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## Topics Covered

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Border Issues  
Budget  
Business Regulation  
Commerce  
Communication  
Constitution  
Corps and Securities  
Customs  
Economic News  
Education  
Energy  
Environment  
Finance  
Foreign / Diplomatic  
Gov't Contracting  
Institutions  
Health/Human Services  
Industry Regulation  
Intellectual Property,  
Science  
Justice / Law / Crime  
Labor  
Maquiladoras  
National Defense  
Natural Resources  
Politics  
Property  
Tax  
Tourism  
Trade  
Transportation

## Next Week:

- Tax Vote ... When? If?
- Fox in Canada selling Energy Projects
- Reaction to Helms Visit
- ... And More

## **Nueva Hacienda Pública Distributiva** **México President Vicente Fox's Proposed** **Overhaul of the Tax, Budget and Financial Systems** **- Overview and Political Analysis\* -**

Welcome to the first installment of CEGSA's weekly newsletter that keeps you informed about all activity in the Mexican government. We would have liked for the first newsletter to conform to our typical format where our intelligence is organized by subject matter, but some extraordinary things are happening in Mexico at the moment, and it has brought all other activity to a complete stop.

President Vicente Fox has sent to the Congress an initiative called the Nueva Hacienda Pública Distributiva. This initiative seeks to completely reorganize the tax, financial and budgetary mechanisms of the federal government. President Fox is selling this package with the argument that (i) the lower income classes will benefit through lower taxes and (ii) that business will enjoy greater growth and development through homogenized rules.

As you will see by this report, there is a great deal more inside this initiative on which President Fox is risking his popularity and his political capital for the balance of his term. What you will find may have a great impact on your business activities in México.

In CEGSA's opinion, this initiative, if approved in its current form, will fill the coffers of the government treasury with new revenues to pay down foreign debt and to finance some of the President's ambitious projects. However, it also will have a negative effect on the economy and on the cost of doing business in Mexico for many companies.

As always, we look forward to your comments and your questions.

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**\* In a detailed Special Report to follow, CEGSA will highlight the many conflicts and inconsistencies the Fiscal Reform package has with existing law, GAAP accounting rules, and well-established business practices in Mexico and abroad. This Reporter gives a thorough overview of the initiative and discusses the political aspects surrounding it.**

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**Table of Contents**

<b>1. Introduction</b>	3
<b>CEGSA Analysis</b>	
• There is Some Truth in Both Pro and Con Positions	3
• Likelihood of Adoption and Timing	3
• Why the Reforms are Being Done – the Money	4
• The Administration's Strategy in Obtaining Passage	4
• There are some Problems With This Strategy	5
• Congressional Response	6
<b>2. Reforma Fiscal : Elements and General Objectives</b>	7
• Marco Tributario (Tax Framework)	7
• Marco Financiero (Financial Framework)	7
• Marco Presupuestal (Budget Framework)	8
<b>3. Changes Proposed to Tax Laws (Marco Tributario)</b>	8
<b>4. Changes Proposed to Financial Laws (Marco Financiero)</b>	10
<b>5. Changes Proposed to Budget Procedures (Marco Presupuestal)</b>	10
<b>6. Statutes to be Modified by Fiscal Reform</b>	11
<b>7. Bibliography – Mexican Government Documents Available on Request</b>	12

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## 1. Introduction.

President Vicente Fox (PVF) has presented to the Congress almost 1000 pages of legislative initiatives known as the Nueva Hacienda Pública Distributiva, better known as the Reforma Fiscal (Fiscal Reform, or FR). Collectively, it is a restructuring of the Nation's tax, budgetary and financial systems.

PVF states that the FR is the base that will support a dynamic, competitive and stable economy, in the process stimulating innovation, technological change and employment growth.

Others, critical of the Fiscal Reform, claim that the initiative will harm the economy, injure the poor and increase the cost of doing business in Mexico.

### CEGSA Analysis.

a) There is some truth in both pro and con positions.

- Many of the changes are needed to allow Mexico to enjoy dependable tax revenues, with less leakage from poor record keeping and social losses from unregulated activities.
- However, contrary to the promise that he would lower taxes, PVF is actually raising them in net terms, even though his program includes some tax rate reductions. Surprisingly, even PVF's own Secretary of Labor this past Monday (April 16) declared, officially as the Secretary of Labor, that the middle class would pay the cost of the FR and that the tax on the poor would be proportionately higher. In other words, he declared the tax regressive.
- Additionally, it is anticipated that business will suffer, inflation will increase, and there will be a net loss in private savings rates, general economic prosperity and consumer confidence if the FR is adopted as it has been presented.

b) Likelihood of Adoption and Timing.

