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DOCUMENT OF THE INTER-AMERICAN DEVELOPMENT BANK

MEXICO

PUBLIC FINANCE STRENGTHENING PROGRAM II

(ME-L1189)

LOAN PROPOSAL

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* At the request of the borrowing country, the information contained in this electronic link will not be disclosed. “The non-disclosure of this information is in accordance with the country-specific information exception in paragraph 4.1 i of the Bank’s Access to Information Policy”, document GN-1831-28.

ABBREVIATIONS

CEMABE	Census of Schools, Teachers, and Students of Basic and Special Education
CFDI	Comprobante Fiscal Digital por Internet [digital tax invoices via Internet]
EAP	Economically active population
FATCA	Foreign Account Tax Compliance Act
IEPS	Impuesto especial sobre producción y servicios [special tax on production and services]
IMT	International multimodal transit
IRPM	Impuesto sobre la renta de personas morales [corporate income tax]
ISR	Impuesto sobre la renta [income tax]
LFPRH	Ley Federal de Presupuesto y Responsabilidad Hacendaria [Federal Budget and Fiscal Responsibility Act]
LIBOR	London interbank offered rate
OECD	Organization for Economic Cooperation and Development
PBP	Programmatic policy-based loan
PEMEX	Petróleos Mexicanos [state oil company]
PITA	Proyecto de Integración Tecnológica Aduanera [Customs Technology Integration Project]
PSFR	Public sector financing requirements
REPECOS	Régimen de Pequeños Contribuyentes [small taxpayer regime]
RIF	Régimen de Incorporación Fiscal [fiscal incorporation regime]
RISS	Régimen de Incorporación a la Seguridad Social [social security incorporation regime]
SAT	Servicio de Administración Tributaria [Tax Administration Service]
SCS	Structural current spending
SHCP	Department of Finance
UDIs	Investment units

PROJECT SUMMARY
MEXICO
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<tr><th colspan="7">Financial Terms and Conditions</th></tr>
<tr><td colspan="3" rowspan="2">Borrower: United Mexican States</td><th colspan="2">Flexible Financing Facility[a]</th></tr>
<tr><td>Amortization period:</td><td>Bullet payment on 15 July 2028</td></tr>
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Project at a Glance
Project objective/description: This is the second and final operation in a programmatic series of two operations, the overall objective of which is to strengthen public finances by increasing tax revenues and controlling public spending. This will be achieved by: (i) improving the design and administration of the policy on hydrocarbon revenues; (ii) increasing the exchange of financial information with other countries for tax purposes; and (iii) enhancing the efficiency of public expenditure and controlling its growth.
Special contractual conditions precedent to the first and only disbursement of loan proceeds: (i) signature of the agency agreement between the borrower and the financial agent, Nacional Financiera, Sociedad Nacional de Crédito (NAFIN), a development banking institution; and (ii) fulfillment of the policy reform conditions set out in the policy matrix (Annex II), the policy letter, and the conditions established in the loan contract (see paragraph 3.2).
Exceptions to Bank policies: None.

Strategic Alignment			
Challenges:[d]	SI ☐	PI ☑	EI ☐
Crosscutting themes:[e]	GD ☐	CC ☐	IC ☑

[a] Under the terms of the Flexible Financing Facility (document FN-655-1), the borrower has the option of requesting changes to the amortization schedule, as well as currency and interest rate conversions. The Bank will take operational and risk management considerations into account when reviewing such requests.

[b] The original weighted average life and grace period may be shorter, depending on the effective date of signature of the loan contract.

[c] The credit fee and inspection and supervision fee will be established periodically by the Board of Executive Directors as part of its review of the Bank's lending charges, in accordance with the applicable policies.

[d] SI (Social Inclusion and Equality); PI (Productivity and Innovation); and EI (Economic Integration).

[e] GD (Gender Equality and Diversity); CC (Climate Change and Environmental Sustainability); and IC (Institutional Capacity and Rule of Law).

I. DESCRIPTION AND RESULTS MONITORING

A. Background, problems, and rationale

1.1 This is the second and final operation in a programmatic series of two operations under the programmatic policy-based loan (PBP) modality aimed at strengthening the public finances of the Mexican government by increasing tax revenues and controlling public spending. The tax reform component of the program's first operation (loan 3201/OC-ME) provided support to enhance the collection, equity, and simplicity of the main taxes. This was done through changes to the Income Tax Act, the Value Added Tax Act, the Special Tax on Production and Services Act, and the Federal Fees and Charges Act. The first operation's component to improve tax and customs administration provided support to tighten control of tax evasion through modern tools for invoicing and control of operations. Measures were also taken to facilitate voluntary compliance and the exchange of taxpayer financial information with the United States. Lastly, the first operation's component to control public expenditure provided support to rationalize spending and improve the federal government's budget control by fine-tuning the fiscal rule in force at the time, and instituting a new mechanism for federal government salary payments to teachers working in the states.

1.2 This second operation will continue these actions by providing support to deepen regulations and promoting implementation of the policies and strategies included in the first operation. In addition, it supports new actions associated with the taxation of hydrocarbons and use of those resources, which represent a very significant revenue source for the Mexican government; increased exchange of financial information with other countries; and the rationalization and improvement of budgetary expenditure.

1.3 **Macroeconomic context.** Mexico's sound economic policy framework[1] has enabled it to maintain macroeconomic stability despite recent volatility in the global financial markets and the sharp drop in the price of oil. Consequently, despite the unfavorable global environment, the economy has continued to experience moderate growth, averaging 2.1% between 2013 and 2015.

1.4 To cope with the economic slowdown that began in 2013, the government implemented expansionary fiscal and monetary[2] policies. On the fiscal front, it implemented a stimulus package on the expenditure side that led to an increase in primary spending of 1.3 percentage points of GDP between 2012 and 2014.[3] This

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1 Monetary policy is governed by an inflation targeting regime, which has helped keep inflation at relatively low levels. In fact, 2015 had the lowest annual inflation rate on record (2.1%). The country's flexible exchange rate has enabled the economy to adjust to external shocks. Fiscal policy is governed in accordance with the guidelines of the Federal Budget and Fiscal Responsibility Act, following a fiscal rule that places an annual cap on the deficit and on growth in structural current spending (SCS). Mexico's regulatory framework and financial system supervision are also strong (International Monetary Fund, 2015) and comply with international standards.

2 From early 2013 through mid-2014, the Bank of Mexico lowered its benchmark rate on four occasions, taking it from 4.5% to 3%. It kept this rate at 3% until December 2015, when it decided to raise it by 25 basis points (0.25%).

3 The increase in primary spending occurred mainly in the categories of physical investment, pensions and retirements, and subsidies. Spending increased by approximately 0.4 of a percentage point of GDP in each of these categories.

caused a deterioration of the fiscal deficit, which reached 3.2% of GDP in 2014, and an increase in gross debt (see Table 1).

1.5 In 2015, government revenues were impacted by the sharp drop in international oil prices.[4] Government oil revenue amounted to 4.6% of GDP in 2015—3.7 percentage points below its 2013 value.[5] That drop was largely offset by significant growth in nonoil revenue, which increased by more than 3 percentage points of GDP during the same period. This increase was attributable to the tax reform approved at end-2013, which eliminated the gasoline subsidy and improved tax and customs administration. The aforementioned tax reform was supported by the first operation in this programmatic series (see paragraphs 1.33 to 1.35).

Table 1. Selected economic indicators[6]

	2010	2011	2012	2013	2014	2015[a]
Real GDP growth (% change)	5.1	4.0	4.0	1.4	2.3	2.5
Unemployment (% EAP)	5.4	5.2	5.0	4.9	4.8	4.3
Inflation (end of period in %)	4.4	3.8	3.6	4.0	4.1	2.1
Nonoil tax revenue (% GDP)	9.5	8.9	8.4	9.7	10.5	13.0
Oil revenue (% GDP)	7.7	8.6	8.9	8.3	7.1	4.6
Total spending (% GDP)	25.1	25.0	25.1	25.9	26.4	27.0
Primary spending (% GDP)	23.3	23.2	23.2	24.0	24.5	24.8
Public sector fiscal balance (% GDP)	-2.8	-2.4	-2.6	-2.3	-3.2	-3.5
Public sector debt[7,8](% GDP)	36.2	37.5	37.7	40.4	43.4	46.9

1.6 To contend with the prospect of decreased revenues in a scenario of a prolonged period of low international oil prices, the government restructured spending in the 2016 budget and reviewed operating and investment expenditure, and spending by government structures. These activities, which are included in this operation (see paragraph 1.51), helped facilitate the approval of a reduction in annual public spending of about 2% in real terms and could decrease the public sector financing requirements (PSFR)[9] by roughly 0.7 of a percentage point of GDP. The government has also committed to continuing this fiscal consolidation in the medium term, which should stabilize the PSFR at 2.5% of GDP in 2018.

