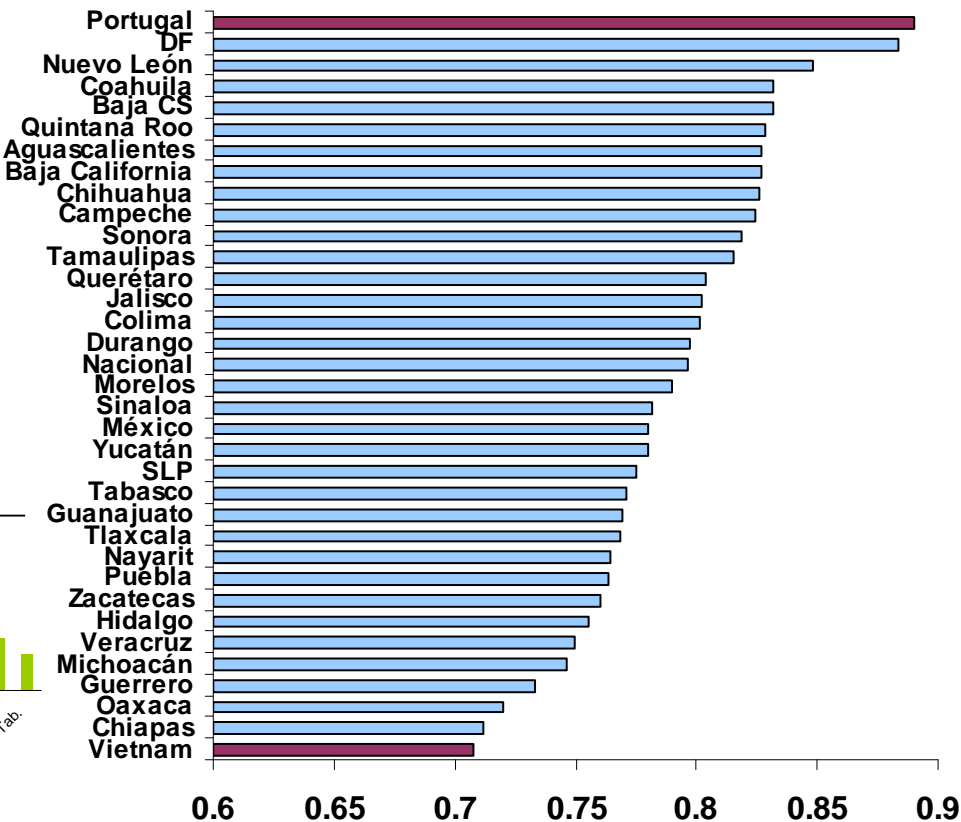
# Low levels of subnational revenue and distorted intergovernmental fiscal relationships.

- Although in recent years poverty levels have come down, there are still wide inequities and 20% of the population living in extreme poverty. These problems require increased expenditures in social development programs.

