Challenges Facing Tax Administrations in Emerging Economies

Case Study: Mexico

May, 2009
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  - High administrative burden
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  - Effects of the current crisis on the Mexican economy
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Economic and Social Background

Total population: 107.2 million

60.7% of the population is between 15 and 65 years of age

Economically active: 40.6 million

Registered taxpayers (individuals) 29.9 million

Registered taxpayers (legal entities) 1.6 million

Total registered taxpayers 31.5 million
### Economic and Social Background

#### Gross Domestic Product (2008)
- **GDP growth (2008)**: 1.3%
- **GDP average growth (2004-2007)**: 3.8%
- **Inflation (2008)**: 6.2%
- **Major exports (2008)**: Manufactures (80.7%)
- **Major imports (2008)**: Intermediate goods (71.9%)

Mexico has trade and investment agreements with 52 countries.

• The richest 10% of the population concentrates 35% of income, while the poorest 40% receives only 15%.

• In 2000 the per capita income was USD$5,110. Today it stands at US$8,340.

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The size of the hidden economy is around 12% of the GDP.

The hidden economy employs 9.9% of the employed population.

Most of the income in the lowest levels of the population originates in the hidden economy.

It is estimated that the potential revenue from the Value Added Tax would be 0.52% of GDP, while potential Income Tax revenue would be negative due to tax expenditures.

Source: Internal calculations based upon Mexican Bureau of Statistics (INEGI) data, 2003
Only 26% of the economically active population in Mexico has access to banking services. While this number is 23.6% in Mexico City, it is only 6% in rural areas.

In 52% of the towns/cities in Mexico, with a total population of 11.6 million, there are no financial institutions.

Total deposits in the financial system equal to 23% of GDP, less than half of what is to be found in other Latin American economies such as Brazil (52%) and Chile (47%). It is also lower than the figure for Germany (99%), Spain (109%) or the US (68%).

Total credit to private sector as a % of GDP is only 20%. The percentage for Brazil is 33% and 75% for Chile. For countries like Spain or Canada, the corresponding percentage is 151% and 184%, respectively.
The use of the internet in Mexico remains low.

- Approximately 25% of the population uses the internet. This rate is lower than the average of high income OECD countries (67.7%). In Latin America and the Caribbean the percentage is 26.9%.

- Only 7.8% of the internet users in Mexico actually engage in e-commerce transactions. 26.6% use the internet, exclusively, to make online payments, 29% for shopping and 44.3% engage in both kinds of transactions.

- Of the 28 million households in Mexico 7.1 million have a computer and only 3.7 million – around one in ten – have internet access.

- The main reasons for not having internet access are:
  - cannot afford it: nearly 50% of the cases.
  - do not find it necessary: nearly 25% of the cases.

Source: Mexican Bureau of Statistics (INEGI) data.
Economic and Social Background

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- Tax revenue concentration
- High administrative burden
- Low perception of risk and levels of compliance

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The role of the FTA in relation to the needs identified by Tax Administrations in emerging economies
Challenges faced by the Mexican Tax Administration

**Tax Revenue Concentration**

- One single taxpayer, PEMEX, accounts for 38.5% of the total net revenue which amounts to 2.07 trillion pesos.

- In addition, 13,400 large taxpayers – 0.04% of all taxpayers – contribute 35.8% of the total net revenue.

- The rest of the taxpayers – around 31.4 million – contribute 25.7% of the total net revenue.
High administrative burden

- In Mexico, as in other emerging economies, there is a high administrative burden on companies and individuals; although not all of it pertains to tax obligations.

- The data below shows the tax that a medium-sized company must pay or withhold in a given year, as well as measures of the administrative burden in paying taxes. These measures include the number of payments an entrepreneur must make; the number of hours spent preparing, filing, and paying; and the percentage of their profits they must pay in taxes.

<table>
<thead>
<tr>
<th>Indicator</th>
<th>Mexico</th>
<th>Region</th>
<th>OECD</th>
</tr>
</thead>
<tbody>
<tr>
<td>Payments (number)</td>
<td>27</td>
<td>34.8</td>
<td>13.4</td>
</tr>
<tr>
<td>Time (hours)</td>
<td>549</td>
<td>393.5</td>
<td>210.5</td>
</tr>
<tr>
<td>Profit tax (%)</td>
<td>23.2</td>
<td>20.4</td>
<td>17.5</td>
</tr>
<tr>
<td>Other taxes</td>
<td>1.4</td>
<td>13.6</td>
<td>3.4</td>
</tr>
<tr>
<td>Total tax rate</td>
<td>51.5</td>
<td>48.6</td>
<td>45.3</td>
</tr>
</tbody>
</table>

- Mexico ranks at the 149 position in the *ease of paying taxes indicator*. At the 86 position for tax payments, 162 for time to comply, and 136 for total tax rate.
Low perception of risk and levels of compliance

- Enforcement activities (audit and collection) were traditionally carried out through case by case analysis without any risk analysis.
- Tax evasion in Mexico has been estimated to be around 3% of GDP or 27% of the total revenue of the main taxes.