That it will be adopted without substantial change is unlikely.

- The PRI party paid a deep price politically when it proposed virtually the same tax reforms in 1995, when the PAN vehemently opposed these reforms and made great gains as a result. You can expect the PRI to return the favor this time around.

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- The PRI as well as the other political parties oppose the measures, both as payback and as a way to increase their potential in the 2003 congressional election cycle.
- Even though at least a part of the PRI ultimately will approve some form of the FR, PVF and the PAN will be challenged and will suffer substantial damage to their populist image.
- The Financial Reforms package (Marco Financiero) will pass during the normal session in April 2001.
- The Budget Reforms (Marco Presupuestal) will not be decided for another year because it involves constitutional amendments that must be approved by 2/3 of the states, but its passage is likely.
- Nobody has any idea if and in what form the Tax Reforms package (Marco Financiero) will be approved. Hardly anyone completely understands what it includes yet, and the PRI has stated that it is in no hurry to rush it through.

c) Why the Reforms are Being Done – the Extra Revenue.

- As it now stands, tax increases are necessary if PVF hopes to initiate even a small percentage of the programs he has proposed and promised, both before and since the election. Current revenues are sufficient only to service the national debt and to support the programs that were already in place when PVF assumed power (88% of Mexico's budget is dedicated to debt service and pre-existing entitlements. Foreign debt is more than triple the amount in Mexico's reserves).
- Existing revenues are completely inadequate to finance any new programs in Education, Health Care, Social Security, Infrastructure, Chiapas investment and development of a southeastern Mexico investment zone (Puebla-Panamá Program), all of which are high on PVF's stated list of priorities.
- For PVF and the PAN to accomplish anything, they need the additional tax revenues that this FR will generate. The PRI and the other parties will try to slow them down and to reduce the extra cash they will have to work with in order to reduce the PAN's chances in the 2003 elections.

d) The Administration's Strategy in Obtaining Passage.

- PVF is trying to speed passage and minimize discussion and modification of the Reform Fiscal in a number of ways.
- PVF has split the initiative into a number of packages, distributing them among the Senate (2) and Camara de Diputados (House of Representatives) (18). The consensus is that this was done to ensure that passage of one part of the initiative was not used as a bargaining chip for changes to another.
- Likewise, the initiatives in each of the two legislative bodies have been spread among a number of different Comisiones (committees) in an effort to reduce the likelihood that one group will have the jurisdiction and reach to coordinate changes among the various pieces of legislation. Not only does this strategy protect the integrity of the overall package, but it also makes it difficult for the individual members of Congress to understand and appreciate the total impact of the full package. This keeps the FR a political matter, rather than one of substance.

- The net effect is that the Congress has been inundated with these FR pieces of legislation, and it is unlikely that it will do any substantive work on the many other pieces of legislation that are already in the pipeline, or that are awaiting introduction for consideration, before the end of the session on April 30. One possible exception is an initiative amending the Constitution for indigenous rights. PVF might push this matter as it addresses the Chiapas situation and it might be a way to negotiate a few PRD party votes for FR. (Note: Unlike the US, pending initiative do not die at the end of a session; rather they merely become dormant until the next regular session.)
- Indeed, Congressional leaders have concluded that all of PVF's FR legislation cannot be handled during this ordinary session.
- The Financial Reforms (Marco Financiero) will be passed during regular session in April. However Tax Reforms will not be touched this term. Either they will be handled during a special session sometime between May and August, if the PRI and the PAN can make a deal and agree next week (prior to the end of the session on April 30), or they will have to wait until the next regular session in September.
- At the same time that he is trying to confuse and keep the Congress in disarray, PVF and his Cabinet Ministers have been actively lobbying the public and various interest groups from the same tightly controlled list of talking points. Their goal is to create a grassroots demand for the Fiscal Reform package, thereby pressuring the Congress to go along.

e) There are some problems with this strategy.

