



Challenges Facing Tax Administrations in Emerging Economies

Case Study: Mexico

May, 2009



- **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**

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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

Population

Formal economy

Income

Hidden economy

Access to banking services

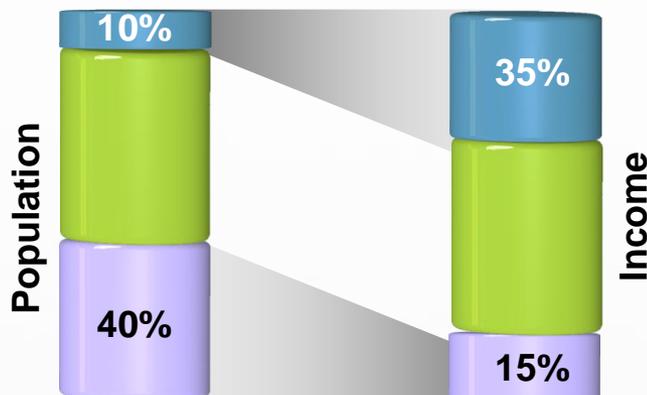
Use of the internet

Gross Domestic Product (2008)	USD\$ 959bn (PPP: USD\$1624bn)
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	

- Population
- Formal economy**
- Income
- Hidden economy
- Access to banking services
- Use of the internet

Sources: Mexican Bureau of Statistics (INEGI). The World Bank, The International Finance Corporation, and Palgrave Macmillan, Doing Business 2009. The World Bank, Country Brief. The Economist.

