Fiscal reform... was necessary under President Zedillo, urgent under President Fox and can be postponed no longer under President Calderón. 
– OECD Secretary General Angel Gurría (2006)

INTRODUCTION

This paper describes the main features of the Mexican fiscal system, details the most important changes that have occurred/not occurred over the past two decades, and explains what factors influenced the rate, degree and direction of change. In brief, we contend that there have been profound and ideologically consistent changes in spending assignment and in the institutional arrangements governing taxes, spending and debt management. Over the past 20 years, Mexico has moved from a highly centralized fiscal system characterized by extensive presidential discretion to a moderately decentralized system with more meaningful checks and balances. Decentralization of spending assignments has been coupled with steps designed to increase transparency, efficiency and accountability over public funds. Changes to the revenue collection system, by contrast, have been much smaller in magnitude and not as consistent in ideational terms; while the general trend has been to increase tax revenue in an equitable manner, not all changes in tax law have increased revenue or equity.

Two factors—crisis and democratization/electoral competition, notably the emergence of multi-party government in 1997—particularly help explain the patterns of change and stasis in Mexican fiscal policies and institutions. The former has compelled presidents to push for policies that guarantee fiscal solvency, while the latter has altered the incentives of political actors and raised the transaction costs of negotiating exchange, thereby changing the nature of inter-branch negotiations: With democracy, Congress has increasing asked for—and gotten—ever increasing amounts of decentralization on spending; in return presidents have sought to—and sometimes realized—control over how these resources will be spent.
This paper proceeds as follows. Section 1 provides an overview of the status quo in terms of fiscal policies and outcomes. Section 2 presents an inventory of reforms, including ones that failed. Section 3 offers an analytical summary. Section 4 presents three case studies—the 1995 successful increase to the VAT under Zedillo, Fox’s failed 2001 fiscal reform, and Calderon’s (partially) successful reform in 2007. Part 5 concludes.

1. STATUS QUO

This section describes the status quo for Mexico's fiscal policy in place at the start of the 1990s and traces its evolution through 2008. The focus is on government revenue, government expenditure, budget balance, and decentralization.¹

1a. The Fiscal Balance (deficit and debt)

Figure 1 puts the revenue and spending series together, reporting the budget balance of the central government in the period. It distinguishes what Hacienda calls balance primario from balance público. The former excludes interests to service the existing government debt, which the latter includes. The Mexican government has had primary surpluses in all years since 1990, averaging around 3 percent of GDP. The primary surplus reached about 7 percent during the peak period of privatization and fell to around 1 percent of GDP following the 1994-95 peso crisis and bank bailout. The ability of the government to contain that crisis and maintain a primary surplus regardless of external circumstances has allowed Mexico to reduce government interest payments from nearly 9 percent of GDP in 1990 (the debt was inherited from the 1980s) to about 2.5 percent of GDP since 2000. As a result, the overall public sector deficit has averaged about 1 percent of GDP in most years.

¹ One complication with studying economic (and other) statistical data in Mexico is reliability. It is not uncommon that the same datum from two official sources has important differences. This problem led us to compute as many indicators as possible from the same primary source, aggregating the different budgetary categories to produce the figures that secondary official sources report in pre-computed (but invariably discrepant) fashion. The primary source we rely upon is “Estadísticas Oportunas de Finanzas Públicas y Deuda Pública,” produced and distributed by Hacienda. The file reports monthly aggregates from January 1990 to date for all public budgeting categories in terms of income and spending by the federal government. With some exceptions, notably taxes, our data is generally consistent with information from academic and government sources.
Balanced budgets are just one element of the debt/deficit story. In addition, Mexico has maintained a relatively manageable debt to GDP ratio, which started the series (see Figure 2) at nearly 40 percent of GDP in 1990 but had dropped by nearly half by 1993, after many money-losing state-owned-enterprises were privatized. Public sector debt spiked with the 1994-95 peso crisis, but has remained steady at roughly 20 percent of GDP for a decade. (The increase from 17.6 percent of GDP in 2000 to 22.6 percent in 2008 reflects debt incurred in the reform of the public sector pension system, which added 2.1 percent of GDP to the overall burden).

Moreover, Mexico has switched a large fraction of dollar dominated debt into pesos, making it less vulnerable to downward swings in the exchange rate: at the end of 2008, peso denominated debt stood at 80.3 percent of the total, compared to 55.3 in 2000. Likewise, it extended the average maturity of its debt from approximately 6 months in 1995 to approximately 3 years by 2004 (Cadena and Trillo 2006). It also created a Petroleum Stabilization fund in 2000, which contained some 145 billion pesos at the end of 2008, thanks to
contributions of 55 billion in 2007 and 71 billion in 2008. Finally, Mexico has fundamentally altered the rules concerning debt management and finance. Debt management efforts have paid off, as seen in the drop in interest paid yearly in the right side of Figure 2. Fiscal discipline to obtain a balanced budget was an informal constraint driven by preferences of Hacienda officials until 2007, when the Ley de Presupuesto mandated a balanced budget in which deficits are only permitted under extraordinary circumstances.

Figure 2
Federal government debt (left) and interests (right) as % of GDP

Source: see Table 1’s footnote, series Deuda interna neta, saldos, gobierno federal XEA00, Deuda neta, saldos, gobierno federal XET50, Balance primario XAA30 and Balance público XAA.

Section 1b. Revenue

Hacienda classifies revenue in Mexico into four main streams: oil revenue, income from parastatal agencies, non-tax income, and tax income (Figure 3). Between 1990 and 2007, petroleum accounted for 25-35 percent of budgetary revenue (ingresos presupuestarios in Hacienda's terminology), roughly 6-8 percent of GDP—double its contribution before the 1970s

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2 The Petroleum Stabilization Fund got off to an auspicious start as the original savings target (40 percent of revenue above the reference price) was diluted, if not ignored, during the first years of operation. It has only been an effective source of savings since 2006.
oil boom. Federal taxes accounted for roughly 40 percent of budgetary income during the same period, approximately 7-10 percent of GDP.

![Figure 3]

**Budgetary income as % of GDP**

Source: see Table 1’s footnote, series Ingresos no petroleros XAB22, Tributarios XAB2210, No tributarios XAB2230, Organismos y empresas XAB2240, and Ingresos Petroleros XAB21.

Revenue from parastatal entities, such as the Social Security Institute (IMSS) and the electric utility (CFE), accounted for 15-25 percent of revenue, some 3-5 percent of GDP. Revenue from non-tax sources, such as government bonds and privatization proceeds, provided another 5-15 percent of budgetary revenue, some 1-3 percent of GDP. Taken together, non-oil government revenue oscillated between 13-18 percent of GDP from 1990 to 2007.

As suggested by Figure 3 above, the revenue collection system has been characterized by considerable volatility both within and between categories, not just from petroleum sales (see also Martinez-Vázquez 2001).³ The non-tax revenue category, for example, swelled to over 15 percent of revenue during the peak period of privatization (1991-1992), but has fallen to only 5 percent of revenue today. The reliance on oil and other non-tax revenue is not sustainable because PEMEX’s production and reserves are falling precipitously (Figure 4). Crude oil production peaked at 3.383 million of barrels per day (MDB) in 2004 and stood at in 2.685

³ The value of Mexican petroleum exports was $1.5 billion in January 2009, compared to monthly average of $3.6 billion in 2008.
MBD in January 2009, while reserves have dropped monotonically. The substantial falls in 1997 and 2002 reflect changes in reserve measurement criteria, which were updated to international standards. By 2006, proved reserves were a mere dozen years; adding probable reserves brings this figure to about 25 years. The changes in PEMEX’s fiscal regime adopted in 2007 (detailed later) should at least marginally expand long-term production.

**Figure 4**

*Oil reserves (left) and output (right)*

![Graph showing oil reserves and output](source: Ley de Ingresos de la Federación 2007 (available at [www.shcp.gob.mx](http://www.shcp.gob.mx)).)

1c. Taxes

During the period under consideration, Mexico’s tax system has experienced numerous small changes (noted in the inventory), none of which could be considered profound; even when taken together, the changes seem relatively small if tax revenue and the distribution of the tax burden in 1990 serve as the reference point.

The most notable features of the Mexican tax system are not its rates, but its yields. Mexico’s tax take is, and has been, exceptionally low from virtually any standpoint (see Martínez-Vázquez 2001 and OECD 2007). Figure 5 shows trends over time and breaks down federal taxes (*ingresos tributarios no petroleros* in Hacienda terminology) into their main components. The income tax (*impuesto sobre la renta*) represented nearly half of tax revenue between 1990-2007, roughly 3.5-5 percent of GDP, including both personal and corporate.
income tax.4 Other taxes (detailed below) have steadily dropped since 1994, the year NAFTA began. They represented more than 20 percent of all taxes in 1990 (and about 2 percent of GDP); they were down to slightly more than 10 percent of tax revenue in 2007 (about 1 percent of GDP).5 The drop in other taxes has been paralleled by a steady rise in revenue from the VAT. Table 1 reports the ebbs and flows of the VAT rate between 1991 and the present (a story that we expand on in the case study below). VAT gave the federal government one-third of all tax revenue in 1991, one-fourth in 1992, and one-third again since 1995. Thanks to marginal changes in the application of the VAT and efforts to reduce evasion, the VAT accounted for 40 percent of all tax income in 2007 (4 percent of GDP). Despite the increase in revenue, however, Mexico still has one of the lowest yielding VATs in the world (for reasons discussed below).6

![Figure 5 Taxes as % of GDP](source)

Source: see Table 1’s footnote, series Tributarios XAB2210, Impuesto sobre la renta XAB2211, Impuesto al valor agregado XAB2212, Producción y servicios XAB2213, Importaciones XAB2214, and Otros impuestos XAB2215.

