

OECD Economic survey: Mexico 2007 – ADDENDUM

The *Economic Survey of Mexico* was finalized in July 2007. The OECD Economic and Development Review Committee discussed a draft on 2 July 2007 and approved the final Survey, which was revised in the light of the discussion, on 18 July 2007.

The Survey has not been updated to reflect new developments that have occurred in Mexico since the finalization of the Survey in July. Prominent among these has been the approval by Congress of a tax reform bill on 14 September 2007.

The tax reform is a key element of the broader public finance reform which was presented by the government in June 2007. The public finance reform included four main pillars: i) strengthening of the tax administration; ii) improving the institutional framework for public spending; iii) reviewing the fiscal relations across levels of government; and iv) engaging in a tax reform that strengthens public finances and improves the stability of revenue. A detailed review of the proposed reform is provided in Chapter 2 of the Survey with an assessment and recommendations on its various components.

The major components of the approved tax reform are the following:

1. *The IETU (Impuesto Empresarial a Tasa Unica)* is introduced. It is an income tax on firms and professional activities to be applied on the firms' revenues from the sale of goods, the provision of services and the temporary grant for the use of goods, after deduction of capital spending. Similar to the originally proposed CETU (see Chapter 2, Box 2.2 in this Survey), the IETU acts as a minimum tax for the income tax. The tax will be compared with the firm's income tax and the income tax withheld by the firm for third parties, such as salaries, wages, and compulsory social contributions paid by the firm, and the higher of the two taxes will be paid. The Mexican asset tax is abolished. The rate for the IETU has been set at 17.5% (rising gradually from 16.5% in 2008 and 17% in 2009, to 17.5% in 2010). This is slightly below the rate which was proposed initially for the CETU (19%).
2. A 2% tax on cash deposits greater than US\$2 500 is introduced (this threshold is slightly higher than the original proposal of US\$2 000). Formal businesses and professionals can credit their payments of this tax against their other tax payments.
3. *The fiscal regime for the state oil company PEMEX is changed*: the change is aimed at reducing the taxes that PEMEX pays on extracted hydrocarbons from 79% to 74% in 2008 (this was not in the original proposal). The tax will be further reduced by an annual 0.5% in 2009-2011 and by 1% in 2012. In 2008, this change is estimated to provide around US\$2.8 billion in extra resources for PEMEX in 2008 and up to around US\$5 billion in 3 to 4 years. In addition, the company has to carry out a program to improve operating efficiency to international standards and funds must be spent on research and modernization rather than on current expenses.

4. A new tax on *petrol and diesel* of 5.5% is introduced to be phased in over 18 months (this was not in the original proposal). The revenue from this tax will be allocated in its entirety to state governments.

Coming after a long period of stalemate on tax reforms, this tax bill is to be welcomed. It helps to strengthen Mexico's public finances by reducing the dependence on oil revenue and providing more stable sources of revenue to support essential spending needs. The tax reform is expected to raise around 2.3% of GDP by 2012. This is a significant amount, even though somewhat below what was expected from the original proposal (around 2.9% of GDP).

As indicated in the Survey, additional tax measures should be considered in the longer run, notably on the consumption tax front, where VAT remains an area of concern because of the large number of exemptions and zero rated goods and services that introduce distortions and complicate tax administration.

Chapter 2

Putting public finances on a firmer footing

Mexico has shown responsibility in fiscal policy, and its headline fiscal position is good. However, the underlying situation of public finances is not yet comfortable because of the heavy reliance of the budget on uncertain oil revenue. As a consequence, fiscal policy is heavily influenced by world oil prices and the sustainability of national oil production. At the same time, there are increasing demands made on the budget for development priorities in the areas of basic infrastructure, education, health and poverty alleviation, which require reliable financing. Increasing the efficiency of public service delivery is a sine qua non for fiscal policy to support the catching-up process, but it will go only part of the way to meeting increased budgetary demands. Mexico's tax/GDP ratio is one of the lowest in the OECD and a far-reaching tax reform is a priority in order to increase revenues while reducing distortions. A review of fiscal relations across levels of government is also needed to improve the division of powers and responsibilities and strengthen sub-national governments' accountability. The new government is planning a broad public finances reform, which is promising. Passing the required reforms and implementing them remains a major challenge.

Mexico has a good fiscal record

Mexico has shown responsibility in fiscal policy. Budget deficit targets have been attained and its headline fiscal position is good. The revenue increases produced by rising world oil prices since 2002 have helped bring public finances into balance. Even the wider definition of the budget deficit – which includes the cost of banking sector rescue package and of public-private schemes, PIDIREGAS¹ – has come down, with the public sector borrowing requirement (PSBR) down to 1.2% of GDP in 2006 (Figure 2.1). The broad public debt has come down to about 35% of GDP. Its structure has been strengthened by a reduction of foreign indebtedness and a lengthening of the average maturity of debt instruments.

Recent years have been a test on fiscal discipline, when faced with high oil revenue

Over the past five years, Mexico has benefited from rapidly growing oil prices and rising oil revenue. The reference oil price used for the budget has been constantly raised since 2002, but oil revenue turned out to be higher than budgeted every year because prices had risen to above the reference price (Figure 2.2). In particular, high – and partially unexpected – revenue were recorded in the past two years.

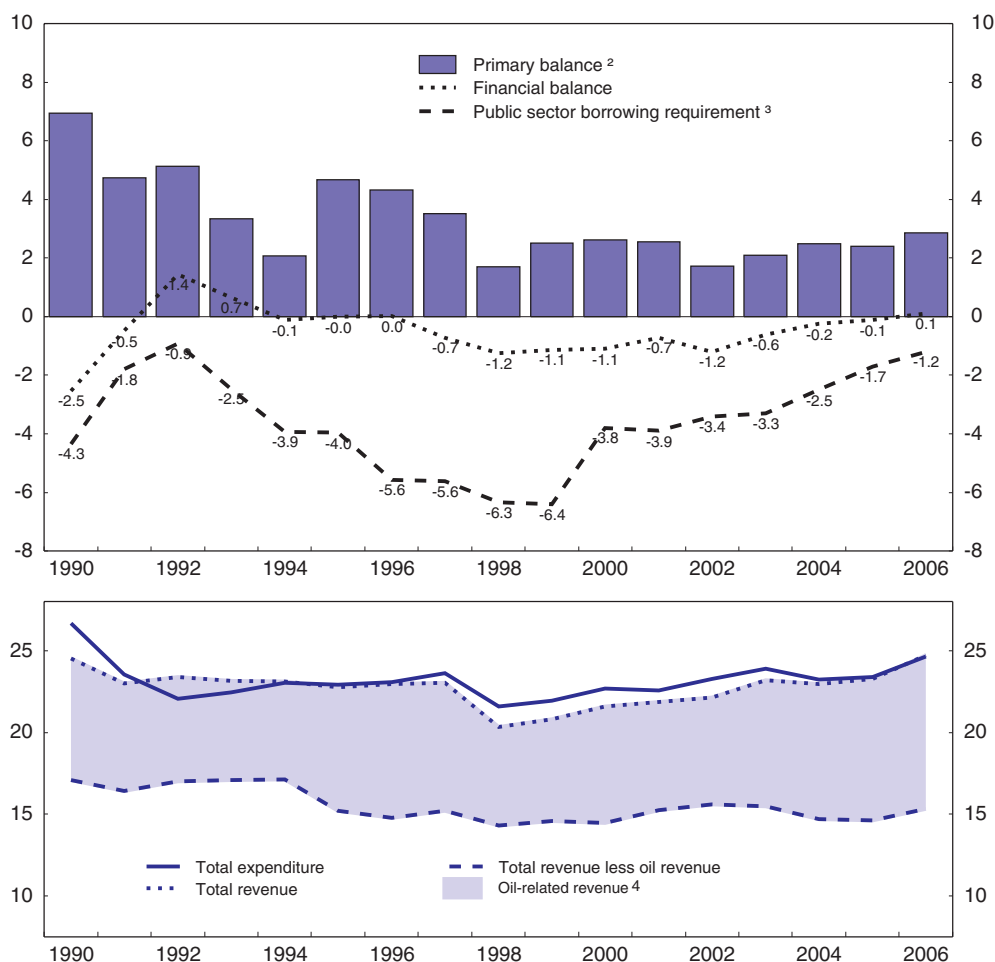
Abundant fiscal resources in 2005 and 2006 have allowed additional public spending while reducing the public debt and transferring resources to the oil stabilisation fund. Budget rules have been applied for several years, supporting fiscal discipline and helping to protect the budget against the volatility of oil prices: in particular, rules have been in place since 1998 to adjust spending in case of revenue surprises, and since 2000 to allocate extra revenue in case of windfalls. Furthermore, a formula was introduced, although it was not mandatory, to set the annual oil reference price on a technical basis. This has helped fiscal management, and extra revenue has generally been spent wisely or saved.