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4 In 2015, the average price for Mexican oil blend was 48.9% less than in 2014. Moreover, the price of Mexican oil blend at end-2015 was only 28.2% of the value observed at end-2013.

5 These figures do not include the returns from the government's 2015 oil hedges, which amounted to 0.6% of GDP.

6 Source: National Statistics and Geography Institute, Central Bank of Mexico, and the Department of Finance.

7 SHCP estimates.

8 Refers to the Historical Balances of the Public Sector Financing Requirements (SHRFSP), which represented a broad definition of public debt.

9 In addition to the traditional fiscal deficit, the PSFR include adjustments associated with the financing needs of the Instituto para la Protección al Ahorro Bancario [Bank Savings Protection Authority] (IPAB), Proyectos de Inversión Diferida en el Registro del Gasto [deferred budget impact investment projects] (PIDIREGAS), the commercial bank savers and borrowers support program, Fondo Nacional de Infraestructura–Carreteras [National Infrastructure Fund–Highways], adjustments in budget reporting, and the change in the equity of the development bank.

1.7 **The Mexican tax system.** Mexico's tax revenues were highly dependent on oil revenue. On average between 2010 and 2013, oil revenue accounted for 8.4% of GDP and 36.9% of total revenues. Because the government lacked a robust institutional mechanism to promote long-term savings by requiring it to accumulate windfall profits during periods of high oil prices, the federal government's fiscal policy was highly vulnerable to oil price shocks.[10] Such dependence on oil revenue has been significantly reduced since the fiscal reform was first implemented in 2013. As a result of increased nonoil revenue and the drop in the price of oil, the country's oil revenue in 2015 shrank to 4.6% of GDP and to 19.7% of total revenues.

1.8 In addition, the hydrocarbons tax regime was complex[11] and imposed a tax on exploration and production activities based on the returns obtained, without considering production costs or future investment needs. This distorted investment decision-making and failed to align the interests of the federal government with those of Petróleos Mexicanos (PEMEX). Furthermore, the price of hydrocarbons and, consequently, associated tax revenue, were highly variable, which made it necessary to consider instruments that could stabilize these revenue streams.

1.9 In terms of nonoil tax revenue, Mexico's tax burden was among the lowest of the member countries of the Organization for Economic Cooperation and Development (OECD).[12] This low tax collection was due in part to problems with the design of the main taxes, resulting in significant tax expenditure.[13] The taxes associated with the highest tax expenditure included the personal and corporate income tax, the value added tax (VAT), and the special production and services tax (IEPS), generating expenditures equivalent to 1.7%, 1.5%, and 0.6% of GDP, respectively.[14]

1.10 The income tax (ISR) on individuals included numerous exemptions and deductions that resulted in significant revenue losses.[15] Some also had important equity implications, such as exemptions for capital gains from the sale of securities on the stock market, dividends paid, and deductions for medical expenses and tuition. Moreover, the ISR on companies presented complexities, because there were numerous regimes and three overlapping business income taxes.[16] In addition, tax evasion was very high under the small taxpayer regime (REPECOS), eroding the ISR's taxpayer base. Regarding the VAT, its low collection is

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[10] The Mexican government has various funds to stabilize budget revenue at the federal and federative entity levels. However, the average balances in those funds have not exceeded a cumulative balance of more than 1% of GDP in the last 10 years. The government also systematically contracted oil hedges to ensure a certain level of oil revenue.

[11] PEMEX and its subsidiary companies were taxed under two categories: royalty payments on upstream activities and taxes on downstream activities. Royalties accounted for most of PEMEX's tax burden, and there were nine types of royalties on its upstream activities.

[12] The OECD member countries' tax revenues reached an average of 33.6% of GDP between 2003 and 2013. Mexico was the country with the least relative tax revenue, reaching 18.6% of GDP in 2013.

[13] Tax expenditure is lost revenue owing to differential rates, exemptions, fiscal subsidies and credits, forgiveness, and other forms of preferential treatment established in the different federal tax laws.

[14] SHCP estimates published in the 2013 Tax Expense Budget.

[15] According to SHCP estimates, these losses amounted to roughly 1% of GDP.

[16] Business income was subject to the ISR, the flat-rate business tax (IETU), and the tax on cash deposits (IDE).

attributable to the extensive number of goods and services taxed at a rate of zero, the reduced (border) rate, and certain tax-exempt goods and services.[17]

1.11 With respect to the IEPS, 94.2% of the estimated fiscal expenditure associated with this tax in 2013 was due to gasoline and diesel sales.[18] The IEPS on this activity included two tax components: a relatively low fixed rate, and a variable rate adjusted monthly based on the margin between the producer and consumer benchmark prices. Whenever the consumer price was less than the producer price, the variable rate could be negative, entailing a de facto subsidy, since the consumer would benefit from a lower price than the international price, thus resulting in a tax expenditure. This expenditure was very high in 2011 and 2012, when the IEPS tax rate was negative by 1% and 1.3% of GDP, respectively. This de facto subsidy was also regressive, due to higher consumption of automotive fuel among high-income deciles.[19]

1.12 With the support of the first PBP operation (see paragraphs 1.33 through 1.35), the government reformed the ISR, the VAT, and the IEPS to address some of the problems described. The first operation also included the introduction of levies on fossil fuels, flavored drinks, and calorie-dense foods to correct negative externalities[20] (see paragraph 1.35); however, the issuance of regulations for the measures introduced remained pending.

1.13 **Tax and customs administration.** At end-2012, Mexico's Tax Administration Service (SAT) lagged somewhat behind in the use of electronic media for tax control of operations, which were conducive to tax evasion and informality, as reflected in the limited use of electronic invoicing.[21] This also hindered control over the issuance of fictitious invoices and the control of company payrolls. In addition, there were no international agreements to facilitate the automatic exchange, electronically, of financial information for tax purposes.

1.14 As for taxpayer relations, some problems were observed with: (i) the slowness of dispute resolution processes;[22] and (ii) the cost to taxpayers of hiring an independent expert to issue a tax opinion for certain types of tax returns.

1.15 With respect to customs, the SAT's General Customs Administration (AGA) continued to implement a cargo control system based on double inspection (which

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[17] A full 81.7% of VAT tax expenditure corresponds to losses associated with zero or reduced rates, and the remainder is attributable to exemptions (SHCP, 2013).

[18] In contrast to the ISR and VAT tax expenditure, IEPS tax expenditure tends to be volatile, since the portion associated with the IEPS on automotive fuel is highly dependent on oil prices.

[19] According to SHCP estimates, 57% of the total subsidy is absorbed by the 20% of Mexicans with the highest incomes, while the lowest 20% receive only 3.2% of the total subsidy.

[20] Mexico ranks second among the OECD countries in obesity after the United States and, according to the World Health Organization, is the world's largest consumer of soft drinks.

[21] As of December 2012, only 14% of the taxpayers required to issue electronic invoices did so.

[22] Proceedings for voidance brought before the Federal Court of Fiscal and Administrative Justice (judiciary) took two years on average, and appeals for reconsideration to the SAT took about three months (data for 2013 provided by SAT).

slowed the transit of goods),[23] and did not use electronic media or video for control purposes. Moreover, customs users were required to hire a customs broker to clear goods, driving up international trade costs for companies that did not need this service.