**Subnational Revenue  
% of Total Revenues 2007**



**Human Development Index  
(2003)**

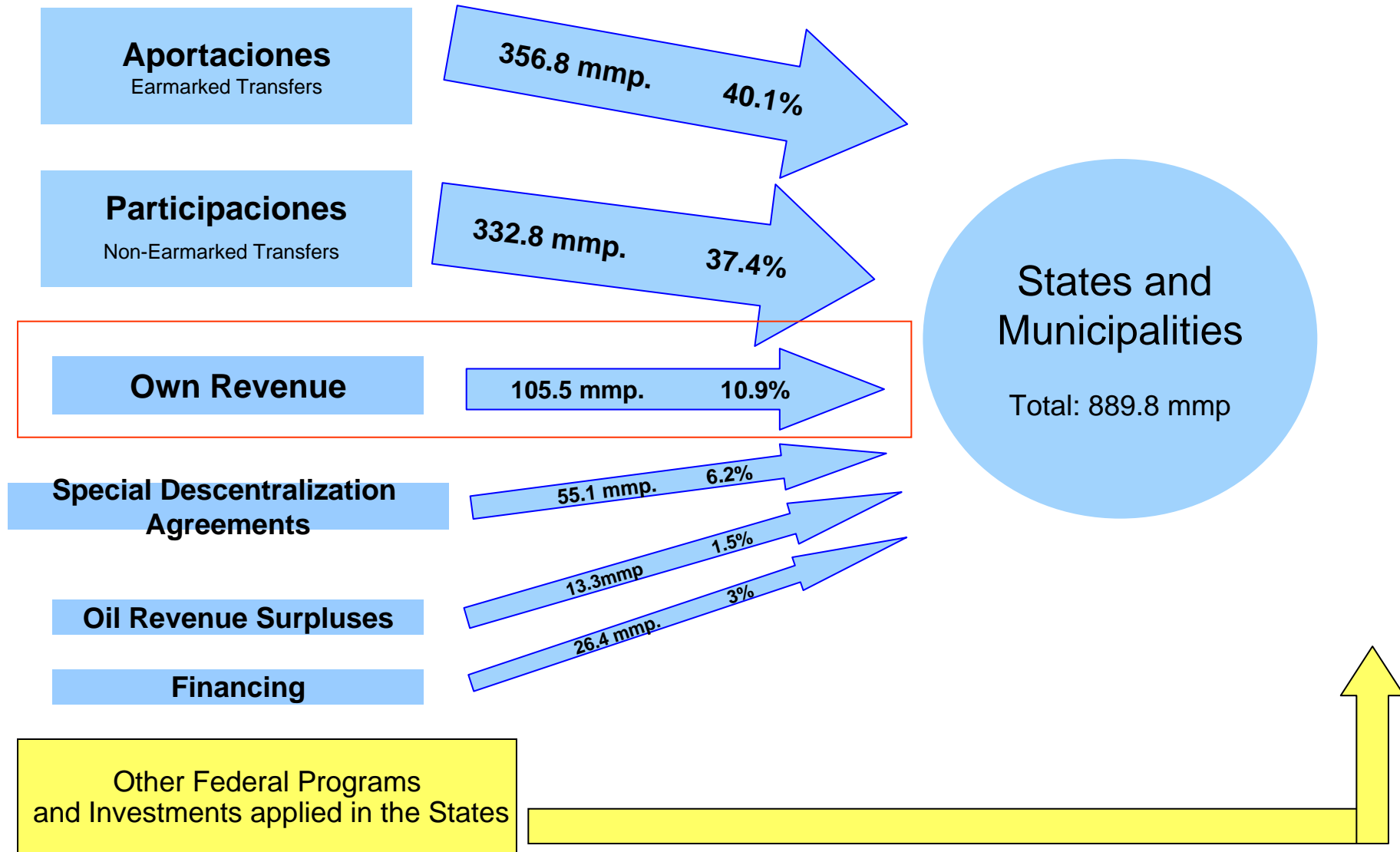


# The fiscal federalism framework in Mexico before the reform

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- The structural elements of the current system were designed under a different political reality.
- As the political realities in Mexico have evolved, the system suffered a series of patches that led to the current complex set of rules.
- The states and municipalities depend heavily on federal transfers.
- Lack of homogenous accounting and reporting standards.
- At the end of the day, the fiscal pact has not helped or contributed to the strengthening of public finances at any level of government.

