

## Fiscal responsibility continues in 2020, with some optimism in underlying assumptions

September 9, 2019

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- Minister of Finance Arturo Herrera delivered yesterday the budget proposal for fiscal year 2020 to the Lower House
- The proposal includes three documents:
  - (1) The General Economic Policy Criteria;
  - (2) The Revenue Law; and
  - (3) The Government Spending Proposal
- We believe macroeconomic estimates are consistent -even slightly more conservative- with market expectations, particularly regarding the exchange rate, inflation and interest rates
- Nevertheless, growth estimates are a tad above consensus, while oil output could face some skepticism from market participants
- In terms of public finances, for 2019, the government maintained its primary surplus estimate at 1% of GDP, while increasing the PSBR deficit to 2.7%. For 2020, these concepts are expected at 0.7% and 2.1%, respectively
- We highlight the announcement that MXN129.6 billion (~US\$6.6 billion) of the stabilization fund will be used this year to make up for lower-than-projected revenues without sacrificing spending
- Meanwhile, on the revenue side, they expect virtually no changes in real terms vs. latest estimates for 2019, highlighting the 4.5% rise in oil revenues, while non-oil tax collection would edge-up 3.7%
- On spending, the MoF is looking at a 0.9% yoy rise in real terms, with an expansion in programmable spending (+0.8%) and financial costs down by 1.2%
- All in all, in our view the budget proposal delivers on the commitment of maintaining healthy public finances, while recognizing a more challenging backdrop
- We also welcome the efforts to increase tax collection, as we consider it to be one of the main areas of opportunities for the country

**The MoF submits to Congress its budget proposal for fiscal year 2020.** The Minister of Finance, Arturo Herrera, delivered the documents to the Lower House which included: (1) The *General Economic Policy Criteria* –which states the macroeconomic projections used to estimate the budget–; (2) the *Revenue Law*; and (3) the *Spending Budget*. In the first two cases, they must be approved by both the Lower House (October 20<sup>th</sup>) and the Senate (October 31<sup>st</sup>), while the spending budget should be approved only by the Lower House no later than November 15<sup>th</sup>.

Document for distribution among public

### Main deadlines for FY2020 Fiscal Budget

Deadline	Document
September 8	2020 Budget Proposal
October 20	Lower House approval of the Revenue Law
October 31	Senate approves the Revenue Law
November 15	Lower House of the <i>Spending Budget</i>

Source: Ministry of Finance

**Updated assumptions to reflect a more challenging backdrop.** We highlight the following features from the documents: (1) The downgrade of 2019 GDP growth expectations, to 0.6-1.2% (mid-point: 0.9%) this year, from 1.1-2.1% in the *Preliminary Criteria* released in April; while estimates for 2020 were revised up to 1.5-2.5% (previous: 1.4-2.4%); (2) lower estimates for the price of the Mexican oil mix, edging down to US\$/bbl 49 for 2020 (previous: US\$/bbl 55) and US\$/bbl 55 for 2019 (previous US\$/bbl 57); (3) mixed revisions for oil production, with lower expectations for 2019 (current: 1,727kbpd; previous: 1,783kbpd) but an upward adjustment for 2020 (current: 1,951kbpd; previous: 1,916kbpd), now incorporating oil production estimates from private producers; (4) the proposal to use MXN129.6 billion (~US\$6.6 billion) from the stabilization fund in 2019, offsetting for what would have been lower tax revenues relative to the approved budget; (5) the primary surplus targets of 1% this year (unchanged) and 0.7% in 2020 (down from 1.3%, which we believe is realistic); (6) the deficit in the *Public Sector Borrowing Requirements* (PSBR) edging-up to 2.7% and 2.6% of GDP, for 2019 and 2020, respectively; and (7) the *Historical Balance of the PSBR* (HBPSBR) of 45.3% for 2019, in line with the approved amount, and at 45.6% of GDP, 50bps higher than in the *Preliminary Criteria* document (see table below).

**In our view, most of the macroeconomic framework and targets are realistic, confirming the commitment of the Federal Government to maintain healthy public finances.** Nevertheless, given an adverse global and local backdrop, we believe there are some risks that need to be looked after. In particular, the growth estimate for next year is relatively high vs. market expectations. In addition, oil output could also be relatively optimistic, which could further impact on oil revenues. In detail, the estimate for 2020 takes as an input the 1,866kbpd forecasted oil output within Pemex's business plan, with the remaining 85kbpd stemming from the private sector and existing *farm-outs*, among others.