The fiscal framework was further strengthened in 2006, with the new Budget and Fiscal Responsibility Law. The new law establishes strict budget rules in the law and a formula to calculate oil-related revenues. It also defines new guidelines for allocating excess revenue and drawing from the various stabilisation funds (the States Revenue Stabilization Fund, PEMEX Investment Stabilization Fund and the Oil Stabilization Fund). The new law is expected to establish good budget practices more firmly, ensuring that extra resources of a non-recurrent nature are oriented to non-recurrent spending, to be saved or invested. This is appropriate since oil wealth, as a non-renewable resource, should be used for investment (including human capital formation) so as to enhance growth potential.

Prudent assumptions underlie the 2007 budget

Budget targets were easily met in 2006. Higher-than-projected revenue allowed increases in spending and a reduction in the deficit, as well as additional transfers to the oil-stabilisation fund, to the PEMEX investment fund and to states and local governments for infrastructure. The PSBR (including the cost of bank restructuring and public-private

Figure 2.1. **Public sector budget aggregates**¹
Per cent of GDP



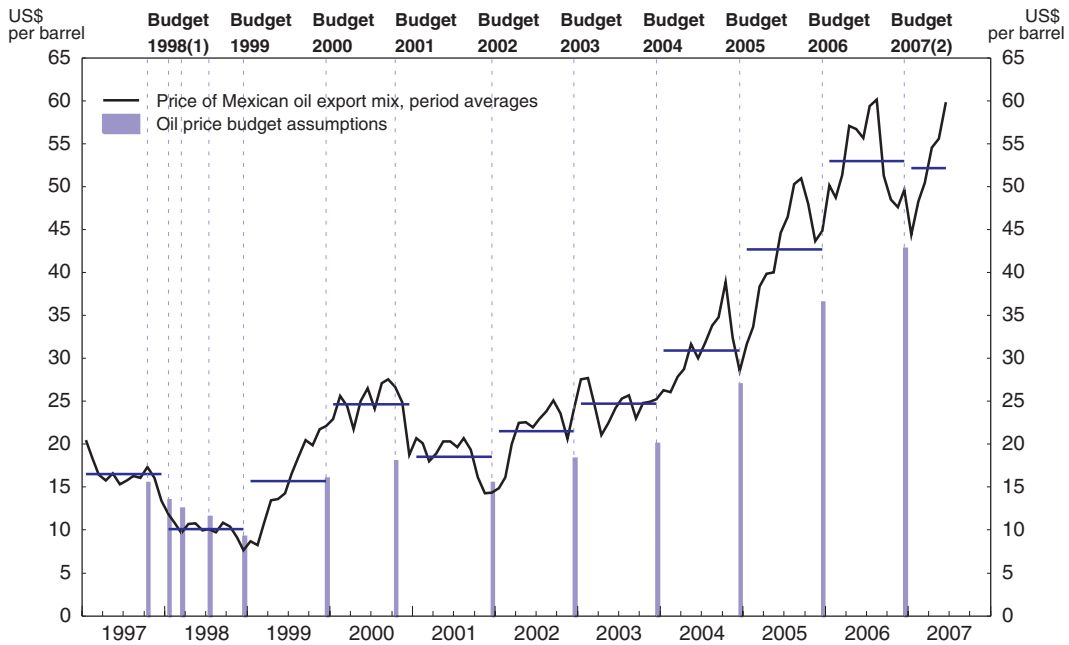
1. The public sector comprises federal government and public enterprises under budgetary control.
2. The primary balance is the financial balance less net interest payments (such as PEMEX). Financial intermediation by development banks is not included.
3. Public sector borrowing requirement (PSBR) includes net costs of "PIDIREGAS", inflation adjustment to indexed bonds, imputed interest on bank-restructuring and debtor-support programmes and financial requirements to development banks. Non-recurrent revenues (privatisation) are not included. Further adjustment to include the net non-recurrent capital costs of the financial sector support programmes would increase the PSBR.
4. Includes oil extraction royalties, VAT and excise taxes on oil products.

Source: Ministry of Finance; Banco de México; OECD, *Economic Outlook* database 81.

StatLink  <http://dx.doi.org/10.1787/104180315863>


investment projects but excluding non-recurrent revenue) was down to 1.2% of GDP, half a percentage point below the 2005 outturn.

With a lower oil price reference and oil export volume built in the 2007 budget, public spending is projected to be constrained. The 2007 budget projections target a balanced budget, with a PSBR at 1.7% (excluding non-recurrent revenue). A reduction of oil-related revenues of a little more than 1% of GDP is incorporated in the budget projections, based on a (prudent) oil price assumption of 42.8 d/b for the Mexican export mix, roughly equivalent to 50-51 d/b for world oil prices. The prudent assumptions for oil prices and export volumes underlying the 2007 revenue projections are appropriate given prevailing uncertainties.²

Figure 2.2. **The oil prices and budget assumptions 1997-2007**

1. Three adjustments were made to the 1998 budget assumptions in the course of 1998.
2. According to the approved budget for 2007.

Source: Ministry of Finance; PEMEX.

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In case of revenue windfalls, the new Fiscal Responsibility Law defines specific rules to distribute extra revenue. In particular, after adjustment for a number of possible surprises, windfalls have to be allocated to three stabilisation funds (40% for the oil stabilisation fund, 25% to the states revenue stabilisation fund, 25% to the PEMEX investment stabilisation fund), and the rest is to be transferred to the states for investment spending. The large share allocated to investment in case of revenue windfalls is appropriate, given outstanding needs, provided several conditions are filled. First, at all levels of government, investment projects should be set within multi-year budget planning, to avoid the inefficient and costly “stop and go” approach that has often characterised the past when investment was adjusted in accordance with oil revenue surprises. Second, the accountability of sub-national governments, which have been receiving increasing resources, has to be strengthened. Whether or not oil windfalls materialise again in 2007 will depend not only on world oil price developments, but also on the production capacity of PEMEX and Mexico’s oil exports volume.

The underlying fiscal position is not yet comfortable

More reliable revenues are needed to support long-term economic growth

Non-oil revenue is low relative to GDP, and Mexico’s tax/GDP ratio is one of the lowest in the OECD. Even including oil-related revenue (close to 40% of the total), budget revenue is very low in international comparison (Figure 1.5 in Chapter 1). This reflects the narrow tax base associated with numerous tax exemptions and special regimes, which make tax collection difficult. The heavy reliance on uncertain oil revenue and the narrow tax base

makes fiscal policy too sensitive to the oil cycle and unable to properly smooth the business cycle. Furthermore a number of structural weaknesses have yet to be addressed. First, under the existing budget constraints, some spending needs are not met, among which physical and social infrastructure in health and education services, which are important factors for long term growth. Second, off-budget operations have been contributing to spending pressures. Third, the way states deal with transfers earmarked for investment (whether budgeted or funded by windfall revenue) is difficult to assess, although it is highly relevant to gauge the effective capital formation in the country.

There are development priorities in education, health, poverty alleviation and basic infrastructure (roads, water, sewage, etc.). Some of these recurrent spending needs have to be financed by permanent sources of revenue that are not affected by the changes in oil revenue. Spending for poverty alleviation for instance needs to continue on a large scale and its source of financing has to be stable. There is a long list of areas where additional spending is required, some of it having already been committed.

- In education, increasing cohorts are being enrolled in secondary schooling and basic investment shortages need to be addressed. Considering quantitative improvements only, additional spending of about 1½ per cent of GDP is required.³ Increases in the system's efficiency, which could be obtained through appropriate reforms are also needed.
- In health, the widening of the *seguro popular* (basic health insurance) has a substantial budget cost. The programme, which insures the “uninsured/uncovered” population, had an estimated cost of 0.8% of GDP per year, when in full operation, with the objective of reaching a full coverage of the targeted population by 2010. The on-going expansion is rapid.⁴
- Population ageing puts pressures on the budget through the pension regimes of various government employee categories. The reform of the federal government employees' pension regime, ISSSTE, has reduced liabilities (Box 2.1); but reforms of other public pension systems, including those for state employees and PEMEX employees, remain to be done.

Box 2.1. Reforming the government employees social security system (ISSSTE)

A pension reform of federal government employees (ISSSTE) was passed in March 2007. By tightening eligibility rules and generosity of benefits, it significantly reduces the federal government's pension liabilities. With the reform, the present net value of contingent liabilities is expected to decline from 57% to around 35% of GDP. Pension contributions will be channeled to individual accounts, allowing portability. The transition generation receives a bond recognising their accrued pension rights as debt – maturing at the time corresponding to the retirement age of the worker. This will allow inter-temporal distribution of the impact of the transition on public finances.