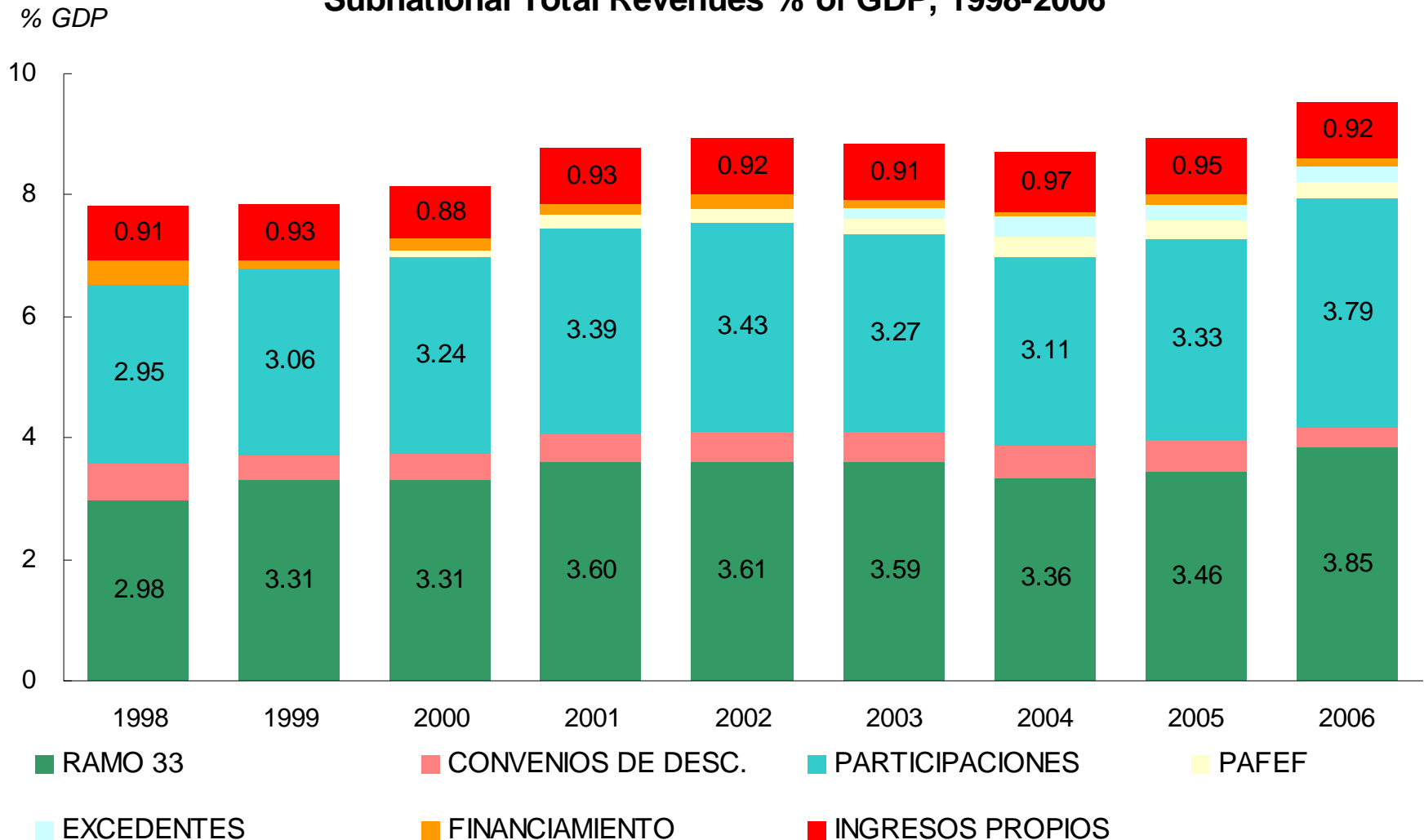
Federal Transfers account for 90% of all resources managed by subnational governments.



Note: data is for 2007.

In the last years, federal transfers as a share of GDP have increased from 6.5% in 1998 to 8% in 2006. In the same period federal non-oil revenue has increased 1% of GDP while subnationals own revenue has remained constant at around 0.9% of GDP.