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4 Though there is some year-to-year fluctuation, personal income and corporate income taxes each account for roughly 50 percent of collections (SHCP 2008a).
5 Pinpointing the exact cause of the decline in other taxes is not possible with data from SHCP; much of the decline appears to reflect a fall in trade tax revenue.
6 For comparative worldwide yields, see Cnossen 1998.
Table 1
Value-added tax (IVA) rates since 1980

<table>
<thead>
<tr>
<th>Period</th>
<th>VAT rates and exemptions</th>
</tr>
</thead>
<tbody>
<tr>
<td>1980-1982</td>
<td>6% groceries and medicines. 10% general rate. No exemptions</td>
</tr>
<tr>
<td>1983-1988</td>
<td>0% produce and tortilla. 6% groceries and medicines. 15% general rate. 20% import tariffs; sales by owner (enajenación de bienes); independent service sales; and luxury goods. Exemptions: home sales, school tuition, books and newspapers, doctor fees</td>
</tr>
<tr>
<td>1988-1991</td>
<td>0% produce, groceries, and medicines. 6% border cities. 15% general rate. 20% luxury goods. Exemptions: home sales, school tuition, books and newspapers, doctor fees</td>
</tr>
<tr>
<td>1991-1995</td>
<td>0% produce and medicines. 10% general rate. Exemptions: home sales, school tuition, books and newspapers, doctor fees</td>
</tr>
<tr>
<td>1995-1997</td>
<td>0% produce and medicines. 15% general rate. 10% border cities. Exemptions: home sales, school tuition, books and newspapers, doctor fees</td>
</tr>
<tr>
<td>1997-today</td>
<td>0% produce and medicines. 10% general rate. Exemptions: home sales, school tuition, books and newspapers, doctor fees</td>
</tr>
</tbody>
</table>

Source: Departamento de Estudios Económicos de Banamex.

Non-income related labor taxes (social security, payroll) have been and continue to be relatively low in comparative terms, though not trivial in budget terms. In 2007, social security contributions (which Mexico classifies in the parastatal category) accounted for 15 percent of total revenue, roughly 3 percent of GDP, while (state-level) payroll taxes accounted for just over 1 percent of revenue.

Other wealth and income taxes raise minimal revenue, a situation has not changed much during the period under consideration, despite the introduction of several new taxes. Property taxes account for considerably less than 1 percent of GDP. Its corporate asset tax (created in 1989) accounted for a mere 15B pesos in 2007 before it was replaced by a minimum corporate income tax (IETU); this tax, by contrast, raised approximately 46B pesos in its first year of operation, slightly more than double the amount raised by the cash deposits tax (IDE = 17.8
billion pesos), which was also created in 2007. Together, IETU and IDE raise less than 1 percent of GDP. Mexico has no inheritance tax.

1c1. Raising Tax Effort

The failure to collect more revenue has been attributed to a variety of factors, including statutory exemptions/loopholes, administrative capacity and political will. We will highlight statutory issues as well as Mexican attempts to address them. According to Hacienda’s calculations, Mexico’s tax expenditures (the cost of deviations from the standard tax rate) accounted for 7.4 percent of GDP in 2008, compared to 6.3 percent of GDP in 2003, the first year for which we could find (roughly) comparable figures, shown in Table 2. These tax expenditures—in effect preferential regimes for certain sectors, products and activities—generate widespread abuse, raise administrative costs and undermine horizontal equity.

<table>
<thead>
<tr>
<th>Tax type</th>
<th>% GDP</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total</td>
<td>7.41</td>
</tr>
<tr>
<td>Total Income Tax</td>
<td>2.43</td>
</tr>
<tr>
<td>Corporate Income Tax</td>
<td>1.53</td>
</tr>
<tr>
<td>Personal Income Tax</td>
<td>0.90</td>
</tr>
<tr>
<td>Minimum corporate income tax (IETU)</td>
<td>0.92</td>
</tr>
<tr>
<td>Value Added Tax</td>
<td>2.01</td>
</tr>
<tr>
<td>Other Taxes</td>
<td>1.91</td>
</tr>
<tr>
<td>Subsidies</td>
<td>0.13</td>
</tr>
</tbody>
</table>


Tax expenditures come in a variety of forms. Mexico’s VAT zero-rates a variety of items—e.g., food, medicine, and books—and exempts a variety of services—e.g., medical and transportation services—greatly reducing the potential tax base. According to Hacienda, the

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7 The figure for the cash deposit tax is preliminary; it does not reflect credits against the income tax.
8 Tax expenditures figures are calculated under the assumption that if the expenditure were cancelled it would result in no behavioral changes, overestimating potential gains to the fisc.
9 The SHCP (2008) provides a more fine-grained breakdown of the expenditures by category.
10 The OECD (2007a) estimates that taxes are paid on only 30 percent of consumption expenditures, with zero-rating/exemptions costing more than evasion.
tax expenditures associated with the VAT cost some 2 percent of GDP per year. Mexico’s personal and corporate income taxes also have numerous statutory provisions that depress revenue, several of which deserve mention.\textsuperscript{11} First, the personal income tax is highly progressive, barely affecting those with incomes below the mean.\textsuperscript{12} Because of this progressivity, only 5 million people pay the personal income tax, roughly 5 percent of the population.\textsuperscript{13} Second, fringe benefits and overtime pay of salaried workers in the formal sector are not taxed; to compensate workers with fewer fringe benefits, there is a tax subsidy that entails non-negligible costs to the government in terms of foregone revenue.\textsuperscript{14} Third, some sectors—notably agriculture, ranching, fisheries, and land transportation—have special regimes, allowing them to greatly reduce taxable income on both the personal and corporate side. Because of these special regimes, marginal tax rates vary enormously by sector (Martínez-Vázquez 2001).

Mexico’s tax take from all sources is not helped by the presence of a large informal sector, which accounts for roughly half of employment; given the fact that the tax wedge on labor is relatively small; the informal sector is surprisingly large.\textsuperscript{15} The informal sector escapes income and labor taxes and at least some fraction of consumption taxes, and complicates the politics of tax administration. The cash deposits tax (IDE) approved in 2007 is one attempt to incorporate the informal sector to the tax base; in addition, in 2002, the federal government empowered state governments to enact a surtax on incomes of non-salaried employees (essentially the self-employed). As of 2007, few states had used this power to raise revenue.

\textsuperscript{11} For more details, see Dalsgaard 2000; OECD 2007 and Martínez-Vázquez 2001.
\textsuperscript{12} The OECD (2007b) estimated that a single person (with no children) earning the average wage in Mexico would have paid an average income tax rate of 3 percent in 2004 versus the OECD average of 14.3 percent.
\textsuperscript{13} That figure is for 1997 (Dalsgaard 2000). We have been unable to attain an updated figure. Even now, only 20 percent of the labor force is registered with the SAT (OECD 2007).
\textsuperscript{14} The tax subsidy was introduced in 1991, additional credits were added in 1994 (SHCP 2009).
\textsuperscript{15} The OECD estimates that 50 percent of the labor force is in the informal sector, using a definition-based on economy activity (OECD 2008a). As a percentage of labor costs, Mexico’s tax wedge for a single person earning the average salary was 15.4 percent in 2004 (including income taxes and social security), the lowest in the OECD and less than half the OECD average.
Finally, the tax expenditures embedded in the minimum corporate income tax (IETU) cost an estimated 96 billion pesos (or 0.9 percent of GDP) in 2008, twice as much the tax collected, with many of the privileges going to the same groups as noted above.

1c1a. Sub-national taxes

Sub-national taxes in Mexico accounted for 0.6 percent of GDP in 2005, some 3.2 percent of total tax revenue. Of that amount states accounted for two-thirds of collections, while municipalities accounted for the remainder. Little has changed on this front since the start of the period. One reason for the low sub-national tax collections in Mexico is that states/municipalities have limited tax authority. The federal government has exclusive control over tax policy with respect to foreign trade, natural resources (including all petroleum and mining concessions), financial institutions, as well as excise taxes on electricity, tobacco, natural gas, matches, distilled alcohol, forestry products, and beer. States, by contrast, have the capacity to levy selected surtaxes on specific types of income, and on specific goods and services that are subject to the VAT, and on payroll taxes, and on other taxes not explicitly listed on the Constitution (Díaz-Cayeros Nd). Of these taxes, payroll taxes have been the most important, accounting for approximately 50 percent of state tax revenues for most of the period under discussion. Municipal governments have the right to levy property taxes as well as a variety of user and licensing fees. With a few exceptions, the Constitution grants these rights conditional on Congressional authorization. In practice, Congress tightly circumscribes the rates and activities subject to sub-national taxation. While Congress has gradually authorized more sub-national taxation, especially since 2002, not all states/municipalities have taken advantage of their powers, leading to less sub-national collection than desired by the federal government.

1c2. Distribution of the fiscal burden

16 Including Eastern Europe and other new entrants, the OECD average for sub-national taxes, by contrast, was 11.5 percent of GDP during the same period, the equivalent of 31.9 percent of tax revenue (OECD 2008).
17 Many are specified in the Ley de Coordinación Fiscal.
By all accounts the Mexican tax system is and has been highly progressive (Dalsgaard 2000), with the top 20 percent of households accounted for nearly 60 percent of the total non-oil tax burden in 2006 (SHCP 2009). There is one big gap in the data, however: the tax rate on very top incomes. According to Mexican tax authorities, the average effective tax rate for corporate and personal income taxes for the top 10 percent of income earners is 18-24 percent. Given the amount of revenue raised from income taxes (typically 4.0 percent of GDP), these figures cannot hold for the entire decile. If the top 1 percent of the distribution account for at least 20 percent of national income and that they paid an effective average rate of 20 percent, their tax collections alone would account for some 4 percent of GDP, roughly the entire collection from the combined income tax category. According to SHCP (2007a), however, the top decile only accounts for 42-64 percent of income tax revenue, around 2 percent of GDP, suggesting that the actual incidence of income taxes falls considerably at the very tail end of the distribution.

1d. Spending

Figure 6 turns attention to expenditures (gasto programable corriente y de capital in Hacienda’s terminology). Government spending has mirrored trends in economic growth. Expenditures increased from 13.5 to 16 percent of GDP between 1990 to 1994; dropped to 13 percent with the peso and banking crises in 1995; grew more or less steadily until the slowdown of the dot com bubble burst was felt in 2004. Spending reached 18 percent of GDP in 2007. The size of expenditures, however, has little effect in the distribution between spending categories. Salaries and administrative costs (what Hacienda calls gasto corriente) represent the bulk of spending by the federal government, averaging 80 percent of spending between 1990-2007. Investment in public buildings and equipment (what Hacienda refers to as inversión física), while much smaller, was the second largest spending category, ranging from 15-18 percent of all expenditures in this period. The remaining 2-5 percent corresponded to credits and endowments (what Hacienda calls inversión financiera).

18 Data is for FY2004 (SHCP 2007a).
Figure 6
Expenditures as % of GDP

Source: see Table 1’s footnote, series Inversión física XAC1310, Inversión financiera y otros XAC1320, and Corriente XAC12.

Figure 7 breaks gasto corriente into its main components: wages, administrative and operating costs. Operating costs represented the largest spending category (50 percent of all spending, just less than 10 percent of GDP) in 1990, but began dropping noticeably when privatizations stripped the government of many state-owned companies.