<table>
<thead>
<tr>
<th>Year</th>
<th>Value Added Tax</th>
<th>Income Tax Legal entities</th>
<th>Income Tax Workers</th>
<th>Income Tax Lease of properties</th>
<th>Income Tax Freelance</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>1998</td>
<td>29.80%</td>
<td>33.20%</td>
<td>20.22%</td>
<td>77.58%</td>
<td>80.41%</td>
<td>35.12%</td>
</tr>
<tr>
<td>2000</td>
<td>24.87%</td>
<td>36.70%</td>
<td>19.06%</td>
<td>74.32%</td>
<td>79.35%</td>
<td>33.19%</td>
</tr>
<tr>
<td>2002</td>
<td>23.58%</td>
<td>21.45%</td>
<td>17.22%</td>
<td>71.84%</td>
<td>78.11%</td>
<td>27.64%</td>
</tr>
<tr>
<td>2004</td>
<td>20.17%</td>
<td>26.09%</td>
<td>14.83%</td>
<td>69.60%</td>
<td>80.29%</td>
<td>27.08%</td>
</tr>
<tr>
<td>2004 % GDP</td>
<td>0.93%</td>
<td>0.61%</td>
<td>0.41%</td>
<td>0.22%</td>
<td>0.83%</td>
<td>3.0%</td>
</tr>
<tr>
<td>2004 2003 million pesos</td>
<td>68,687</td>
<td>45,021</td>
<td>30,321</td>
<td>16,118</td>
<td>61,055</td>
<td>221,202</td>
</tr>
</tbody>
</table>

- Even when the performance of tax revenue has followed a positive trend during the last years, evasion remains high, it is approximately 25% of the potential tax collection.

• Economic and Social Background

• Challenges faced by the Mexican Tax Administration
  • Tax revenue concentration
  • High administrative burden
  • Low perception of risk and levels of compliance

• How these challenges are being met

• Challenges faced by the Mexican Tax Administration in the current economic environment
  • Effects of the current crisis on the Mexican economy
  • Effects of the current crisis on tax collection
  • Countercyclical policies implemented by the Federal Government
  • Actions taken by the Mexican Tax Administration under the crisis scenario

• The role of the FTA in relation to the needs identified by Tax Administrations in emerging economies
Our strategy began by centering the core of our business model around the taxpayer.

This action was followed by the creation of a strategic map which set forth a vision and mission statements.

Our strategic objectives are divided into four main areas: services, audit, human resources and infrastructure.

A portfolio of projects has been implemented to reengineer taxpayer services and audit processes with a strong emphasis on risk management and a large investment in both human capital and infrastructure.

Each of these strategic objectives has performance indicators all of which are aimed at increasing and facilitating tax compliance.
## How these challenges are being met

<table>
<thead>
<tr>
<th>…2004…</th>
<th>2009</th>
<th>…2010…</th>
</tr>
</thead>
<tbody>
<tr>
<td>537 disjointed processes</td>
<td>Different groups of services divided into 12 tiers</td>
<td>Single services portfolio</td>
</tr>
<tr>
<td>Mostly manual and paper operations</td>
<td>Electronic processes and electronic documents</td>
<td>Online processes</td>
</tr>
<tr>
<td>550 taxpayer service locations</td>
<td>550 taxpayer service locations</td>
<td>Multiple service locations</td>
</tr>
<tr>
<td>Taxpayer attention in a single service location</td>
<td>Taxpayer attention in any location</td>
<td>Online attention</td>
</tr>
<tr>
<td>Taxpayer identified what obligations were applicable</td>
<td>Obligations to be detected on the basis of data provided by means of a questionnaire</td>
<td>Strengthen voluntary compliance</td>
</tr>
<tr>
<td>Paper forms (+150)</td>
<td>Electronic systems</td>
<td>Integrated systems and solutions</td>
</tr>
</tbody>
</table>
## How these challenges are being met

