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FEATURED Q&A

How Important Are Mexico's Proposed Tax System Reforms?

Q Mexican President Enrique Peña Nieto on Sept. 8 unveiled his plan for an overhaul of the country's tax system. The reforms would impose new taxes on the country's top earners as well as on capital gains. How important are tax system reforms for Mexico's economy? Do the specific parts of the reform address the right areas? How valid are the concerns of critics who oppose the reform's proposals to tax private education and end mortgage rebates?

A James R. Jones, member of the *Advisor* board and co-chair of Manatt Jones Global Strategies: "The purpose of Mexico's tax reform proposal is laudable: broaden the tax base, increase tax revenues as a percent of gross domestic product and use that money to invest in economic and social programs that will grow the economy and reduce income inequality. While I have not studied these tax recommendations thoroughly, they remind me of President Obama's laudable goal of improving health care coverage under the Affordable Care Act. Both reforms are complex and will need to be tweaked and modified over the next few years to get them right. But it is necessary that they move forward. Mexico's tax revenues as a percent of GDP are the lowest among the OECD countries at around 10 percent. About half of Mexico's population lives in poverty and thus pay no taxes. Of the other half, 60 percent are estimated to be in the informal sector which means they pay little or no taxes. So the burden of taxation rests with 20 percent of Mexicans. That means that Mexicans making over approximately $40,000 per year will see tax increases in the form of increased rates and closing loopholes. There will be a new tax of 10 percent on gains of capital assets sales. In the United States, the capital gains tax is 15 percent. This reform will close a glaring loophole that primarily benefitted the wealthiest of Mexicans. For corporations, eliminating tax consolidation of affiliated

Continued on page 3

Rousseff Cancels State Visit to Washington Over Spying Case

Brazilian President Dilma Rousseff (L), shown above earlier this week alongside Maria das Graças Silva Foster, the CEO of state oil company Petrobras, said Tuesday she has decided not to travel to Washington next month for a scheduled state visit. See story on page 2.

File Photo: Agência Brasil.

Inside This Issue

NEWS BRIEFS

At Least 57 People Killed by Storms in Mexico This Week

Tropical storms Ingrid and Manuel have disrupted the lives of 1.2 million Mexicans this week, *El Universal* reported Tuesday. The beach resort of Acapulco has been particularly hard hit, with food being rationed and tens of thousands of tourists stranded. Acapulco's international airport terminal was waist deep in water Tuesday, and a main road out of the city was blocked by mudslides. At least 57 people across the country have been killed by the storms and their aftermath.

AES Gener Plans to Raise $450 Million in Stock Offering

AES Gener, the Chilean unit of Virginia-based energy provider **AES Corp.**, said Tuesday it plans to raise up to $450 million in a stock offering, Reuters reported. The company is looking to increase investments in hydropower generator Alto Maipo and coal-fired thermoelectric plant Cochrane, among other projects, according to the report. A shareholder meeting has been called for Oct. 3 to approve the offering.

Ecuador Suspends Tax on Banana Exporters

Ecuador's government has decided to suspend the collection of a special levy worth some $12 million to $15 million that has been placed on domestic banana exporters for nearly two decades, *Fresh Fruit Portal* reported Tuesday. The tax, worth 0.7 percent of total banana export values, was instituted in 1994 with a goal of supporting the Andean country's National Banana Program. But since 1998, the money has been used primarily for highway construction instead of agriculture promotion.

Political News

Rousseff Cancels State Visit to Washington Over Spying Case

Brazilian President Dilma Rousseff on Tuesday decided to postpone her state visit to Washington, scheduled for October 23, until concerns over U.S. spying revelations are addressed, Reuters reported. The Brazilian government said in a statement that "the conditions are not suitable to undertake this visit on the agreed date." A White House statement Tuesday said that President Obama told Rousseff in a call Monday that he "understands and regrets" the concerns that disclosures about U.S. intelligence activities have generated in Brazil, and that he "looks forward to welcoming President Rousseff to Washington" in the future. Some analysts suggest the Obama administration did not handle the situation well when the revelations surfaced. "The inaction in the face of such an overreach has proved costly," Michael Shifter, president of the Inter-American Dialogue, told the *New York Times* Tuesday. "Washington would be wise to reflect on what this means for its most crucial diplomatic efforts in this hemisphere." Others said the cancellation could be bad news for some U.S. businesses, but it is unlikely to derail ongoing talks. "The decision to cancel the visit will add tensions to the U.S.-Brazil relationship, but it will not be enough to disrupt most existing negotiations in the bilateral business agenda," **Eurasia Group** senior analyst João Augusto de Castro Neves said in a research note circulated Tuesday. While efforts to streamline visa issuance and to enhance cooperation on taxation will likely move ahead, the risks to U.S. companies operating in sensitive sectors have increased, he added, citing **Boeing**'s chances of securing a contract to sell fighter jets to the Brazilian military being significantly reduced. "In the energy sector, there will certainly be a political firestorm if an American company wins the pre-salt bid round in October," de Castro Neves suggested. "That said, even though the scandal will stoke nationalist sentiment and create incentives for Brasília to impose some restrictions on American companies operating in sensitive sectors, the threat of outright retaliation against Brazilian companies in the U.S. is likely to prevent the scandal from escalating into a trade war," he said.

