

ECONOMIC PROGRAM FOR 2006

- ✓ *The Revenues Law and the Expenditures Decree for 2006 were published on December 14th and 22nd, respectively.*
 - ✓ *Public finances were further consolidated by approving a balanced budget for 2006.*
 - ✓ *Total public sector revenues considered in the Revenues Law for 2006 are 6.1 percent higher in real terms to those approved for 2005*
 - ✓ *Total public sector spending approved in the Expenditures Decree for 2006 is 6.3 percent higher in real terms to that authorized by Congress for the previous year. In the 2006 program, the real increases with respect to the 2005 program of 5.2 percent in programmable spending and almost 5 percent in federalized spending stand out.*
- The Revenues Law approved by Congress considers resources that are Ps. 92.3 billion higher than those in the Executive's proposal. This increase results from: a) The reduction of the proposed budget surplus to a balanced position, b) the revision of the Mexican crude oil mix reference price to a higher level, and c) the modifications to the estimated non-oil tax revenues.
 - In terms of the corporate income tax regime, the following changes stand out. The exemption on interests obtained by foreign residents from credits granted to the Federal Government or to Banco de México, as well as those proceeding from instruments issued by such institutions. Also exempt are interests from operations with financial derivatives of debt instruments referred to the *inter-bank interest rate (TIIE)*, certain other public debt titles issued by the Federal Government or Banco de México, and those determined by the Tax Administration Service (SAT). Additionally, changes were made to the tax regime to facilitate the operation of real estate investment funds, giving them a similar treatment to corporations (*sociedades mercantiles*) dedicated mainly to the real estate business.

- In terms of the personal income tax, the main change is the repeal of the dispositions that were to be effective in 2006, which i) created a single tax schedule with only two rates, ii) allowed a deduction on income for up to Ps. 76 thousand per year, and iii) substituted the fiscal subsidy and the salary credit with the employment subsidy and the subsidy for income leveling.
- The total budget in the Federation's Expenditures Decree for 2006 approved by Congress is Ps. 2 trillion 72 million, 6.3 higher in real terms than that approved for 2005. Of this amount, Ps. 1 trillion 433.5 billion were destined to programmable expenditure and Ps. 566.6 billion to non-programmable spending. Consequently, programmable spending is 5.2 higher in real terms than that approved for 2005. Additionally, approved federalized expenditure increased by almost 5 percent with respect to that authorized for the previous year.
- Congress implemented reductions of Ps. 13.2 billion from the budget project sent by the Executive. This involved the following reductions: Ps. 5 billion to the Judicial branch, Ps. 3.1 billion to the personnel services item, Ps. 1.6 billion to Adefas, Ps. 1.5 billion to financing costs, Ps. 1 billion to the Electoral Institute (IFE), 880 million to the Legislative branch, and 120 million to the Human Rights Commission (CNDH).
- The additional resources considered in the Revenues Law and the reductions to the budget proposal sent by the Executive imply expenditure increases by Ps. 105.5 billion. Notwithstanding, the Chamber of Deputies approved increases for 132 billion pesos, i.e. 26.6 billion in excess to those resources considered in the Revenues Law. This amount is the increase given to the Social Security Institute (IMSS) by the Chamber of Deputies. It is worth highlighting that, in attention to the request made by the Chamber of Deputies, the Ministry of Finance will carry out the necessary measures to adjust spending to the resources approved in the Revenues Law. This is in accordance to Article 25th of the Budget, Accounting and Public Expenditure Law, as to the applicable articles of the Federation's Expenditures Decree for 2006.
- Approved budget increases were assigned as follows: 26.6 billion pesos to the IMSS, 10 billion to grants and federal participations to the states, 6.3 billion to CFE and 89.1 billion to those programs and projects convened by the Chamber of Deputies. Among these, the following stand



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out: PAFEF with 22.5 billion, rural development and agriculture with 17.3 billion, education with 15.8 billion, and highways with 13.5 billion. The remaining resources will be directed to programs to promote public health, social security, water supply, public safety, science and technology, as well as to provide support to the most vulnerable sectors of the population.

Economic Outlook for 2006

The economic program approved for 2006 anticipates GDP growth at 3.6 percent in real annual terms and general inflation at 3.0 percent. Congress modified the Mexican crude oil mix reference price from 31.5 to 36.5 dollars per barrel, and the public sector balance for 2006 was revised from a surplus of 0.2 percent of GDP to a balanced position.