<table>
<thead>
<tr>
<th>...2004...</th>
<th>2009</th>
<th>...2010...</th>
</tr>
</thead>
<tbody>
<tr>
<td>Attention given to</td>
<td>Portfolio management</td>
<td>Effective collections</td>
</tr>
<tr>
<td>oldest credits</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Mass audits aimed</td>
<td>Detection of conducts by type of taxpayer</td>
<td>Risk management</td>
</tr>
<tr>
<td>at specific sectors</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Non existent data</td>
<td>Data protection strategy and plan</td>
<td>Full data base protection</td>
</tr>
<tr>
<td>base protection</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Dispersed data</td>
<td>Unify data bases</td>
<td>Consolidated data bases</td>
</tr>
<tr>
<td>In house capabilities</td>
<td>Outsourcing, when required</td>
<td>Balance between in house capabilities</td>
</tr>
<tr>
<td></td>
<td></td>
<td>and outsourcing</td>
</tr>
<tr>
<td>Segmented processes</td>
<td>Audit and taxpayer services processes certified</td>
<td>Fully certified processes</td>
</tr>
<tr>
<td></td>
<td>to ISO 9000 standard</td>
<td></td>
</tr>
</tbody>
</table>
Economic and Social Background

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Effects of the current crisis on the Mexican economy

• In 2008, the performance of most macroeconomic indicators was relatively favorable given the international environment. However, during the fourth quarter of 2008 there was a sharp decline in the economic activity that persisted through the first quarter of 2009, in which GDP fell by 8.2%.

• Indicators on economic activity, industrial production, sales, and non-oil exports have decreased on annual rates. However, it is worth mentioning that recently available data show a partial stabilization for the first period of the year, before the influenza episode, due to the global cycle and the countercyclical measures.

• Consumption has recovered significantly and the monthly loss of jobs moderated in March and April.

• As a reduction in inflation is expected, the Central Bank has reduced its reference rate by 36.4%. In addition, the stock market has recovered significantly with respect to its minimum of the year.
Challenges faced by the Mexican Tax Administration in the current economic environment

Effects of the current crisis on tax collection

Net tax revenue
(January – April)
Million pesos

<table>
<thead>
<tr>
<th>Year</th>
<th>Income, Value Added, Flat Rate Taxes</th>
<th>Corporate, Cash Flow, and Excise Taxes</th>
<th>Government Fees</th>
</tr>
</thead>
<tbody>
<tr>
<td>2008</td>
<td>222,841</td>
<td>196,041</td>
<td>222,841</td>
</tr>
<tr>
<td>2009</td>
<td>158,463</td>
<td>136,068</td>
<td>119,399</td>
</tr>
</tbody>
</table>

Tax Revenue
(January – April)
Million pesos

<table>
<thead>
<tr>
<th>Year</th>
<th>Income Tax</th>
<th>Value Added Tax</th>
<th>Flat Rate Corporate Tax</th>
<th>Cash Flow Tax</th>
<th>Excise Tax</th>
<th>Foreign Trade Tax</th>
<th>Other taxes</th>
</tr>
</thead>
<tbody>
<tr>
<td>2008</td>
<td>19,582</td>
<td>21,784</td>
<td>13,164</td>
<td>0</td>
<td>28,691</td>
<td>19,582</td>
<td>196,041</td>
</tr>
<tr>
<td>2009</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>11,102</td>
<td>9,715</td>
<td>22,718</td>
</tr>
</tbody>
</table>
Countercyclical policies implemented by the Federal Government

- Supporting the measures implemented by the Federal Government, the Ministry of Finance and Public Credit has put in place three types of measures:
  - Countercyclical policies to face the economic slowdown – implemented for the first time in Mexican modern economic history.
  - Actions in the financial sector in response to the international contagion.
  - An agenda of structural reforms aiming to generate confidence under the current circumstances, and to promote higher medium and long-term growth.

- Countercyclical policies are being implemented under the following initiatives:
  - Program for Growth and Employment
  - The National Accord in Favor of Households and Employment

- They mainly consist on fiscal stimulus, increased financing, accelerating infrastructure expenditure, structural reforms such as improvements of the investment regime for PEMEX, an ambitious government purchases program from Small and Medium sized Firms, and measures to reduce expected inflation for 2009.

- Up to March, programmable expenditures and fostered investment were 24.6% and 33.2% higher, in real terms, relative to the same period of 2008.