Economic News

Argentine Judge Rules Against Officials in Inflation Data Suit

A federal judge in Argentina on Tuesday found cause to go ahead with the prosecution of Guillermo Moreno, the country's domestic commerce secretary, in an abuse of authority case, *Clarín* reported. Judge Claudio Bonadío declared that Moreno, along with two other officials, acted "illegally" and "arbitrarily" in fining a private sector research firm for releasing inflation estimates that differed from the government's data. Jorge Todesca, the head of consulting firm **Finsoport**, brought the suit, claiming he had been "illegally sanctioned" by the officials. Two other bureaucrats, Fernando Carro and Adalberto Guillermo Rotella, were also indicted. A third colleague, Guillermo David, was acquitted.

Moreno

File Photo: Clarín.

In 2010, Argentina's government announced a policy to fine private research firms for disseminating inflation data that contradicted official state figures compiled by the controversial INDEC statistics agency. In April of 2011, the government fined consultancy **abeceb.com.ar** $123,500 for allegedly publishing inflation estimates that "lack scientific rigor." The government slapped similar fines on **Estudio Bein & Asociados, MyS Consultores**, **GRA Consultoras** and Finsoport, Dow Jones reported. Officials said the fines were aimed at deterring economists from "deceiving" the public into making poor financial decisions. Some firms declared they would no longer release inflation estimates as a result of the policy.

Peru Central Bank Raises Growth Outlook for 2013 and 2014

Peru's central bank governor said Tuesday he expects the country's economy to expand by about 5.6 percent this year, state news agency Andina reported. Julio Velarde told reporters in Lima that Peru's economy will benefit from an improvement in international markets and mining output. The new estimate is a slight increase from the bank's August forecast. In July, the central bank surprised some market analysts by posting a weaker-than-expected gross domestic product gain of 4.51 percent, bringing growth in the first seven months to 4.99 percent compared to the year-earlier period. In 2014, Peru's GDP will likely grow 6.2 percent, Verlarde said, which is up from a previous forecast of 5.9 percent. Peru's exports are expected to improve in the second half of this year as mining production ramps up and prices increase. Planned mining projects valued at over $34 billion in Peru will create 1.5 million additional jobs in the sector, Finance Minister Luis Miguel Castilla said Tuesday at a conference in Arequipa.

Company News

Peru's Graña y Montero Wins $131 Million Gas Plant Contract

Peruvian construction and engineering firm **Graña y Montero** said Tuesday that it had won a $131 million, two-year contract to build a natural gas compression plant for **Transportadora de Gas del Peru**. The deal is booked through a consortium with **Construcciones y Montajes**, which holds 40 percent of the project. Peruvian President Ollanta Humala has been on the road in recent days, visiting local communities to "reaffirm" his government's commitment to promoting the mass use of natural gas for household and industrial purposes nationwide. Despite rich natural gas resources, many rural communities in Peru do not have connections to natural gas supplies, which has caused a popular backlash in recent years against exports of the commodity abroad.

Featured Q&A

Continued from page 1

companies will close a loophole and raise new revenue. Eliminating the IETU and cash deposit taxation will simplify the system. Serious questions should be answered about putting a tax on mortgages and rents, as those relate to the overall policy of stimulating the housing sector. It was regrettable that the expansion of the VAT on food and medicine was jettisoned at the last minute as part of political compromises. That would have provided much new revenue and expanded the base, but I understand that any legislative proposal can withstand only so much political baggage. Overall the tax reform is necessary for Mexico to grow. But this proposal is only an initial step and must be followed with additional reforms if Mexico is to achieve what it wants for its people."

A **Andrés Rozental, former deputy foreign minister of Mexico and president of Rozental & Asociados:** "President Peña Nieto's proposed tax reform doesn't go far enough to change the fact that a large percentage of Mexicans pay little or no income tax, find ways of avoiding the VAT by under-invoicing or paying cash, are not liable for inheritance or wealth taxes and in general put the country at the bottom of the OECD list of fiscal revenue as a percentage of GDP. Rumors floated in the weeks and months before the September deadline that the proposal included a general rise in the VAT rate, removing the VAT-free status of some foods and medicines, doing away with a majority of the loopholes that currently allow individuals and companies to pay little or no tax, etc. In the end, the government opted for a 'light' reform that most analysts agree will add much less to fiscal revenue than what is needed. As on previous occasions, the fiscal reform such as it is targets captive middle- and upper-class taxpayers who will have to add to their fiscal burden, while doing little to enlarge the tax base to the millions who pay little or nothing. It's clear that the president was frightened by the continuing marches and social disruptions by opponents to the education and energy reform packages presented earlier to Congress, and that he decided to avoid provoking further street protests by those who would be most affected by a real fiscal reform. Hopefully, in the coming years the government will build on this partial reform and give Mexico the fiscal structure its economy so badly needs in order to replace the national oil company, Pemex, as the funder of close to 40 percent of public expenditure."

