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Federalism: Fiscal Issues and Public Expenditure

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I am very pleased to be invited to speak at this Forum on the subject of taxation. Most of what I will say in the next few minutes is explained in more detail in Chapter 2 of the OECD book, *Getting it Right*, which was distributed yesterday.

Many speakers at the Forum, including some of my OECD colleagues, have emphasised the need for a revenue-raising tax reform. It is very unusual for OECD officials to recommend tax increases – we normally advise our member countries to reduce taxes – and this should be a recognised as a sign of how great the need is for increased government revenues in Mexico. These are needed both to replace uncertain and declining oil revenues but also to finance increases in social programmes.

I will start with some comparative information about the Mexican tax system and then move on to the OECD recommendations for tax reform.

First, Mexico has a very low tax-to-GDP ratio: the lowest in the OECD at about half of the OECD average. It therefore cannot provide the government expenditures on infrastructure and social programmes that are provided in other OECD countries.

Second, this tax-to-GDP ratio becomes even smaller if we eliminate oil-related tax revenues, which will decline substantially if oil production cannot be sustained at current levels.

Third, Mexico has the lowest proportion of tax revenue collected at state and local government levels for an OECD federal country, and the proportion is also lower than most OECD unitary countries. This can cause a problem of political credibility for the federal government if the population does not understand that the federal government grants large sums of money to sub-national governments. They see local governments that provide services in exchange for very low taxes and feel that the federal government is providing very bad value for money in comparison.

Fourth, statutory tax rates in Mexico are also low but they are not as low, compared to other OECD countries, as the tax revenues. This implies that Mexico grants too many exemptions in its tax rules and does not do enough to ensure compliance with the tax laws.

These facts lead to our main recommendation: that tax revenue in Mexico should be increased by concentrating on broadening tax bases – reducing or eliminating exemptions – and by improved tax compliance and administration. I will now look at how this general recommendation can be applied to specific taxes.

I will start with VAT, where we see the greatest opportunities for raising revenues. Mexico has the narrowest VAT base in the OECD. About two extra percentage points of GDP could be raised from VAT if its base was broadened to the OECD average, and this would still leave plenty of room to keep exemptions or zero-rating for key necessities such as tortillas. There is concern in Mexico that removing exemptions and zero-rating will hurt the poor but it is important to recognise that the rich benefit much more from the exemptions than the poor – because they have more money to spend on these goods. The OECD's view is that it would best to remove all zero-rating and almost all exemptions for VAT (raising perhaps 4 or 5 percentage points of GDP) and use some of the additional revenue to compensate the poor through increased cash payments from the government. This would still leave large amounts of additional revenues that could be used to improve government services. Such a simplification in the VAT would also make it much easier to administer, enabling the tax administration to improve compliance with the tax laws.

I must recognise that several OECD countries have not followed this advice of applying a single rate of VAT and eliminating almost all exemptions, because many people see such a policy as hurting the poor. However, this should not be seen as an argument for having a wide range of zero-rating and exemptions. Analysis in other developing countries shows that the advantages for the income distribution of exemptions come almost entirely from a very limited number of goods. This, if Mexico decides to have some exemptions, they should be limited to very basic food stuffs such as tortillas, eggs and milk.

The personal income tax also needs to have its base broadened by reducing the many exemptions and special allowances, most of which favour the rich. Indeed, such a reform of the personal income tax can make a major contribution to increasing the amount of redistribution that takes place through the tax system, thus more than compensating for any perceived worsening of the income distribution from broadening the base of VAT.

Finally, a reform of property tax can also increase both revenue and the redistributive power of the tax system. The most important reform here is to improve property valuations, to reflect what they are really worth, while making the tax schedule more progressive, perhaps by exempting the low value properties that are owned by the poor. An additional advantage of strengthening the property tax is that it will make it possible to give more revenue responsibilities to sub-central governments.