- As of March, credit fostered by development banks has increased by 52.0%.

- The impact for 2009 is estimated at 1.4% in terms of its effect on GDP, and at 1.8% on aggregate demand.
Challenges faced by the Mexican Tax Administration in the current economic environment

Actions taken by the Mexican Tax Administration under the crisis scenario

- The term allotted to individuals to file their tax returns, which comprises the month of April, was extended by 30 days. Furthermore, and in order to support cash flow in the economy, a fast track tax refund program was established (10 working days).
  - 239,670 tax refunds have been made to individuals who filed their annual return in time. This amounts to approximately $1.6 billion Mexican pesos.
- Tax debts can be paid in installments, without the need to issue collateral, under a simplified payment process. Fines are pardoned, when full payment is made.
- Tax incentives, among others, to: technological research and development activities, diesel fuel consumption, excise tax, personal savings accounts and retirement funds and deduction on fixed assets.
- Under the current crisis scenario taxpayers will attempt to evade payment of taxes and/or finance themselves with taxes withheld (such as value added tax).
  - To prevent the above and to promote compliance, the following was carried out. Since 70% of the revenue derived from withheld income and value added taxes comes from, approximately, 5000 companies, and the remainder 30% came from approximately 1,550,000 individual taxpayers, a reinforced monitoring of said 5000 taxpayers was implemented.
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Challenges faced by the Mexican Tax Administration in implementing FTA recommendations

Tax Administrations should enhance a trust-based and a co-operative relationship with taxpayers and tax intermediaries in order to improve risk management and achieve a better trilateral relationship.*

- Some taxpayers actually try to reduce risks by increasing transparency towards the Tax Administration, even when this might impose higher compliance costs.
- The reason for this is that a public company must have a fine corporate governance in order to avoid contingencies that might compromise its value, resulting in a lack of confidence from stockholders. This is a common practice among publicly listed companies worldwide, however private companies are less compelled to act accordingly.

<table>
<thead>
<tr>
<th>Exchange</th>
<th>Domestic Cies</th>
</tr>
</thead>
<tbody>
<tr>
<td>Australian SE</td>
<td>1924</td>
</tr>
<tr>
<td>BME Spanish Exchanges</td>
<td>3536</td>
</tr>
<tr>
<td>London SE</td>
<td>2415</td>
</tr>
<tr>
<td>Mexican Exchange</td>
<td>125</td>
</tr>
<tr>
<td>NASDAQ OMX</td>
<td>2616</td>
</tr>
<tr>
<td>NYSE Euronext (US)</td>
<td>2596</td>
</tr>
<tr>
<td>Tokyo SE Group</td>
<td>2374</td>
</tr>
</tbody>
</table>

Challenges faced by the Mexican Tax Administration in implementing FTA recommendations

Tax Administrations should develop internet search engines that allow them to monitor e-commerce trends, identifying high risk websites and suppliers.

<table>
<thead>
<tr>
<th>Country</th>
<th>Total population (million)</th>
<th>Internet users (million)</th>
<th>Internet users / total pop</th>
<th>Homes with internet access</th>
</tr>
</thead>
<tbody>
<tr>
<td>US</td>
<td>304.2</td>
<td>227.2</td>
<td>75%</td>
<td></td>
</tr>
<tr>
<td>Japan</td>
<td>127.3</td>
<td>94</td>
<td>74%</td>
<td>60%</td>
</tr>
<tr>
<td>UK</td>
<td>60.9</td>
<td>43.8</td>
<td>72%</td>
<td>62%</td>
</tr>
<tr>
<td>Germany</td>
<td>82.4</td>
<td>55.2</td>
<td>67%</td>
<td>67%</td>
</tr>
<tr>
<td>France</td>
<td>62.2</td>
<td>40.9</td>
<td>66%</td>
<td>40%</td>
</tr>
<tr>
<td>Mexico</td>
<td>107.2</td>
<td>27.4</td>
<td>25%</td>
<td>10%</td>
</tr>
</tbody>
</table>

Sources: [http://www.internetworldstats.com](http://www.internetworldstats.com)

• Use of the internet in Mexico is low

• Still, the Tax Administration has undertaken important steps to improve service delivery through the internet.

• This is part of a capability building effort by the Tax Administration to establish the foundations for and successfully adapt new technological and economic developments.

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Mexico, as any other emerging economy must take into consideration its particular situation in order to adopt the FTA recommendations: population, economy, size of the hidden economy, concentration of income, access to banking services, use of internet, and others.