- CEGSA has reviewed their talking points and in one case has obtained a copy of a PowerPoint presentation put together by PVF. They are misstating important parts of the legislation they have proposed. This will not stay a secret forever.
- In order to develop grass roots support, they must convince the population that this package has a direct and beneficial effect on them. However, since they are going to use the proceeds for foreign debt reduction and new programs that are very long term in scope, they cannot talk about the revenue and expenditure aspect.
- Consequently, they can only speak in generalities as to how they are reducing taxes and improving housing.
- The unrecognized fact is that reducing income taxes will only benefit those at the top end of the income scale. Everyone else will receive little or no benefit from the reduction whereas their daily necessities will now cost at least 15% more because of the new value added tax (IVA) on food, tuition and medicine.
- The PAN is sticking with PVF, but this reality is creating extreme discomfort and fear about the reaction of the voters once this reality comes to light, whether before or after the vote on the FR. An informal and anonymous poll of PAN legislators, in which CEGSA has confidence, indicates that 30-40% of them are doubtful about the advantages of FR as represented by PVF, his ministers and his surrogates. It should be noted that this doubt is not because they have read and understand the FR. The vast majority have not because of the way PVF has presented it. Rather it is the result of the internal frictions and doubt of PVF by his own party.
- Finally, one other risk PVF runs is that his trying to flank the Congress will further sour relations with that branch of government, including those in his own party.

## f) Congressional Response to PVF's Fiscal Reform Initiative.

- To date, CEGSA cannot report on the various positions and strategies in the legislative branch to the overall FR initiative because there are none as of yet.
- While PVF's cabinet has been very active in supporting the FR through coordinated use of the same talking points, the rapid and wholesale inundation of the Congress with the many pieces of the initiative has precluded senators and diputados (representatives) from examining the program in its entirety.
- Just a few senators and diputados (representatives) thus far have been able to access and evaluate all of the relevant materials for the whole of the FR, which means that there is no real understanding of the whole issue. Instead, it is PVF's plan that the Fiscal Reform package pass on the basis of political terms rather than substance.
- Notwithstanding their not having been able to read the full Fiscal Reform initiative, the political parties have taken positions.
  - The PAN likely will approve each element of the FR as a block vote of 80-85% of its membership.
  - The PRD is going to vote against the FR as a block. The Mayor of Mexico City, arguably the second most powerful government position in Mexico, and a leading PRD figure, already has reflexively opposed all elements of the initiative package.
  - The smaller PT and PVEM parties, as well as the two independent diputados, likely will oppose the FR as a block.
  - The PRI holds the power to pass the FR, and it has not taken a position, except with regard to the Financial Reforms discussed below, which it supports overall.
    - As for the Tax Reforms, they have told the PAN and PVF that they will not be rushed into making a decision to support or not support. They want PVF to roast for awhile over the fire he set for himself, they want to negotiate concessions for any support they are willing to give, and they have to decide whether to support the measure or not. If they do not support it, they will use the summer to agitate the public and generate public opposition to the measure.
    - The PRI leaders of both comisiones on Hacienda, the congressional committees in charge of tax matters in the Senate and Camara de Diputados, have both said that they are not in a hurry to force the FR package through Congress.
    - Even with 100% party line approval by the PAN, PVF will need at least 44 PRI votes, or 25% of the PRI membership in the Camara de Diputados, to pass each piece of the FR. This gives the PRI a very big voice in the timing and substance of the final product.

## 2. Reforma Fiscal : Elements and General Objectives.

CEGSA has obtained and examined the various documents given piecemeal to the senators and diputados, and CEGSA has considered them in toto. The following is an objective summary of the FR, together with whatever comments CEGSA or other analysts have had as to the impact or effect of the proposed changes. Note: This is not an exhaustive analysis of all of the impacts and implications of the FR. CEGSA is preparing to issue a more in-depth analysis of the impacts of and issues created by the FR.

The FR is comprised of 3 independent groups of initiatives:

### a) Marco Tributario (Tax Revisions).

- Most important.
- Most contentious.
- Is essentially the same program advocated by the PRI in 1995 that the PAN and PVF ridiculed and opposed, to the great political cost of the PRI.
- Look for the PRI to extract a great political cost as quid pro quo and to improve their chances in the 2003 congressional elections.
- Cannot be passed without support from a substantial block of the PRI.
- Will not be voted on until at least the end of May 2001 after the end of the regular congressional session.
- The leaders in the congress already are discussing an extraordinary (emergency) session for the debate and vote.
- Official Objectives:
  - Establish equality of treatment for all businesses;
  - Stimulate regional development and employment;
  - Ensure Stable and Dependable Public Investment;
  - Obtain Macroeconomic Stability.
- Unstated Objective:
  - Increase tax revenues for debt retirement and new programs PVF has promised.