1.16 With the support of the first PBP operation (see paragraphs 1.40 and 1.42), the SAT tightened evasion and fraud controls by expanding the use of electronic invoicing, making it possible to block the issuance of electronic tax receipts and facilitating the automatic exchange of financial information with the United States under an intergovernmental agreement for the reciprocal implementation of the Foreign Account Tax Compliance Act (FACTA). It also streamlined the dispute settlement process with taxpayers by introducing final settlement agreements, and made the practice of requiring tax opinions from independent experts optional. With regard to customs, the decision was made to eliminate the second physical inspection by an appraisal firm at customs facilities and the mandatory requirement of hiring a broker for customs clearance.

1.17 Despite the gains made in tax administration, areas for improvement remained. The use of electronic invoicing and the issuance of digital payroll statements remained limited and no administrative rules were in place for blocking the issuance of digital tax stamps. As regards the exchange of information for tax purposes, no agreement existed to enable the exchange of financial information with a large number of countries, and the formulation of administrative rules for FATCA implementation remained pending. As for taxpayer relations, no effective mechanism was in place for electronic communication with taxpayers, because the databases had out-of-date or incorrect information. With respect to customs, the potential existed for further automating the entry and exit of goods to facilitate trade, expanding control measures on passenger vehicles at border crossings, and enhancing national security through video surveillance monitoring.

1.18 As a result of the tax reform and improvements in oversight, the government witnessed a sharp increase in tax collection. In 2014, tax revenues increased to an annual real rate of 11%.[24] The sharp increase in revenues continued in 2015, growing by 28.8%. These measures caused the tax revenue-to-GDP ratio to increase by more than 50% between 2012 and 2015, reaching 13% of GDP. This figure represents an all-time high for Mexico.[25] In addition, the reform achieved the objective of expanding the taxpayer base. In 2014, the tax roll grew 11% over the previous year. Replacing REPECOS with the fiscal incorporation regime (RIF), the main measure introduced to address informality,[26] was very effective. In 2014, nearly 900,000 taxpayers joined the rolls under the RIF.[27] Moreover, the

[23] Goods in customs were subject to an initial inspection by officials of the General Customs Administration, followed up with a second inspection by firms subcontracted by the SAT. According to SAT estimates, this double inspection regime resulted in an average customs clearance time for goods of 2.5 hours.

[24] Tax revenues increased 13.8%, excluding revenues generated by the Ponte al Corriente ["Get Current"] program (2013), which forgave surcharges and fines on unpaid taxes.

[25] Between 2013 and 2015, income tax system revenues increased by the equivalent of 1 percentage point of GDP, VAT by 0.5 of a percentage point of GDP, and the IEPS by 1.9 percentage points of GDP.

[26] Informality is understood as economic activity that is not reported to the SAT.

[27] Some 100,000 new participants were admitted under the RIF in the first half of 2015, bringing the number of new microenterprises included under that regime since its creation to more than one million.

introduction of levies on flavored drinks and fossil fuels had a positive impact by reducing activities with negative externalities.[28]

1.19 The reform's progressiveness increased the tax policy's distributive impact. According to the authors' estimates (see Financial Analysis), the 20% of the population with the highest incomes will bear more than about 70% of the additional burden, while the 40% with the lowest incomes will bear less than 7%. SHCP estimates show that, as a result of the tax reform, the reduction in the Gini coefficient[29] that can be attributed to taxes and transfers increased from 0.018 to 0.032—a 77% increase.[30]

1.20 **Control of public expenditure.** Mexico's fiscal rule[31] had no mechanism to control expenditure—especially current expenditure—that promoted long-term savings during the expansionary phase of the economic cycle. Furthermore, the requirement to present a balanced budget encouraged fiscal "procyclicality"[32] and the one-off use of financial operations to balance the budget.[33]

1.21 Spending associated with federal government transfers to the states and Federal District to pay the salaries of teachers and support staff, which amounted to 1.8% of GDP in 2013, was not effectively controlled. In part, this was due to the lack of an effective reconciliation of employee rosters, resulting in duplications of posts, job classification errors, and differences in teacher tax and social security payments, among others.[34]

1.22 Lastly, despite the efforts of the Mexican government to implement results-based budgeting, the federal government expenditure budgets continued to stubbornly follow the same course and grow incrementally, failing to efficiently utilize the information generated on the effectiveness of budgetary programs and on the efficient use of resources by the different agencies. This resulted in the duplication of objectives and beneficiaries, as well as expenditure overruns, especially operating expenditure. In the area of public investment, the amounts of investment

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28 In the case of flavored drinks, an impact study by the University of North Carolina finds that the tax has resulted in a 6% reduction in consumption of such beverages and a 4% increase in the consumption of purified water. A study by Centro Mario Molina shows that the environmental measures introduced in the reform resulted in a 3.8% reduction in carbon monoxide emissions and a 3.5% reduction in carbon dioxide emissions.

29 Mexico's Gini coefficient is 0.46—47% higher than the average for the OECD member countries.

30 The new value of the fiscal policy impact on the Gini coefficient is similar to those observed in Korea (0.029) and Chile (0.032).

31 The fiscal rule introduced in 2006 required the federal government to present a balanced budget, excluding PEMEX investment under normal circumstances. In exceptional circumstances, the government could invoke an escape clause, enabling it to present a budget deficit.

32 The procyclical behavior was due to the government's need to increase revenues or reduce expenditures during recessions, and to do the opposite during economic expansions.

33 According to International Monetary Fund estimates, one-off financial operations, such as the sale of assets and the revaluation of government bonds, amounted to 1% of GDP in 2011 and 2012.

34 According to the National Statistics and Geography Institute's Census of Schools, Teachers, and Students of Basic and Special Education (CEMABE), 2,247,279 teachers and support staff were working in schools at end-2013. Inconsistencies were discovered in 13.3% of the cases. Of this total, 38% corresponded to staff that were working in a different school; 10.3% were either on leave or attending to union business, another 38.5% had left service due to resignation, retirement, or death. The remaining 13.2% involved cases in which nobody knew the teacher or staff member.

by Department tended to be determined by inertia, resulting in inadequate prioritization of public investment projects.

1.23 The problems identified in paragraphs 1.20 and 1.21 were addressed with support from the first PBP operation. By reforming the fiscal rule in effect at the time, fiscal responsibility was strengthened. The new rule capped growth in structural current spending (SCS)[35,36] and mandated the setting and publication of medium-term PSFR targets.[37] The mandatory publication of the PSFRs was effective in controlling total public expenditure. Despite the expected decrease in revenues in 2016, the government decided not to present PSFRs that were higher than the ones announced, thus the expenditures in the 2016 budget as a percentage of GDP had to be reduced by 0.6 of a percentage point.

1.24 [redacted][41]

1.25 With the first operation, the Mexican government agreed to promote strategic actions with the aim of: (i) improving the design of the main taxes; (ii) speeding up modernization of tax and customs administration; (iii) fine-tuning the fiscal rule that places caps on current public spending; and (iv) having the Federal Treasury pay the salaries of teachers financed by the federal government who work in the states. This second operation maintains the objective of the programmatic series and strengthens the original structure of the components that the Bank agreed on with the Mexican government at the outset of the series, and includes additional actions that strengthen the program. It should be noted that all the programmatic commitments—including the additional ones—have been fulfilled.[42] Detailed information on the triggers and programmatic commitments for this second operation are presented in the Comparative Matrix.

1.26 **Operational work and technical support.** The Bank has provided the Mexican government with ongoing support to strengthen public finances. In 2008, the

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[35] Structural current spending is equivalent to total net spending, excluding expenditures for financing costs, transfers to the states, local governments, and the Federal District, debts from previous fiscal years, fuel used to generate electricity, public sector pension and retirement payments, and direct physical and financial investments by the federal public administration.

[36] A transition period was established until 2016, during which SCS can only grow at a real rate of less than 2%. Starting in 2017, it may not exceed growth in potential GDP, which will be calculated by the SHCP.

[37] These targets are presented annually in the document *Criterios Generales de Política Económica* [General Economic Policy Criteria], which is delivered together with the *Iniciativa de la Ley de Ingresos Fiscales* [Tax Revenue Law Initiative], and the draft Expenditure Budget of the Federation.