Figure 7
Gasto programable corriente as % of GDP

Note: The Finance ministry only began reporting pensions separate from other operating costs in 1995. Source: see Table 1’s footnote, series Corriente XAC12; Servicios personales XAC1210; Otros gastos de operación XAC1220; Ayudas XAC1230; and Pensiones y jubilaciones XCB14.
In 1995, when Hacienda began reporting the costs of pensions separately from other operating costs, the share grew again in response to interest rate increases. Pensions of government employees represent a growing burden for public finance, driving overall operating costs to nearly 40 percent of all expenditure (nearly 6 percent of GDP) in 2007, a level comparable to 1990; subsidies from the federal budget for pensions reached 2 percent of GDP in 2007 alone. Wages increased from 40 percent of all spending in 1990 to nearly 60 percent in 1999, but have dropped since, reaching about 45 percent in 2007. In terms of GDP, wages have gone from 4 to 6 percent between 1990 and 2007. Subsidies, by contrast, have typically moved in the opposite direction of wages, and have ranged from 1 to 2.5 percent of GDP.

**1e. Fiscal decentralization (expenditures and revenues)**

The third policy area of interest is the central-state government share of revenue and expenditure. Mexico's government has a formal federal arrangement: 31 state governments plus a federal district (including Mexico City) coexist under the umbrella of the federal government; 2,500+ municipalities further subdivide the administration.

Fiscal relations between the central government and sub-national units have changed considerably over time. Until the early 1960s, Mexico had a moderately decentralized fiscal system. Between the 1960s and the 1990s, both revenue and spending authority became increasingly centralized, exemplified by the unification of the VAT in 1980. The centralization of fiscal authority was inherently entwined with the centralization of political authority under the PRI. The president was the informal head of the party and controlled the nomination process in a system banning reelection at all levels; as such there were strong incentives for party discipline. Because the PRI monopolized entry into electoral politics and most administrative positions were patronage-based, the president was the central broker for all party negotiations (Cornelius 1996). Presidents and the national PRI leaders used their control over access to power to acquire control over public finances; the upswing in petroleum revenues in the 1970s was particularly
important because it allowed presidents to guarantee a flow of funds to sub-national governments, even while stripping them of the revenue raising powers (Diaz-Cayeros 2006). The centralization of revenue meant that governors pleaded one-on-one with presidents for the allocation of federal public investment (IPF); while the federal government controlled most IPF spending, governors were able to influence the selection of beneficiaries of public works contracts within their territories. During the 1980s and the early 1990s IPFs represented 2 to 4 times the sum of all states budgets (Diaz-Cayeros 2006, p.134).

This bargain began to break down the emergence of competitive elections, notably the election of the first PAN governor in 1989. While decentralization was initially promoted by opposition parties, the PRI began to favor decentralization once their lock on Congress and the Presidency was threatened (and after the executive’s role in the party nomination process diminished). Decentralization has been pushed by the PRI, in part because state and local political offices remain their strongholds, and it does not control the Presidency anymore (detailed more in section 4).

The current bargain over fiscal federalism has the government transferring increasing amount for the states, while attempting to retain as much control as possible over the actual spending, both in terms of its functional use and actual outcome via detail earmarks. If the federal government must take the blame for taxes, it is doing what it can to control spending. While this micro-management frustrates sub-national governments, it has been politically feasible because sub-national governments covet spending and executive have relatively few bargaining chips to obtain favorable policies on other dimensions, including tax policy and debt management. Sub-national officials have also clamored for more tax authority, but we suspect that most do not truly want the responsibilities/blame associated with taxation. To wit: relatively few sub-national units make full use of the taxing authority already vested in them—shown in Tables 3 and 4. We also suspect that the executive has not and will not relinquish control over tax authority because of the commitment to fiscal balances.
The current fiscal federal arrangement means: (1) the federal government can easily impose spending priorities on other levels of government through earmarks; (2) states and municipal governments with incentives for inefficient spending because they do not collect the taxes; and (3) sub-national units have less incentive to collect taxes.

Table 3
Used and unused tax powers by 32 state governments’ in 2008

<table>
<thead>
<tr>
<th>Tax type</th>
<th>Number of states using tax power</th>
</tr>
</thead>
<tbody>
<tr>
<td>Salaries</td>
<td>32</td>
</tr>
<tr>
<td>Car/House sales</td>
<td>30</td>
</tr>
<tr>
<td>Hotel romos</td>
<td>30</td>
</tr>
<tr>
<td>Lottery prizes</td>
<td>30</td>
</tr>
<tr>
<td>Cars</td>
<td>15</td>
</tr>
<tr>
<td>Additional</td>
<td>15</td>
</tr>
<tr>
<td>Lotteries</td>
<td>13</td>
</tr>
<tr>
<td>Medical fees</td>
<td>12</td>
</tr>
<tr>
<td>Concerts and shows</td>
<td>10</td>
</tr>
<tr>
<td>Contracts</td>
<td>8</td>
</tr>
<tr>
<td>Professional licenses (cedulares)</td>
<td>5</td>
</tr>
<tr>
<td>Books and magazines</td>
<td>1</td>
</tr>
</tbody>
</table>

Source: prepared by authors with information from www.indetec.gob.mx.

Table 4
Used and unused tax powers by the municipal governments of 32 states in 2008

<table>
<thead>
<tr>
<th>Tax type</th>
<th>Number of states using tax power</th>
</tr>
</thead>
<tbody>
<tr>
<td>House purchases</td>
<td>32</td>
</tr>
<tr>
<td>Property</td>
<td>32</td>
</tr>
<tr>
<td>Concerts and shows</td>
<td>29</td>
</tr>
<tr>
<td>Lotteries</td>
<td>13</td>
</tr>
<tr>
<td>Additional</td>
<td>11</td>
</tr>
<tr>
<td>Lottery prizes</td>
<td>7</td>
</tr>
<tr>
<td>Gated communities</td>
<td>7</td>
</tr>
<tr>
<td>Used cars and house sales</td>
<td>2</td>
</tr>
<tr>
<td>Contracts</td>
<td>2</td>
</tr>
<tr>
<td>Hotel guests</td>
<td>2</td>
</tr>
</tbody>
</table>
Figure 8 reports spending resources by state and municipal government as a share of GDP, and its main components. A sharp increase in funds spent by subnational governments is apparent in the figure, reaching about 9 percent of GDP in 2007, up from 3.5 percent in the mid-1990s. Six categories are identified.

Figure 8

State governments’ income as % of GDP

Earmarked resources are drawn in blue colors. These include standing earmarks, what Hacienda calls *aportaciones* and are grouped in *ramo 33* of the federal budget. Ramos are budgetary categories grouping lines for specific entities or activities; Ramo 33 appeared first in the FY1998 budget after reforms to the Ley de Coordinación Fiscal. Initially the fund was disbursed in a highly discretionary manner by the president, along the lines of the IPFs above; over time, however, formulas were established to distribute these resources in a more objective manner (because poverty is part of the formula, there is bias towards PRI-dominated states). *Aportaciones* fund federal policy that statutes mandate to be administered by state and municipal
governments. *Aportaciones* fund some education, health, infrastructure, and so forth. Agreed earmarks are what Hacienda calls *convenios de descentralización*, transfers of federal policy to state and municipal governments not mandated by law but agreed by each subnational government with the federation on yearly MOUs. Earmarked funds represented less than 2 percent of GDP in 1995, surging to about 3 percent in 1998, when *ramo 33* was adopted and more federal policy came to be administered by sub-national governments. 1998 also marks the reduction of agreed earmarks, most of which became mandated by law and funded by the new *ramo 33*. Earmarked appropriations have trended up: in 2007, an amount equal to about 4 percent of GDP was transferred from the federation to sub-national governments.

The third blue category consists of what Hacienda calls *adeudos del ejercicio fiscal anterior* (ADEFAS), goods and services unfinished or undelivered at the end of the fiscal year; this precommitted money is transferred to the next fiscal year, but remains tied to the initial items. Adding ADEFAS to the other blue categories shows that state and municipal governments have no discretion over approximately half of their income since 1998, up from two-fifths in 1995-97.

While state and municipal governments cannot change spending priorities in the blue categories, these 4 percent of GDP earmarked transfers remain powerful sources of patronage: governors have considerable discretion to hire who will do the job – unlike federal hires, no state or municipal government is subject to civil service laws. The number of subnational government employees spiked from about 1 million in 1992 to more than 2.5 million in 1997 (OECD 2000).

Sub-national governments can establish spending priorities with the other three sources of funding. First among discretionary appropriations are what Hacienda calls *participaciones*, grouped in *ramo 28* of the federal budget. These non-earmarked revenue transfers from the federation to states include rough guidelines about how to distribute resources to municipal governments. *Participaciones* represented 2.5 percent of GDP in 1995, 3 percent in 2007, and year-to-year growth has been remarkably constant.
Another source of income that states and municipalities control are taxes they raise on their own, which were less than 1 percent of the GDP throughout the period. Sub-national governments' own income represented approximately 15 percent of their income before the introduction of ramo 33, and approximately 10 percent afterwards.

A fund was set in place in 2000 to redistribute a share of unexpected oil windfalls due to international prices greater than the price anticipated in the budget before the start of the fiscal year. In times of rapidly increasing oil prices, such as 2001-2007, what Hacienda calls *excedentes petroleros* added between a quarter and half a percentage GDP point to state and municipal finances. The *Ley de Coordinacion Fiscal* formally ties the central government’s hands to transfer about half of it to states’ revenue. Anecdotal evidence indicates that it is used for pork barrel projects rather than developmental expenses.

While all sub-national units raise a minimal share of the money they spend, there are important differences between state and municipal governments. The latter get a constitutionally-mandated transfer of property taxes, letting them raise on average 23 percent of their budget in 2005. That same year, state governments raised 11 percent of their revenue on average. Municipal relative performance appears to be highly driven by cities (Moreno 2003); states with one large city and few other municipalities appear to be most acquisitive, shown in Figure 10. Due to recent increases in transfers from the central government this share has gone down in recent years, although data on state differences is unavailable.

**Figure 9**
State governments' own revenue as % of their total revenue 2005
Another significant change was the introduction of new rules for states to borrow. The Constitution greatly restricts sub-national borrowing. Among other things, it requires that sub-national debt must be in pesos, must be borrowed from Mexicans, and must be used for productive investments; furthermore, state congresses must approve and guarantee all municipal debt. Until 1999, the central government was obliged to pay for sub-national government defaults. Prior to the 1999 reform, sub-national debts were small, in part because the federal government pre-emptively bailed out states with budget deficits. The 1999 reform forced sub-national government to participate in the credit market as any other agent, using their own assets as collateral: states established specific funds in which federal participation revenue would be deposited to guarantee their debt payment. Sub-national entities have to register their debts at

Source: prepared by authors with information from the Presidency (primer.informe.gob.mx/pdf_excel/P339.xls).