### b) Marco Financiero (Financial Revisions)

- Least contentious;
- CEGSA prediction based on interviews with congressional leaders: Will pass during regular session in April 2001 with few changes.
- Official Objectives:
  - Improve internal savings as a percent of GDP;
  - Improve efficiency in the financial system;
  - Increase credit availability and stability.
- Unstated Objectives:
  - Increase investment in housing through programs that attract foreign capital, redirect increased domestic savings, and do not cost the government anything other than the required guarantees.
  - Increase housing supply by 750,000 units annually.
  - Increase employment through construction of housing.
  - Increase tax revenues through the increased employment.

**c) Marco Presupuestal (Budget Revisions).**

- Requires Constitutional Amendments, including approval by state legislatures most of which are PRI (19 of 32) controlled.
- Process is likely to take 9-12 months.
- Official Objectives:
  - Increase timeline for budgetary process;
  - Permit multi-year investment projects;
  - Increase transparency by enabling immediate access to federal expense reports.

**3. Changes Proposed to Tax Laws (Marco Tributario).**

- All goods and services will be subject to the Value Added Tax (IVA) regimen. Specifically, food, medicine, school tuition and book purchases will be taxable for the first time.

**CEGSA Commentary:** This new IVA is going to impact disproportionately the disposable income the vast majority of Mexicans, far in excess of any tax savings they might receive by the reduced income tax. Additionally, this new IVA will be inflationary through wage pressures and by businesses raising prices in anticipation of the IVA change.

- Value Added Tax (IVA) costs for business are increased by tightened restrictions.
  - IVA credits can no longer be used to pay non-IVA government obligations, such as income tax and employee taxes.
  - Companies must wait 5 months and 10 days before they can obtain refunds of IVA for unsold inventory and customer credit balances.
  - Companies must file IVA returns monthly, with payments, instead of quarterly.
  - Companies lose their right to IVA refunds if they do not apply for them within 60 days.

**CEGSA Commentary:** This is an inflation sleeper. Companies will do away with net terms as IVA will not be recoverable until date of payment. Likewise, many marginal companies with longer carrying times for inventory (e.g., cyclical handling of crops or huge buys for better prices) will be unable to stay in operation since they cannot recover their IVA payments before sale of goods. Finally, those companies that can finance their investment in IVA will merely raise their prices to cover the additional cost.

- Elimination of the special tax for production and services (IEPS) applicable to alcoholic drinks, tobacco, gasoline, natural gas and diesel, and incorporates these products into the normal IVA regimen.
- Maintenance of the current special IVA program in the 20 km. border zone with the United States.
- Income Tax (ISR) will be calculated using the cash basis method of accounting for individuals in managerial activities, as well as for individuals and entities in the trucking, agricultural, forestry and fishing industries.

- Income tax rate reduction for entities from 35% to 32%, with additional deferment of up to 5% for reinvestment in profits.
- Income tax for interest income will now be calculated and paid on a real basis, indexed for inflation.
- Deductibility from gross income by companies for employee profit sharing plans.
- Deductibility from gross income by companies for employee programs relating to education, health and other social benefits.
- Income tax rates for individuals are reduced for each bracket.

**CEGSA Commentary:** This is an illusory fulfillment of a campaign promise as it truly benefits only the 10-15% of the population in the top tax brackets. Most of the population pay virtually no income taxes. Any income tax savings will be more than offset by the new 15% IVA on necessities.

- Elimination of the preferential income tax treatment for raw materials and commodities, educational fees, trucking and book editors.
- Income tax withholding rules are homogenized for foreigners, eliminating the disparate rules depending on entry type, effective beneficiary, or nationality.
- Exemption from income tax for foreigners' investment funds, pensions and retirement funds.
- Payment of income tax in Mexico is completely deductible abroad in countries with applicable tax treaty agreements with Mexico, avoiding double taxation.
- Rule changes for operation transfers of multinationals and tax in the event of change of fiscal residence.
- Simplification in the calculation and payment mechanisms for income tax, including electronic payment via internet and use of banking statement of accounts as proof of expense.
- Immediate and total deductibility, of the present value of the investments made outside of the metropolitan areas of Monterrey, Guadalajara and the Federal District (a la Enterprise Zones in the U.S.).
- Various tax measures to encourage private investment in environmental efforts and to discourage the informal economy.