[38] [redacted]

[39] [redacted]

[40] [redacted]

[41] At the request of the borrowing country, the information contained in this paragraph and its corresponding footnotes, will not be disclosed. “The non-disclosure of this information is in accordance with the countryspecific information exception in paragraph 4.1 i of the Bank's Access to Information Policy”, document GN-1831-28.

[42] One trade facilitation trigger was substituted for a condition that was broader in scope, as explained in paragraphs 1.44 and 1.45.

Program to Support Results-based Budgeting (loan 2043/OC-ME) made public spending more efficient by implementing and consolidating a results-based budget. In 2010, the Program to Support the Consolidation of Fiscal Sustainability (loan 2378/OC-ME) included rate hikes in the VAT and ISR and changes to specific taxes on tobacco products, alcoholic beverages, and beer. Worthy of note has been the productive technical support relationship between the Mexican government and the Bank in preparing this programmatic series, under which a number of studies were performed to diagnose and recommend improvements to the main taxes (see Sector Work Indexes). This series has also promoted the sharing of experiences between Mexico's different fiscal agencies and the Bank on such relevant mechanisms as the dual-condition fiscal rule, the issuance of digital payroll statements, and the restructuring of public expenditure, which represent important Mexican contributions to innovative fiscal instruments for the region. In this context, support was also provided for working meetings and international workshops to discuss and disseminate good practices on issues associated with reserve funds,[43] the use of electronic invoicing,[44] and the international exchange of tax information. In the labor markets sector, the Bank is supporting Mexico through a study on the implications of the RIF for the social security incorporation regime (RISS) (ATN/OC-14000-ME and ATN/OC-15248-ME).

1.27 The Bank has provided technical assistance in the region to support tax reform. This experience has demonstrated that widening the tax bases of the ISR, VAT, and the excise taxes generated significant returns. Such was the case for the reforms in Mexico supported by this programmatic series, where an increase in revenue of more than three percentage points of GDP was achieved together with significant tax administration gains. It was also discovered that tax reforms that impact sensitive prices can be implemented in successive phases to avoid economic policy complications. The IEPS on gasoline is a case in point: in the first operation its fuel price adjustment mechanism was updated, and in the second, it becomes a flat tax per liter, which is the international standard.

1.28 **Strategic alignment.** The program is consistent with the Update to the Institutional Strategy 2010-2020 (document GN-2788-5) and with the productivity and innovation development challenge through the implementation of a fiscal incorporation regime aimed at increasing the formalization of microenterprises. It is in keeping with the crosscutting theme of institutional capacity and rule of law through support for revenue generation and macrofiscal management. It will contribute to the Corporate Results Framework 2016-2019 (document GN-2727-6) by increasing collections as a percentage of GDP. The program will further the sector priority of the Sector Strategy Institutions for Growth and Social Welfare (document GN-2587-2) by supporting revenue generation and macrofiscal management. It is also consistent with the Fiscal Policy and Management Sector Framework Document (document GN-2831-3), since it supports fiscal policy management that promotes a stable macrofiscal environment. Lastly, the program dovetails with the IDB's Country Strategy with Mexico 2013-2018 (document

[43] Resources from a technical cooperation operation (ATN/OC-14771-ME) were used to fund a trip by Mexican government officials to Chile to learn about and discuss that country's experience with its Economic and Social Stabilization Fund and tax control of large taxpayers.

[44] Second regional seminar on electronic invoicing, 26 to 28 August 2015, Mexico City.

GN-2749), since it helps strengthen public management by supporting fiscal reform and the efficient use of public resources.

B. Objectives, components, and cost

1.29 The overall objective of the programmatic series is to strengthen public finances by increasing tax revenues and controlling public spending. This will be achieved by: (i) improving the design and administration of the policy on hydrocarbon revenues; (ii) increasing the exchange of financial information with other countries for tax purposes; and (iii) enhancing the efficiency of public expenditure and controlling its growth.

1.30 Like its predecessor, the second PBP program will have the following components:

1.31 **Component 1. Macroeconomic stability.** The objective of this component is to ensure a macroeconomic context that is consistent with the program's objectives as set out in the Policy Matrix.

1.32 **Component 2. Tax reform.** The objective of this component is to improve the tax system's collections, equity, progressivity, and simplicity.

1.33 With the support of the first operation, the Mexican government implemented a comprehensive tax reform. The Income Tax Act was amended to improve collections and enhance equity. These objectives were achieved by increasing the marginal rate on high-income brackets,[45] limiting deductions for individuals and corporations,[46] and reducing exemptions.[47] The capital gains exemption,[48] which has a significant redistributive impact, was among the exemptions that were eliminated. The tax system was also simplified by eliminating the business flat tax (IETU), the tax on cash deposits (IDE), and other special regimes,[49] and by replacing the REPECOS with the RIF.[50]

1.34 The reform of the Value Added Tax Act eliminated some exemptions,[51] which made it possible to expand the tax base. The border rate[52] was also increased to match it with the rate for the rest of the country and generate efficiency gains.

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[45] The top marginal income tax rate for individuals was increased from 30% to 35% and the top marginal rate for corporations was maintained at 30%, instead of being reduced to 28% as originally planned.

[46] Personal deductions for individuals were capped at the lesser of four annualized minimum wages or 10% of gross income. For corporations, caps were placed on the deductibility of tax-exempt employee benefits and on other deductions, such as investments in and leasing of automobiles.

[47] The exemption for the sale of a home was reduced from 1.5 million investment units (UDIs) to 700,000 UDIs (approximately Mex$3.8 million).

[48] For individuals, a 10% tax was established on dividends paid and capital gains from the sale of shares or securities on the stock market.

[49] The "intermediate" and "simplified" regimes were eliminated, the latter of which was applicable to automotive transport and the primary sector, among others. Special regimes for corporations were also eliminated, including regimes for real estate companies, installment sales, and bank loan loss provisions.

[50] The RIF was designed as a scheme for transitioning to the general regime, which can be used by individuals who invoice less than Mex$2 million annually. Within the first years of joining, the RIF offers strong incentives to encourage small taxpayers to regularize their status.

[51] The most significant exemptions that were eliminated include those associated with temporary imports and (inter-city) overland transport by foreign companies of passengers.

[52] Before the reform, the VAT rate in the border zone was 11%, but 16% in the rest of the country.

1.35 The reform also established an adjustment for inflation in fuel prices (gasoline and diesel), increasing collection of the IEPS. Taxes have also been imposed on nonbasic calorie-dense foods, flavored drinks with added sugar, pesticides, and fossil fuels (due to their carbon content).[53, 54]

1.36 This second operation in the programmatic series will maintain the conditions established at the start of the series regarding publication in the Federal Official Gazette of the regulations for the components of the tax reform, the approval of which was a condition of the first operation in the series. In addition, three new conditions—which were not considered at the start of the programmatic series—will be added and supported that strengthen the objectives of this component.

1.37 The first additional condition is a reform of the IEPS on gasoline and diesel to make it a fixed tax.[55] Eliminating the variable rate, which introduced the potential for de facto subsidies, strengthens collection and ensures the progressivity of the tax. This new condition also provides that rates[56] are to be updated annually for inflation to ensure stable, real tax collection. This new IEPS regime for automotive fuel will enter into effect in 2016; however, a period for transitioning to the regime has been established until 2017.[57]

1.38 The second and third additional conditions are related to the comprehensive reform introduced in the taxation of hydrocarbons.[58] This change is the result of constitutional and legal reforms in the energy sector that have made it possible to award hydrocarbon exploration and extraction contracts to private companies alone or in association with PEMEX, and the rollout of a new, more autonomous corporate structure for PEMEX.[59] The new fiscal regime aims to better align the interests of the government with those of contractors or assignees, since the consideration payments received by the government capture the economic rent progressively and simply. The tax changes introduce a homologous structure of consideration payments for "asignaciones" [entitlements granted to PEMEX], and

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[53] These taxes increase economic efficiency by raising the production or consumption prices of goods that generate negative externalities. These measures also increased tax collection by 0.2% of GDP.

[54] The tax on the mining sector was also modernized by introducing a special 0.5% duty on sales of gold, silver, and platinum and a mining tax of 7.5% on the operating balance.

