

# Mexico: Economic Development and Tax Reform

By Carolina Bolivar

In a short time, Carlos Salinas de Gortari has managed to win the trust of a great number of Mexicans, and especially of businessmen, who at the start of his presidency would have wished for a change of political party. In spite of the disillusion and previous bad experiences with the ruling Institutional Revolutionary Party (PRI), the business and labor sectors have shown themselves to be generous and ready to deal with Salinas and support him in the efforts needed to defeat the economic crisis. This is because Salinas de Gortari has known how to handle public opinion and has taken intelligent measures which seek to free the Mexican economy and sponsor development. Among the important changes that Salinas de Gortari has made to regain credibility:

- ◆ He has fought inflationary pressure, lowering the price index from 159.2 percent annually in 1987 to 19.7 percent in 1989. In part this was possible because the issuance of currency dropped from 140 percent annually in 1987 to 40 percent in 1989. It is important to point out that this reduction is also due to agreements to freeze prices and wages.<sup>1</sup>
- ◆ He reduced the percentage of government deficit in relation to Gross National Product (GNP) from 11.3 percent in 1988 to 6.3 percent in 1989; however, this was achieved not by the reduction of spending, but by increasing tax revenue.<sup>2</sup> Currently, 72.2 percent of government revenue comes from taxes, which have become the principal source of funding.<sup>3</sup>
- ◆ Another achievement was that, according to officials, the government had the highest budget surplus in the country's history: 8.3 percent of the GNP.<sup>4</sup> This surplus is presented to public opinion as proof that the Salinas de Gortari administration is efficient and is eliminating losses.
- ◆ The privatization of 1,155 businesses, begun by former President Miguel de la Madrid, has continued under Salinas de Gortari, and it is currently estimated (there is no certainty because published reports do not always agree) that there are still 389 businesses run by the government. The official goal is that at the end of Salinas de Gortari's administration there be only 100.

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1 Banco de México Annual Report, 1989.

2 La economía mexicana al primer semestre del año, 1990; Centro de Estudios Económicos del Sector Privado (CEESP).

3 Banco de México Annual Report, 1989.

4 Banco de México Annual Report, 1989.

- ◆ Mexico-U.S. relations have improved considerably and this has increased the trust of the private sector, and the middle class in general, in the government.
- ◆ His intention to reach a Free Trade Agreement with the United States and Canada has also been very positive for Salinas de Gortari's image.

The tax policies, which have become the most controversial topic in Mexico today, contrast with this atmosphere of optimism and openness. Some of the tax reforms, and especially certain aggressive attitudes of the authorities, do not agree with Salinas de Gortari's plan for modernization. They are contrary to the objectives of commercial openness and the privatization of state-run enterprises, which seek to strengthen industry and commerce.

## **BUSINESS EXPECTATIONS**

The government has permanently modified the tax system since 1986; its objective has been and is to combat the decrease of tax revenue which began a decade ago. This decrease was due, in part, to the lack of credibility by Mexicans in the populist governments of those years, and the high income tax rates which they imposed and which reached 60 percent. De la Madrid, aware of this, reduced the rates to 40 percent before the end of his term.

Due to the great differences between the economic policies of Salinas de Gortari – who favors a free market – and previous presidents – who favored central planning – businessmen and employees expected major decreases in the tax load. Of course, significant changes took place, but these were somewhat different from what was expected. The tax reforms traditionally approved by Congress in November are known as “tax miscellany.” In spite of the fact that the general objectives of the “tax miscellanies” of 1989 and 1990 have a free market orientation, some of their laws and strategies contradict Salinas de Gortari's determination to open and free the Mexican economy.

## **TAX REFORM**

### **Objectives**

According to Pedro Aspe, Secretary of Finance and Public Credit, the objectives of the tax policy are:

- 1) to stimulate economic growth,
- 2) to increase the standard of living,
- 3) to equalize interest rates with foreign rates for product prices to be competitive and favor exportation,
- 4) to widen the tax base, and
- 5) to obtain more funds to finance and reduce public spending.

### **Tariffs, Means and Strategies**

The tax authorities announced that their program would contain tariff reductions and some support measures. The maximum income tax rate was reduced from 40 percent to 35 percent and the marginal rates of other taxpayers were also adjusted. These measures generated political support for Salinas de Gortari. Mexicans felt encouraged by this announcement, since government concessions to the people are rare. At the same time,

however, the tax brackets were changed significantly; with the goal of compensating for the tax rate reduction and inflation, "minor" taxpayers (those with low salaries) had their brackets changed and they were classified automatically as "major" taxpayers (those with high salaries). The following chart shows these modifications.