**Subnational Total Revenues % of GDP, 1998-2006**

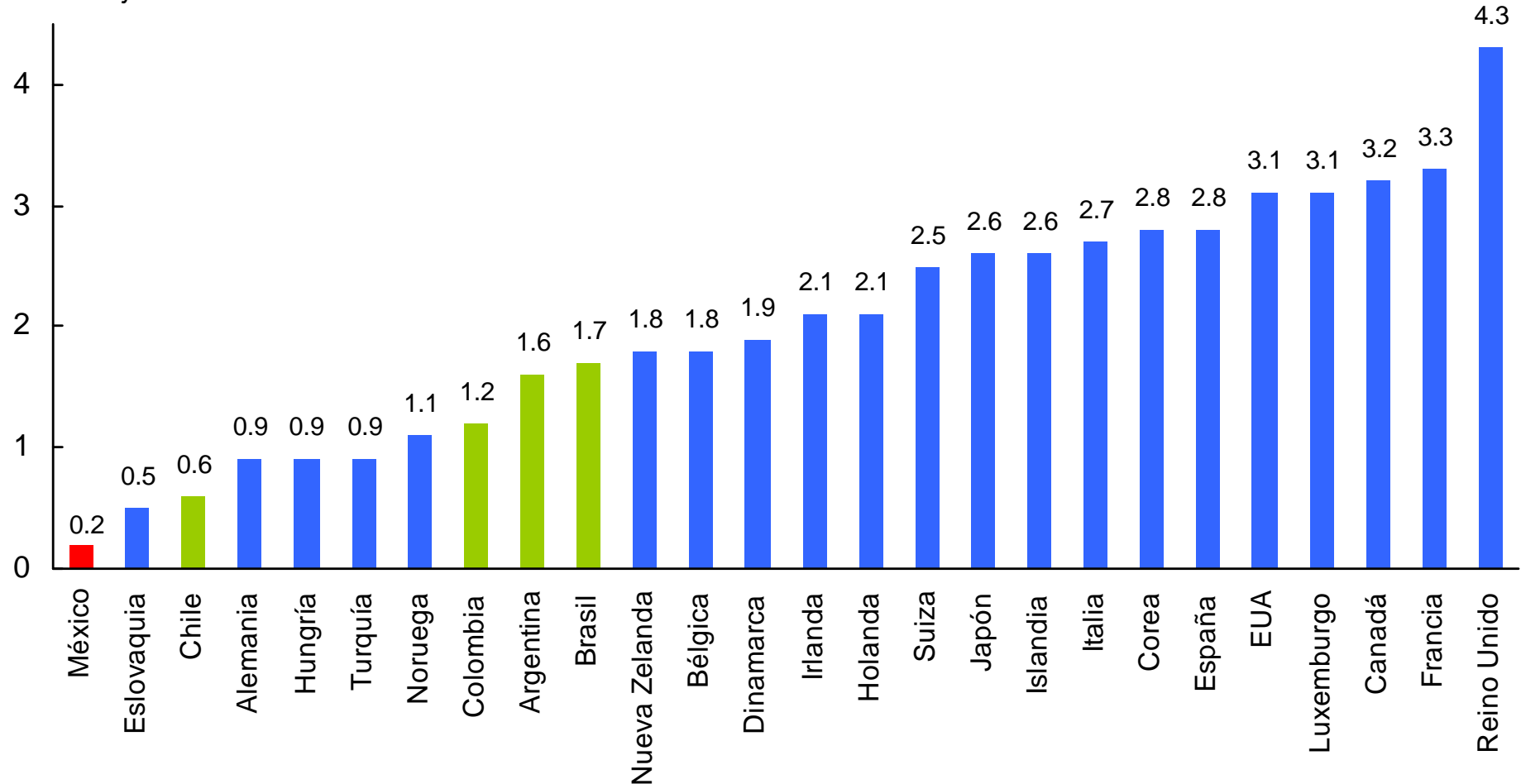




# The property tax in Mexico is well below its potential

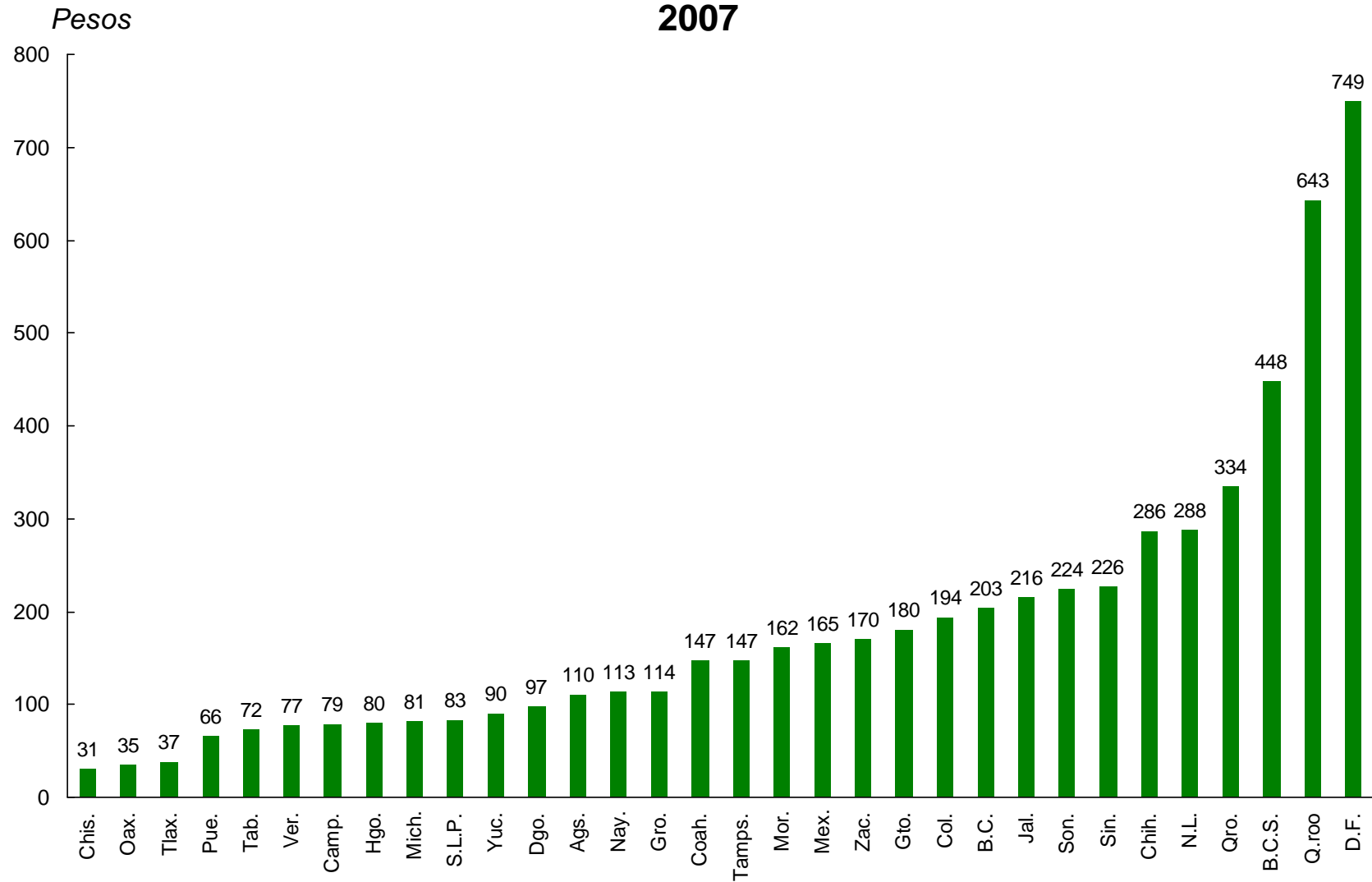