The annual deficit of ISSSTE, absorbed by the government, was growing at a constant and alarming pace – up from 10.3 billion pesos in 2000, it reached about 37.7 billion in 2006 and was expected to reach some 55 billion pesos in 2009, in constant 2006 pesos.

Besides the federal government ISSSTE scheme, most states have their own ISSSTE pension systems for their employees. The social security institute, IMSS, for its own staff (including its medical staff) and state-owned companies also have their own social security sub-systems. Building on the recent ISSSTE reform, which covers a large share of public sector employees, these schemes will also have to be reformed.

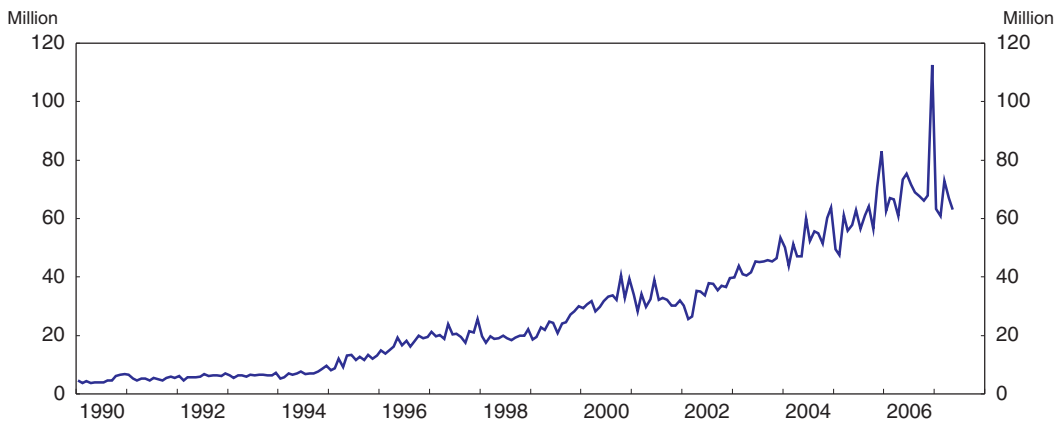
- In the private sector employee pension scheme, IMSS, based on individual savings accounts, the minimum guaranteed pension is often higher than savings, creating a liability for the budget – although recent measures were taken to improve rates of returns on savings account.⁵
- The cost of amortising long-term infrastructure projects built under the hybrid PIDIREGAS schemes is substantial, reaching between ½ and 1% of GDP per year for some time ahead.⁶
- In social policies, new programmes were introduced in 2007, requiring some additional financing.

The total of additional spending required (including spending already committed) amounts to several percentage points of GDP.


How large will oil-related revenue be in the longer run?

A major challenge for public finances in Mexico is how to reduce dependence on oil revenue in the medium term. Oil revenue followed an upward trend over the past four years or so, but volatility has increased and there are growing uncertainties about future oil revenue (Figure 2.3). In the recent past, uncertainties were typically related to the duration of the high price environment.⁷ Today the speed of depletion of Mexico's oil reserves has become another critical issue.

Figure 2.3. **Public sector oil revenues**
Monthly oil revenues in pesos



Source: Ministry of Finance; PEMEX.

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Production from the main extraction fields has already started to decrease (see PEMEX oil production in Annex 2.A1). Oil production in the years to come depends heavily on the development of new extraction projects, which will require significant investment resources as well as new technologies and the application of best practices. These investments in new production fields are essential, but there is also a need to reduce the dependency of the budget on oil revenue without delay. Advertising prospects of declining production and the depletion of proven oil reserves could help the public understand the underlying fragility of public finances.

Whatever the factors affecting fluctuations in oil revenue, it is important to reduce the impact on the budget by strengthening the more stable tax revenue component. The formula to set the oil reference price in the Budget and Fiscal Responsibility Law is an

improvement. It can be further improved by reducing the influence of temporary hikes in oil prices. For example, it may be appropriate to define a prudent long-term reference price for oil and maintain it for several years. As set in the current guidelines, the extra revenues arising from prices above the reference are to be used in ways that improve public sector net worth – i.e. capitalising the Oil Stabilisation Fund, reducing the public-sector debt, financing pressing infrastructure needs at the federal, state and local government levels and strengthening the financial position of PEMEX itself. With these rules in place, legislators and the public at large are likely to understand that additional revenue from a predictable source is required to finance higher spending of a recurrent nature. They also have to be convinced that additional public resources will be used in an efficient manner, which certainly requires close monitoring and evaluations as well as policy measures to improve the quality of spending and the impact of programmes.

Large-scale investment in PEMEX exploration and production is needed

Oil revenue has been extracted from the state-owned oil company, PEMEX, in a manner that is reducing the long-term return from this revenue source. Until now, raising investment in the oil sector has meant either fiscal policy tightening or issuance of public debt – through PIDIREGAS schemes. The new tax regime for PEMEX is an improvement and, according to new budget rules, PEMEX will get a larger share of any revenue windfalls. But more should be done, along the following main lines of action:

- Reforming the corporate governance of PEMEX to strengthen incentives for maximising the company's efficiency and introducing more independent commercial experience on the Board. The accountability of the company's Board and management should also be increased.
- Improving the framework for PEMEX investment decisions.
- Assessing whether the additional resources PEMEX gets with the newly introduced fiscal regime are sufficient for the company to undertake adequate oil-field maintenance and investment.
- Restrictions on PEMEX entering into joint ventures will have to be eased even if this requires changes in legislation. This will be important to enable the company to access the technology it needs and help it to better manage risk exposure in developing deep water resources, which are large and difficult projects.

A detailed discussion on PEMEX is included in Annex 2.A1.

Measures to strengthen public finances should not be delayed

Aware of the importance of strengthening public finances to avoid problems in the future, the government submitted to Congress in June 2007 a comprehensive public finance reform, which includes four main pillars: i) strengthening of the tax administration to facilitate tax compliance and tackle tax avoidance and evasion more effectively; ii) establishing an institutional structure for systematic impact evaluation of public programmes at the three levels of government to improve spending efficiency; iii) reviewing relations between levels of government, so as to promote responsibility and accountability at each level; and iv) engaging in a tax reform that seeks to reduce the dependence on oil revenue and reinforce more stable sources of revenue. The broad approach that is being followed is appropriate and can help to overcome political resistance against one element of the reform or another. If approved, the reform would imply significant progress in strengthening public finances.

Further improving tax administration

As in other OECD countries, Mexico's tax administration (SAT) faces many challenges: there are the day-to-day requirements of helping to achieve budget revenue targets and providing adequate services to taxpayers, against a backdrop of significant and diverse non-compliance issues, and the on-going need to develop a competent and trustworthy workforce, information technology services, and internal financial management. Mexico also faces some additional – although not unique – challenges. There is a considerable number of individuals who should be, but are not, registered for tax purposes and overall revenue leakage is substantial. Tax revenue collection is seriously affected by weak compliance, even in the formal sector. At the same time, in international comparison, the administration appears to be understaffed.⁸ Audit activities are relatively small in scale – and have been on a declining trend in recent years. A related issue is the substantial level of unpaid tax debts which is very high in international comparison (reaching 34% of annual revenue collected in 2004, compared with less than 10% for Brazil and Spain and about 13% for Hungary).

The government's proposal includes some measures to facilitate voluntary compliance to tax obligations as well as measures aimed at reducing tax evasion and taxing the informal sector, including the following: i) a simplification of the personal income tax regime (the fiscal subsidy that currently mitigates inequality created by the non-taxation of fringe benefits will be incorporated into a single tax rate, a measure expected to be revenue neutral); and ii) the introduction of a new tax on cash deposits over 20 000 pesos per month (about 2 000 US\$), which will be recoverable against the income tax.⁹ By raising the perception of fairness in taxation, the tax administration measures are important for the success of the overall public finance reform.

Seeking efficiency gains in public spending

Efficiency gains in spending are needed at all levels of government. They can go some way towards limiting new funding needs.¹⁰ Two main examples among the various areas to be addressed can illustrate the need to implement efficiency-enhancing reforms. In the education sector, in particular, measures are needed to increase efficiency and improve the quality of teaching.¹¹ The most promising options include:

- making better use of existing evaluations to influence policy decisions;
- further strengthening teachers' selection and training, and ensuring that the existing financial incentive scheme (*Carrera Magisterial*) promotes good performance;
- raising the share of educational funding that goes to non-wage expenditure, which international experience has shown to be essential to the quality of teaching;
- better balancing of education spending across education levels, giving more priority to secondary schooling, in particular upper secondary, where more and better services have to be offered to coming cohorts;
- giving more priority to states that have the largest enrolment lags, which would bring benefits both in terms of equity and efficiency.¹²

Another area to tackle is the use of subsidies in many areas: for instance, water, electricity and gasoline (where price at the pump did not rise with crude oil prices). These subsidies distort incentives, and are regressive and costly for public finances. They also are detrimental for the environment and long-term energy efficiency of the economy.