**ANNUAL INCOME TAX RATES**  
(Converted to U.S. dollars @ 2,600 pesos)

Income Tax Brackets	1989 Marginal Rate	Income Tax Brackets	1990 Marginal Rate
0 - 312	3%	0 - 335	3%
312 - 2,652	10%	312 - 2,846	10%
2,652 - 4,461	18%	2,846 - 4,999	17%
4,461 - 6,292	28%	4,999 - 5,811	25%
6,286 - 11,624	38%	5,811 - 6,957	32%
11,624 +	40%	6,957 +	35%

This new classification has caused strong irritation among businessmen. Minor taxpayers have seen their income affected by the change in their bracket. For some of them it was already difficult to face the high cost of living; frozen salaries and these modifications have made it almost impossible. The change has also caused the bankruptcy of many small businesses, whose profit margin did not permit them to defray operating expenses, nor pay the increase in taxes.

The reduction of marginal rates is more evident for the people than the changes in tax brackets, and therefore generates public support. The economic reality, however, belies this perception.

Says economist Alan Reynolds, "Curiously, the salaried Mexican reaches the highest marginal rate with an annual income of only \$6,957. In the United States, a taxpayer with that same income, and under the same circumstances, would pay no tax. Of course, an equivalent amount of dollars buys more in Mexico. But even so, the maximum category is extremely low."<sup>5</sup>

Other groups which before paid no taxes were converted to minor taxpayers, for example: artists, independent workers of modest means, peasants, small market merchants and street vendors, among others. These last three groups could not be integrated in the intended way, because the reforms were not well thought out. Now all will pay the same fixed rate.

As far as other taxes are concerned, some suffered significant increases, as in the case of real estate taxes, which in Mexico City increased between 80 and 3,000 percent in some instances. Others did not change, such as the value added tax (VAT) of 15 percent, the business payroll tax of 2 percent, the education tax of 2 percent as well as the 1 percent federal tax on personal income.

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<sup>5</sup> *México 2000* (Polyconomics, Inc., New Jersey, 1990), p. 150.

## **NEW TAXES**

A new tax on business assets of 2 percent was implemented in 1989 to compensate for the decrease of income tax collection and to increase government revenue. This tax did not generate much revenue in 1989, but has given excellent results in 1990, bringing in the equivalent of 12.7 percent of the income tax collection between January and March.<sup>6</sup>

The three taxes which generate the most revenue in Mexico are the income tax, the value added tax, and the tax on fixed assets. Together, they represent 72.2 percent of the taxes collected and 51 percent of total government revenue.<sup>7</sup>

Other taxes have been hidden in the bills for services. The government has renamed some sources of revenue so they would not appear to be taxes. The telephone tariff is a good example: the old tax is now called "rent" and the new tax is called "special tax for production and service," in addition to the 15 percent VAT. Similar changes have been made in the bills for electricity, water, gasoline, and highway tolls.

## **ADMINISTRATIVE SIMPLIFICATION**

Many modifications have been made to the laws as well as to the procedures for the payment of taxes in order to facilitate their application. "The simplification of transactions and the increase in the number of taxpayers are essential for the success of the tax miscellany. We should simplify the procedures for the people to be able to pay," said Finance Secretary Aspe when the reforms were being introduced.<sup>8</sup>

Almost at the same time, Mariano Azuela, Magistrate of the Supreme Court, declared publicly, "When I learned of the new tax measures I felt like a mental retard, because I didn't understand them; but when I knew that not even the accountants understood them, I felt better."<sup>9</sup>

The government requires that all commercial transactions be paid with a check from the business' account, that a record be kept of income and payments, and that photocopies be kept of all receipts and checks given or received. The people who planned the procedures and methods of payment apparently took into account neither the different social means nor the respective cultures of the people at whom they were directed. Nor did they think of the structure of the agency needed to implement these policies. A large percentage of the taxpayers of this type, which are about 1,400,000 small businesses, do not have a checking account, do not know how to keep accounting books, and cannot afford to hire accountants. The instructions for registration and procedures for payment are difficult to understand. The government personnel in charge of collections are as confused as the general public. The laws and regulations are so ambiguous and complex that even if the best advisors do the accounting and even if all stipulated taxes are paid, there is still the risk of breaking the law because certain precepts can be interpreted in different ways. These problems have led

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6 Report on the Evolution of the Economy and Public Debt in the First Quarter of 1990. Mexican Department of Finance and Public Credit.