ECONOMIC OUTLOOK, 2005-2006		
	2005	2006
Gross Domestic Product		
Real growth (%)	3.5	3.6
Nominal (billion pesos)	8,226.2	8,803.6
GDP deflator (average growth, %)	4.1	3.4
Inflation		
Dec/Dec (%)	3.7	3.0
Nominal Exchange Rate ^{*/}		
Average (pesos per US dollar)	11.0	11.4
Interest Rates (28-day Cetes)		
Nominal, average (%)	9.4	8.9
Real, average (%)	5.8	6.1
Current Account		
Million Dollars	-9,892.2	-16,611.5
% of GDP	-1.3	-2.2
Fiscal Balance		
Traditional Balance (% of GDP)	-0.2	0.0
PSBR (% of GDP)	2.2**	1.7
Other variables:		
US GDP		
Real growth (%)	3.6	3.5
US Industrial Production		
Real growth (%)	3.4	3.5
US Inflation		
Dec/Dec (%)	2.2	1.9
Crude Oil (Mexican mix)		
Average price (dollars per barrel)	39.8	36.5
Average export platform (mbd)	1,826	1,868
External Interest Rates		
LIBOR (average, %)	3.5	4.4
Federal Funds Rate (average, %)***	3.3	4.4

e/ Estimated.

*/ Since there is a free-floating exchange rate regime, this does not constitute an exchange rate forecast. However, these reference levels were used to estimate some budgetary items.

**/ Excluding CRL.

***/ Based on the corresponding futures contracts.

The Federation's Revenues Law for 2006

For the 2006 fiscal year, Congress approved total public sector revenues for Ps. 1 trillion 973.5 billion. This amount is Ps. 92.3 billion higher than that proposed by the Executive. The following explains this increase:

Adjustments to the Revenues Law for 2006 (Million pesos)

I. Law Initiative	1,881,200.4
II. Adjustments	92,299.6
Higher Oil Revenues 1/	46,676.2
Duties (<i>Derechos</i>)	48,343.2
Excise taxes on gasoline and diesel	-37,964.3
Tax on Oil Returns	4,838.5
PEMEX's own revenues	31,458.8
Higher Tax Revenues	28,037.7
Income Tax	22,957.0
VAT	5,080.7
Lower duties from Public Entities	-21.5
Foregoing the fiscal surplus (de 0.2 a 0.0)	17,607.2
III. Approved Law (I+II)	1,973,500.0

1/ Includes the effect of increasing the oil price from 31.5dpc to 36.5dpc and the effect of PEMEX's new tax regime.

The adjustment to the non-oil tax revenues of Ps. 28 billion, with respect to the Executive's proposal, is due to higher expected revenues from the income tax and the VAT for Ps. 23 billion and Ps. 5 billion, respectively

With respect to the projected income tax revenue, the increase is explained by the repeal of the dispositions that would have taken effect in 2006 (described in more detail further on in this document) and the revision to the estimation of tax revenues, based on the new information generated in the months of September and October. The latter, along with the effect of additional fiscal measures that affected the VAT regime, led to the upward adjustment to the projected VAT revenues.

The increase in oil revenues, due mainly to Congress' revision of the reference price for the Mexican crude oil mix, also stands out. In this regard, it is worth noting the modifications to the structure of budgetary revenues for 2006 due to the changes to PEMEX's fiscal regime approved by Congress. It is important to clear up that these changes do not affect total public sector oil revenues but merely

their composition: For PEMEX, it conveys a reduction in taxes of Ps. 23.6 billion in 2006 and a corresponding increase of its own revenues (after taxes). Conversely, the Federal Government's oil revenues will decrease by this same amount.

In the Revenues Law for 2006, the main changes in terms of **fiscal stimuli** are the following:

- Individuals and firms whose total income in the previous fiscal year did not exceed Ps. 4 million are exempt from the tax on assets (IMPAC).
- The total fiscal stimulus for expenses and investments in research and technology is increased from Ps 3 million to Ps. 4 million.