Moreover, there were no additional details of the 2020 oil hedge program, although the MoF stated in the document that they still intend to use them as a key tool to protect revenues. In this context, it should be noted that the price of the Mexican oil mix last Friday stood at US\$/bbl 57.13, 16.6% above the US\$/bbl 49 level estimated for 2020. Even though this gives the government some leeway in terms of hedging oil revenues, markets will still pay attention to final details vs. this proposal. Finally, we highlight the increase in the PSBR and HBPSBR, which we consider to be more realistic given the update to the macro framework and the previously outlined risks, despite higher overall debt for both years, which could be an additional risk factor for the sovereign credit rating.

**Mostly realistic assumptions for 2020.** As we previously mentioned, we believe estimates for 2020 are consistent with market expectations and achievable. We highlight that FX and interest rates are broadly in line with consensus. Inflation stands below market, but in line with the central bank's target. By contrast, the GDP forecast range is more optimistic, which could present an additional risk for non-oil tax revenues. We also consider that the expected increase in oil output could be achieved considering Pemex's business plan but could be seen with some skepticism by other market participants. On the oil price, we see as positive that the price is below current levels due to the possibility of a global economic deceleration and should favor margins for the purchase of the oil hedge. Lastly, they reduced the expectations for the primary surplus to 0.7% of GDP, while HBPSBR would edge up to 45.6% resuming its downward trend in the following years.

### General Economic Policy Criteria (GEPC) – 2019-2020

	2019				2020		
	GEPC (Sep'19)	Preliminary (Apr'19)	Approved (Dec'18)	Consensus*	GEPC (Sep'19)	Preliminary (Apr'19)	Consensus*
<b>GDP (% yoy)</b>							
Range	0.6 - 1.2	1.1 -2.1	1.5 - 2.5	0.1 - 0.9	1.5 - 2.5	1.4 - 2.4	0.8 - 2.2
Mid-point	0.9	1.6	2.0	0.5	2.0	1.9	1.4
<b>Inflation (%)</b>							
December / December	3.2	3.4	3.4	3.4	3.0	3.0	3.6
<b>Nominal exchange rate</b>							
End of period	19.8	19.9	20.0	19.8	20.0	20.1	20.3
Average	19.4	19.5	20.0	--	19.9	20.0	--
<b>Interest rate (28-day CETES)</b>							
% nominal, end of period	7.8	8.0	8.3	7.7	7.1	7.6	7.3
% nominal, average	8.0	8.0	8.3	--	7.4	7.8	--
<b>Current Account Balance</b>							
% of GDP	-1.8	-1.8	-2.2	--	-1.8	-2.0	--
<b>Fiscal Accounts (% of GDP)</b>							
PSBR**	-2.7	-2.5	-2.5	-2.5	-2.6	-2.1	-2.8
Public Balance							
with high-impact investments	-1.9	-2.0	-2.0	-2.2	-2.1	-1.6	-2.4
without high-impact investments	0.1	0.0	0.0	--	-0.1	0.0	--
Primary balance	1.0	1.0	1.0	--	0.7	1.3	--
HBPSBR***	45.3	45.1	45.3	--	45.6	45.1	--
<b>Mexican oil mix</b>							
Price (average, US\$/bbl)	55	57	55	--	49	55	--
Production (average, kbpd)	1,727	1,783	1,847	--	1,951	1,916	--
Exports (average, kbpd)	1,115	1,008	1,016	--	1,134	1,085	--

\* According to the latest Banxico survey. For GDP, the mid-point corresponds to the survey median

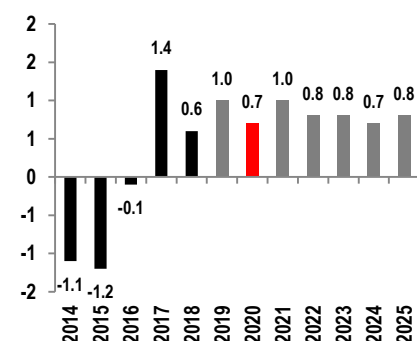
\*\* Public Sector Borrowing Requirements

\*\*\* Historical balance of the PSBR, which is the broadest measure of the country's public debt