7 *Ibid.*

8 *Excelsior*, April 30, 1990.

9 *Excelsior*, April 27, 1990.

to many protests and marches throughout the country against the reforms. Even the more important accounting firms have shown their displeasure with the reforms.

## **“TAX TERRORISM”**

At the same time, the Department of Finance has tried to end all tax evasion, using measures such as investigations, audits, fines and even prison terms to penalize evaders. These are some of the reforms made to the National Tax Code, which are in effect since January 1, 1990:

- ◆ Article 111 states that those who falsify losses in their business with the intent to evade tax payment will be sentenced to between three months and three years in jail.
- ◆ Article 115-bis states that if a taxpayer trying to avoid payment of taxes engages in illicit activity or disguises the origin of goods by transporting them from one part of the country to another, or to another country, he or she will be condemned to between three and nine years in prison.

Forty-nine businessmen of various levels were convicted and sentenced for tax evasion in 1989 to show that the government was serious in its intent to apply the law. Currently, many businessmen are fearful. Some have already been tried for tax evasion and others are under investigation. The combination of complexity of the law and penalties have brought about corruption at certain levels. Many businessmen are confused and frightened because they must declare and pay taxes, but do not know how to go about it.

The aggressiveness of the government in enforcing the new laws has caused many protests and lockouts throughout the country. The response of Finance Secretary Aspe to this was, “Although it displeases some, we will increase investigations. We plan to investigate 10 percent of the taxpayers.” This attitude is disconcerting. The so-called “tax terrorism” would seem to come from an opposition group, and not from a government which seeks to regain credibility and support from the business sector.

## **EFFECTS AND IMPLICATIONS OF THE TAX REFORMS**

### **Immediate results**

The short term objective of the government of increasing tax collections has been achieved. Between January and March of 1990, budgetary revenue for the federal government was 28 billion pesos; that is to say, a real level 4.5 percent higher than for the same period in 1989 and 13.8 percent over what was expected.<sup>10</sup> Tax collection is much improved compared with previous years. However, these measures could have serious implications in the medium and long term. It is difficult to estimate the economic, political and social impact which these high taxes and penal measures produce.

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<sup>10</sup> Report on the Evolution of the Economy and Public Debt in the First Quarter of 1990. Mexican Department of Finance and Public Credit.

## **Economic Impact**

**What has been the cost in investment and formation of capital? How many business which would have been started were not started? How many jobs which would have been created were not created?**

**It is estimated that in the last nine years, the formation of capital in Mexico has dropped 14.2 percent.<sup>11</sup> The efficient use of resources generated by society constitutes the difference between a rich country and a poor one. In Mexico, as in many developing nations, taxes drain the economy. Much capital which could have been productive is used to finance the current spending of the public sector, which is not productive. This has meant fewer businesses and jobs.**

**How much has the modernization of businesses been impeded by taxation of fixed assets? How much investment in new machinery, in technology, and in new equipment was lost because of these measures?**

**It is well known that the more something is taxed, the less of it there is. It is strange that a government seeking economic expansion and greater tax revenues would apply these types of taxes. "Just as excise taxes on liquor and tobacco are designed to discourage the use of those products, taxes on earning additional personal or business income must likewise discourage the process of wealth creation that leads to increased income."<sup>12</sup>**

**How much revenue was lost from businesses which went bankrupt, or passed from the formal to the informal sector in order to avoid problems and red tape? The heavy tax loads, which represent a large disbursement of money, makes people think of how to evade them, and it makes the government think of how to stop these people from being productive. More and more laws and regulations are created, which complicates the process further and unleashes a vicious cycle difficult to break. When these factors converge, and investigations are carried to an extreme, the risks of being investigated are greater than those of living in the anonymity of the black market. If tax policy does not change in Mexico, the black market informal sector of the economy will grow.**

**It is difficult to estimate how much investment of Mexican and foreign capital in Mexico was discouraged by these policies. According to statements from the National Chamber of Industrial Transformation, the government expected \$16.5 billion of foreign investment during the first quarter of 1990, but only \$9.8 billion were invested. It is hard to say if this was due to the tax policy, but it could very well have been.**