Income Concentration



- 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.

Population

Formal economy

Income

Hidden economy

Access to banking services

Use of the internet

- 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.

Population

Formal economy

Income

Hidden economy

Access to banking services

Use of the internet

- 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.

Population

Formal economy

Income

Hidden economy

Access to banking services

Use of the internet

- 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.

Population

Formal economy

Income

Hidden economy

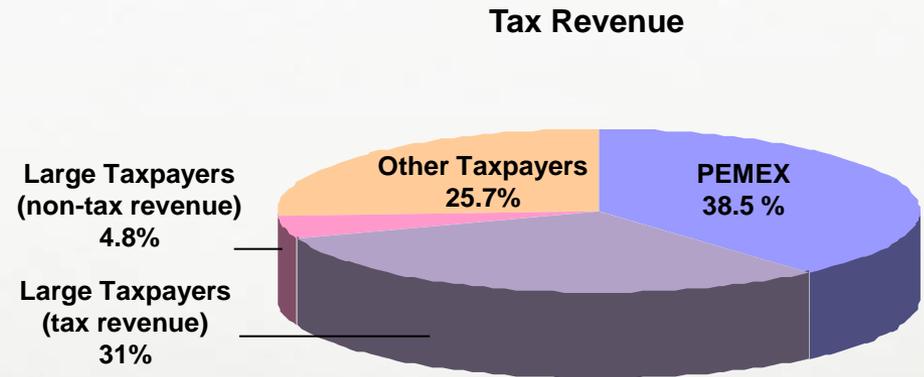
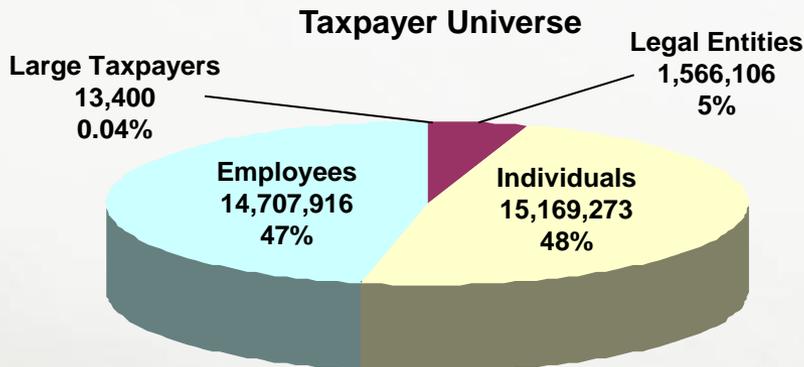
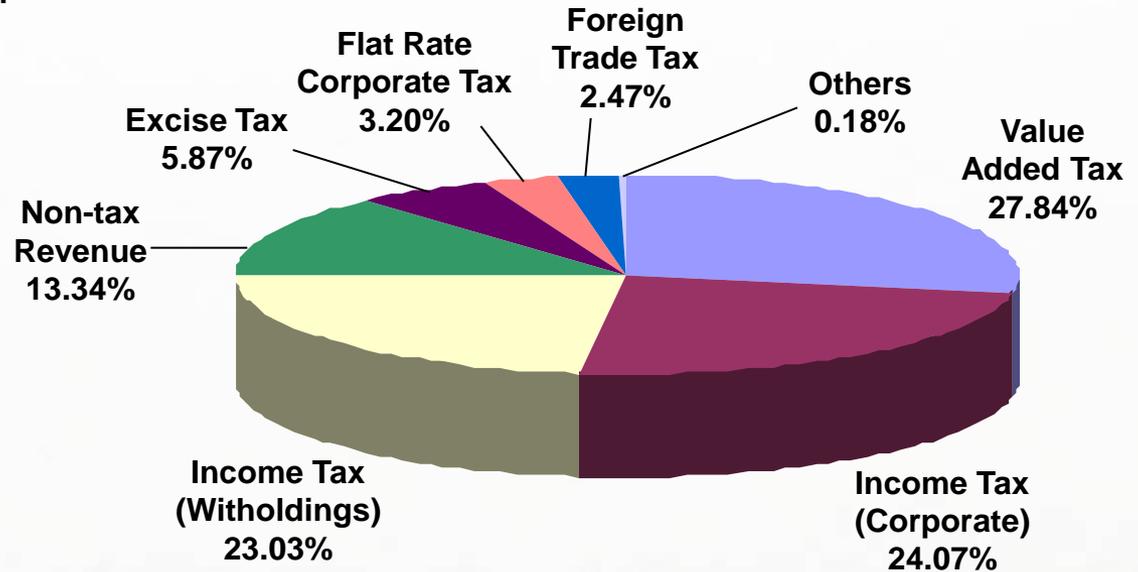
Access to banking services