Source: MoF, Banxico

#### Primary balance

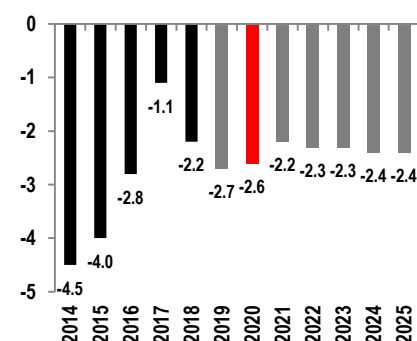
% GDP



Source: CGPE 2020, MoF \*Primary Balance

#### Public balance\*

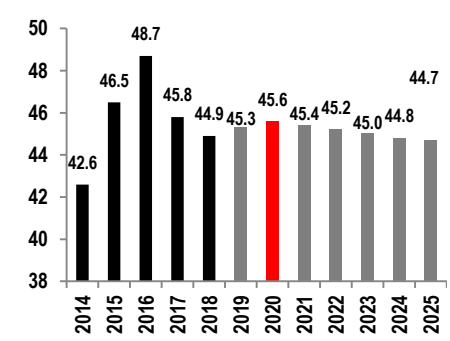
% GDP



Source: CGPE 2020, MoF. \*Measured by the PSBR

#### Total public sector debt

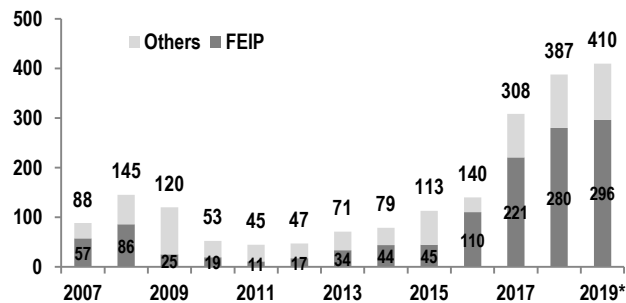
% GDP



Source: CGPE 2020, MoF. \*Measured by the HBPSBR

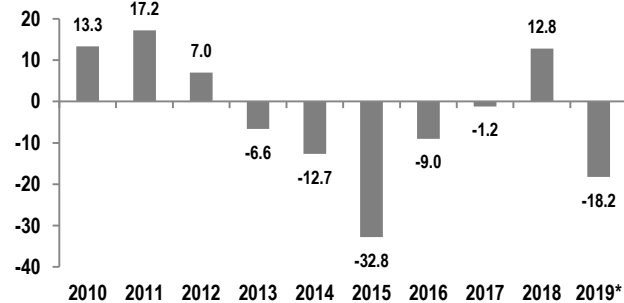
**Use of the *Stabilization Fund*.** As previewed by officials back in July, the Government plans to deploy MXN 129.6 billion (US\$ 6.6 billion) of the resources in the *Stabilization Fund* (FEIP, in Spanish) to make up for lower-than projected revenues during 2019. It should be mentioned that this amount represents around 43.7% of the size of the Fund (see chart below, left), and is equivalent to 0.5% of GDP. In this regard, and using the FEIP, the updated forecast of total income for 2019 stands at MXN 5,323.7 billion, which is MXN 25.6 bn above the amount approved in the budget. During the first seven months of the year, this shortfall stood at MXN 89.4 billion, made up of: (1) Lower-than-expected oil-related income by MXN 122.3 billion, falling 18.2% yoy in real terms (chart below, right); and (2) stronger non-oil revenues by MXN 32.9 billion surplus. Given that spending commitments were largely unchanged, the MoF estimates an additional gap in revenues of MXN 14.6 billion for the rest of year. It should be stressed that given that spending did not increase, these additional resources are not considered to be fiscal stimulus.

**Stabilization Fund resources**  
MXN billion



\* All figures by year-end except for 2019, as of June  
Source: MoF

**Oil-related fiscal revenues\***  
%, yoy in real terms



\* Full-year figures with the exception of 2019, which is for the Jan-Jul period  
Source: MoF

**Revenues unchanged in real terms relative to 2019.** The MoF expects overall income to remain virtually unchanged in real terms (+0.4% yoy) next year vs. 2019 updated figures, amounting to MXN 5,511.9bn. This is consistent with no new taxes and no changes to current rates. In addition, fiscal stimulus for the Northern border would continue, with VAT at 8% and income tax at 20%.