Porcentaje del PIB

## Property Tax Revenue



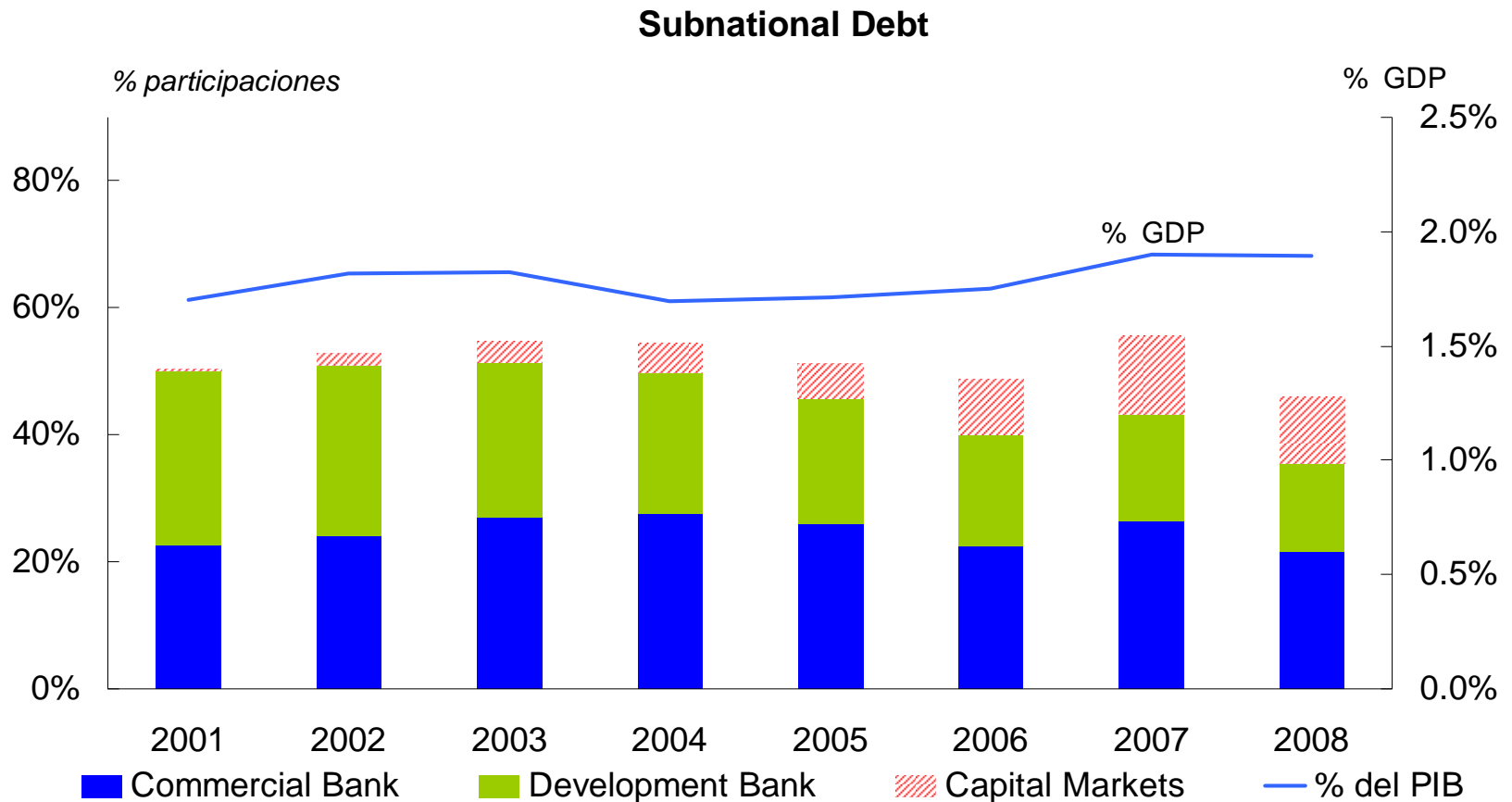
# The amount collected per person in property taxes by