Removing subsidies and using part of these funds for direct cash transfers to the poor when appropriate would achieve several policy goals simultaneously:

- helping to reduce distortions in the economy and encourage investment in areas of vital importance for growth and living standards, including water and electricity infrastructure;
- helping to reduce poverty by directly augmenting the incomes of the poor;
- improving income distribution by increasing the progressivity of public policy;
- enhancing the fiscal position by reducing overall expenditure;
- increasing incentives for consumers to be more efficient.

The government proposal currently under consideration to increase spending efficiency and improve resource allocation involves setting up a performance evaluation system which will aim at evaluating economic and social impact of government programmes. A National Council for the Evaluation of Public Policies would be created, and the scope of the current Council of Social Development Policy Evaluation (CONEVAL) would be expanded so that it can evaluate all policies at the federal level. The results of the evaluations would be made public, and they would be used to influence policy decisions. The use by sub-national governments of federal grants (*i.e.* earmarked grants) and federal subsidies would also be evaluated by local independent institutions to assess whether they attain their objectives.

It is an ambitious project made of two main components: the evaluation of programmes and the evaluation of the public administration. Once the new system is approved, plans are to develop the evaluation programme in 2008, so that it can be implemented in preparing the 2009 draft budget. Since there are some already well-identified weaknesses in various spending areas, for instance, education and subsidies as mentioned above, action to address these could be undertaken without further delay.

Measures are also proposed to provide greater certainty to public infrastructure investment and reduce costs. The procedures for determining investment priorities in the Expenditures Budget would be strengthened. Furthermore, the federal government would be required to develop an investment plan, ranking projects over the short, medium and long term, according to their socio-economic returns, including considerations of their impact on poverty and their consistency with other investment projects. Multi-annual budgets for investment projects in infrastructure would also have to be established. These measures, if approved and implemented, would provide more certainty to public investment and contribute to reduce the financial cost of projects.

Equally important is the question of state and local government spending on infrastructure development. While there are large transfers to states, including from the special funds created from oil-revenue windfalls, there is a lack of accountability at the sub-national level. The government's proposal envisages standardising government accounting across the three levels of government, a measure recommended in the OECD *Economic Survey of Mexico* (2005) to promote transparency and accountability.

Revamping relations with sub-national governments

Fiscal relations across levels of government can be improved. Sub-national governments have been receiving increasing transfers from the federal government, coupled with spending responsibilities, but accountability is weak. Some of the recommendations made by the OECD in its 2005 *Economic Survey of Mexico* are particularly

relevant to enhance the soundness of public finances.¹³ On the revenue side, it is important that states and local governments share in the effort to raise more revenue nationwide, using the taxing powers they enjoy. Transfers from the federal government should not be increased further, so as to give sub-national governments an incentive to raise their own revenue to finance part of the new spending they are responsible for. This would increase responsibility. On the spending side, the share of the budget channelled to states and municipalities for investment has increased from less than one-third in 2000 to nearly 40% in 2005.¹⁴ However, there is little control on how the recent additional resources transferred to sub-national governments are being used. The lack of accountability is a concern for all earmarked grants more generally, for instance, FAIS for social infrastructure or FAEB for education. Controls on their use exist practically only at the local level. There is no way to ensure that the grants are spent for the purpose they are designed for in the first place. Positive incentives or sanction mechanisms are absent and information is not well-developed. Because the amounts transferred are substantial, increasing accountability at the sub-national level has become all the more important. It could help if taxpayers (hence voters) were better informed about the responsibilities (and accountability) of the various levels of government in the provision of public services.

The reform proposal includes a number of specific measures to improve fiscal relations across levels of government. First, the proposal seeks to give more possibilities to states and municipalities to raise their own taxes: sub-national governments would be allowed to establish a specific tax on the final sales of goods already taxed through a federal excise tax (IEPS); and in the medium-term, the tax on vehicle property would be replaced by a state-level tax. Second, incentives to collect tax revenue would be strengthened. In particular, the revenue-sharing formulas would be modified so that the future increases in transfers would be distributed according to the states' growth performance and its efforts at collecting taxes. Third, the proposal envisages changes in the allocation of earmarked grants across sub-national governments. The objective is to increase the redistributive component of these transfers and to better reflect local needs. For instance, in the case of the earmarked funds for education (FAEB), the increase in transfers would be allocated across states according to the number of students enrolled in the public schools of the state (and an index measuring quality – to be developed by the Ministry of Education). The measures in the proposed reform of fiscal relations tackle some of the areas of concern identified in the 2005 *Economic Survey*. An important step to help the monitoring of the use of public funds at the sub-national levels of government would be to promote the publication of standardised financial accounts, as noted above.

Moving ahead in tax reform¹⁵

Beyond what can be achieved to release some additional revenue at all levels of government through efficiency gains on the spending side, a tax reform is needed to both increase revenue and reduce distortions. Clearly the tax system is not robust enough to finance additional spending already committed and incompressible, which, as noted above, is substantial.

Mexico's taxes in comparison

A comparison of Mexico's tax system with those in other OECD countries, based on standardised revenue statistics, shows a much lower tax-to-GDP ratio in Mexico – at 19% in 2004, a number falling to about 15%, excluding oil revenues. This is well below the OECD

Table 2.1. **How Mexico's tax system compares with other OECD economies**

	Tax/GDP	Percentage of total tax revenues			TOP PIT rate	CIT rate	TAX wedge ⁴	TOP rate on dividends	Standard VAT rate
		Personal income tax (PIT)	Corporate income tax (CIT)	Consumption tax					
	2004	2004	2004	2004	2005	2006	2005	2006	2006
Mexico	19.0	24.6¹		55.5²	30.0	29.0	18.2	29.0	15.0
Canada ³	33.5	35.1	10.3	25.9	46.4	36.1	31.5	50.9	7
United States	25.5	34.7	8.7	18.3	41.4	39.3	29.2	48.7	0
Australia	31.2	40.2	18.2	28.5	48.5	30.0	28.4	46.5	10
Japan	26.4	17.8	14.2	20.0	50.0	39.5	27.7	45.6	5
Korea	24.6	13.6	14.3	36.3	38.5	27.5	17.2	48.7	10
New Zealand	35.6	41.0	15.5	33.8	39.0	33.0	20.5	39.0	12.5
France	43.4	17.0	6.3	25.6	55.9	34.4	50.1	55.9	19.6
Germany	34.7	22.8	4.5	29.2	45.2	38.9	51.9	52.4	16
Italy	41.1	25.4	6.9	26.4	44.1	33.0	45.4	44.8	20
Spain	34.8	17.7	9.8	28.0	45.0	35.0	39.0	50.0	16
United Kingdom	36.0	28.7	8.1	32.0	40.0	30.0	33.5	47.5	17.5

1. Mexico reports a combined share of PIT + CIT.

2. Tax revenue under the consumption tax for Mexico includes all oil-related taxes (in the standard OECD revenue statistics, the taxes on the production, sale, transfer, leasing and delivery of goods and rendering services include that part of the profits of state-owned enterprises that is transferred to the general government).

3. The VAT rate for Canada is the Federal Government Rate. Some provinces also levy a VAT.

4. The tax wedge is the difference between the costs to an employer of employing an unmarried worker with no children and the net wage that the worker receives after tax, as a percentage of the employer's costs.

Source: OECD, Tax database.

average (36%) and other “low tax” countries, such as the United States or Korea (Table 2.1). Even in comparison with other countries in Latin America, such as Brazil, Argentina and Chile, Mexico's tax-to-GDP ratio is low.

The relatively low tax/GDP ratio in Mexico is coupled with a tax mix that is skewed towards goods and service taxes. Indeed, personal and corporate income taxes provide only 25% of overall tax revenue in Mexico, compared with 34% for the OECD average and 43% for the United States (in 2004, Table 2.1). Similarly, social security contributions provide only 17% of total revenue, against 26% for the OECD average. Balancing this, reliance on goods and services taxation is relatively high although this reflects mostly the fact that taxes on oil production and sales are included in this category. Excluding oil-related taxes and focusing on VAT, the share of VAT in total tax revenue is 19% in Mexico, about the same as the OECD average. Other significant Latin American countries have an even lower share of income tax than Mexico and similar shares of taxes on goods and services, but in their case this generally does not include high oil taxes.