#### **4. Changes Proposed to Financial Laws (Marco Financiero).**

- Establishment of a National Mortgage Bank, Sociedad Nacional de Crédito (SNC) categorized as a National Credit Institution (NCI), whose purpose is to promote the construction and ownership of housing – preferably for those of low and moderate income -- by means of the grant of credits and guarantees. Funding will be through private sources, including from foreign interests and international financial organizations;
- Transformation of the Patronato del Ahorro Nacional into the Banco del Ahorro Nacional y Servicios Financieros, SNC, also a NCI. The stated goal is to promote savings, financing and investment between government-owned integrating companies and the privately owned savings and credit that are regulated by the Law of Saving and Popular Credit (LSPC).
- Authorize the above institution to act as financial agent of the federal government in the negotiation and handling of credits from outside the government, coming from any source type or institution.
- Administrative modernization of the Institutions of Banking of Development, enlarging their operation capacities, and authorizing their administrators to approve general budgets, subject to observance of the Laws of Acquisitions, Leases and Services of the Public Sector and of that of Public Works and Services.
- Expansion of the authority of the Administrators of the Fund for the Retired (AFORE) to solicit and accept the saving of independent, unsalaried workers, as well as the savings of local, state and federal employees. Also, Specialized Societies of Investment of Funds for the Retired are created to manage and protects the savings of retired persons.
- Refinement of the provisions that regulate the Societies of Investment to avoid conflicts of interest with the operation of the stock brokerage firms, so as to both invigorate and decentralize the stock market and increase market access by small and medium investors.
- Decreases the restrictions imposed on the operation of the Clearing Trusteeship of Institutions of Credit and Auxiliary Organizations of Credit (FIDELIQ), exempting it from restrictions on the public sale of assets from companies that were transferred to it for liquidation.
- Various regulatory proposals for the operation of currency exchange firms (relating to money laundering).

#### **5. Changes Proposed to Budget Procedures (Marco Presupuestal).**

- Moves the congressional budgetary process forward one month so as to allow more time for negotiation and resolution. (Initiatives for the Law of Revenues and of Budget of Expenditures of the Federation).
- Introduction of the concept of multi-year budgetary programming so as to guarantee

## 6. Statutes to be Modified by Fiscal Reform.

- Tax Reform
  - Ley del Impuesto sobre la Renta.
  - Ley del Impuesto al Valor Agregado.
  - Código Fiscal de la Federación.
  - Ley del Impuesto Especial sobre Producción y Servicios.
  - Ley Federal del Impuesto sobre Automóviles Nuevos.
  
- Administration
  - Ley del Servicio de Administración Tributaria.
  - Ley Orgánica del Tribunal Federal de Justicia Fiscal y Administrativa.
  - Ley General de Bienes Nacionales.
  
- Constitution
  - Amendments to Constitución Política de los Estados Unidos Mexicanos.
  - Article 72, Section K
  - Article 74, Sections III, IV, V, VI, and VIII
  - Article 75
  - Article 126
  - To amend the Constitution, the following votes are required:
    - 2/3 (334) of the Camara de Diputados;
    - 2/3 (86) of the Camara de Senadores (Senate); and
    - 2/3 (22) of the State Legislatures, by 2/3 vote in each.
  
- Banking
  - Nueva Ley Orgánica de Nacional Hipotecaria.
  - Nueva Ley Orgánica del Banco del Ahorro Nacional y Servicios Financieros.
  - Ley de Instituciones de Crédito.
  - Ley General de Organizaciones y Actividades Auxiliares de Crédito
  - Ley Orgánica de Nacional Financiera.
  - Ley Orgánica del Sistema Banrural.
  - Ley Orgánica del Banco Nacional de Comercio Exterior.
  - Ley Orgánica del Banco Nacional de Obras y Servicios Públicos.
  - Ley Orgánica del Banco Nacional del Ejército, Fuerza Aerea y Armada.
  
- Pension Funds
  - Ley de los Sistemas de Ahorro para el Retiro.
  
- Investment
  - Ley de Sociedades de Inversión.

**7. Bibliography – Mexican Government Documents Available on Request.**

- Complete text of the Exposition of Motives and Integrated Proposals of Fiscal Reform by President Vicente Fox.
- Current texts of the 20 laws described above, with revisions pursuant to the proposals of the FR.
- Text of discussions about the FR on the floors of the Camara de Diputados and the Senate, as well as in the various comisiones having jurisdiction of parts of the FR.
- Reprints of quoted opinions and on-record statements by legislative leaders, party leaders, and executive branch officials.
- As they are issued, reprints of all studies and commentaries on the FR by academics, accountants and other professionals.