Figure 10
Municipal governments' own revenue as % of their total revenue 2005

Note: Federal District has no municipal governments.
Source: prepared by authors with information from the Presidency (primer.informe.gob.mx/pdf_excel/P339.xls).

The legal reform actually took place in 1995, but it was not fully implemented until 1999.
Hacienda for informative purposes. To date, sub-national borrowing has been small and stable, growing from 94 billion (constant) pesos in 1994 to 102 billion pesos in 2002, less than 2% of GDP (see Giugale, Trillo and Oliveira 2000).

If. Fiscal Institutions and the Budget Process

Mexico’s budgetary institutions have been transformed over the past two decades. Congress has increasingly sought to increase its role in the budgetary process and tie the presidents’ hands by limiting presidential discretion over spending. Presidents, by contrast, have given up some of their direct control over spending in return for an oversight role on sub-national transfers. Virtually all of those changes are an outgrowth of democratization. In this section we describe the institutions, track changes over time and show how it affects inter-branch negotiations.

Budget process. In systems with separations of power, like Mexico, the branches of government concur in the establishment of the federal budget. The executive branch initiates the process by submitting the income and budget bills before the new fiscal year; Congress discusses, amends, and votes revenue (Ley de Ingresos) and appropriation (Presupuesto de Egresos) bills; the executive decides whether or not to veto the bills; Congress performs oversight of executive programs to verify that they conform with budgetary and general policy lines drawn by Congress; and the Supreme Court settles disputes.

Congressional asymmetry. As in most other countries, the executive has the exclusive power to draft and submit the budget request for Congressional approval. SHCP has two sub-secretariats—conveniently named Ingresos (revenue) and Egresos (expeditures)— specializing in preparing requests to Congress. Bills require approval by both the Chambers of Congress (Deputies and the Senate); the one important exception is the appropriations bill: only deputies discuss, amend, and vote on it, a practice enshrined in the 1857 Constitution. The income bill, on the other hand, requires bicameral approval like regular legislation.

The most important implication of this asymmetry occurs at the executive veto gate stage: for decades it remained uncertain whether the president could veto bills produced by a single
chamber of Congress, like the appropriations bill. In May 2005, the Supreme Court ruled that the Mexican president is constitutionally endowed with a power to veto the appropriations bill. The ruling also established that the veto is a line-item veto, letting the president return only those parts of the bill prepared by deputies that he opposes, while letting him publish the rest to avoid starting the fiscal year with no budget at all. As such, the president passed overnight from (perhaps) not having a veto over the most important piece of regular legislation (Shugart and Carey 1992, Mainwaring and Shugart 1997) to having a very strong one.

The reversion point. The Mexican constitution does not specify the reversion point. Most believe that the true “reversion point” (cf. Kiewiet and McCubbins 1988) in case of bargaining failure is $0 in Mexico. Other things constant, a $0 reversion point increases the influence of the agenda-setter at different stages of the process – the president against Congress, the Budget committee of the lower chamber against the floor, etc. Scholars and practitioners have argued in favor of a reform to this feature to avoid the possibility of government shutdown in case of bargaining failure, which remains a real possibility under divided government.

Timing. Mexico's fiscal year runs from January 1 to December 31, so the new budget needs approval before the end of the calendar year. In the heyday of PRI hegemony, the president had until December 1 to introduce budget legislation, leaving a mere month for consideration. One consequence of the short time-frame was that congressional input on the overall budget was limited, giving the president considerable discretion. Another consequence was the members of congress could credibly threaten to reject the bill, forcing last-minute concessions by the executive that were largely pork. Since the emergence of divided government in 1997, that time frame has been extended several times (see Table 7).

The constitution currently mandates that the executive should submit the income and appropriations’ bills to Congress no later than September 8; however, a secondary law (Ley Federal de Presupuesto y Responsabilidad Hacendaria, art. 42, enacted in 2006) actually pushes that date forward to April 1. Extending the budget process leaves for more time for negotiation
between Congress and the Executive, allows for more congressional input on initial priorities and reduces the threat of last minute hold-up by Congressional members.

**Resource asymmetry.** As in the rest of Latin America, the lion’s share of staff and resources are under executive control. This resource asymmetry gives the executive bargaining advantage over the assembly: the latter may not be in a position to draft a technically feasible alternative to the president's proposal. In addition, the new Accounting law (2008) has introduced a balanced budget clause, requiring that any amendment to appropriations must also provide a source of revenue. Since the revenue bill is passed first, there may be constraints to actually amend the executive’s **egresos** proposal.

**Oversight.** Committees in the U.S. Congress let members specialize in the policy domains of major interest to their constituents (Weingast and Marshall 1988). This makes the monumental task of executive department oversight manageable for 535 elected representatives. The Mexican Congress features standing committees like those in the United States, but their oversight role was minimal until the emergence of multiple-party democracy. During the period of PRI hegemony, committees were only expected to report (**dictaminar**) bills in their jurisdiction, while oversight activities were fully centralized in a technical chamber body (the **Contaduría Mayor de Hacienda**). This body reported once a year to Congress (in November, shortly before the executive's deadline to submit the fiscal and appropriation drafts) to provide “general comments” about the way the executive had handled programs and expenditures compared to the budget mandates (Gutiérrez et al. 2001, Ugalde 2003). Shortly after the PRI lost control of the lower chamber (1997 midterm election), the **Ley Orgánica del Congreso**, which contains congressional rules along with the constitution and an executive norm of lower legal status, was reformed. Those reforms empowered congressional committees to become directly involved in executive oversight; even so, SHCP retains ample discretion to alter spending and reallocate funds between different programs.
2. INVENTORY OF REFORMS

This section describes most significant changes in the three areas of study. While there were multiple changes to fiscal laws and policies in the period, many were minor incremental changes irrelevant to understand variance in the dependent variables; thus, we do not report them here. To choose significant changes we relied on the existing literature and attempted to gauge the real magnitude of a change in terms of its expected results and its actual effects.

Reforms are organized in tables stating the main specific points of the reforms and the variables we infer triggered the change. We also include specific episodes of failed reform attempts, which were publicly known.\(^\text{20}\) However, especially during the PRI era, much of the bargaining was done behind doors and, thus, information is scarce and ambiguous in this respect. The items we report as non-reforms were documented through personal talks with Hacienda personnel and media reports. There are likely many non-reform episodes which we do not document here because there is insufficient evidence.

2a. Taxes

From the changes reported here, there are two clear trends. First, there has been an increasing centralization of revenue, which was consented to by states. Second, a continuous, but not always successful, search to increase revenue by widening the tax bases, especially on consumption, and reducing evasion, especially of income taxes. One striking feature that deserves mention is a relative dearth of ambitious reform proposals, particularly on the tax side. Major increases in labor taxation have not been formally proposed, for example, nor has there been a sustained effort to eliminate most tax exemptions or the special income tax regimes.

We begin by detailing the main non-reforms in taxes. In 2001, a key proposal to the Fox administration derailed: an attempt to create a flat VAT rate of 15%, which would have nullified all exemptions and 0% rates over goods and services. The well publicized failure deprived the government of an important and feasible source of extra revenue. A second failed attempt was

\(^{20}\) Non-reform is especially hard to observe since few governments will introduce proposals they know will be defeated, introducing selection bias.
made in 2004, after the president’s party lost the plurality in the lower house of Congress in the midterm election, to change the VAT. It proposed to create a flat VAT rate of 10% over goods and services and a drop of the income tax on business from a maximum rate of 35% to 32%. A gradual reduction to 32% over three years was approved instead. Currently at a maximum rate of 28%. Table 6 summarizes the main reforms in taxes.

2b. Budget

Budget-making institutions changed, reflecting the fact that Congress operates in a multi-party environment in which, as compared to the PRI hegemonic regime, interests are plural and credible commitments harder to reach. The trend in budget outcomes has been to keep a balanced budget—a consequence of the recurrent crises from the 1980s and 1990s—and to reduce discretion on spending. We see two other clear trends, both of which reflect the preferences of the central government and those of the states and parties out of the executive. On the one hand, democratization has increased spending decentralization to sub-national units, in part because opposition parties (including the PRI since 2001) have their strongholds at those levels of government. On the other hand, the central government is struggling to control how states and municipalities spend their resources.

As above, we start with the main non-reforms. Congress lacks since the 1990s a truly effective monitoring mechanism to oversee spending by the central and sub-national governments. The Constitution also retains many ambiguities regarding political actors’ property rights over authority, as exemplified by the uncertainty over presidential veto power and decrees. Table 7 summarizes the main budget reforms.

2c. Decentralization

The overall picture of reforms shows how revenue has been increasingly centralized, while spending has been decentralized, widening the fiscal disconnect of the system. Main non-reforms include the failure to construct adequate enforcement mechanisms to make sub-national governments accountable for their spending. The 1995 and 1999 reforms on sub-national entities
debt are a step forward in this respect, but little more has been done directly regarding spending. Neither have sub-national governments been induced to collect more revenue. Table 8 summarizes main reforms.
### Table 6 – Tax reforms

<table>
<thead>
<tr>
<th>Year</th>
<th>Change</th>
<th>Specifications</th>
<th>Causal variables</th>
</tr>
</thead>
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| 1980 | - The VAT is created.  
- The general rate is 10%; the special rate for food and medicines is 6%.  
- See Table 1 for details on VAT evolution. | - The VAT replaced 18 federal taxes and 458 state taxes. It was more of a reorganization than a new tax.  
- States were compensated by presidential guarantees that federal transfers (available thanks to oil revenues) would meet or exceed the revenue they would forego by giving up their taxing powers. | Need for revenue.  
Fiscal centralization strategy of the central government. |
| 1983 | The standard VAT rate is increased from 10% to 15%. | - It raised revenue by about 1% of GDP (García-Alba 2006, 4). | Need for revenue in crisis situation. |
| 1987 | Maximum income tax rate on individuals is reduced from 60.5 to 55%. | | Need to make the system more competitive by international standards after Mexico joined the GATT. |
| 1988 | Maximum income tax rate on individuals reduced from 55 to 50%. | | Same as above. |
| 1989 | Income tax reduction.  
- 50% to 35% on individuals.  
- 42% to 35% on business. | | Same as above. |
| 1989 | - The Tax on Business Assets (Impuesto al Activo de las Empresas) is created. | - Designed to be a minimum tax business, it aimed to reduce income tax evasion by businesses that systematically declared loses.  
- Before this tax around 70% of business declared no profits (Elizondo 1994, 177).  
- It increased income tax revenue by 13%. | Need for revenue. |
| 1989 | Many special regimes in the Taxing Regime of Special Bases (Régimen de Bases Especiales de Tributación-RBET) are eliminated. | - Main losers: farming, fisheries, road transportation, editorial industry, and medium and small business.  
- Around 17% of all citizens saw their fiscal privileges removed, including those not paying taxes and those with special tax regimes.  
- However, a further reform in February of 1991 returned tax privileges to most of these groups. | Need for revenue. |
| 1989 | Tax evasion penalties get tougher | - Between 1921 and 1987 only two tax evaders ended up in prison; | Need for revenue. |
and enforcement gets more effective. in 1988, 7 went to jail; 50 in 1989; and 400 in 1990 (Elizondo 1994, pp.181-182).