Considering tax rates, the top rate of personal income tax – at 30% in 2005 – was lower than the average for OECD countries, many of which have top rates of more than 40%, and it was reduced to 28% in 2007. At the same time, Mexico's corporate income tax rate – 29% in 2006 – was in the middle of the range for OECD countries and it was also brought down to 28% in 2007. Finally, Mexico's tax wedge (including social security contributions) in per cent of gross labour costs stands at 18%, well below the OECD average or the United States.

Mexico's VAT rate of 15% is somewhat below the OECD average although Japan, Switzerland, Korea, Australia and New Zealand have lower rates.¹⁶ Other OECD countries have rates of up to 25%. In comparison with major Latin American countries, Mexico is the

lowest rate country for VAT. Equally important, Mexico has the narrowest VAT base in the OECD, with tax paid on only 30% of consumption expenditures, compared with over 50% for most OECD countries.

In sum, Mexico stands out in the OECD with a tax-to-GDP ratio well below other countries, while its statutory tax rates are simply towards the low end of the range. The picture is fairly similar when Mexico is compared with other major Latin American countries. This suggests that the bases on which Mexico's taxes are levied are significantly narrower than in other OECD countries. A revenue-enhancing tax reform should therefore concentrate on broadening the base and further strengthening the tax administration. The main concerns are the preferential regimes and deficiencies in tax administration (which are closely related). The preferential regimes, besides diluting revenue and complicating administration *per se*, create significant loopholes, distort economic activity and facilitate evasion.¹⁷ They also create a perception of unfairness, which reduces the willingness to pay taxes.

The tax reform proposal

The government's proposal envisages introducing a minimum general tax on firms and professional activities as well as an excise tax (IEPS in Spanish) on gambling and lotteries and an excise tax on spray paint. Together, the proposed tax administration measures and the tax reform are expected to generate additional revenue of close to 3% of GDP by 2012.

The Unique Rate Corporate Contribution (CETU) is a minimum general tax that would be applied on a broad basis, tackling the exceptions, tax deductions and preferential regimes in the income tax that currently create distortions. It would be a direct tax on firms and professional activities, at a rate of 19%, to be applied on the firms' revenues from the sale of goods, the provision of services and the temporary grant for the use of goods, after deduction of capital spending. The CETU would act as a minimum tax for the income tax. It would be compared with the firm's income tax and the income tax withheld by the firm for third parties including the employment credit, and the higher of the two taxes would be paid (Box 2.2). The CETU would substitute the "asset tax" which would be abolished. The estimated increase in tax collection from the CETU would mainly come from base broadening. Additional revenue would also be expected from improved tax administration and better compliance to fiscal obligations.

Medium-term challenges

Regarding *income taxes*, measures have been taken in recent years to eliminate various preferential regimes both for corporate and individual tax payers. The corporate income tax rate has been cut and the top marginal rate of individual income tax has been reduced (as well as the number of brackets). Some of the reforms made over this period under the personal income tax regime did not have the expected impact and the calculations to comply with the tax obligations remain complicated. The scope of tax expenditure has been broadened, and there are still exemptions, tax deductions and preferential regimes on a range of economic activities that create uneven incentives and complicate tax administration. The proposed minimum general tax (CETU) would tackle some of these problems.

In the longer run, consideration will have to be given to further broadening the tax base by taking measures on the *value added tax* (VAT) side. Numerous exemptions and a large proportion of zero-rated goods and services in the VAT system imply that only a small

Box 2.2. The minimum tax on firms and professional activities (CETU)

The main advantage of the proposed CETU is that it would broaden the tax base and contribute to raise tax revenue. Capital spending, which includes machinery, equipment, land and constructions, inventories, expenditures related to the acquisition of goods, and independent services or the temporary use of goods that the taxpayers use for their income-generating activities, would be deducted. The CETU would not operate as a “payroll tax”, because it would be complemented by an employment credit applicable to the tax, the credit being higher for low-income workers.

A transition period of two years has been proposed; the tax rate would be 16% in the 2008 fiscal year, and 19% from 2009 onwards.

The information required for the CETU would be a part of what any business currently has to prepare for their income tax payment, and the tax base would be similar to that of the VAT, with the deduction of the capital investments as the only difference. As a result, firms would not be expected to be subject to additional administrative burdens nor would they have to create new fiscal accounts.

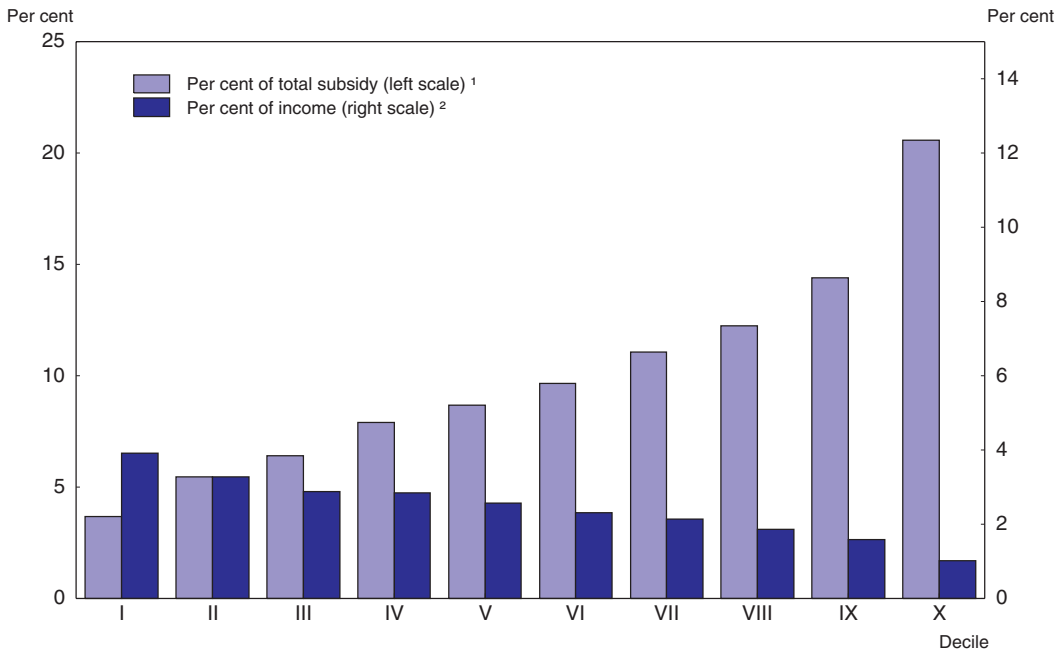
part of the potential base is actually being taxed. It also contributes to low VAT compliance as some transactions are falsely attributed to the zero-rated base. An indicator of the effectiveness of the VAT in raising revenue can be measured by the effective VAT rate (share of VAT revenue to national consumption) in per cent of the standard VAT rate. Thus measured, the effectiveness for the OECD is just above 50%. Mexico is at the low end with the lowest VAT efficiency (about 30% in 2003), indicating that only a small part of the potential base is actually taxed – the likely result of the narrow tax base and poor collection capacity, while the standard tax rate is not particularly low. By contrast, several OECD countries, including Canada, Japan, Korea, Luxembourg, New Zealand and Switzerland have efficiency indicators higher than 65, pointing to VAT bearing uniformly on a broad range of consumption combined with effective tax collection. Thus, VAT has proved to be a buoyant source of tax revenues in OECD countries, each having a specific mix of rates, exemptions and thresholds. Mexico stands out as the country with the lowest revenue-raising capacity from VAT.

OECD experience shows that complex VAT systems create administrative burdens and reduce the compliance of taxpayers. Simplifying the VAT system in Mexico, by reducing the scope of exemptions and zero-rating, would bring in substantial additional revenue and facilitate tax control.¹⁸ For example, increasing VAT efficiency to the OECD average would increase VAT revenues by around 2% of GDP, with additional revenue to be expected from having a less complex regime to administer, hence closing loopholes that facilitate evasion. Other OECD country experience also suggests that it might be appropriate for Mexico to raise the threshold for VAT registration as this would enable the tax administration to concentrate its efforts on collecting worthwhile amounts of revenue.