A **Rogelio Ramírez de la O, president of Ecanal in Mexico City:** "The tax reform consists of across-the-board tax increases. Although it may raise revenues in the formal sector, it would discourage an even larger sector from participating in the formal economy. A large increase in revenue will be obtained by cancelling special tax regimes, such as tax consolidation in business groups, real estate developers and mining. In these and other cases, the regimes had become vehicles for artificial reduction of taxable income, resulting in ridiculously low effective tax rates for corporations. Limitations of deductibles for companies, however, are excessive (e.g. social security contributions). Perhaps driven by the need for additional revenue, the proposal is to cancel facilities that are too little for the political noise they arouse (such as a VAT on college fees) or that will discourage producers from participating in the formal economy. In the latter case, cancelling simplified regimes for the large number of producers that are too small and conduct transactions with part of the formal economy, for example by providing repairs or food production, will make them stay away. The government's plan to lure informal producers to the formal economy by offering them free access to medical services and other benefits seems unpromising. More worrying is that public spending is to increase in order to grant universal pensions, unemployment insurance and, for those becoming part of the formal econ-

Continued on page 4

Featured Q&A

Continued from page 3

omy, medical coverage, all of it at a very high cost to an already overstretched social security sector. In the best scenario, tax revenue will increase by 2-3 percent of GDP, and public spending in social services will rise by the same amount. This is not conducive by itself to higher investment and growth. It is a mistake that the government does not start instead with a sharp cut in bureaucratic spending and corruption before increasing taxes. The tax increase will be contractionary."

A **Alfredo Coutiño, director for Latin America at Moody's Analytics:** "A fiscal reform is one of the most urgent structural changes that Mexico needs, since its fiscal system is one of the poorest in Latin America in terms of tax revenues. Dependence on oil revenues is one of the main weaknesses of the fiscal system. Since oil provides around one-third of government revenues, it mostly compensates for the obsolescence of the tax system. Tax dispersion, exemptions and privileges have become the main obstacles of the country's fiscal system. To break the dependence on oil, to increase revenues and to have an efficient tax system, the country needs a profound fiscal reform that modifies the structure of revenues and expenditure. Unfortunately, the fiscal proposal already in Congress does not seem to produce the kind of structural changes that the country needs, particularly because it is mainly focused on the income side through increases in tax rates, new taxes and reduction of exemptions and privileges. The structure of the tax system will mainly stay the same with the new reform. On the expenditure side, it is not clear how the reform will bring efficiency to the federal budget, particularly because the expenditure needs to be strictly attached to a precise structural discipline with no variability range. In this case, there remains doubt that the government's proposal will generate the necessary policy flexibility to increase the fiscal countercyclical power. Taxes are not incentives by definition, thus taxing private education could cause a migration of some students to the already low-quality public education system. Hence, even though it might generate some extra revenues, it might not be a good idea to tax private education."

A **Lisa M. Schineller, managing director of sovereign ratings at Standard & Poor's:** "One of the key constraints on S&P's sovereign rating for Mexico (foreign currency BBB/positive) is its comparatively limited ability to smooth the fiscal accounts through economic and commodity cycles compared with higher-rated credits. This reflects the combination of a low non-oil tax base, which has ranged between 9 and 10 percent of GDP over the last decade and budgetary dependence on oil with limited savings in its oil stabilization funds. The fiscal package aims to tackle both of these issues. Regarding taxation, the government proposes to raise the tax base by almost 3 percent of GDP over the coming five years. How it actually does so is a decision for Mexican society. From the rating perspective, Standard & Poor's will consider how the tax reform may or may not improve Mexico's fiscal room for maneuver and will it indeed generate the proposed increase in revenues. A key element in this reform is to close many of the numerous loopholes and exemptions in the Mexican tax regime that have rendered it difficult to raise revenue on the corporate and personal income tax side, as well as eliminating the subsidy for gasoline. The overhaul of the corporate tax framework eliminates many loopholes and special regimes, but also removes the IETU with a loss in revenue that potentially leaves the overall tax-take from the corporate sector unchanged. It is also important to keep in mind that various tax reform proposals in the past failed to generate the proposed revenue increases due to some combination of being diluted in Congressional negotiations, reversed in the court system or simply failing to generate the expected revenue. The tax reform proposal could be positive for Mexico's rating, but will be considered in the broader context of other components of the fiscal package and other reform initiatives, including the energy reform."

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