**The tax reforms must co-exist with the Pact for Stability and Economic Growth (known as PECE for its Spanish initials), which will keep prices and wages frozen until January of 1991. In the coming months, most businesses will not be able to change their prices, and salaried workers will not be able to increase their income. However, both will face a larger tax load than in the previous years and an inflation estimated to be 25 percent in 1990.<sup>13</sup> The co-existence of these forces, which appear to be opposed, will be a difficult obstacle to achieving growth in the Mexican economy. The results will undoubtedly have important effects for Mexico and the PRI in the 1991 federal, state, and municipal elections.**

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**11 Statistics from the World Bank.**

**12 *México 2000*, *op. cit.*, p. 160.**

**13 Centro de Estudios Económicos del Sector Privado (CEESP).**

## **Political Impact**

The middle and lower classes, which have not only made enormous sacrifices in the past fifteen years because of the economic crisis, but also have a continually dropping standard of living, are very resentful of these government measures, because they make them poorer each day. Many of the tax reforms, the cost of services, inflation, and the continuous devaluation of currency are hurting their economic welfare and decreasing their chances for a better life. To this must be added the corruption of a large number of public officials who continually harass them and take through bribes what little they have left. This form of corruption is reaching alarming proportions.

The harassment of small businesses with excessive taxes and too many laws and regulations are causing them to go bankrupt. This could have disastrous results for the Mexican economy since these small companies account for 65 percent of total employment in the country and constitute 95 percent of the industrial base.<sup>14</sup> Even when certain tax measures have been revoked for not being feasible, the "tax miscellany" has been a low blow to the trust of the citizens, who had begun to believe in the possibility of economic improvements and in the good intentions of Salinas de Gortari. The members of the so-called "Cardenista Party" (now the Party of the Democratic Revolution or PRD) have used many of the errors in the tax reforms as a banner behind which to rally peasants and workers against the government. This represents a high political cost for the government. The Mexican people have been hypersensitive because of the haughtiness, arrogance, and deceptions of previous governments. The current authorities must be careful, as their actions could unleash a credibility crisis which would offset the gains made by Salinas de Gortari.

## **Social Impact**

These policies of high taxation also have an important impact on Mexican society. Many young specialists, important for economic development, leave the Mexican market because salaries, besides being lower than in other countries, are even further reduced by high taxes. "The maximum rate of 35 percent is high relative to the present American top rate of 28 percent . . . . The holder of a graduate degree in computer sciences, for example, will typically earn \$15,000 per year in an entry-level position for which he will pay \$6,000 in income taxes. The same graduate can earn about \$50,000 in a similar position in San Diego, and pay \$14,000 in U.S. Federal Taxes."<sup>15</sup> Mexico, along with many other developing nations, loses much human capital each year. The best men and women in the country, including peasants, leave in search of better opportunities and more attractive markets.

## **ORIGIN OF BAD POLICIES**

Are bad policies the result of bad faith by government leaders? Ludwig von Mises, knowledgeable about the defects and causes of the economic backwardness of nations, attributes them to the negative influence of professors at the universities where many of these future leaders of developing nations studied. "To make their own people as

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<sup>14</sup> *El empleo y los salarios en 1989* (Instituto Nacional de Estadística, Geografía e Informática, México, 1990).

<sup>15</sup> *México 2000, op. cit.*, p. 150.

prosperous as those of the West became their foremost aim. So they sent the elite of their youth to the universities of Europe and America to study economics and thus to learn the secret of raising the standard of living. This is what these professors — Marxians, Fabians, Veblenians, socialists of the chair, champions of government omnipotence and all-round planning, peacemakers of inflation, deficit spending and confiscatory taxation — taught their students...the formulas of pseudo-progressism. They have even today not yet realized that progressive taxation has already exhausted this alleged surplus in all other countries and will have exhausted it even in the United States very soon.”<sup>16</sup>

Universities such as Harvard, MIT, and The London School of Economics have had a negative influence on the underdeveloped nations. The errors are not of bad faith, they come from false ideas mixed with academic arrogance, which have damaged these economies. If we add to this the influence of counselors with bureaucratic mentalities and little faith in the efficiency of the free market, such as officials from the International Monetary Fund, we will better understand the reason for this backwardness. “We must comprehend that it is impossible to improve the economic conditions of the underdeveloped nations by grants in aid...It is a spiritual and intellectual problem. Prosperity is not only a matter of capital investment. It is an ideological issue. What the underdeveloped countries need first is the ideology of economic freedom and private enterprise.”<sup>17</sup>