1990 **The Simplified Regime** (Régimen Simplificado) is introduced. - It is an alternative tax scheme that was devised to reduce evasion by making it easier for small business to pay their taxes. Need for revenue.

1990 The federal government assumes full control over **VAT administration**, supplanting state authority. Fiscal centralization strategy of the central government.

1991 **The VAT general rate is reduced** from 15% to 10%. - Decreased VAT revenue about 1% GDP (García-Alba 2006, p.4). - The government could afford to reduce this source of revenue since total budgetary income as percentage of the GDP was at its historic peak (See Figure 3). - Crisis situation. - Electoral incentives. It was done a few months before midterm elections.

1991 **Income tax reduction.** - 35% to 34% on individuals. Need to make the system more competitive by international standards just before NAFTA comes into effect.

1993 **Income tax reduction.** - 35% to 34% on business. Need to make the system more competitive by international standards just before NAFTA comes into effect.

1994 **NAFTA comes into effect.** - It reduced certain tariffs and, thus, imports revenue in the short-term. On the other hand, it gradually increased the volume of imports and exports, which was expected to more than compensate the losses from decreasing import taxes.

1995 **The SAT (Servicio de Administración Tributaria) was created** - It is a quasi-independent entity to supervise tax collection and enforcement (It became operational in 1997). Need to make a more efficient tax collection agency.

1995 **Tax on Business Assets rate (Impuesto al Activo de las Empresas) reduced** from 2 to 1.8%. Crisis situation.

1995 **VAT general rate is increased from 10% to 15%** (See Section 6 for further details). - Except in border cities, where it remained at 10%. Need for short-term revenue in a crisis situation.

1996 **Small and medium business are exempted from the Tax on Business Assets.** - It was designed to provide incentives for investment and prevent many business from going into bankruptcy. Need to reactivate the economy in a crisis situation.
1997 | Reform to the public pension system for private-sector workers. | - It changed the state-administered pay-as-you-go system (IMSS) into a private administered defined-contribution system (AFORES).  
- The reform left the health care system untouched. The IMSS is still the main provider of health care for private sector workers. | IMSS huge deficit. Its liabilities were estimated to reach 141% of GDP by 2069 (Grandolini and Cerda 1998). |

1999 | Corporate tax reduction; personal tax increase. | - 34% to 30% on business.  
- 35% to 40% on individuals | |

2002 | Personal income tax reduction | - 40% to 35% on individuals, with phased in reduction to 28% in 2007 | |

2007 | The Impuesto Empresarial a Tasa Única, IETU, a new minimum corporate income tax, is created. | - 17% flat rate on non-deductible income.  
- In place in 2008, it replaces the Business Asset Tax.  
- This tax is devised to prevent evasion and induce investment.  
- Revenues for 2008 from this tax fall short 30% of the expected (estimates from Hacienda). | Need for revenue. |

2007 | New cash deposit tax (Impuesto a los Dépósitos en Efectivo) created. | - 2% on cash deposits above 25,000 pesos per month.  
- It is aimed indirectly at informal businesses. | Need for revenue. |

2007 | Reform to the pension system of public-sector workers. | - Even though the reform allows workers to choose between a state (ISSSTE) and a private administered pension system (AFORES), the scheme is constructed to provide sufficient incentives for workers to move into the private system. | The pension system was bankrupt. |

2008 | Reform to the fiscal regime of the state-owned oil company (Pemex). | - In place in 2009.  
- It reduced Pemex’s fiscal load and freed up resources to be invested in the company, which were previously assigned to other budgetary items.  
- Pemex’s investment expenditures taken out of the yearly budget.  
- Pemex’s debt was also directly accounted as Pemex Debt and not as central government debt (in the PIDIREGA). | Decreasing oil production. |

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<thead>
<tr>
<th>Year</th>
<th>Change</th>
<th>Specifics</th>
<th>Causal variables</th>
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<tbody>
<tr>
<td>1998</td>
<td>Presidential discretionary spending authority is reduced.</td>
<td>- The new constitutional rules require the executive to get Congressional authorization to contract new debt and to use</td>
<td>Democratization.</td>
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Table 7 – Budget reforms
<table>
<thead>
<tr>
<th>Year</th>
<th>Event</th>
<th>Description</th>
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| 1999 | Amendments to Congress’ Organic Law (Ley Orgánica del Congreso). | - They modified the composition of the ruling bodies of Congress to have a more proportional representation of parties in the legislature (Weldon 2004).  
- It also changed the way committees posts were assigned to reduce the PRI’s over-representation. |
| 2000 | The Accountability Law of the Federation (Ley de Fiscalización Superior de la Federación) is approved. | - It creates the main organization that the Legislative has to monitor the budget execution by the executive, the Auditoría Superior de la Federación.  
- A first step towards greater accountability of the executive by the legislature, however, it has not became yet an effective check. |
| 2000 | Petroleum Stabilization Fund established. | - The fund was largely ceremonial until recently as the rules were watered down, if not ignored altogether, until around 2006. |
| 2004 | The Constitution is amended to change the deadline for budget approval from December 31st to November 15th. | - The December 31st deadline imposed a lot of pressure on the bargaining since the budget was supposed to commence the following day. The new deadline allowed more maneuvering room in the bargaining process. |
| 2005 | The Supreme Court ruled that the executive has veto power over the budget. | - The Court ruling was divided, 5 vs. 4, which implies that the Court’s decision can still be revised if a similar case is presented in the future.  
- The shadow of the veto changed the dynamic of budget bargaining by inducing all actors to negotiate ex ante. |
- It pulls forward the deadlines for passing the budget, from December 15 to the end of October (revenue) and mid-November (appropriations). |

- The president also needs Congress authorization to spend on programs or public works when costs exceed the previously budgeted amount by 10 percent.

- New revenue generated above the budget estimates.

- Democratization.

- Need to curb spending at subnational levels.
| 2008 | A new Accounting Law (Ley de Contabilidad Gubernamental) was approved by Congress. | - It reduces SHCP’s margin to reallocate moneys from one spending category to another during a fiscal year.  
- One of the main changes is a new frame for the budget that is based on outcomes (presupuesto basado en resultados), as opposed to the previous scheme based on expenditures.  
- While it is a significant breakthrough on how resources are, or should be, assigned, its implementation has proven difficult, varying its success from budget area to budget area.  
- In case of unexpected deficits, it includes specific rules to restore a balanced budget.  
- The new legislation requires that laws determining new expenses must identify the source of revenue that will finance such expenditure. | Need to curb spending at subnational levels. |

2008 | A new Accounting Law (Ley de Contabilidad Gubernamental) was approved by Congress. | - This is a major change (at least formally) aiming to induce greater transparency on the use of resources by sub-national governments by stating unique accounting criteria for all levels of government.  
- Immediate results are not expected, given its complex implementation and the lack of existing enforcement mechanisms by the central over sub-national governments.  
The hope is that it will function smoothly in the near future, say, 4-6 years. | Need to curb spending at subnational levels. |
<table>
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<tr>
<th>Year</th>
<th>Change</th>
<th>Specifics</th>
<th>Causal variables</th>
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</table>
| 1989 | The Social Development Agreements are created (Convenios de Desarrollo Social-Ramo 26). | - Its main objective was to disburse the resources of the National Solidarity Program (PRONASOL), a wide anti-poverty federal program, to the states.  
  - While recognized as a major change in terms of decentralization, there is ample evidence of electoral bias in the selection of recipients of poverty alleviation funds, with PRI constituencies/regions benefitting disproportionately (e.g. Molinar and Weldon, 1994; Diaz-Cayeros et al. 2007). | Democratization.                  |
| 1992 | National Agreement to decentralize basic education.                    | Its results were mixed across states. Some states managed to take charge of education, but others, arguing lack of resources, failed to do so.                                                             | Democratization.                  |
| 1995 | Reforms to the Law of Fiscal Coordination (Art. 9 Ley de Coordinación Fiscal-LCF) regarding rules for state’s debt. | - The central government is no longer obliged to pay state debt in the case of default.  
  - This reform, however, was not fully implemented at this time because it lacked of specific rules.                                              | Need to curb spending at subnational levels.                                      |
| 1996 | National Agreement to decentralize health services.                    | - This was the second great area that was decentralized, after education.                                                                                                                                  | Democratization.                  |
| 1998 | A new scheme to redistribute resources to the states is devised: The Ramos 28 and 33. | - The Ramo 28 transfers non-earmarked resources (participaciones) to the states. Resources are redistributed on three main criteria: state population, states tax collection of federal taxes, and inversely to states per capita non-earmarked transfers. | Democratization.                  |
| 1999 | Two new funds are added to the Ramo 33 (earmarked transfers)           | Two new funds are added to the Ramo 33 (earmarked transfers): Technological and adult education (FAETA) and the Public safety (FASP).                                                                           | Democratization.                  |
| 1999 | New rules for state debts are created (implementing the Dec 9th, 1995 reform). | - It implemented the December 9th reform.  
  - The federal government is no longer responsible in case of state defaults and states now operate as any other agent in the                                                                           | Need to curb spending at subnational levels.                                      |
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<th>Year</th>
<th>Event</th>
<th>Description</th>
<th>Sector</th>
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<tbody>
<tr>
<td>2000</td>
<td>A new fund to strengthen states finances is created (FAFEF).</td>
<td>Even though it is an earmarked fund, it provides ample discretion to states to decide its use in the realm of investment, debt, or pensions.</td>
<td>Democratization</td>
</tr>
</tbody>
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| 2001 | The National Conference of Governors (CONAGO) is created.            | - Governors organized the CONAGO to build a coalition that would put them in a better position to negotiate with the executive—as opposed to one-by-one bargaining that was the norm during the PRI era.  
- Preliminary evidence shows that the CONAGO has not had a substantive impact on states’ income, other than wide media coverage (Díaz-Cayeros, 2005). | Democratization |
| 2005 | States are legally allowed to tax part of their income tax base (specifically non-salaried income) at a 2%-5% rate. | - The objective was to provide incentive for states to become more active in collecting taxes and building an adequate tax administration structure.  
- Few states, however, have opted to implement this tax.                                                                                                         | Need to reduce the fiscal disconnection between states spending and revenue. |
| 2008 | A new criteria to redistribute non-earmarked resources (participaciones) to states is created. | - It aims to induce states to generate their own revenue.  
- Resources are distributed on this criteria: 60% based on the states’ GDP; poorer states get more. 30% based on states tax collection change with respect to the previous year; those with higher revenue get more. 10% based on the state level of tax collection. | Need to reduce the fiscal disconnection between states spending and revenue. |
| 2008 | A new non-earmarked fund is created to compensate the 10 poorer states (FOCO-10). | - It is financed by 2/11 of gasoline revenue.  
- While it serves equity criteria, it also gives perverse incentives to poorer states to underperform on tax collection.                                                                 | It was a side-payment to the PRI and governors in exchange of an increase to gasoline prices. |
3. ANALYTICAL FRAMEWORK