municipalities cannot finance even basic services

Revenue tax per head in subnational states in Mexico, 2007



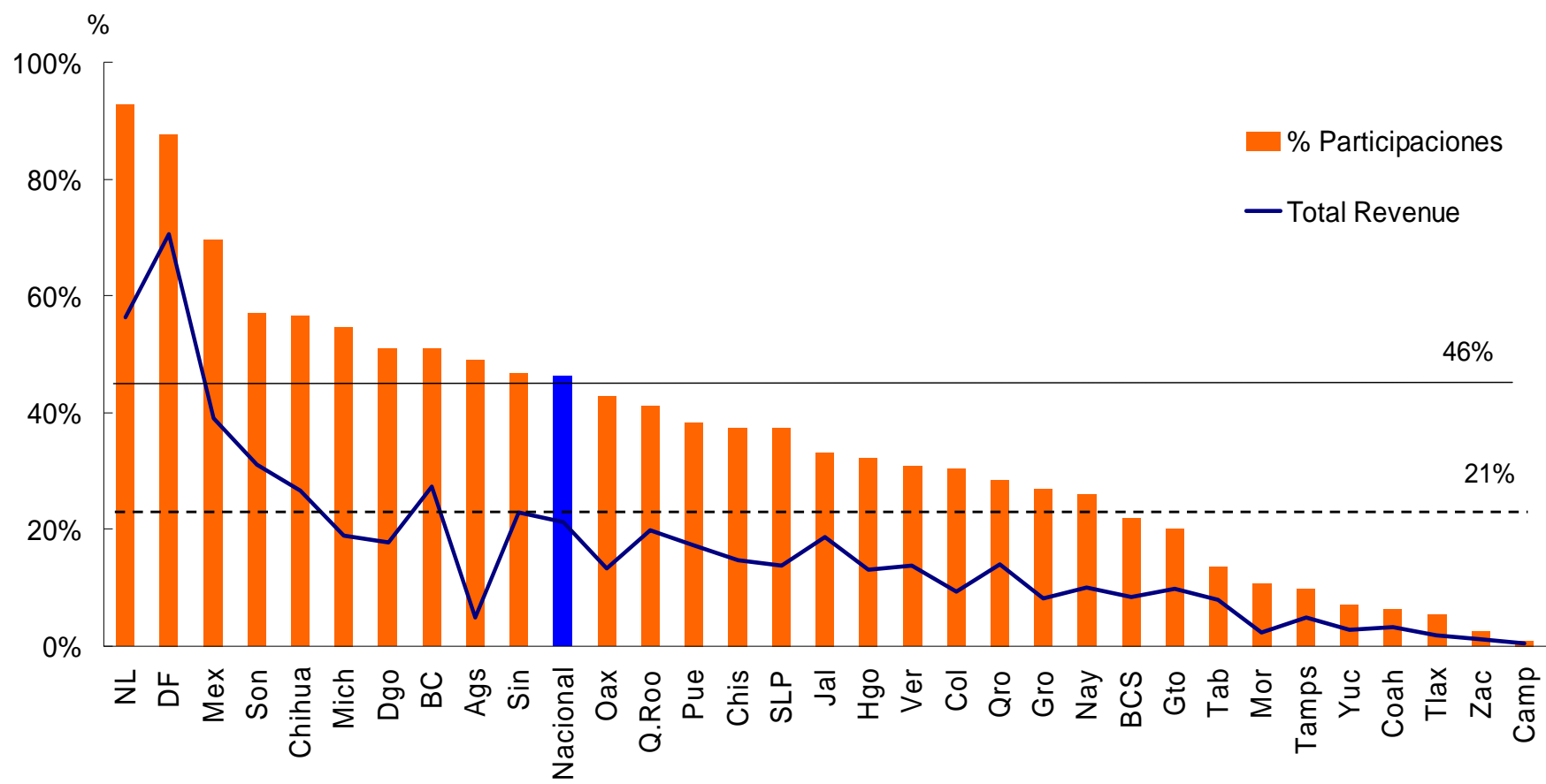
Fuente: SHCP, INEGI.