By type, oil revenues are expected to increase 4.5%, driven by the 13% upward adjustment in oil output (given that the expected price is lower this year), while non-oil revenues are estimated to be 1% lower in real terms. This would be mainly explained by an adverse base effect, as the use of the FEIP this year is accounted in this concept. Nonetheless, tax collection is expected to edge-up 3.7%, driven by new policies which aimed to promote tax collection.

#### Measures to improve tax collection

- (1) Elimination of some forms of tax relief
- (2) Increased sanctions and risk perceptions
- (3) Income taxes on property leasing
- (4) VAT retention from outsourcing
- (5) Improvements in tax collection related to digital businesses
- (6) Administrative facilities for independent salespeople
- (7) Fiscal incentives for communal parcels
- (8) Updated retention rate on capital in debt instruments

Source: CGPE 2020, Ministry of Finance

In fact, the Federal Government proposes eight targeted actions:

- (1) Elimination of some forms of tax relief. Since last May, the MoF committed not to eliminate, totally or partially –with the use of presidential decrees or other legal measures– tax debts;
- (2) Increased sanctions and risk perceptions. The government will combat tax fraud and fake invoicing by classifying them as serious crimes and organized crime, in the same order. Specifically, they estimate that legislation required for the latter will be approved by January 2020. The main target is to increase the perception of risk –with a higher probability of being detected– on top of higher sanctions if found guilty;
- (3) Income taxes on property leasing. This will try to incentivize owners to provide invoices to renters. This would be done by specifying that in trials where rents are due, the only way for a renter to pay is if there are invoices issued to back these payments. The MoF estimates that evasion from tax revenues pertaining to this concept is around 0.1% of GDP;
- (4) VAT retention from outsourcing. According to authorities, the businesses that use outsourcing services fully deduct expenses related to VAT, while the service providers sometimes do not pay this amount in full. Therefore, this measure would force businesses to retain and eventually pay the amount due by the outsourcing company. This would be a similar scheme to the one applied to salaried workers under the tiered income tax system;
- (5) Improvements in collection related to digital businesses. While the measure does not imply the creation of a new tax, it will carry out a series of measures that look to improve fiscal compliance for businesses not based in Mexico. Among the measures we highlight: (a) simplified registration procedures; (b) incorporate VAT in the price of their services; and (c) deliver operational figures to regulators; among others;
- (6) Administrative facilities for independent salespeople. The goal is to facilitate the administrative burden and tax contributions of retail sales made by people that do not have a physical location, such as catalog-based sales and demonstrations. There would be a simplified income tax retention scheme, incentivizing formality and tax certainty to independent salespeople;
- (7) Fiscal incentives for communal parcels. There would be a preferential treatment that allows a reduced fiscal burden for businesses in accordance with agricultural law, constituted by communal parcel holders. This would boost activities such as agriculture, ranching, forestry and fishing; and
- (8) Updated retention rate on capital in debt instruments. The rate would be updated to 1.45% from 1.04%, in line with procedures established in 2019's revenue law. This is based on average returns of financial instruments and realized inflation.

**Public spending is set to increase at a faster pace than revenues.** Overall spending would increase 0.9% yoy in real terms, amounting to MXN6,059 billion, out of which 60.7% will be allocated to current spending, 22% to pensions and 17.3% to investment. Moreover, programmable spending is set to increase 0.8%, while non-programmable is expected to expand 1.1% yoy in real terms. In the case of programmable spending, the main upward revisions –in nominal terms vs. previously approved budget–, will be seen in autonomous branches (+6.1%) and government-controlled entities (+6.0%). By contrast, administrative branches would continue to be the main focus of the government’s austerity measures (-2.6%), in particular: Ministry of Tourism (-44.7%); Ministry of Agricultural and Urban Development (-43.7%); and the President’s Office (-43.5%). In the meantime, the following will see an increase in their budgets: Ministry of Energy (+72.0%); Ministry of Internal Affairs (+56.5%); and the Judicial Advisory to the Executive Branch (+25.1%). In addition, Pemex’s spending is set to expand 8.8% yoy, besides an additional budgetary prevision of MXN 46.3 billion (US\$ 2.4 billion), while CFE’s will increase 1.4%. Within non-programmable spending, we highlight lower financial costs (-1.2% vs relative to updated figures), while transfers to states would edge-up 1.8%.