The main changes in the law with respect to the **corporate income tax** are:

- The income tax rate decreases one percentage point, to 29 percent in 2006 and 28 percent in 2007, according the terms approved in November of 2004.
- Interest payments obtained by non-residents from credits granted to the Federal Government or to Banco de México, as well as from instruments issued by these institutions, are exempt.
- Also exempt are interests from operations with financial derivatives of debt instruments referred to the *inter-bank interest rate (TIIE)*, certain other public debt titles issued by the Federal Government or Banco de México, and those determined by the Tax Administration Service (SAT), placed in the stock market or other recognized markets, as long as the effective beneficiaries are foreign residents.
- Profits from the transference of real estate trust fund certificates are exempt in order to give them the same fiscal treatment that equity receives.
- Corporations (*sociedades mercantiles*) whose objective is similar to that of real estate trust funds will receive similar benefits to such funds.
- The immediate deduction can be made in the fiscal year in which the investment is made.
- With respect to the income tax treatment of non-profit organizations, those institutions in defense of human rights were incorporated to this scheme.

With respect to the income **tax on individuals**, the following changes stand out:

- The repeal of the dispositions that would have come into effect in 2006, which established a simplified tariff and a general exclusion that allowed taxpayers to deduct up to Ps. 76 thousand annually, eliminated the fiscal subsidy and the credit to the salary and established the subsidies for

employment and for income leveling. Therefore, the current fiscal regime applicable to wage employees, including the subsidy and the salary credit in place in 2004 and 2005, remains in place.

- It is worth noting that the measures mentioned before did not imply that employees' benefits were taxed, since the general exclusion allowed the employee to choose between keeping his benefits as established by the standing regime or the annual income exemption for up to Ps. 76 thousand.
- The reduction in the maximum marginal tax rate is maintained so that this rate is 29 percent in 2006 and 28 percent in 2007, in accordance to the reductions in the corporate income tax rate.

With respect to **excise taxes (IEPS)**, the following stands out:

- In order to protect the environment, beer producers, bottling companies or those who import beer will pay the greatest between the excise tax and a fixed amount per liter, diminished by a tax credit for recyclable containers.
- The obligation of attaching label tags to cigarette boxes is eliminated.

The Federation's Expenditure Budget for 2006

The Federation's Expenditure Budget approved by Congress for the 2006 fiscal year amounts to Ps. 2 trillion 72 million, 6.3 percent higher in real terms than that approved for 2005. Of this amount, Ps. 1.43 trillion were assigned to programmable expenditure and Ps. 566 billion were destined to non-programmable expenditure. Therefore, programmable expenditure approved for this year is 5.2 percent higher in real terms than that approved for the last year. Additionally, federalized expenditure (which includes contributions, transfers, the Federal Program for the Strengthening of Entities (PAFEF) and federal expenditure assigned through decentralization agreements)¹ will increase by almost 5 percent in real terms with respect to that approved for 2005.

The Chamber of Deputies made expenditure reductions to the budget proposal sent by the Executive for a total of Ps. 13.2 billion. Of these, Ps. 5.0 billion correspond to the Judicial branch, Ps. 3.05 to personnel services, Ps. 1.6 billion to accrued expenditure from the previous year (ADEFAS), Ps. 1.5 billion to financing costs, Ps. 1 billion to the IFE, Ps. 880 million to the Legislative branch, and Ps. 120 million to the Human Rights Commission (CNDH).

Approved Reductions for 2006 (Million pesos)	
Total	13,173.2
Programmable	10,050.0
Personnel Services	3,050.0
Judicial	5,000.0
Legislative	880.0
Federal Electoral Institute	1,000.0
Human Rights Commission	120.0
Non-Programmable	3,123.2
Financing Cost	1,500.0
ADEFAS	1,623.2

The resources considered in the approved Revenues Law and the reductions to the budget proposal sent by the Executive result in additional expenditures for Ps. 105.5 billion pesos. However, Congress approved additional expenditures for Ps. 132 billion, Ps. 26 billion more than the total revenues considered in the Federation's Revenues Law, which refer to additional expenditure for the Social Security Institute (IMSS) approved by Congress during the same session in which

¹ Expenditure assigned through decentralization agreements will depend on the agreements reached during the fiscal year between Federal Entities and the Central Government.

the Budget was approved. The increases to Administrative and General Branches for Ps. 54.6 and Ps. 44.6 billion, respectively, stand out. It is also worth noting that, from this expenditure expansion, Ps. 54.4 billion will be channeled to federal entities; this is 56 percent of the total amount excluding IMSS.²