# Subnational debt has remained stable at around 2 percent of GDP



On average the stock of subnational debt represents 46 percent of yearly non-earmarked transfers and 21 percent of states total revenues (including Federal Transfers)

Debt as share of Total Revenues and Non-Earmarked Transfers



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# Spirit and objectives of the fiscal federalism reforms

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- The objective of the reform was not to reconstruct the fiscal pact, but to focus on the most pressing issues:
  1. To give subnational entities more tax powers and the incentives to use them, without jeopardizing the federal public finances, and avoiding a proliferation of distortive or inefficient local taxes.
  2. A simplification and improvement of the incentives in the formulas of distribution for federal transfers with a hold harmless clause.

# New tax powers

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- As it was mentioned before, state's own revenues are only 10% of their total revenues. With the reform:
  - Subnationals can tax the final sale of a certain subset of goods currently taxed by the federation with an special production tax (IEPS).
  - A new tax on gasoline and diesel. This new tax will represent important fresh resources for the States.
  - The Federation will transfer the power over the vehicle tax to the States.

# Changes in the formulas of federal transfers

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- There are two different types of federal transfers in Mexico:
  - The reform modified the non-earmarked transfers (*Participaciones*) to give more incentives to increase local revenue, and --according to their original motivation-- to be better correlated with economic activity.
  - The reform modified the formulas for some of the earmarked funds (*Aportaciones* education, health, security, social programs, etc.). The objective was to make them more related to needs and more redistributive.
- All the changes in formulas include a “hold-harmless” clause in nominal terms.