## CONCLUSION

President Salinas de Gortari faces many challenges. The decade of the 1990s is an extraordinary opportunity to integrate, through free trade, the markets of the United States, Canada, and Mexico. This is a historical moment of great consequence in which there exists the possibility of turning political violence into economic splendor. Mexico will be a mirror which reflects the ability of Latin America to form an economic bloc for the benefit of the entire continent. For this to occur, Salinas de Gortari must continue with the freeing of the economy and convert Mexico into an economic power. The country has enormous natural resources and sufficient human resources to make this possible. The important thing is for his government to be realistic and favor the dynamics of the free market and not obstruct it with excessive regulations. The measures he has adopted are correct in principle, but do not go far enough. There is still the need for a major effort to lay their foundations, without which the results could be precarious. It will be necessary to change the tax policy of his government, since this presents serious deficiencies and does not agree with the objectives of modernizing the country.

### Tax Policy For Development

Here are some proposals for a tax policy which does not obstruct economic growth.

- ◆ The punitive and anti-business approach, which discourages investment and compliance with tax obligations, should be transformed into a positive tax policy of low rates which stimulate and attract investment. This will generate a climate of trust which will be reflected in economic growth.

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<sup>16</sup> *Money Method and the Market Process, Essays by Ludwig von Mises* (Praxeology Press of the Ludwig von Mises Institute), p. 171.

<sup>17</sup> *Ibid.*, pp. 172-173.



- ◆ **Free fixed assets from all taxation to stimulate capital reinvestment, which is necessary to modernize businesses and allow them to acquire new production equipment.**
- ◆ **No taxes on the purchase of equipment, machinery, and new technology to improve the quality and productivity of the Mexican economy.**
- ◆ **No taxes on savings and capital which is brought back to the country for investment. The restructuring of the economy requires much capital.**
- ◆ **Low and attractive income tax rates, not greater than 10 or 15 percent uniformly and without any exceptions. This will encourage the formation of capital, and stimulate people to pay their taxes and would teach them to live within the law, thereby widening the tax base.**
- ◆ **Put into effect promotional discounts for advanced payments, as has been done for years with the real estate tax.**
- ◆ **Allow education deductions from taxes. The creation of training programs for workers in all cases and conditions where necessary. Education and training are indispensable for increasing quality.**
- ◆ **Drop the VAT to 5 percent, and phase it out, as is being done in the case of local businesses which work with "maquila" companies for export.**
- ◆ **Mexican taxes should be lower than those in the developed nations for its prices to be competitive. Mexican tariffs continue to be higher than U.S. and Canadian tariffs, which hurt Mexican products in the integrated markets under free trade agreements.**

**Other parallel and important economic policies are to:**

- ◆ **Balance public spending to avoid a deficit which causes an increase in tax rates.**
- ◆ **Free prices and salaries, since the pacts under which they were frozen are deceptive palliatives that sooner or later generate counter-productive effects.**
- ◆ **Restore to the Constitution measures which guarantee private property.**
- ◆ **Free the financial market, which is currently designed to finance the government through the sale of official bonds. The Mexican stock market should become international. It must become a true market tool to finance investment and facilitate the transfer of capital.**
- ◆ **Achieve privatization through the stock market. The break up of stocks would give the public the opportunity to have access to the property of businesses. This, in addition to increasing government revenue, would increase its popularity and would defuse criticism and opposition from socialist leaders.**
- ◆ **Optimize the services obtained through the payment of taxes, so that the citizen will understand the benefits of paying his share.**
- ◆ **Simplify as much as possible red tape, which is now excessively complicated, to decrease the cost in time and money.**
- ◆ **Decrease the number of public employees who currently cause an increased economic load. The government should strive toward efficiency and productivity by doing more with less people.**

- ◆ **Accountability in the handling of resources should be adopted by the government to rescue its moral authority.**
- ◆ **Improve the Mexican infrastructure, which is still precarious. It is necessary to build more highways, expand and modernize ports, and optimize means of transport and communication.**

**All of these elements together will favor productivity and encourage economic growth. They will stimulate the taxpayer to meet his tax obligations and will increase government revenue without the need to hurt or irritate society with high taxes and punitive measures.**