[55] A system of fixed fees on automotive fuel is in place in most Latin American countries.

[56] Different rates are established for gasoline with an octane rating of less than 92, gasoline with an octane rating of 92 or higher, nonfossil fuels, and diesel. The government plans to set these rates to ensure a level of collection similar to the one obtained under the previous regime.

[57] Establishing a transition period is justified, since full liberalization of the fuel market will enter into force in 2018 (IEPS Act of 18 November 2015). Until then, price caps will be established that will fluctuate, but only within a determined price band. A formula will be used to determine the caps for a given month, and the maximum price bands will be approved annually by the Congress. In a context of variable fuel prices, the price cap for a given month may fall outside the band predetermined by the Congress. In the event the price cap falls below the lower limit of the band, the IEPS rates will be increased to the point at which the price cap is equal to the band's lower limit. When the price exceeds the upper limit of the band, the rates will be reduced to the point at which the price cap is equal to the band's upper limit. In this case, once the cumulative collection losses due to the reduction in rates reach 1% of GDP, the rates will revert to their original values.

[58] Hydrocarbons Revenue Act (11 August 2014).

[59] The Petróleos Mexicanos Act was issued, establishing a new corporate and organizational structure for PEMEX, which defined an autonomous corporate structure with separate legal status and its own assets, and technical, operational, and management autonomy.

for contracts with private firms or PEMEX. This homologous structure is reflected in the policy matrix in that entitlements to PEMEX as well as contracts must contain consideration payments to the State that include: (i) an exploration phase fee;[60] (ii) royalty payments that increase on the basis of price ranges; and (iii) consideration payments based on operating profit[61] or the contract value of the hydrocarbons in question. Contracts will also include an adjustment mechanism that will increase payments to the State as the project's cumulative returns increase.

1.39 **Component 3. Improvement in the tax and customs administration.** The objective of this component is to tighten control of tax evasion through modern invoicing tools and control of operations, and to facilitate voluntary compliance.

1.40 With the support of the first operation, an increase in the use of electronic invoicing was sought with the aim of including at least 20% of the taxpayers required to issue electronic receipts, and it became possible to block the issuance of digital tax stamps in the event of a verifiable risk of fraud. Moreover, an intergovernmental agreement was signed for the reciprocal implementation of the FATCA, with a view to streamlining the automatic exchange of financial information with the United States.

1.41 With respect to taxpayer relations, final settlement agreements were introduced as a dispute settlement alternative, with the Office of the Taxpayer Advocate (PRODECON) acting as witness. This measure is expected to reduce the time and costs of disputes with the Treasury. In addition, the need for third-party tax opinions was eliminated.

1.42 With regard to customs, the transit of goods was streamlined by replacing the second physical inspection with an advanced risk-based system and the use of nonintrusive technology. The mandatory use of customs brokers was also eliminated.

1.43 In this second operation, three of the seven trigger conditions will remain unchanged: (i) approval of administrative and data processing rules to facilitate reciprocal implementation of the FATCA; (ii) publication of at least one list of delinquent clients by the SAT and guidelines for blocking the SAT's digital stamp; and (iii) publication of guidelines for the final settlement procedure. Three other conditions will be modified for the purpose of strengthening them and to reflect the larger scope of the tax administration modernization achieved. With respect to the conditions related to electronic invoicing (digital tax invoices via Internet, CFDI) and the issuance of digital payroll statements, the percentages of their use will be doubled.[62] The condition regarding the electronic mailbox for taxes will stipulate

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[60] The use of exploration phase fees is very common in international practice, since they act as an incentive to expedite exploration in areas allocated under the contract, reducing the likelihood that they will be held for long periods of time.

[61] These consideration payments will be the primary contractual instrument for capturing economic rent. They also have the advantage of minimizing distortions in the event of negative shocks between prices and costs.

[62] In the case of electronic invoicing (CFDI), the inclusion of taxpayers required to issue tax receipts will increase from 30% to 60%. In the case of digital payroll statements, their inclusion will increase from 20% to 40%.

that it is already operational and not in the pilot phase, and is now also applicable to individuals and not just corporations.

1.44 The only trigger of the component that has been replaced is associated with the implementation of a new form of international multimodal transit (IMT), as a pilot, in at least one port or airport linked to another border point. This project was based on border control cooperation with another country and did not materialize. In the second operation, this condition will be replaced with another project (also on trade facilitation and customs control): the Customs Technology Integration Project (PITA).

1.45 The PITA is a comprehensive initiative that seeks to automate, facilitate, and streamline the entry and exit of goods in the country's customs facilities.[63] It also aims to enhance national security by expanding passenger vehicle control measures at border crossings and video surveillance monitoring. The development and implementation of the PITA will also facilitate the exchange of information with U.S. Customs and Border Protection. This groundbreaking project will automate 60 checkpoints for the clearance of goods that process nearly all customs and revenue collection operations associated with trading goods. In addition, control will also be tightened at 52 land border crossings, including the control of passenger vehicles at these crossings. The system will use video surveillance to monitor the SAT's main customs facilities (310 points of national coverage). Lastly, the PITA's territorial reach and security coverage are much broader than that of the IMT initiative.[64] The design and bidding phases of this important project are a condition of this program.

1.46 In addition, two new conditions are included that were not considered at the start of the programmatic series, which strengthen the objectives of this component of the program. To improve the scope of the exchange of tax information, signature of the Agreement for the Automatic Exchange of Tax Information among Jurisdictions of the Global Forum on Transparency and Exchange of Information for Tax Purposes is added as a condition. This agreement was signed by 78 countries that, beginning in 2017 or 2018, are committed to sharing financial information about their residents with each other using a common reporting standard. The agreement is expected to improve tax control and help reduce tax evasion.

1.47 The second additional condition of this component is the creation of specialized units under the SHCP and the SAT with a view to the efficient implementation of the new hydrocarbons tax regime. Accordingly, the new condition provides for the creation and implementation of a: (i) Hydrocarbons Revenue Unit within the SHCP, specializing in advisory services and oversight of economic and administrative conditions under the framework of the Hydrocarbons Revenue Act; and (ii) the Hydrocarbons Administration within the SAT, specializing in monitoring tax compliance under the framework of the Hydrocarbons Revenue Act.

[63] Owing to the new technology, the standard wait time for the entry and clearance of goods is expected to decrease from five minutes to less than one minute.

[64] The IMT and the PITA are trade facilitation interventions. However, the scope of the PITA is broader in terms of its territorial reach (comprises 52 land border crossings and 310 points of video surveillance) and security coverage (not only for screening goods, but also persons). The IMT, conversely, was an administrative pilot project for a single border crossing.

1.48 **Component 4. Control of public spending.** The objective of this component is to rationalize public spending and improve the federal government's budget control.

1.49 With the support of the first operation, the Mexican government implemented a reform of the Federal Budget and Fiscal Responsibility Act (LFPRH), introducing changes to the fiscal rule in effect (see paragraph 1.23). It also supported tightening control of salary payments to teachers and support staff through the implementation of the Fund for Education Payroll and Operating Expenses (FONE) (see paragraph 1.24).

1.50 This second operation maintains the original objectives and builds on the work carried out in the first phase. The condition on publication of the regulations of the LFPRH, established at the start of the programmatic series, is maintained. In addition, two new conditions that were not considered at the start of the programmatic series are included, which strengthen the objectives of this component.

1.51 The first additional condition provides for the creation and implementation of the Mexican Oil Fund for Stabilization and Development.[65] This fund was established as an irrevocable trust of indefinite duration and has two fundamental objectives. It seeks to guarantee the transparent management of oil revenues. To that end, the fund administrator will be responsible for receiving and executing payments associated with the various oil extraction and exploration contracts and entitlements, publishing quarterly financial statements and reports on the fund's activities and transfers. The fund was also created to ensure the responsible use of oil revenues. Accordingly, it will follow clear operating rules, limiting the amount of resources that can be transferred to the federal government[66] and restricting the use of its cumulative resources.[67] The limit on transfers to the rest of the public sector will help to reduce the dependence of public finances on oil revenues and facilitate the accumulation of windfall revenues when prices are high.[68] Consequently, the fund is expected to become a robust economic stabilization mechanism.[69]

1.52 The second additional condition recognizes the need to control the growth of expenditure and make spending more efficient. Accordingly, it requires a restructuring of public spending to be implemented in the 2016 Expenditure Budget of the Federation. As part of the process of preparing the proposed 2016

65 The Bank of Mexico will serve as trustee. The fund will include a committee made up of the Ministers of Finance and Energy, the Governor of the Bank of Mexico, and four independent members who must be approved by Congress.