This section overviews change and stasis, focusing heavily on taxation, given that it has been the thorniest issue. While recognizing that there are many paths to reform, with serendipity playing a large role, we believe that democratization and electoral competition explain a good deal of spending decentralization and changes in budgetary institutions, while taxes are partially explained by one variable, crisis. Four additional variables round out the story, particularly with respect to tax policy: The first has been the need to retain fiscal balance, the one binding constraint that every president since the late 1980s has accepted; whenever imbalances have emerged presidents have acted to restore fiscal discipline. Second, the availability of alternative revenue sources; the willingness and ability of Presidents to cut deals with Congress has hinged on the amount of extraordinary income available at any moment in time. Third, the mapping of revenue collection onto spending authority; as spending decentralization has advanced, the incentive of executives to bargain for new taxes has fallen. Fourth, the transaction costs associated with negotiating exchange under different Constitutional and partisan configurations of government; the emergence of multiparty government, particularly divided government after 1997, has raised transaction costs.21

Our contention is that the rate of change has increased when fiscal imbalances emerge and/or when the people that control tax authority also control spending; it has fallen when transaction costs rose and/or when alternative sources of revenue were available. Maximum change in tax policy would be associated with large fiscal imbalances (i.e., a major crisis), a high degree of overlap between tax authority and spending control, low transaction costs and few alternative options. Stasis would be associated with fiscal balances, a minimal overlap between control over taxes and spending, high transaction costs, and myriad alternative revenue sources.

21 To that list, one might add a fifth constraint on the tax side: tax rates in neighboring countries. Because capital flight and cross-border purchases are genuine threats, it is thought that Mexico’s statutory tax rates cannot grossly deviate from those in the United States and Canada.
In the period we analyze, these variables have never taken on the values one would associate with maximum change or complete stasis in tax policy. Instead they have moved in opposite directions: while imbalances have fluctuated over time, alternative revenue sources have fallen, transaction costs have risen, and the overlap between taxation and spending has declined. Fluctuations in revenue associated with petroleum dependence and economic volatility pose a continuous threat to the fiscal balance, so no recent government has had the luxury of staying pat: all have made adjustments, even if only minor. But minor adjustments have not always been adequate to maintain fiscal stability; hence executives have occasionally pushed through more substantial changes, often by making major concessions in other areas. Side payments on tax and debt management issues have frequently taken the form of increased transfers to sub-national units. At the same time, no recent government has had the will and the capability to fundamentally re-structure the revenue system. All have faced strong resistance from interest groups benefiting from the status quo. As such, Mexico has meandered forward, staying afloat fiscally, but never reaching solid ground.

\textit{Democratization and its consequences}. Mexican voters ended seven decades of uninterrupted PRI government in 1997-2000, inaugurating multiparty competition. Democratization had a number of consequences. First, democracy brought in new groups demanding institutions and resources that matched their political weight. During the PRI era, the president was the central figure in politics, serving as the central broker between party factions and interest groups. The president’s strength, in the years of hegemony, was based on partisan powers, not constitutional ones (Weldon 1997). As detailed elsewhere (e.g., Shugart and Carey 1992), the Mexican president’s constitutional powers are relatively weak: he has no power to produce policy unilaterally when Congress fails to cooperate; has no areas of exclusive policy initiative; and until 2005, constitutional scholars firmly believed that his veto power excluded the appropriations bill of the budget, something that the Supreme Court changed in a very
important ruling (see the section on the budget). Since the PRI lost majority status in Congress in 1997, and the presidency three years later, informal negotiation mechanisms were replaced by formal bargaining in a system with a high level of separation of power.

The judiciary. Courts make policy by interpreting the constitution and the constitutionality of statutes. Even if they can only react to other players' actions, the power that they can wield is enormous (e.g. McCubbins and Lax 2006). A strong judiciary is, in principle, just another veto gate. In practice, their role can be more subtle. During the era of PRI hegemony, virtually all judges were priistas (or sufficiently well-garbed to pass as one); even if judges were independent, their preferences were aligned with those of the ruling party. The emergence of multi-party democracy has invigorated the court.

Transaction costs. As seen with the Court’s involvement in policy bargaining, multi-party democracy has increased transaction costs substantially, as bargains now need to be struck across parties and between independent institutions. The PAN nearly doubled the size of its contingent in both houses of Congress between 1997 and 2006, with an important drop in the 2003 midterm (when only deputies are renewed) and the recent 2009 election, in which it did not even win a third of the chamber, the number needed to defend a presidential veto on the budget (only voted by the lower chamber). The PAN, however, has options to block PRI action in the Senate. The PRD has had more volatile returns, capturing a favorable swing in the 1997 midterm election followed by an unfavorable one in 2000, when Fox’s coattails played in favor of PAN. Having lost majority status in 1997, the PRI managed to stop the monotonic drop in victories in the 2003 midterm; it had a dismal showing in 2006, coming in third, but regained the lower chamber majority in 2009 (allied with the small Green party).

Overall, these developments have increased party fragmentation in both chambers of Congress: the lower house had 2.3 effective parties in 1994-97, the last instance of PRI majority, surging to 2.8 in both 1997-2000 and 2000-03, 3.0 in 2003-06, 3.5 in 2006-09, and
3.0 in 2009-12. The upper house lagged behind, but fragmentation is also acute: it had 1.7 effective parties in 1994-97, 2.2 in 1997-2000, 2.7 in 2000-06, and 3.5 in 2006-12.

Democratization also fragmented power at the sub-national level. In 1997, the PRI accounted for nearly 100 percent of sub-national electoral posts; by 2008, that number had dropped to approximately two-thirds. While a majority of state governments remain controlled by the PRI, the number of opposition-won governorships has surged importantly. Since the PAN won the state of Baja California in 1989 – the first time the PRI was defeated in a gubernatorial race – the number of PRI-governed states decreased more or less linearly until 2000, as shown in Figure 12A. The rhythm of PRI defeats was about 1 every two years until 1997, then 2.5 every year. After 2002 the situation appears to have stabilized with the PRI at 17-18 governors, 8-9 for PAN, and 6 for PRD. Two-thirds of governors’ parties have majority status in the assembly. The fragmentation of partisan control of state governments brought important changes in the demand for more federalism in Mexico. Given that most states have PRI governments, while the executive has switched to PAN control, there have been greater demands for local control over spending. This could change if PRI regains the presidency. State executives are not held accountable for much of what they do, thanks to unprofessional state assemblies and widespread patronage networks (Keefer 2007).

*Changed electoral incentives.* In Mexico no elected official is allowed to seek immediate reelection. As a result, elected officials have no option but to be driven by progressive ambitions (Schlesinger 1994), searching out different constituencies with each new electoral cycle. Mayors, local and federal deputies have to get a new nomination before the 3-year term ends; governors, senators, and presidents enjoy 6-year terms. Since party elites control all key resources to jump successfully to the next slot (such as nominations, campaign money), parties are highly disciplined. With the emergence of competitive elections, connections to party elites have declined in importance, in part because external competitors
from other parties, notably the PAN and PRD, can be as important as internal ones. Furthermore, because external competition means that candidates must have some appeal to the electorate, nominations have been partly decentralized, with governors and local party organizations having more input than before.

The change in the nature of the electoral connection has re-shaped power relations with important fiscal consequences. Because it seems that many political careers run from Congress to sub-national posts, in part due to term limits, congressional actors have strongly favored decentralization of authority, particularly with respect to control over spending, arguably the basis of a successful career.\textsuperscript{22} It has also driven Congress to push for changes in the institutional arrangements governing spending, documented in section 2.

\textit{Fiscal Federalism.} Although Mexico is a federal State, state governments were politically and economically dependent on the central government up to the 1990s. Mexican federalism was largely fictional. States’ powers have increased over time. The combination of a partially decentralized nomination process and fiscal decentralization means that governors have emerged as more than bit players. Although Mexican governors are not the power brokers they are in Brazil (Samuels 2003), state-level delegations in Congress are aware of governor preferences, even if they are not beholden to them.

\textit{Crisis.} The hardening of the budget constrain has been a key impetus for change, especially during the period of PRI hegemony. As a catch-all party, the PRI had no ideological base; its main focus was retaining power. It demanded little from society and gave little back, siphoning off what it could to give to its main constituents, notably urban labor, large land owners, especially in the south, and selected business groups. There were no non-crisis tax reforms under the PRI during the period under analysis (unless one counts the introduction of the VAT in 1980, which was largely a re-organization of taxes, rather than a new tax).

\textsuperscript{22} Good data on political mobility in Mexico is lacking. The idea that career progression runs from Congress to sub-national posts is largely based on anecdotes.
because it was largely a status quo party. But because the PRI was committed to rectifying major fiscal imbalances (see below), they responded to every crisis. In the crisis of 1983, for example, the VAT rate was raised from 10 to 15 percent. In the crisis of 1989, a variety of special tax regimes for agriculture, fishing and ranching were eliminated and the business asset tax was created. In 1991, a time of plenty, the special regimes were restored, the VAT was reduced from 15 to 10 percent and a variety of exemptions were introduced—not surprising, perhaps, for a status quo party that sought to minimize demands on society. In the crisis of 1994/95, the VAT was once again lifted to 15 percent, but the exemptions remained.