#### Proposal for 2020’s Budget

MXN\$bn, % of GDP, % yoy in real terms

	MXN billion (nominal)		% of GDP		% yoy
	2020	2019*	2020	2019*	
<b>Economic Balance</b>	<b>-547.1</b>	<b>-477.1</b>	<b>-2.1</b>	<b>-1.9</b>	<b>10.7</b>
Ex. high-impact investments	-22.1	26.7	-0.1	0.1	--
<b>Budget Balance</b>					
<i>Revenues</i>	5,511.9	5,323.7	21.0	21.4	0.0
Oil revenues	987.3	912.6	3.8	3.7	4.5
Non-oil revenues	4,524.5	4,411.2	17.2	17.7	-1.0
Federal Government	3,659.9	3,578.8	13.9	14.4	-1.3
Tax collection	3,499.4	3,257.2	13.3	13.1	3.7
Non-tax revenues	160.5	321.6	0.6	1.3	-51.8
Government-controlled entities (IMSS, ISSSTE, CFE)	864.6	832.4	3.3	3.3	0.3
<i>Spending</i>	6,059.0	5,800.8	23.1	23.3	0.9
Programmable	4,357.9	4,176.1	16.6	16.8	0.8
Non-programmable	1,701.1	1,624.8	6.5	6.5	1.1
Financial costs	732.9	716.2	2.8	2.9	-1.2
Transfers to states of federal tax revenues	944.3	895.7	3.6	3.6	1.8
Accrued spending of previous fiscal years	24.0	12.8	0.1	0.1	80.7
<b>Primary Balance</b>	<b>186.2</b>	<b>239.6</b>	<b>0.7</b>	<b>1.0</b>	<b>-25.0</b>

Source: CGPE 2019, Ministry of Finance. \*Note: Estimated figures for YE18

**Slightly lower allocation of resources to federal states, but still at healthy levels.** Allocations to states will fall 0.5% in comparison with the figures from 2019’s budget in nominal terms. Although the fall would be concentrated in lower transfers resulting from taxes collected as a federal level (-0.9%), contributions would also decrease (-0.2%). Nevertheless, we believe that the figures reflect the adjustments expected in tax revenues but are still at healthy levels and will allow states and municipalities to carry out their spending properly.

### Federal allocations to states

MXN\$bn, % yoy in nominal terms

	2020 Budget	2019 Budget	% yoy
<b>Total</b>	<b>1,972.1</b>	<b>1,982.2</b>	<b>-0.5</b>
Transfers resulting from taxes -collected at a federal level	944.3	952.6	-0.9
Contributions	816.7	818.0	-0.2
Other concepts	211.0	211.6	-0.2

Source: CGPE 2020, Ministry of Finance

**In our view, the proposal sent to Congress reinforces the government’s commitment to healthy public finances.** Even though the primary surplus in 2020 is slightly lower than initially estimated (0.7% of GDP vs. 1.3%) and public debt upticks to 45.6% of GDP, we believe this responds to a more realistic view of the fiscal balance. Moreover, we believe forecasts for the exchange rate, inflation, oil prices, and the interest rate, are realistic and close to market expectations. In the particular case of the interest rate, we found the estimate even slightly conservative, which is a positive attribute when building up the budget. In the case of growth and oil production, which are above consensus, we share the MoF’s optimism about both domestic and external factors that can potentially improve growth dynamics in Mexico next year. This would be the case considering the substitution effect due to the trade war between the US and China, which has benefited our country, along lower uncertainty about new government policies and inflation pressures. Moreover, the forecast for oil production includes additional output by the private sector in 2020, leaving a positive sentiment regarding the government’s energy policy.

**Moreover, we see measures to increase tax collection as favorable.** Mexico is among the countries with relatively low levels of tax revenues (15% of GDP) when compared to other emerging markets. We believe it is important to improve efficiency in tax collection, more so as this could provide the government the resources needed to increase infrastructure spending and strengthen social programs to step up to the challenge of increasing economic growth and tackling inequality.

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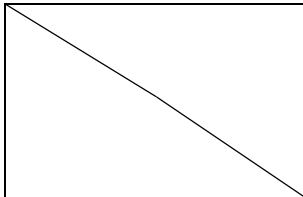
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