A key issue is the impact that a broadening of the VAT base would have on the progressivity of the tax system. Although zero rating and exemptions under VAT are often perceived as a way of reducing inequality, it is actually the most affluent households that gain most from them as they buy more goods in general, including goods that are zero rated. Given the distribution by income deciles, high-income households are actually heavily subsidised by the non-taxation of many consumption goods. Calculations for 2005


show that the highest two deciles together capture close to 35% of the value of the implicit subsidy, while the lowest two receive less than 10%, although as a share of income, the subsidy is highest for low-income brackets (Figure 2.4). About half of the increase in revenue from base broadening would come from the higher income categories (the three highest income deciles). If part of this revenue was redistributed to the three lowest deciles, it would more than compensate them for the loss of subsidy on their food consumption, and there would still be extra revenue to spend on social programmes.

Figure 2.4. **Distribution of implicit VAT “subsidy”, 2005**



1. The implicit VAT subsidy at each income decile is estimated by the corresponding expenditure on food multiplied by the standard VAT rate of 15%.
2. The consumption of food and household income per decile (referring to total income) are based on the INEGI 2005 Household Survey.

Source: INEGI, “Encuesta nacional de ingresos y gastos de los hogares 2005”; OECD calculations.

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There are many options available to compensate the poorest categories when broadening a consumption tax base, including applying reduced rates to basic necessities and/or direct income transfers to the lower income population groups. Some relevant examples from other countries are noted in Box 2.3.

Another potential area for reform is the *real estate tax*, which is administered by the municipalities. This tax accounts for the bulk of municipalities own revenues (59% in 2004), but its proceeds – at 0.2% of GDP in 2004 – are much lower in Mexico than in most other OECD countries (the OECD average is 0.9% of GDP, with ratios as high as 3.3% in the United Kingdom and 2.8% in Canada or the United States). Real estate taxes are less easy to evade than taxes on financial assets and are generally regarded as having little distortionary effect. A main limitation to effective collection through this tax in Mexico has been the outdated land register (leading to undervaluation of property) and lax local administration and enforcement of collection. Contrasting with practices in many other OECD countries (including Belgium, France, Japan and Spain), in Mexico the register is

Box 2.3. Lessons on VAT reform from other countries

Mexico is not alone in finding it difficult to broaden the base of VAT. Although many OECD countries have increased their rates of VAT over the past thirty years, there are very few cases in which countries have broadened its base, partly reflecting the political difficulties that would arise. Despite this lack of experience of broadening VAT bases, there is considerable experience to be drawn from countries broadening the base of their indirect taxes – mainly in the process of adopting a VAT. Relevant lessons can be drawn from these examples because the process involves similar issues as broadening the VAT base, i.e. the concern that poor people would lose from extending taxation to goods that are seen as necessities. In many cases, countries have adopted VAT because of some over-riding political necessity. For instance, for many countries in Central and Eastern Europe, adopting VAT was the necessary price of joining the European Union. Many economies in transition and developing countries have adopted VAT systems because they were seen as the only way of raising sufficient revenues to finance development.

Even when VAT is seen as a necessity, governments have taken steps to minimise any adverse effects that it may have on poor households. Most OECD countries apply reduced rates and/or exemptions to particularly “sensitive” goods although the scale of these is generally much smaller than in Mexico. As noted above, the strictly economic logic of this approach is not compelling. Other compensation mechanisms are undoubtedly more effective. For instance, Canada introduced a payable tax credit (which the household would receive even if they paid no income tax) into the personal income tax system for low income households. More generally to compensate for the price rises produced by VAT, developed countries have increased benefits for the poor, the unemployed and the elderly.*

* In developing countries, exemption of sectors such as small-scale agriculture is often viewed as a better approach than zero rating. This is because such exemption gives favourable tax treatment to food consumed mainly by the poor at the same time as reducing the burden on the tax administration of assessing large numbers of small farmers for VAT.

managed by local governments and, in a few cases, by the states. Updating it entails high political costs in the short-run, while benefits may not be immediate, so that sub-national governments have been reluctant to update registers. It would be appropriate to change this practice and give administrative responsibility for re-evaluating the land register to a national agency (from the public or private sector). Upgrading the land register would allow to increase tax revenues in a fair way and it would increase taxing powers of sub-national governments. With a sufficiently high lower limit, it would be possible to achieve a progressive profile, thereby contributing to taxing the highest-income individuals more heavily, as wealthy people usually hold a substantial proportion of their wealth in the form of real estate.

Administrative feasibility is an essential feature of any tax reform programme. Tax administration reforms carried out across the OECD over recent years share some common features, including:

- Establishing institutional arrangements that provide adequate autonomy to the tax administration, as is the case in Mexico and providing it with adequate powers for the conduct of compliance-checking functions, tax debt collection, and appropriate sanctions for tax offences. In Mexico, however, excessive use of judicial proceedings (*amparos*) can undermine the implementation of sanctions (Chapter 4).

- Creating a single revenue body to collect both direct and indirect taxes – and increasingly social contributions. Typically, these bodies are organised on a functional basis, but with a dedicated organisational unit responsible for the administration of its most important taxpayers (*i.e.* large businesses and non-profit bodies). Only 6 of the 30 OECD countries administer tax and customs from within a single agency as Mexico does, with Canada deciding in 2003 to separate the administration of tax and customs.
- Increasing application of risk management techniques to identify major compliance risk areas (*e.g.* the informal sector) and to assist the formulation of a balanced set of responses (*i.e.* service and enforcement).
- Increasing the use of modern technology for the delivery of services to taxpayers (*e.g.* information provision to taxpayers, electronic filing of tax returns and the collection of tax payments, as well as for operational risk profiling purposes (*e.g.* for audit case selection and debt collection).
- Intensifying efforts to increase staff competences.

Although Mexico's tax administration has taken some steps in these directions over the past years, there is still considerable scope for progress. If approved, the tax administration measures included in the government's proposal would go some way to further strengthening compliance and tax control.¹⁹

Concluding remarks

To support Mexico's growth process, public finances should be put on a firmer footing. This requires improving public spending efficiency and strengthening accountability of spending entities at all levels of government, improving further tax administration and introducing a revenue-raising tax reform. The government's proposal for a wide-ranging public finance reform, if approved, would imply significant progress along those lines. In the current context, it is particularly relevant to raise awareness on some of the concerns and fragilities noted above: i) the need to meet spending commitments in education, health care and social policies; ii) the depletion of Mexico's oil reserves; and iii) the importance of developing basic infrastructure for long-term growth. Taking action to improve the cost-efficiency of spending would also strengthen the case for a tax reform. Moving ahead with tax reform to address some of the underlying weaknesses of the tax system is a priority. It is important to launch the reform process without delay. By introducing some key revenue-enhancing measures before the end of 2007, the government can facilitate budgeting next year and, in the future, creating the reliable sources of additional tax revenue that are needed and reducing the dependence on oil revenue.

Achieving sound public finances should go hand-in-hand with a modernisation of the corporate governance of PEMEX. A summary of recommendations to consolidate public finances is included in Box 2.4.

Box 2.4. Main recommendations for strengthening public finances

The fiscal framework

- Ensure that fiscal rules and guidelines are implemented, extra resources of a non-recurrent nature should be oriented to non-recurrent spending, to be saved or invested.

Enhance the efficiency of public spending

- Launch a systematic evaluation of the impact of public programmes and start addressing weaknesses that have already been identified, with no delay.
- In the education sector, better balance education spending between wage and non-wages expenditure. Develop the evaluation of teachers and schools and use results to provide feedback and influence policy. Review the financial incentive scheme for teachers, *Carrera Magisterial*, so that it rewards performance.
- Reduce subsidies (in water, electricity, gasoline), using part of the funds for direct cash transfers to the poor, as appropriate.

Review powers and responsibilities of sub-national governments

- Strengthen state and local governments' accountability. Put in place standardised public accounting and information bases to facilitate monitoring of the impact of fiscal policy at the national level.
- Limit the growth of federal transfers, to give sub-national governments an incentive to use their taxing powers.
- Review the allocation of federal transfers to states, using objective criteria as a base – e.g. education transfers should be allocated in proportion to the number of children in school age in the state.
- Review the property tax, to increase the tax capacity of municipalities (consider creating a national agency to take responsibility of property revaluation in land registers).

Increasing tax revenue while reducing distortions

- Introduce a multi-faceted tax reform that enhances revenue by broadening the tax base, reduces distortions and simplifies the system.
- Under direct taxation, reduce the scope of exemptions, tax deductions and preferential regimes, to improve both efficiency and equity.
- Consider further broadening the tax base by taking measures on the VAT side. Reducing the scope of zero-rating under VAT would contribute to raise more revenue while reducing distortions. As part of the VAT reform, consider taking measures to provide some compensation to low-income families. Consider raising threshold for application of VAT, to facilitate compliance and tax control.
- Further strengthen tax administration.