66 Each year the fund may transfer up to 4.7% of GDP to the Federal Treasury, the stabilization funds, and sector funds.

67 Once the fund's accumulated resources exceed 3% of GDP, 60% of any additional resources entering the fund may be used to finance the Universal Pension System (up to 10% of total additional resources); science, technology, and renewable energy projects (up to 10%); an investment vehicle in oil and infrastructure development projects (up to 30%); and scholarships and projects to improve connectivity and the development of industry in the region (up to 10%). The remaining 40% must be left in the fund.

68 The fund will also be responsible for managing the accumulated savings, investing them in financial assets.

69 In exceptional circumstances, the fund may transfer additional resources to the Treasury. Such transfers must be approved by the Chamber of Deputies by a vote of two thirds of its members in attendance.

Expenditure Budget of the Federation, the SHCP led a public expenditure restructuring process, conducting an in-depth review of the budgetary programs to identify complementarities and/or duplications in their objectives and beneficiaries.[70] This effort made it possible to reduce the number of budgetary programs, merging some and eliminating others. Some programs were "re-sectorized" or reclassified under a different sector authority to boost synergies with existing programs.[71] An analysis of public administration organizational structures was also conducted with a view to containing the increasing human resources and operating costs of the various agencies, and to identify potential reductions in that regard.[72] Lastly, investment projects were reconsidered and prioritized on the basis of their social returns, regional development impact, and technical feasibility.[73] These efforts are expected to result in permanent savings of 0.7% of GDP in 2016.

C. Key outcome indicators

1.53 The policy actions included in this operation are expected to have a positive impact on tax revenue levels and control public expenditure. The expected outcomes (see Results Matrix) include an impact indicator consisting of compliance with PSFR targets, together with the following outcome indicators: (i) the increase in nonoil tax revenues; (ii) widespread use of electronic invoicing and digital payroll statements; and (iii) a reduction the number of budget programs. It should be noted that the increase in tax revenues indicator is also included in the Corporate Results Framework 2016-2019 (document GN-2727-6).

1.54 **Economic and financial analysis.** The analysis of the tax reform's performance and distributive impact was updated (see Financial Analysis). In terms of additional tax revenues, the approved reform is expected to have a return of 3.3% of GDP when its measures take full effect in 2018.[74] This entails an increase of 0.9 of a percentage point with respect to the expected returns at the time the first operation was prepared.[75] Moreover, the new equity estimates indicate that the 20% of the population with the highest incomes will bear roughly 70% of the additional burden,

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[70] The information available in the Sistema de Evaluación del Desempeño [Performance Evaluation System] was used as input for this process, which includes the programs' purposes and objectives, the population served, and program evaluations.

[71] As a result of this exercise, 261 budgetary programs were merged into 99, seven were reclassified under another sector, 56 were eliminated, and four new ones were created. In 2016, the government will evaluate the performance of the new budgetary programs that resulted from merging existing programs and the ones that will remain unchanged. In so doing, it expects to identify areas of opportunity and improvement in the budgetary programs.

[72] Adjustments to administrative structures will also be sought with a view to adapting them to the budget's new programmatic structure. Moreover, the review of operating expenses will continue in 2016 to identify new areas of budget savings and evaluate the results of the savings introduced.

[73] In 2016, the government plans to evaluate the results of the new methodology for prioritizing investment projects. This new prioritization methodology will be used to identify new investment projects and programs for 2017.

[74] Similar reforms in the region have achieved comparable returns. In income or excise taxes, examples include: Uruguay (2006); Peru (2006); El Salvador (2009 and 2011); Nicaragua (2009 and 2012); Panama (2009 and 2010); Dominican Republic (2012); and Chile (2014).

[75] The new estimates take into account the revenue observed in 2014 and 2015. The difference in the total expected revenue collection is due to greater collection of VAT and IEPS, each of which represents 35% of the difference in the total estimate. The other 25% is from the income tax.

while the 40% with the lowest incomes will bear less than 7%.[76,77] In addition, the positive impact of the tax reform and the savings generated by restructuring expenditure were calculated, which included the fiscal savings associated with paying lower interest rates due to less cumulative debt. In the base case scenario, the 2013 present value of the savings over a five-year period would be equivalent to 2.96% of GDP. The sensitivity analysis found that the result of significant fiscal savings is robust to changes in the main assumptions used to calculate these savings.

II. FINANCING STRUCTURE AND MAIN RISKS

A. Financing instruments

2.1 **Financing instrument.** The proposed operation is the second of two that are technically related, but independently financed in accordance with document CS-3633-1 for the preparation and implementation of the PBP. The programmatic modality was selected because: (i) it provides medium-term support to the government's program of fiscal policy reforms; (ii) it promotes ongoing dialogue; and (iii) it facilitates monitoring and fine-tuning of the implementation strategy.

2.2 **Amount and currency.** The amount of this operation is up to US$600 million to be disbursed in a single tranche. The amount proposed for the program represents 1.1% of the PSFR for 2016 and 21.7% of federal government financing from multilateral sources. This operation would be financed with resources of the Flexible Financing Facility in United States dollars from the Bank's Ordinary Capital.

B. Environmental and social risks

2.3 As a policy-based loan, this operation does not envisage activities with negative implications for natural resources. Consequently, it does not require ex ante impact classification (Directive B.13) under the Environment and Safeguards Compliance Policy (Operational Policy OP-703).

C. Fiduciary risks

2.4 The funds from this operation will be deposited directly into the Master Treasury Account to cover the financing needs of the Mexican government, and therefore no fiduciary risks are identified.

D. Other risks

2.5 **Macroeconomic sustainability risk.** This risk is linked to the possibility that the program's objective of strengthening the public finances might not be achieved, as a result of their vulnerability to: (i) a drop in oil revenues; and (ii) an unexpected slowdown in capital inflows. To mitigate this dependence, the government established a tax certainty agreement, setting out the commitment to respect the downward trend of the deficit, and providing for cuts to public expenditure in the

[76] In the original estimates, these figures were 60% and 13%, respectively.

[77] The SHCP study (2016) "Distribución del pago de impuestos and recepción del gasto público por déciles de hogares y personas 2014" [Distribution of Tax Payment and Receipt of Public Spending by Deciles of Households and Individuals] found that high-income families contributed 64% of revenues before the fiscal reform and 71% after the 2014 reform.

event that public revenues decline. Moreover, as a result of the energy reform (2014), investment in the hydrocarbons sector is expected to increase—and, consequently, in the production sector as well—in the medium term. This would have a positive impact on oil revenues. As for the risk of an unexpected slowdown in capital inflows, this would be mitigated by the country's significant level of international reserves (18% of GDP) and its US$65 billion Flexible Credit Line with the International Monetary Fund.[78] In addition, Mexico has a flexible exchange rate regime and a sound financial system.

III. IMPLEMENTATION AND MANAGEMENT PLAN

A. Summary of implementation arrangements

3.1 **Borrower and executing agency**. The borrower is the United Mexican States, through the SHCP. The SHCP Tax Policy Revenue Unit, with the support of the International Financial Affairs Unit, will carry out the program's execution and utilize the Bank financing. The SHCP will bear technical responsibility for execution, coordination with the SAT and the Oil Fund, and commit to the following: (i) maintaining, through Nacional Financiera Sociedad Nacional de Crédito (NAFIN) official communications with the Bank and submitting reports and evidence that the conditions of the operation have been fulfilled, together with any other reports requested, in the agreed periods and conditions; (ii) promoting actions to fulfill the policy objectives established in the program; and (iii) compiling, filing, and submitting to the Bank all the information, indicators, and parameters that enable the Mexican government and the Bank to monitor, measure, and evaluate program outcomes.