Additional Expenditures Approved for 2006 (Million pesos)	
Total	132,045.1
1. Autonomous Branches	21.6
Legislative	21.6
2. Administrative Branches	54,605.6
Interior	328.5
Finance	2,293.3
Defense	863.0
Agriculture	13,588.8
Transport and Communications	13,595.0
Commerce	901.4
Education	12,503.0
Health	2,750.0
Navy	137.0
Agrarian Reform	1,576.57
Environment	4,369.1
Public Safety	700.0
Science and Technology Council	1,000.0
3. General Items	44,562.2
Contributions to Social Security	1,890.8
Wages and Salaries	5,000.0
Adult Education	4,322.0
Federal Contributions to States and Municipalities	2,866.3
PAFEF	22,500.0
Shared Revenue to States and Municipalities	7,893.1
4. Public Entities under Direct Budgetary Control	1,374.6
ISSSTE	143.0
IMSS	625.8
CFE	178.6
5. Transfers to Entities under Direct Control and contributions to ISSSTE-FOVISSSTE	876.4

It is worth mentioning that, considering Congress' petition and in accordance with Article 25 of the Budget, Accounting and Public Expenditure Law, and the relevant articles of the Federation's Expenditure Decree for 2006, the Ministry of Finance will take the necessary measures to insure that expenditures meet the resources approved in the Revenues Law.

² The additional expenditures for federal entities correspond to the following: contributions, shared revenue, PAFEF and subsidies (Education, Health Public Safety, Reconstruction and the Metropolitan Fund).

Automatic Adjustments to Changes in the Economic Environment

The Federation's Expenditure Budget Decree for 2006, as in previous years, sets clear rules that specify the way in which the stabilization mechanisms will work in case of collecting a higher or lower level of revenue to that projected in the Revenues Law.

To illustrate the distribution of excess revenues established in the Federation's Expenditure Decree for 2006, we must first explain the changes made by Congress to PEMEX's fiscal regime. In this sense, it is worth noting that a duty (*derecho*) and a fee (*aprovechamiento*) were established, whose revenues are destined specifically to states, which are both applied to the product of crude oil exports and the difference between the average observed oil price and the price set in the Revenues Law (base). These are:

- The Extraordinary Duty on Crude Oil Exports (*Derecho Extraordinario sobre Exportación de Petróleo Crudo, DEEPC*) calculated as 13.1 percent of the aforementioned base, and
- The Fee on Excess Revenues (*Aprovechamiento sobre Rendimientos Excedentes, ARE*) calculated as 6.5 percent of the aforementioned base.

Given that the duty and the fee (that together represent 19.6 percent of the base) are applied to the same base as the ARE for 2005, the resources would equal half of the 2005 ARE (whose applicable rate was 39.2 percent). Since the Expenditures Decree for 2005 established that 50 percent of the ARE would be destined to the states, the distribution of these new duties and fees to states would remain the same as before. Additionally, since PEMEX will not have to pay the other half of these resources, it will be able to assign them more efficiently than before, when it had to wait for these resources to be returned by the Federal Government.

Once the main effects on the distribution of excess oil revenues and their relation with PEMEX's new fiscal regime are established, we present the overview of the determination of excess revenues for 2006. The following table shows the distribution of excess revenues according to their origin and according to what was approved in the Federation's Expenditures Decree for 2006:

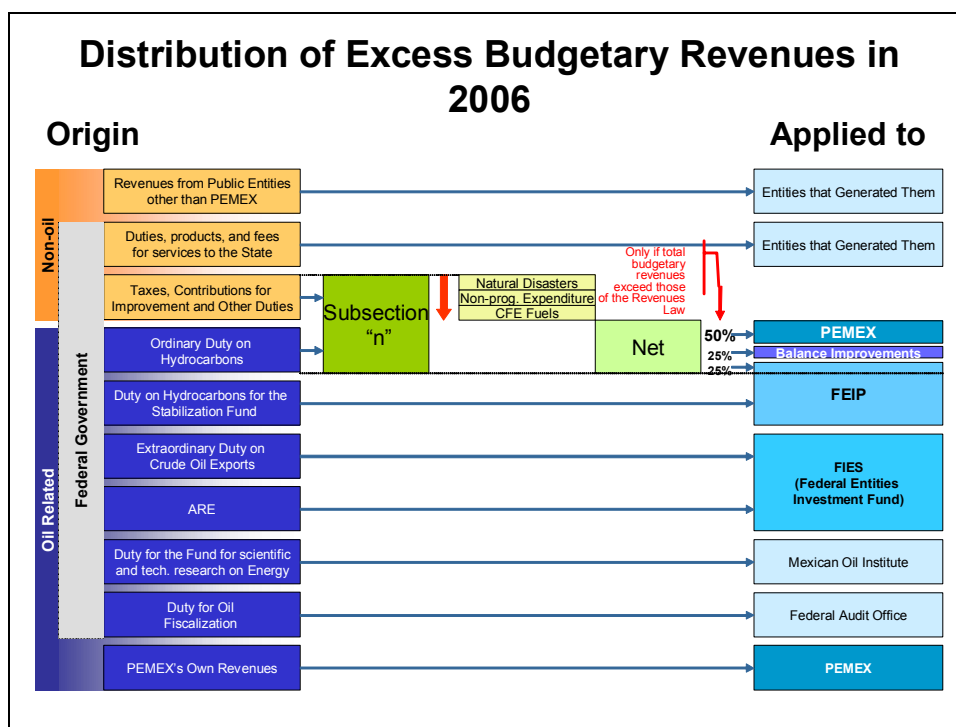
Excess Revenues	Destined to
<p>1. Oil Federal Government Ordinary Duty on hydrocarbons Duty on Hydrocarbons for the Oil Stabilization Fund (for oil prices above 36.5dpb) Extraordinary Duty on Crude Oil Exports Duty for the Fund for scientific and tech. research on Energy Duty for Oil Fiscalization ARE PEMEX 's Own Revenues</p> <p>2. Non-Oil Revenues from public entities other than PEMEX Duties and products for services to the State Taxes, Improvement Contributions and other fees</p>	<p>"Subsection n" Oil Stabilization Fund (FEIP) States' Investment Fund (FIES) Mexican Oil Institute Federal Audit Office States' Investment Fund (FIES) PEMEX</p> <p>Entities that generated them Entities that generated them "Subsection n"</p>

The excess revenues that make up "Subsection n" must be destined first to compensate for possible additional expenditures on the following:

- National disasters when the National Disaster Fund is insufficient.
- Non-programmable expenses in excess to those budgeted.
- With respect to the Federal Electricity Commission (CFE), to cover increases in the price of fuel used to generate electricity.

The rest of the excess revenues will be allocated as follows: 25 percent to the Oil Stabilization Fund (*FEIP*), 25 percent to improve the public balance and 50 percent to investment expenditure in PEMEX. It is worth mentioning that it is only possible to draw resources from "Subsection n" when total budgetary revenues exceed those contemplated in the Revenues Law.

The following diagram shows the origin of excess revenues and their destination in 2006:



It is worth mentioning that, if the Value Added Tax reform to tax the *call center* services with the general rate is approved, the excess revenue from this source will be allocated – up to Ps. 2 billion – according to the following: Ps. 1.7 billion to the Judicial branch, Ps. 200 million to the Fiscal and Administrative Justice Federal Court, and Ps. 100 million to the Juvenile Court. Resources in excess of the aforementioned Ps. 2 billion will be included amongst the excess revenues of “Subsection n.”

When revenues are lower than those projected in the Revenues Law, the following rules apply:

- If the reduction is due to a fall in the Federal Government’s oil revenues, this shortfall will be covered with resources from the *FEIP*.
- Revenue shortfalls from other sources will be compensated with expenditure cuts to approved expenditure, avoiding a negative impact on social programs.

If the amount of the shortfall is less than Ps. 15 billion, the Executive will notify Congress about the measures to be implemented. When the shortfall is equal to or higher than this level, the Executive will notify Congress the amount of programmable expenditure to be cut and a proposal of the specific reductions in the following 15 workdays. Congress will have 15 workdays to analyze the



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proposal and its composition and, if this is the case, to suggest changes to it. The Executive will resolve and inform the actual measures to be implemented, considering Congress' suggestions. In case Congress does not give any suggestion before the deadline, the proposal made by the Executive will take effect.