**Fiscal Imbalances.** The need to maintain fiscal balances has been the one constraint shaping decisions of every president since the mid 1980s. The debt crisis (1981-86) badly damaged Mexico’s credibility in international markets. The sheer quantity of Mexican debt and the spike in global interest rates made international borrowing prohibitively costly, especially in the absence of major reforms. With huge outflows of revenue required just to cover interest payments, the debt crisis also fundamentally altered the perception of budget deficits within Mexico: once seen as a mechanism for promoting growth, they became an anathema, particularly to the neoliberal clique that has controlled the Finance Ministry virtually uninterrupted since the mid 1980s (Elizondo 1994).

Despite considerable volatility in year-to-year revenue, Mexico’s commitment to maintaining a primary surplus has not wavered since 1983:²³ When primary surpluses have fallen below desired levels, governments have consistently made up for the shortfall by selling state assets, cutting spending, and, as a last resort, raising taxes. Revealed preference suggests that tax reforms have been more costly than other alternatives. During times of major imbalances/crisis (e.g., 1982-83; 1989; 1994-95) every president managed to push

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²³ This commitment was codified in 2006 and put in place in 2007; what sustained it before then is not obvious. Ideology has played a key role – a firm belief that international markets immediately penalize red numbers. Hacienda has been in control of a tight clique of neoliberal economists since 1986. The only exception preceded the 1995 crisis when someone with a different group, Jaime Serra Puche, was in charge.
through increases in taxation, sometimes quite quickly. During times of minor imbalances (e.g., 1998) discretionary cuts in programmed spending largely solved the problem. When primary surpluses have exceeded expectations, the converse has also occurred, though not symmetrically: when the primary surplus topped 7 percent in 1991 Salinas lowered the VAT rate and introduced new exemptions, and restored some tax breaks for special interests that had been eliminated just three years earlier (right before the midterm elections).

*Alternative Revenue.* Mexico’s capacity to maintain fiscal balances without substantially raising taxes has been buoyed by alternative sources of revenue, including the possibility of divesting from state-owned firms and receiving revenue from petroleum sales. Privatization allowed the governments of de la Madrid (1983-88) and especially Salinas (1989-1994) to sanitize public accounts without resorting to major tax reforms, except during periods of major crisis. Not only did privatization of money-losing public enterprises (restaurants, hotels, steel factories) staunch a significant source of hemorrhaging, but also helped pay down Mexican debt and left the executive with enough discretionary funds to build their own constituencies. By the time Zedillo (1995-2000) assumed office, only a handful of attractive/potentially lucrative firms remained in state hands, including the state-owned oil PEMEX. Because PEMEX is running out of oil to drill, Mexico’s outside options have fallen precipitously. Future imbalances will have to be met with tax increases/spending cuts.

*Fiscal connection: Overlap between taxes and spending.* The central government has tried to get states to increase their fiscal effort, to little avail. Given the extent of financial transfers from the center, states and municipalities have a small incentive to increase their efforts. From the standpoint of any politician, the ideal solution is to spend money that costs nothing to obtain. A second best solution is to control both taxes and spending. The worst is to be blamed for taxes without control on spending. Because of this inherent tension, tax hikes are unlikely when the those controlling taxation are different from those controlling spending.
Under unified PRI control, there was considerable overlap between taxing and spending, giving presidents incentives to increase taxes, largely offset by relatively large alternative sources of revenue (during non-crisis periods) and the PRI’s commitment to maintaining the status quo. This overlap shrank with democratization. Less in control over spending, recent executives have fewer incentives to pay the political costs associated with increasing taxes. Because prudent fiscal management has prevented any major crisis since 1994-95, tax reform has generally been pushed to the back-burner, despite the fact that recent presidents have repeatedly stated a desire to expand spending, especially on social programs.

Similar incentive problems characterize federal relations with sub-national governments. States would prefer more discretion to spend, no monitoring from the central government, and to collect minimal taxes. The central government prefers the opposite (that is, limited sub-national discretion, high monitoring and greater sub-national tax effort). Until the central government can credibly threaten to stop or roll-back transfers, it is hard to imagine sub-national governments considerably increasing their tax effort.

*Transaction costs.* Transaction costs have varied over time, according to the institutional powers of congress and its partisan composition. Increases in the de-facto power of Congress and in the degree of within and cross-party fragmentation raise the costs of negotiation, while homogeneity and hierarchy lower it. During the PRI hegemony, transaction costs were low, but not negligible as the PRI represented a heterogeneous coalition; in general, however, the executive’s partisan powers trumped the Constitutional division of authority, letting presidents get what they wanted at lower cost than today’s presidents (Magaloni 2006).

The rise in transaction costs was palpable during the Zedillo administration, especially after the midterm election. The PRI lost its majority in the lower chamber and Zedillo relinquished control over his party. Relative weakness meant that more had to be paid for the same outcome. Transaction costs peaked under Fox’s minority presidency (2001-06): his
party lacked majority status in both chambers and he was far from being the uncontested leader of the party. While Fox coveted new revenue and supported an overhaul of the VAT, he was unwilling to pay the price demanded by Congress. Under Calderón’s before the midterm, transaction costs have fallen marginally: the PRI no longer has majority in the senate and he has a firmer grip over the party. He has successfully pushed through several tax proposals, but paid a high price (see Section 4).

Because many changes in fiscal institutions require constitutional amendments, transaction costs will be never be negligible in Mexico. Well-organized interest groups, served well by existing policy, protect the constitutional status quo, so changes will be particularly difficult. Virtually all changes in recent years have been back-handed attempts to expand the tax base, rather than frontal assaults on the privileges held by certain groups.

The perceived fairness of the tax proposals. It is worth noting now that one crucial determinant on the success of reforms during non-crisis periods was the nature of the proposals themselves. Both Fox and Calderón proposed tax increases arguing their necessity to fund more social spending, especially poverty-relief; but Fox’s tax proposal was relatively regressive, while Calderón’s was relatively progressive. We suspect that Calderón’s counter-intuitive proposal (a right-wing president aiming to tax middle and upper income groups) was seen as more fair and hence credible because it hit close to his supporters; Fox’s proposal was rejected in part because it targeted unambiguously non-core supporters, lower income groups, making it easy for opposition parties caricature the proposal as class warfare on the poor.

4. CASE STUDIES

In this section we present three different case narratives that illustrate different values of our independent variables and the variance on outcomes produced by these configurations. We selected one reform episode during crisis, Zedillo’s successful VAT reform in 1995, and
two non-crisis episodes, one successful, Calderón’s (partially) successful fiscal reform in 2007, and one unsuccessful, Fox’s failed attempt of fiscal reform in 2001. These cases are likely the most relevant in the period under study. We have no non-crisis episodes under the PRI, prior to 1997, because there were none during the period under consideration; unless there was a shock forcing them to respond, the PRI largely sought to protect the status quo. Table 9 summarizes the values of independent variables for the cases analyzed.

### Table 9 – Variables values for the case studies

<table>
<thead>
<tr>
<th>Case</th>
<th>Need to retain fiscal balance</th>
<th>Alternative revenue sources</th>
<th>Transaction costs</th>
<th>Distributionally Credible</th>
</tr>
</thead>
<tbody>
<tr>
<td>Zedillo 1994 Successful</td>
<td>High</td>
<td>Medium</td>
<td>Medium</td>
<td>n/a</td>
</tr>
<tr>
<td>Fox 2001 Unsuccessful</td>
<td>Low</td>
<td>Medium</td>
<td>Highest</td>
<td>No</td>
</tr>
<tr>
<td>Calderón 2007 Successful</td>
<td>Low</td>
<td>Low</td>
<td>High</td>
<td>Yes</td>
</tr>
</tbody>
</table>

4a. Reforms in crisis times

Mexican executives have been able to change significant parts of the country’s institutions relatively quickly during crisis moments. But the increasing leverage that crises give executives has not been used to make the fiscal structure more efficient. Instead, crisis has largely served to increase revenue in the easiest and most expedient manner, that is, by increasing consumption taxes and raising income tax on captive taxpayers. These outcomes make sense, given that the main goal is to allow the State to survive the shock.

**Case 1: The VAT reform.** The 1995 raise from 10% to 15% provides a good illustration of our argument. A deep economic crisis began in Mexico at the end of 1994, driven by the vertiginous freefall of the peso and the imminent collapse of the financial system. GDP fell by 6.2%; foreign reserves were exhausted; inflation was above 50%; tax revenue fell by around 2 percentage of GDP from 1994 to 1995. In March of 1995, Zedillo presented a package of policies to Congress (Programa de Acción para Reforzar el Acuerdo de Unidad para la Emergencia Económica) designed to alleviate the effects of the crisis. One of the main proposals to increase revenue was an increase in the VAT rate from 10% to 15%. After
a heated debate in Congress, Zedillo’s party (the PRI), which had the majority in Congress, approved the VAT increase on April 1st; all opposition parties voted against the reform.

Zedillo and the PRI were willing to assume the political costs of unpopular policies because it was clear to all that the country was close to bankruptcy, which would have damaged the PRI label even more, given that the Presidency and Congress were in its hands. PRI support, however, was not unrestricted. Zedillo could not, for example, eliminate the zero-rate on food and medicines. Exempted items remained the same. These changes would have gone against key PRI clientele and, thus, were unacceptable.

The rate raise allowed revenue from the VAT to remain constant from 1994 to 1995 (Figure 5) despite the economic slump. The goal of reform was not increased redistribution, nor a more efficient fiscal structure, but plainly to raise much needed revenue fast.

In terms of our independent variables, the economic crisis drastically increased the need for fiscal revenue. While alternative revenue sources existed (e.g., ramping up oil production and/or selling off state assets, such as PEMEX) they could not be tapped quickly enough fill the fiscal gap the crisis had opened. Because the PRI still controlled all three branches of government, transaction costs were relatively low. Finally, there was still considerable overlap between spending and tax authority; with the central government (and PRI) controlled both taxes and spending, the executive had incentives to push through the tax increases (and not just as temporary measures). The case fits our overall argument: when the urgency of fiscal balance is high, executives are able to reform to raise revenue in the short-term, but such changes are still limited by veto players within the ruling coalition, and such changes are not intended to increase efficiency, only to raise revenue in the easiest way.