# Next steps:

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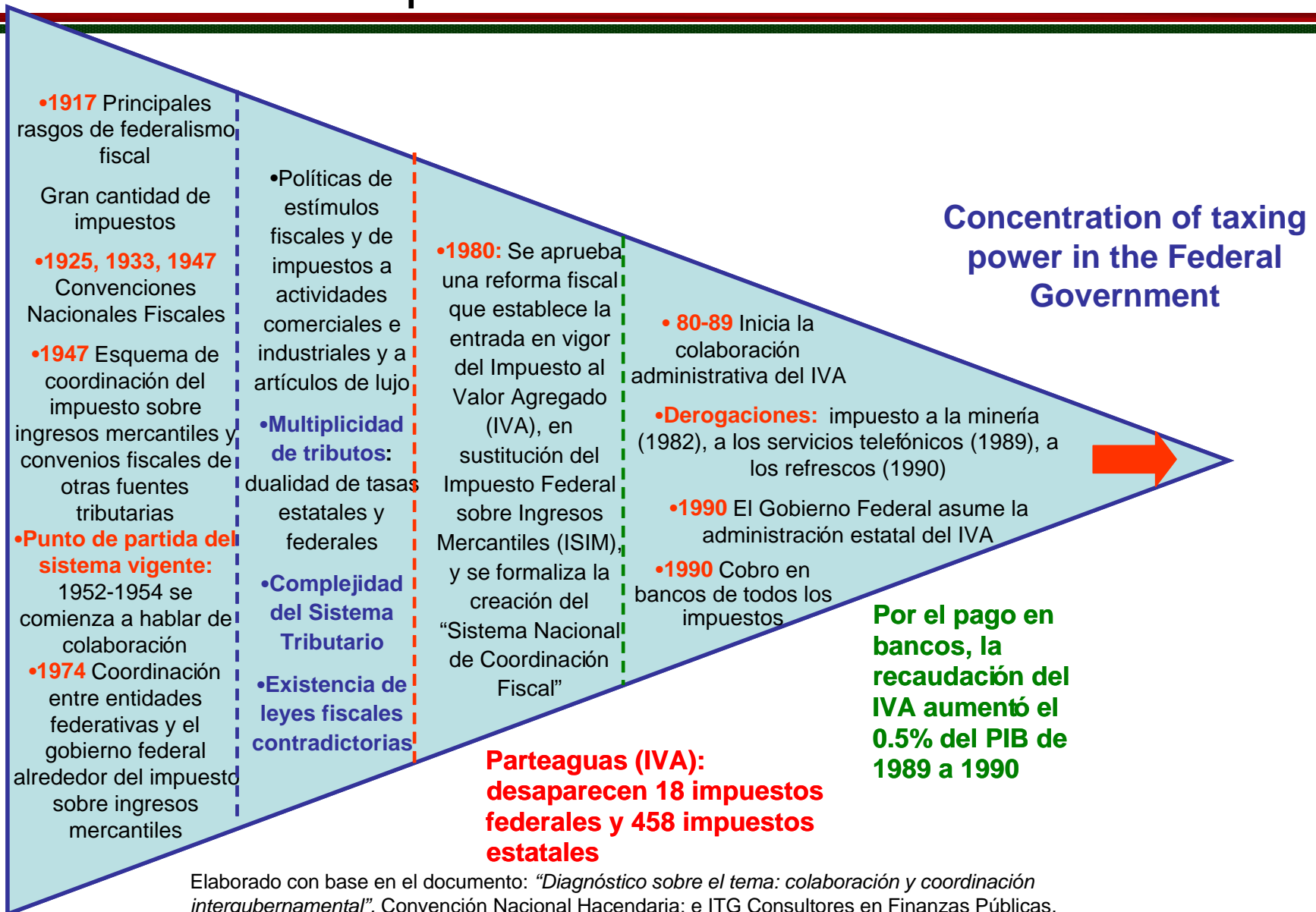
- Harmonization of accounting and budgeting practices and codes at the local level.
- Increased oversight over the use of federal funds at the subnational level.
- Perfecting the subnational debt framework to ensure an orderly market and best practices.



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# There has been an increasing concentration of revenue powers on the federation...



... and at the same time, there has been an increasing decentralization of public expenditure responsibilities

### Transfer of expenditure responsibilities to States

**1947**

Comisiones encargadas de impulsar el desarrollo regional

•**50's** Convenios y acuerdos para impulsar inversiones públicas

•**70's** Recursos para impulsar el campo, la industria y el comercio  
CUC y COPRODES

•**1981**  
COPLADES

•**1983** CUD fortalecer planeación, descentralización y fortalecimiento municipal

•**Finales 80's**  
Programa Nacional de Solidaridad

•**1992** Convenios de Desarrollo Social

Acuerdo Nacional para la Modernización de la Educación Básica

•**1996** Acuerdo Nacional para la Descentralización de los Servicios de Salud

•**1998** Creación de Ramo 33: FAEB, FASSA, FAIS, FORTAMUNDF, FAM

•**1999** Creación del FAETA y FASP

•**2000** Creación del PAFEF y en **2007** conversión a FAFEF