3.2 **The following will be special contractual conditions precedent to the first and only disbursement of financing: (i) signature of the agency agreement between the borrower and the financial agent, NAFIN, a development banking institution; and (ii) fulfillment of the policy reform conditions set forth in the policy matrix (Annex II), the policy letter, and the conditions established in the loan contract. In accordance with SHCP internal regulations, the Mexican government has the power to engage a financial agent to negotiate, procure, and manage loans granted by international financial cooperation organizations for the purpose of promoting economic development. This is the way the Mexican government ordinarily operates.**

B. Summary of arrangements for monitoring results

3.3 Program monitoring is based on verification of the policy measures agreed on as conditions (see Monitoring and Evaluation Plan). The SHCP will furnish the information needed to verify compliance with the program's progress indicators and the phases of the agreed reforms. The reforms will be evaluated by monitoring the indicators in the results matrix. In addition, the ex post evaluation will examine the impact of specific reforms, in particular: (i) study of tax reform returns and equity; (ii) analysis of the design and implementation of electronic invoicing and

[78] In addition, the Mexican financial system is sound (ranked fourteenth of the 62 countries evaluated by the Global Economic Forum) and robustly monitored. The country also has an extensive network of free trade agreements (10 with 45 countries) and agreements for the promotion and reciprocal protection of investments (30 countries).

digital payroll statements, and lessons learned; (iii) document on the methodology for and experiences with restructuring public expenditure; and (iv) evaluation of the RIF and its implications for the enrollment of workers in the RISS. In all cases, fulfillment of the measures and the performance of management will be evaluated, identifying corrective measures, as necessary, and good management practices.

IV. POLICY LETTER

4.1 The Bank and the Government of Mexico have agreed that the Policy Letter reflects: (i) the federal government's commitment to the objectives and actions included in the set of programmatic operations; and (ii) the consistency of policies to achieve fiscal strengthening and balance public finances.

Development Effectiveness Matrix			
Summary			
I. Strategic Alignment			
1. IDB Strategic Development Objectives	**Aligned**		
Development Challenges & Cross-cutting Themes	**-Productivity and Innovation -Institutional Capacity and the Rule of Law**		
Regional Context Indicators			
Country Development Results Indicators	**-Percent of GDP collected in taxes (%)* -Regional, sub-regional and extra-regional integration agreements and cooperation initiatives supported (#)* -Government agencies benefited by projects that strengthen technological and managerial tools to improve public service delivery (#)***		
2. Country Strategy Development Objectives	**Aligned**		
Country Strategy Results Matrix	**GN-2749**	**Support the strengthening of public management at the federal and subnational levels.**	
Country Program Results Matrix	**GN-2849**	**The intervention is included in the 2016 Operational Program.**	
Relevance of this project to country development challenges (If not aligned to country strategy or country program)			
II. Development Outcomes - Evaluability	**Evaluable**	**Weight**	**Maximum Score**
	8.1		**10**
3. Evidence-based Assessment & Solution	**10.0**	**33.33%**	**10**
3.1 Program Diagnosis	**3.0**		
3.2 Proposed Interventions or Solutions	**4.0**		
3.3 Results Matrix Quality	**3.0**		
4. Ex ante Economic Analysis	**8.0**	**33.33%**	**10**
4.1 The program has an ERR/NPV, a Cost-Effectiveness Analysis or a General Economic Analysis	**2.5**		
4.2 Identified and Quantified Benefits	**2.0**		
4.3 Identified and Quantified Costs	**0.0**		
4.4 Reasonable Assumptions	**2.0**		
4.5 Sensitivity Analysis	**1.5**		
5. Monitoring and Evaluation	**6.2**	**33.33%**	**10**
5.1 Monitoring Mechanisms	**1.5**		
5.2 Evaluation Plan	**4.7**		
III. Risks & Mitigation Monitoring Matrix			
Overall risks rate = magnitude of risks*likelihood	**Medium**		
Identified risks have been rated for magnitude and likelihood	**Yes**		
Mitigation measures have been identified for major risks	**Yes**		
Mitigation measures have indicators for tracking their implementation			
Environmental & social risk classification	**B.13**		
IV. IDB´s Role - Additionality			
The project relies on the use of country systems			
Fiduciary (VPC/FMP Criteria)			
Non-Fiduciary			
The IDB's involvement promotes additional improvements of the intended beneficiaries and/or public sector entity in the following dimensions:			
Gender Equality			
Labor			
Environment			
Additional (to project preparation) technical assistance was provided to the public sector entity prior to approval to increase the likelihood of success of the project	**Yes**	**The Bank has provided technical assistance for the recent fiscal reform through diagnostic studies and proposals (see index of sector works).**	
The ex-post impact evaluation of the project will produce evidence to close knowledge gaps in the sector that were identified in the project document and/or in the evaluation plan	**Yes**	**Assessments will be made about: i) the final impact of tax reform, ii) the implementation of electronic invoicing and digital payroll, and iii) the implementation of a reengineering of public expenditure.**	

Note: (*) Indicates contribution to the corresponding CRF's Country Development Results Indicator.

The project is Evaluable.

In 2014, the Bank approved financing for a programmatic series comprised of two operations, whose overall goal is to strengthen public finances by increasing tax revenue and controlling public expenditure. This is the second operation of this series. The first operation supported tax reform (ISR, IVA, IEPS), the improvement of tax and customs administration, tax evasion control, the rationalization of public expenditure and the improvement of budgetary control at the federal level. This second operation continues with this support, and introduces new actions related to oil taxation, increased financial information exchange with other countries; and budgetary spending rationalization. The diagnosis is complete and leads to the set of measures contained in the Policy Matrix.

The Results Matrix has vertical logic where the set of proposed policy measures (products) leads to a set of results (non-oil tax revenues increases, for instance), which in turn leads to the expected final impact (public sector financing requirements).

An update of the economic analysis on the tax reform results and its distributional impact is presented. It is expected that the approved reform will yield, in terms of additional revenue, 3.3% of GDP when its measures are fully in effect in 2018. Three ex-post evaluations are proposed: (i) an experimental study on the elimination of the REPECOS, (ii) a semi–experimental study on the implementation of an electronic invoicing system and digital payroll receipts, and (iii) an ex post cost-benefit tax collection analysis which includes its distributional impact

POLICY MATRIX

Component objectives	Conditions fulfilled – Programmatic operation I	Conditions fulfilled – Programmatic operation II
I. Macroeconomic stability		
To maintain a stable economic policy.	Maintenance of an appropriate macroeconomic policy framework consistent with the program objectives by carrying out actions to strengthen national public finances.	To ensure a macroeconomic context consistent with the program objectives established in the policy matrix.
II. Tax policy reform		
To improve the tax system's collections, equity, progressiveness, and simplicity.	1. Evidence of publication of the legal instrument(s) through which Congress has passed tax legislation that includes the following measures as a minimum: Income tax:[1] (i) Make the personal income tax more progressive by: (a) raising the marginal rate for high incomes to 35%; (b) reducing personal deductions (cannot exceed the lesser of four annualized minimum daily wages or 10% of gross income) and reducing the exemption on housing sales from 1.5 million investment units (UDIs) to 700,000 UDIs (about Mex$3.5 million); and (c) establishing a 10% tax on dividends and capital gains from the sale by individuals of shares or securities on the stock market. (ii) Increase in the tax base (horizontal equity) of the corporate income tax (IRPM) by: (a) eliminating the immediate deduction for capital goods; (b) eliminating the fiscal consolidation regime and replacing it with an integration mechanism with deferred taxes payable in installments over three fiscal years; (c) capping the deductibility of tax-exempt employee benefits such as certain social security benefits and other benefits (fiscal symmetry); (d) capping other deductions (investments in and leasing of automobiles and restaurant consumption); and	1. Evidence of publication of the regulations governing the components of the tax reform whose passage was a condition of the first operation in the programmatic series. 2. Evidence of publication of the legal instrument(s) through which Congress approved the amendment of the IEPS Act[7] and the Hydrocarbons Revenue Act,[8] establishing at least the following measures: (i) Change the IEPS on automotive fuel (gasoline and diesel) to a fixed tax as of 2016, subject to adjustments for inflation in subsequent years.[9] (ii) In the case of hydrocarbon exploration and extraction contracts, impose a hydrocarbons exploration fee, royalty payments that increase on the basis of price ranges, and a payment to the Mexican State based on operating profit or the contract value of hydrocarbons. (iii) In the case of concessions to private State-owned production companies for the exploration and extraction of hydrocarbons, exploration fees, extraction fees, and profit sharing.