Use of the internet

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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.

Indicator	Mexico	Region	OECD
Payments (number)	27	34.8	13.4
Time (hours)	549	393.5	210.5
Profit tax (%)	23.2	20.4	17.5
Other taxes	1.4	13.6	3.4
Total tax rate	51.5	48.6	45.3

- 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.

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

- 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.

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- 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.

...2004...

2009

...2010...

537 disjointed processes

Different groups of services
divided into 12 tiers

Single services portfolio

Mostly manual and paper
operations

Electronic processes and
electronic documents

Online processes

550 taxpayer service
locations

550 taxpayer service
locations

Multiple service locations

Taxpayer attention in a
single service location

Taxpayer attention in any
location

Online attention

Taxpayer identified what
obligations were applicable

Obligations to be detected
on the basis of data
provided by means of a
questionnaire

Strengthen voluntary
compliance

Paper forms (+150)

Electronic systems

Integrated systems and
solutions

...2004...

2009

...2010...

Attention given to oldest credits

Portfolio management

Effective collections

Mass audits aimed at specific sectors

Detection of conducts by type of taxpayer

Risk management

Non existent data base protection

Data protection strategy and plan

Full data base protection

Dispersed data

Unify data bases

Consolidated data bases

In house capabilities

Outsourcing, when required

Balance between in house capabilities and outsourcing

Segmented processes

Audit and taxpayer services processes certified to ISO 9000 standard

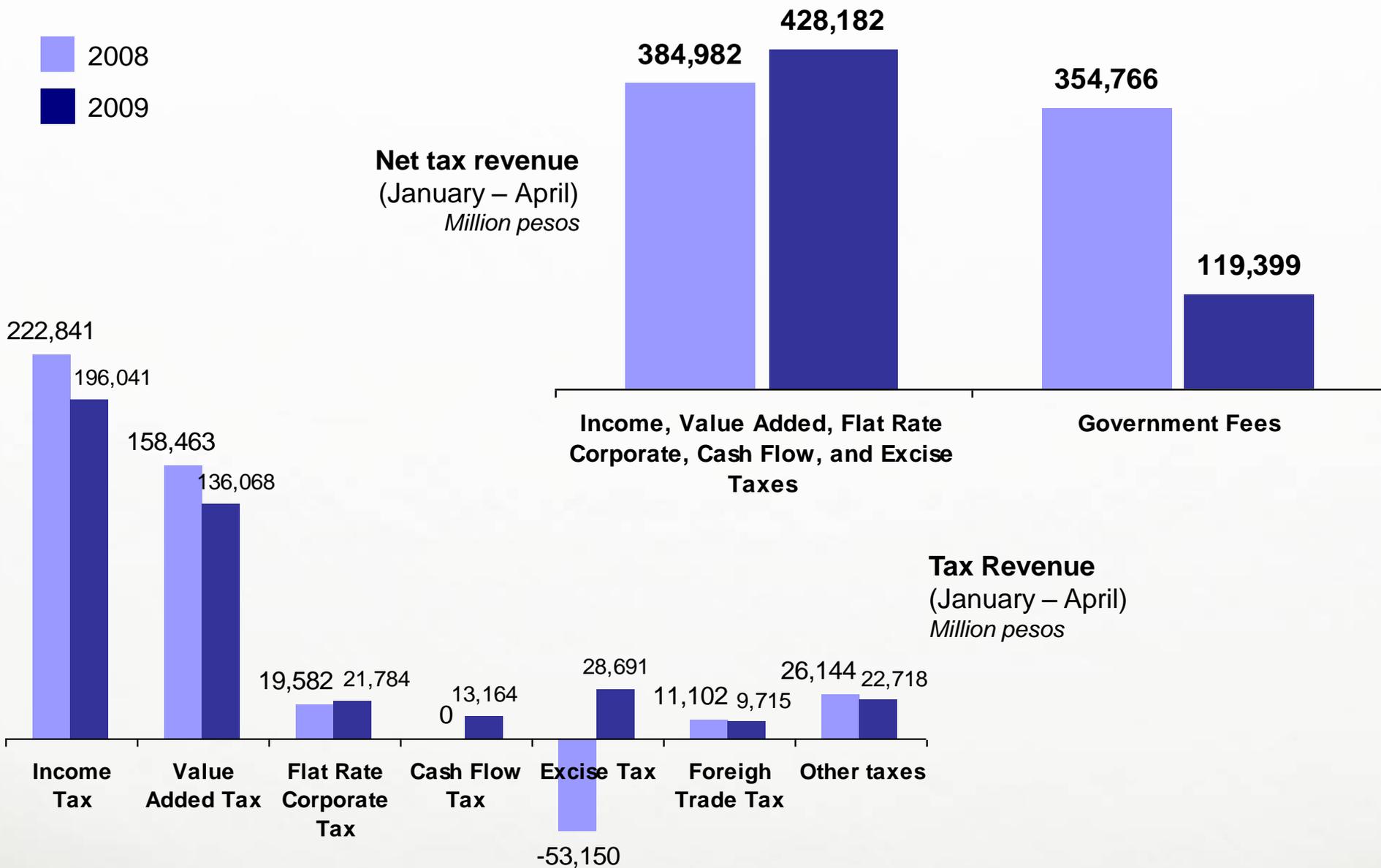
Fully certified processes

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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.

Effects of the current crisis on tax collection



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.

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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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.

- Emerging economies have fewer publicly listed companies, as a result, this incentive to enhance this trilateral relationship is not at all common. The following figures illustrate this fact:

Exchange	Domestic Cies
Australian SE	1924
BME Spanish Exchanges	3536
London SE	2415
Mexican Exchange	125
NASDAQ OMX	2616
NYSE Euronext (US)	2596
Tokyo SE Group	2374

* Study into the Role of Tax Intermediaries, OECD, 2008. World Federation of Exchanges (Annual report 2008).

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

- Use of the internet in Mexico is low

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

Sources: <http://www.internetworldstats.com>

- 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.

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.