The public sector employees' pension systems

- Building on the recent reform of the federal government employees' pension system (ISSSTE), extend the reform process to the other sub-systems for the various categories of public sector employees.

Make changes to the way PEMEX is managed, within the current legal framework

- Improve the governance of PEMEX to ensure that the company can operate as efficiently as a private oil company; reduce the government's interference in management, removing public works constraints that apply to PEMEX projects.
- Assess whether the new fiscal regime applying to PEMEX allows the company to have sufficient resources to undertake adequate investment.
- Reconsider existing constraints on PEMEX with a view to allowing the company to enter joint ventures with private companies that can bring the new technology that will be required for some of the future investment projects.

Notes

1. Mexico has used public-private investment projects under PIDIREGAS schemes since 1997 to develop infrastructure projects – especially in the state-owned oil company (PEMEX) and electricity company (CFE). Under the scheme, the private sector (which does not share the financial risk of the project) finances and builds infrastructure, with payment by the public sector deferred until completion of the project. Liabilities created by these schemes are recorded in the public debt in the broad sense (which amounted to 34.3% of GDP at the end of 2006, against 20.3% for the public sector's net debt (narrow definition).
2. The 2007 oil reference price for the Mexican mix – 42.8 d/b compares with a 2006 average price for the Mexican mix of 53 d/b, about 9 d/b below the OECD oil import price. The average oil export volume, on which the 2007 budget is based, is 1 648 million barrels a day (mbd), close to the exports recorded in the 4th quarter of 2006 and at the start of 2007. It is about 9% lower than the 2006 average (1 793 mbd).
3. The official estimate (published in 2005) includes both investment needs and what is required to bring enrolment of 5 to 14-year-olds up to the OECD average.
4. To the 3.56 million families covered by the programme at the end of 2005 – 11.4 million people, about one third of the “uninsured” population, 1½ million more families were included the following year. The “health insurance for the first generation” created in 2007 gives priority to the youngest age group in the coverage increase.
5. Low net rates of return on savings accounts have implied that pension benefits in many cases were lower than the minimum pension benefits. See Chapter 5 on the 2007 reform of the system of pension savings (SAR).
6. These projects consist mostly of PEMEX infrastructure investment projects constructed by the private sector but financed by public sector debt. The revenue flows generated for PEMEX by these capacity-enhancing projects finances the amortisation of the investment; but, at the same time, the older PEMEX installations are generating less and less revenue. The electricity sector has also resorted to PIDIREGAS schemes, which have represented about 14% of total PIDIREGAS investment.
7. Oil prices are notoriously difficult to forecast accurately; technically, oil prices follow a random walk, i.e. tomorrow's oil price is today's oil price plus an unknown shock. In this case the best forecast of tomorrow's oil price is today's.
8. Mexico has only one member of the tax administration for every 1 600 members of the labour force, as compared to the OECD average of about one to 600.
9. Furthermore, the proposal envisages that deposits amounting to above 1 million pesos during a year will be considered as income, if the individual is not registered in the taxpayers registry.
10. Every OECD country is seeking ways of getting more value for money. The OECD Economics Department is currently involved in a project aimed at drawing cross-country comparisons of efficiency in the provision of public services, and relating institutional and policy settings with higher efficiency of public spending.
11. On recommendations to improve efficiency and equity in the education sector, see S. Guichard (2005), “The education challenge in Mexico: delivering good quality education to all”, *Economics Department Working Paper*, No. 447, OECD, Paris.
12. In particular, federal transfers to states for education should be allocated in proportion to the number of children in school age in the state.
13. See also I. Joumard (2005), “Getting the most out of public sector decentralisation in Mexico”, *Economics Department Working Paper*, No. 453, OECD, Paris.
14. This includes additional transfers on account of extra revenue from oil since 2003. Transfers to states for investment are channelled through traditional earmarked grants (*ramo 33*) and the more recent Programme to Support the Strengthening of Federal Entities, PAFEF (*ramo 39*), which all include an investment component.
15. This section is largely based on B. Larre and C. Heady, “Fiscal policy and tax reform”, in *Getting it right: OECD perspectives on policy challenges in Mexico*, February 2007.
16. Comparisons of standard VAT rates are available in OECD (2006), *Consumption Tax Trends*.
17. Tax evasion was estimated by the tax administration to have reached about 3% of GDP in early 2007, slightly less than in the previous years.

18. In addition to standard exemptions for “social” purposes – education, health and charities – which are applied in the majority of OECD countries, Mexico has exemptions for specific sectors: public transportation of passengers by land; agriculture, forestry and fishing activities. Zero-rated goods in Mexico include all non-processed food, which is also the case in a few other OECD countries. For instance, caviar and smoked salmon are under zero rating [see OECD (2006), *Consumption Tax Trends*].
19. In particular, the proposal includes the following: developing a personalised portal for professional individuals and micro and small-size entrepreneurs; strengthening proceedings for audit and controls; better controlling tax rebates; and fostering the use of the “electronic signature” (FIEL).

ANNEX 2.A1

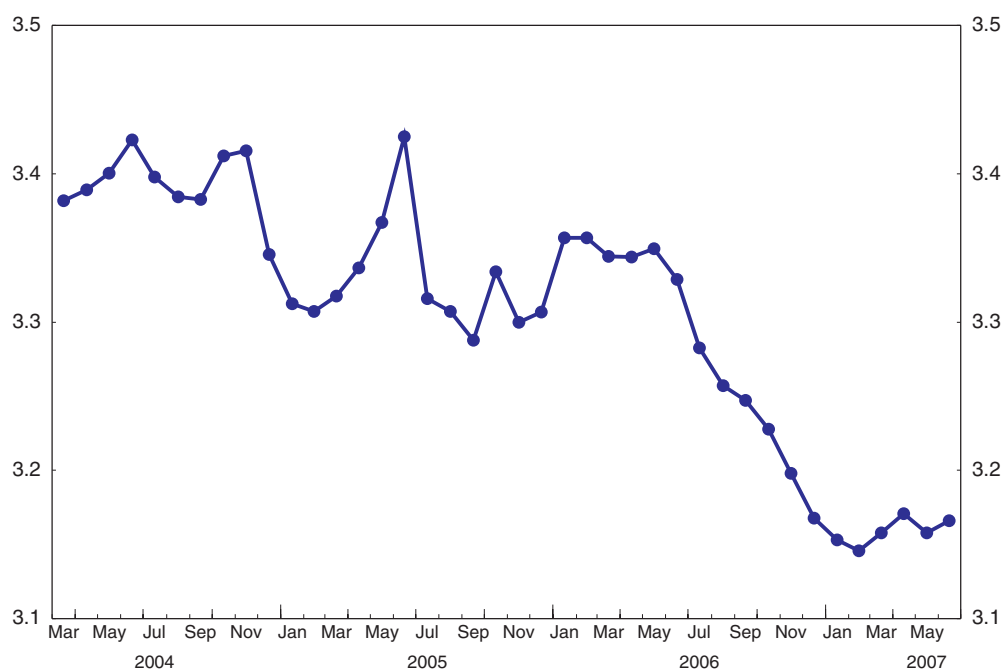
PEMEX exploration, production and governance issues

The Mexican constitution reserves exclusively to the state the right to exploit hydrocarbons (oil and gas) resources of Mexico and by law, *Petróleos Mexicanos* (PEMEX), is granted the right to develop these resources on behalf of the state.¹ Nearly 40% of total budget revenue is derived from oil related sources, but this source of revenue is under threat because of Mexico's declining oil reserves and production.

From 1998 to 2005, the company made ongoing losses, its debt quadrupled, and by 2005 liabilities reached 115.2% of sales. Operational inefficiencies and a heavy tax burden contributed to these losses. This financial situation has constrained the firm's ability to invest in new exploration and production, and even the 2007 investment budget of US\$14 billion may not be sufficient to prevent oil reserves and production from falling further.² For about ten years now, some of PEMEX investment needs have been financed through the public-private PIDIREGAS schemes (investment projects completed and delivered by the private sector and then paid for by PEMEX). Nonetheless, investment has not been sufficient to prevent reserves and production from declining. From 1998 to 2006, proven gas and oil reserves (i.e. on which there is a reasonable certainty of recovery), fell from 25 to 15 billion barrels equivalent in crude oil. Of proven reserves, around 11 billion barrels are in crude oil, which is equivalent to approximately 9 to 10 years' worth of production at current extraction rates (of these, approximately 8 billion barrels are developed, i.e. there are existing wells). Over the same period, total reserves of oil and gas with a lower probability of recovery – “probable” reserves with at least 50% probability of recovery and “possible” reserves with a probability of at least 10% – also fell, from 33 to 30 billion barrels of oil equivalent.³


Mexico's total oil production has been falling since 2004, with the decline becoming steeper in the course of 2006. Total production fell from 3.35 million barrels per day (mbpd) in May 2006 to 3.17 mbpd in April 2007 on a 3-month-moving average basis (Figure 2.A1.1). An important factor contributing to this decline is shrinking production in the large, shallow water and easily developed oil field, Cantarell, which accounts for around 55% of total production. Production there is expected to fall from around 1.8 mbpd in 2006 to 0.6 mbpd by 2015. PEMEX needs to compensate for this decline by a production increase in other fields that are more technically difficult and/or costly to develop, including Chicontopec and Ku-Maloob Zaap, and eventually fields in deep waters. Chicontopec is onshore, in heavily populated areas, spread out and fractured (i.e. the oil is in many separate reservoirs). It also requires new technological solutions and a large increase in well drilling over present levels. Developing deep water fields is technically demanding and will require PEMEX to use new technology that it currently does not employ.