[1] Income Tax Act (11 December 2013).

Component objectives	Conditions fulfilled – Programmatic operation I	Conditions fulfilled – Programmatic operation II
	(e) modifying the presumptive regime (*régimen ficto*) governing maquilas[2] to eliminate the rate reduction benefits granted in 2003. (iii) Maintenance of the IRPM rate at 30% (the proposed reduction to 28% in 2014 has been cancelled). (iv) Simplification of the income tax by: (a) replacing the REPECOS with a fiscal incorporation regime (as a transition to the general regime for taxpayers who invoice less than Mex$2 million); (b) eliminating the “intermediate regime;” (c) eliminating the “simplified regime” (automotive transport, primary sector, and similar); (d) eliminating the IRPM special regimes for: real estate companies, installment sales, bank loan loss provisions; and (e) eliminating the flat-rate business tax (IETU) and the tax on cash deposits (IDE). Value added tax (VAT):[3] (v) Expansion of the VAT base and standardization of the rate: (a) eliminating the border rate (11%) and matching it to the general rate of 16%; and (b) eliminating exemptions for overland passenger transport by foreign companies[4] and temporary imports, and others.	

7 Special Production and Services Tax Act (18 November 2015).

8 Hydrocarbons Revenue Act (11 August 2014).

9 In 2016 and 2017, the fixed rates applicable to different types of automotive fuel may be modified if the if the price of fuel is outside the maximum price band established in the current fiscal year.

2 Presumed tax estimate established by law, frequently used in tax systems.

3 Value Added Tax Act (11 December 2013).

4 Different from the public overland transport of passengers provided exclusively in urban and suburban areas and metropolitan zones (Art. 15 of the VAT Act).

Component objectives	Conditions fulfilled – Programmatic operation I	Conditions fulfilled – Programmatic operation II
	Special taxes[5] and mining duties:[6] (vi) Creation of excise taxes to correct negative externalities affecting the environment and public health: (a) on fossil fuels for carbon emissions; (b) on pesticides; (c) on flavored drinks; and (d) on nonbasic calorie-dense foods. (vii) Update of the procedure for calculating fuel price adjustments, including their adjustment for inflation starting in 2015 in the IEPS on fuels (mainly gasoline and diesel). (viii) Modernization of the tax on the mining sector by: (a) a special duty of 0.5% on sales of gold, silver, and platinum; and (b) taxes on mining based on the operating balance (7.5%).	
III. Improvement in the tax and customs administration		
To tighten controls to fight tax evasion through modern invoicing instruments and controlling operations, and facilitate voluntary compliance.	2. Inclusion in digital tax invoices via Internet (CFDI) of more than 20% of taxpayers required to issue tax receipts at December 2013. 3. Signature of an intergovernmental agreement on implementation of the Foreign Account Tax Compliance Act (FATCA) for the automatic exchange of financial information. 4. Evidence of publication of the legal instrument(s) in which Congress has passed an amendment(s) to the Customs Act that includes the following measures as a minimum: (i) Elimination of the second inspection by an appraisal firm at customs.	3. Evidence of implementation of the measures to modernize the Tax Administration Service (SAT) through: (i) Inclusion in electronic invoicing (CFDI) of at least 60% of taxpayers required to issue tax receipts. (ii) Inclusion of at least 40% of taxpayers required to issue digital payroll statements (CFDIs remitted electronically to the SAT and to employees by email). (iii) Evidence of the implementation of the tax mailbox for individuals and companies that includes as a minimum: (a) electronic

5 Special Production and Services Tax Act (11 December 2013).

6 Federal Fees and Charges Act (11 December 2013).

Component objectives	Conditions fulfilled – Programmatic operation I	Conditions fulfilled – Programmatic operation II
	(ii) Elimination of the requirement to hire a broker for customs clearance. 5. Evidence of the following changes to the Fiscal Code of the Federation: (i) Introduction of final settlement agreements as a dispute settlement alternative, with the Office of the Taxpayer Advocate (PRODECON) acting as witness. (ii) Possibility of blocking the issuance of digital tax stamps in the event of a verifiable risk of fraud (“blockage of the digital stamp”). (iii) Tax opinion by an independent expert becomes optional for taxpayers.	notification; (b) messages and notices of interest; and (c) procedures and services. 4. Approval of administrative and data processing rules to facilitate reciprocal implementation of the FATCA. 5. Evidence of signature of the Agreement for the Automatic Exchange of Tax Information among Jurisdictions of the Global Forum on Transparency and Exchange of Information for Tax Purposes (Berlin Agreement, October 2014). 6. Evidence of the design and bidding phases of the Customs Technology and Integration Project (PITA) for the facilitation of trade and customs control via process automation. 7. Publication of at least one list of delinquent clients by the SAT and guidelines for blocking the SAT’s digital stamp. 8. Publication of guidelines for the final settlement procedure. 9. Creation and implementation of the: (i) Hydrocarbons Revenue Unit within the SHCP, specializing in advisory services and oversight of economic and administrative conditions under the framework of the Hydrocarbons Revenue Act; and (ii) the Hydrocarbons Administration within the SAT, specializing in tax compliance control under the framework of the Hydrocarbons Revenue Act.
IV. Control of public spending		
To rationalize public spending and tighten the federal government’s budget control.	6. Evidence of publication of the legal instrument(s) through which Congress has passed tax legislation that includes the following measures as a minimum:	10. Evidence of publication of the regulations of the Federal Budget and Fiscal Responsibility Act, approval of which is a condition of the first operation in the programmatic series.

Component objectives	Conditions fulfilled – Programmatic operation I	Conditions fulfilled – Programmatic operation II
	(i) A balanced budget rule with a target for public sector financing requirements and a cap on structural current spending.[10] (ii) Payment by the SHCP's Federal Treasury, in coordination with the Department of Public Education (SEP), of the roster of teachers working in the states who are financed by the federal government (budget line 33).[11]	11. Evidence of the creation and implementation of a trust to receive, manage, invest, and distribute payments received by the State for hydrocarbon exploration and extraction concessions and contracts (Mexican Oil Fund for Stabilization and Development).[12] 12. Evidence of the implementation of a restructuring of public expenditure in the 2016 Expenditure Budget for the Federation[13] to include at minimum: (i) a review of budgetary programs and their structures, operating expenses, and public investment; and (ii) the merging, reclassification (under a different sector authority), elimination, and reduction of budgetary programs.

[10] Federal Budget and Fiscal Responsibility Act (24 January 2014). The Act establishes that growth in structural current spending (SCS) may not exceed 2% in real terms in 2015 and 2016 and, as of 2017, SCS cannot exceed the annual growth rate of potential GDP.

[11] The General Education Act (11 September 2013), and the Fiscal Coordination Act (9 December 2013).

[12] Mexican Oil Fund for Stabilization and Development Act (11 October 2014).

[13] Expenditure Budget for the Federation for fiscal year 2016 (27 November 2015).

DOCUMENT OF THE INTER-AMERICAN DEVELOPMENT BANK

PROPOSED RESOLUTION DE-___/16

Mexico. Loan ____/OC-ME to the United Mexican States
Public Finance Strengthening Program II

The Board of Executive Directors

RESOLVES:

That the President of the Bank, or such representative as he shall designate, is authorized, in the name and on behalf of the Bank, to enter into such contract or contracts as may be necessary with the United Mexican States, as Borrower, for the purpose of granting it a financing to cooperate in the execution of the Public Finance Strengthening Program II. Such financing will be for the amount of up to US$600,000,000 from the resources of the Bank's Ordinary Capital, and will be subject to the Financial Terms and Conditions and the Special Contractual Conditions of the Project Summary of the Loan Proposal.

(Adopted on ___ __________ 2016)

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