4b. Reforms in non-crisis times

24 During the initial phases of the 1994 peso crisis, foreign (and domestic) investors were unwilling to roll-over the Mexican government’s dollar-backed bonds (Tesobonos), making default inevitable without external assistance. Even after the U.S., the IMF and the Bank of International Settlements agreed to loan Mexico $51 billion dollars in 2005 (of which approximately $22 billion was used between February and June), the peso continued to fall, only beginning recovery after the economic package, including the VAT increase, was announced in March (see Whitt 1996).
**Case 2- Vicente Fox’s failed fiscal reform (2001).** In his first months in office Fox sent an ambitious fiscal reform package (*Nueva Hacienda Pública Redistributiva*) to Congress; if approved, would have taken effect in 2002. The reform aimed to increase revenue significantly, allowing the new administration to implement its agenda, including a variety of new social programs. The main source of new revenue was, again, the VAT. The bill reduced the income tax in exchange for a flat 15 percent VAT rate for all consumption without exemptions. Exemptions increase the administrative cost of raising the VAT, since reimbursements had to be contemplated for a wide range of produce and foodstuffs. But most importantly, exemptions open a large number of loopholes to successfully evade taxes.

The bill was rejected, even some PAN legislators voted against. The heated debate was at times confrontational. Fox went public to muster citizens’ support against Congress, but failed: the opposition successfully centered debate on highly unpopular VAT for food and drug. Independent variables indicate that incentives for the executive to push hard for a fiscal reform were insufficient. The fiscal situation was stable, a deficit around 1% of GDP and under control thanks to the tight fiscal discipline of the previous administration. Oil was in reasonable shape: even though reserves had fallen considerably (from even 2001 to 2002), output was still rising and the price of oil had doubled since the late 1990s. Alternative sources of revenue were available, such as cheap long-term credit. And unavoidable redistribution to sub-national units limited the federal government’s will to pay the political costs for new taxes, while benefits would be shared among all levels of government.

Auspicious circumstances beg the question of why Fox would push for reform at all. The answer is that regardless of partisan affiliation, the consensus around Hacienda (and international agencies, such as the OECD) was that Mexico should increase tax revenue from the VAT and reduce its dependence on oil revenue. But the proposal was tailored to not harshly affect PAN constituencies. Transaction costs were significantly higher compared to
the recent past, including Zedillo’s post midterm. Fox did not have a majority of Congress either; the PAN had 42% of the Deputies Chamber, and the majority of governorships were in PRI hands. The original bill proposed a quite comprehensive list of changes, including: 1) A flat VAT rate at 15%. This provision would have eliminated all exemptions and zero-rated items, such as food, medicines, books, and school tuition. It contemplated a subsidy for the poorest individuals to compensate for the VAT impact. 2) Significant reduction in income tax for individuals, from a maximum 40% rate to 32%. 3) Many changes that would provide incentives for investment, such as, immediate deduction of investments made outside the three main urban areas, the Federal District, Guadalajara, and Monterrey; and the deduction of social security payments by businesses. 4) The creation of a new fiscal regime, Personas Morales Transparentes, aimed at eliminating some special business tax regimes, in particular those of cargo trucks and transportation buses, and those in the primary sector. These sectors have been traditionally well organized to protect their privileges.

After 9 months of heated debate, the fiscal package was approved in the first hours of 2002. Legislation was far from Fox’s original bill. As expected, the most controversial item was the VAT change, rejected by Congress. Government failed to anticipate opposition to this historically sensitive issue, sticking instead to expert consensus around the urgency of such reform. Concurrently, Fox’s approval rating dropped 10 points from April to December. Other direct and indirect consumption taxes were approved, especially luxury items and sin taxes. These generated a fraction of the revenue from a flat VAT rate.25

While the goal of dropping the income tax rate was increasing investment by improving the country’s relative attractiveness, the opposition managed to frame it as a concession to business, a group close to Fox’s interests. But it passed without much change. The maximum

25 Taxes approved included a 10% tax on cell phone services; a 20% tax on sugarless sodas; an increase in cigarette taxes to 105% for filtered and 60% for un-filtered; a 60% tax on spirits; a special 5% tax on luxury items (including caviar, leather outfits, large-screen TV sets, computers above 25 thousand pesos (US$2,500 at the time). The luxury tax was later declared unconstitutional by the Supreme Court.
income tax rate dropped from 40 to 35 percent, losing an extra point for each of the next three years. A zero tax-rate for incomes below $50,000 pesos (US$5,000 at that time) was added. A simplified regime for small businesses, mostly aimed at the primary sector, was set in place to reduce tax evasion, marginally modifying the special regimes already in place.

On fiscal decentralization, the 2002 Ley de Ingresos allowed state governments to impose a general sales tax with a 3% maximum rate on final consumption of goods and services and a 2-5% income tax on entrepreneurial activities and professional services (but not on salaried workers). Hacienda pushed for this in order to induce state governments to collect their own resources. No state has implemented this to date.

The values of our independent variables suggest that reform was unlikely to succeed. Fox lacked motive and opportunity: Increasing revenue was not such a pressing issue, given the country’s good economic health at that time; revenue as share of GDP was at its highest since 1993 (see Figure 5), federal government debt was at low since 2001, half its 1990 level (see Figure 2). Furthermore, by proposing a tax plan that could be attacked on distributional grounds, Fox undermined the supposed distributional aims of the proposal. Finally, the price of the reform was high since the PRI, pivotal in Congress, exploited PAN’s lack of another viable partner to approve the reform. As a result, Fox was unwilling to make concessions or side payments needed to buy the PRI’s support for his proposal.

Case 3- Calderón’s (partially) successful 2007 fiscal reform. On June 20th 2007 Calderón sent his fiscal proposal to Congress. It aimed at extra revenue by reducing evasion and increasing the tax base. Remembering Fox’s failures, Calderón’s bill did not propose any change to the VAT that would have nullified exemptions or zero-rates; instead, the bill concentrated on income taxes, especially in the corporate sector and for the self-employed, hitting closer to the PANs electoral constituency.
Calderón improved the chances of passage by framing the tax reform as necessary to beef up the poverty alleviation programs in place since the mid-1990s. The executive went public to persuade citizens that government resources were insufficient to deepen redistributive programs. This was an odd framing for a center-right party whose bases of support are mostly in the middle and upper classes, but disarmed left parties’ arguments against reform.

The case behaves as expected based on the values of our independent variables. The need to retain fiscal balance was relatively low since the country’s finances were disciplined and healthy and the budget deficit was close to zero. International oil price were up, but remained volatile, and even at high levels oil reserves were declining fast and at a historical low. In this respect, Calderón had more pressure to reform than Fox did in 2001. On the fiscal connection realm, he (like Fox) was bound to transfer much of any new revenue to sub-national units – the very enclaves where PRI has survived since losing control of the national government in 2000. And given the heated post-electoral conflict that Calderón faced, it seems that bargaining costs, and payments for support in Congress, were high. In general, the reform contemplated compensation items for the opposition on most items the executive wanted to be approved. Some other compensation items were added during the bargaining in Congress. It was an expensive reform in this respect: side payments to secure support came through further decentralization of spending – albeit with more controls – and an electoral reform which was endorsed by the PRI and PRD (Magar and Romero 2008).

The original bill three main elements. 1) The IETU (Impuesto Empresarial a Tasa Unica), a 19 percent minimum corporate income tax against which there were no deductions replaced and expanded the Business Asset Tax – an administratively complex tax with numerous loopholes. 2) More efficient monitoring mechanisms on sub-national governments. 3) Tax on cash deposits above 20,000 pesos per month, directed at informal sector and serial evaders (tax can be deducted against income tax by those filing yearly tax forms).
The bill was approved on September 13th 2007. Back room negotiation included PAN's support for a non-germane electoral reform demanded by the PRI and the PRD. The fiscal package that was finally approved included the following elements: 1) Minimum corporate income tax (IETU) approved: 16.5% flat-rate for 2008, 17% for 2009, and 17.5% for 2010. 2) Cash Deposits Tax approved, 2 percent rate on monthly deposits above 25,000 pesos. 3) New scheme to redistribute the Education, Participaciones, and Municipal funds devised. 4) Pemex’s fiscal regime modified to make its fiscal load lighter, so that more resources can go into investment projects. Pemex’s debt obligations are no longer counted by the Mexican officials as government debt; in effect, Pemex is treated as a private agent in bond markets. 5) Gasoline and diesel prices increased 5.5 percent. The increase was supposed to take effect 15 days after its official publication, around early October, but it was highly unpopular (it was known as the gasolinazo) to the point that the increase was delayed up to January 2008.

It should be noted that while it is true that Congress approved most of Calderon’s bill, it was because the bill was tailored ex ante to approximate congressional party preferences by ex-ante removing many controversial elements desired by the executive. The resulting changes improved the country’s fiscal structure; however, it is still far from meeting the country’s needs. Moreover, many amendments were side-payments to opposition parties, such as increasing spending decentralization, giving more resources to governors. That is why we deem the reform as partially successful, not because Calderon’s bill was significantly modified, but with respect to the limited change over the status quo.

5. CONCLUSION

This report has surveyed Mexican fiscal institutions and policy over the past two decades, attempting to describe the status quo and explain the pattern of stasis and change. On the revenue side, Mexican has been unable to dramatically improve its fiscal effort, despite
relatively pressing needs: whereas alternative sources of revenue (generally) obviated the need for major reforms during the era of PRI hegemony, more recent executives have faced higher transaction costs and declining incentives to impose new taxes. On the spending side, Mexico has managed to contain societal demands, gradually shift some funds towards more productive uses (though wasteful spending continues), and decentralized considerable spending authority. On the institutional side, Mexico has attempted to put together a new set of rules to guide spending and debt management, especially for sub-national entities.

The question is whether this equilibrium will remain stable in the midst of falling petroleum revenue and/or in the wake of new shocks, including those emanating from Wall Street in 2008-09. We suspect that the basic pattern will remain unchanged: presidents will continue to prioritize fiscal stability, while virtually every other actor will continue to favor increased decentralization of spending. The greater the threat to Mexico’s hard-won fiscal stability, the more executives will be inclined to make the side-payments necessary for reforms. A critical question is whether there exists a feasible reform that will raise sufficient revenue to offset the all but certain decline in oil proceeds, let alone new social demands. The consumption tax base has not been fully exploited, but even if a Fox-like overhaul were to succeed it might not yield more than an additional 4 percent of GDP—roughly half of current oil revenue. The labor tax base is considerably under-exploited by OECD standards (OECD 2007b), but the size of the informal sector makes it a risky option. Dramatically increasing revenue from income and capital taxes, by contrast, would require an assault on privileged groups that have heretofore held their own in the policy process. In other words, while pressures for reform will build, the options for reform are not unconstrained.
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