Figure 2.A1.1. **Oil production**
Barrels per day (millions)¹



1. Three-month moving average.

Source: PEMEX.

StatLink  <http://dx.doi.org/10.1787/104303331671>

Changes will have to be made to prevent further production declines. The governance and operation of the company should be changed with a view to improving PEMEX's efficiency in developing oil resources. The investment framework applying to PEMEX should also be altered to give the company greater flexibility in its decision-making and allow it to make investments according to commercial best practice. Because of the time lags involved between the increase in investment and that in production, the reform should not be delayed. It is also important that the new fiscal regime applying to PEMEX be carefully monitored to ensure that the company has sufficient resources to develop the country's oil reserves.

Governance, management and operation of the company

Other national oil companies, including Petrobras (Brazil), Statoil (Norway) and PetroChina, have moved to a corporate-like structure and seen improvements in operating and financial performance. To ensure the best returns from Mexico's oil resources and production stability in the medium term requires improvements in the efficiency and financial performance of PEMEX. Mexico should reform the governance of PEMEX in line with the OECD's *Principles on Corporate Governance 2004*. Specific measures that should be taken include: introducing independent commercial directors to the Board; creating Board sub-committees for audit, nomination and remuneration, procurement and works, and finance; increasing the autonomy and accountability of the Board; and management for meeting clearly defined targets that are transparently measured over time and

benchmarked internationally.⁴ Audit activities need to be streamlined and re-orientated towards value creation rather than compliance with procedures, and the auditors should report to the Board rather than to another government agency as done at present.

As it becomes financially independent, PEMEX will have to be more accountable as well. While its capacity to plan and carry out investment needs to be strengthened, there is also a need to substantially rationalise its current operating spending. On the operational side, employees cannot be transferred from one part of the business to another. This is a significant constraint on efficiency, and it creates a bias towards overstaffing. Greater labour flexibility is needed so that employees can be moved around the business and projects in line with changing demand. There should also be a review of the need for the large in-house non-core medical and telecommunication services to assess whether these services could be acquired at lower cost outside the company.⁵ PEMEX also has a large, unfunded pension liability of approximately US\$40 billion. The PEMEX pension scheme should be reformed, building on the reform of the federal government pension scheme (ISSSTE) which was passed in 2007.

The investment framework

PEMEX's budget is incorporated in the public sector's annual draft budget, which is sent to the Congress for approval. The process subjects PEMEX's planning to excessive uncertainty and does not allow multi-annual budgeting, except for PIDIREGAS. However, PIDIREGAS investment projects are subject to a cost cap. Using a cost cap helps limit the company's expenditure in the absence of an adequate corporate governance framework, but there is a risk that it constrains investment decisions. The requirement for PEMEX to comply with the law on ordinary public works should be eased. The rules and procedures are too inflexible for large complicated investment projects in the oil industry and have resulted in cost overruns and poor asset performance in the past.

Finally, PEMEX uses public works contracts to engage the private sector in production projects, including drilling. However, these contracts are limited in scope and are not suitable for deep water field development. It is standard international practice for companies to share the risk in oil investment projects, particularly large and risky ones, such as developing deep water fields. Furthermore, PEMEX will need to access technology from other companies in developing deep water resources, but other companies are highly unlikely to be willing to share the risk and technology without a share of the profits from these projects. Sooner or later, consideration needs to be given to changing the legal framework to allow PEMEX to engage in joint ventures where risk and profit-sharing would be possible.

The fiscal regime

A new fiscal regime was introduced in 2006, so that PEMEX would have additional resources. Under the new fiscal regime, PEMEX taxation declined from 63% of sales in 2005 to 55% in 2006. More time is required to assess the effects of the new fiscal regime. It will be important to monitor the situation and ensure that the company has sufficient resources for the maintenance of current production fields (in the past, production from some wells has ended prematurely owing to a lack of maintenance) and to invest in exploration and production.

Notes

1. PEMEX exclusive activities include: exploring, exploiting, refining, transporting, storing, distributing and selling (first-hand) crude oil and refined products; exploring, exploiting, producing and selling (first-hand) natural gas. It also has the exclusive right to transportation (long-distance high pressure gas lines) and storage of natural gas that are *inextricably* linked with exploitation and production. Other transportation facilities and distribution (low pressure reticulation networks to end users) and commercialisation can now be carried out by the private sector.
2. According to PEMEX CEO, Jesus Reyes Heróles, the company needs to invest US\$15 billion per year to keep production at 3.05 to 3.1 million barrels per day (Dow Jones Newswires, 8/2/2007, www.rigzone.com). On this basis, with an investment budget of US\$14 billion in 2007, production might be expected to fall below the current 3.15 mbpd.
3. *Proven reserves* are the estimated volumes of hydrocarbons, which geological and engineering analysis demonstrates with reasonable certainty will be commercially recoverable in future years from known reservoirs under the prevailing economic conditions, operational methods and government regulations. *Proven developed oil and gas reserves* are reserves that can be expected to be recovered through existing wells with existing equipment and operating methods; a key element of this definition is that capital expenditures for the development of a field should be generally complete or fully committed to. *Probable reserves* are the estimated volumes of hydrocarbons that analysis of geological and engineering data suggests are more likely than not to be recoverable, i.e. there is a probability of at least 50% of recovery; while *possible reserves* are those for which the probability of recovery is greater than 10%. From 1998 to 2006, *probable reserves* fell from 21 billion to 15 billion barrels, while *possible reserves* rose from 12 billion to 15 billion barrels, resulting in a small decline for the total of probable and possible reserves.
4. At present, Mexico's President appoints the CEO and 6 members of the 11-member Board, all of whom are Government Ministers. The five remaining representatives are appointed by the PEMEX Workers Union. The Board does not currently participate in nomination and compensation or strategic planning decisions, and there is no audit committee.
5. Of a total of approximately 140 000 employees in 2005, over 12 000 employees are involved in non-core activities, essentially medical and telecommunication services.

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BASIC STATISTICS OF MEXICO

2006

THE LAND

Area (sq. km)	1 964 375	Inhabitants in major metropolitan areas	
Agriculture area (sq. km) (1990)	394 000	(millions), 2005:	
		Mexico City	19.3
		Guadalajara	4.2
		Monterrey	3.7

THE PEOPLE

Population (thousands)	104 748	Employment ¹ (thousands)	42 342
Inhabitants per sq. km	53.3		
Annual population growth (1990-2006)	1.6		

PRODUCTION

Structure of production (per cent of total, 1993 prices):		GDP (US\$ billion)	839.7
Agriculture	5.2	GDP per capita (US\$, current prices and current PPPs)	11 547
Industry	25.9	Gross fixed capital formation (per cent of GDP, 1993 prices)	21.8
of which: Manufacturing	18.8		
Services	68.8		

THE GOVERNMENT

Public sector indicators (per cent of GDP):		Composition of Parliament	Senate	Chamber of Deputies
Public sector expenditure	24.6	(December):		
Public sector total revenue	24.7	PAN	52	206
Oil-related revenue	9.4	PRI	33	106
Net debt of public sector (December)	20.3	PRD	26	127
		Other	<u>17</u>	<u>61</u>
		Total	128	500

FOREIGN TRADE

Exports of merchandise (per cent of GDP)	29.8	Imports of merchandise (per cent of GDP)	30.5
Main exports (per cent of total):		Main imports (per cent of total):	
Manufactures	81.1	Intermediate goods	73.6
Petroleum products	15.6	Capital goods	11.9
Agriculture	2.7	Consumer goods	14.4

THE CURRENCY

Monetary unit: peso		Currency units per US\$, average of daily figures:	
		Year 2006	10.9031
		June 2007	10.8378

1. People economically active according to results of the *Quarterly National Employment Survey*.