

US Fiscal reform and its implications for the Mexican economy

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- The Senate approved on Saturday its version of the tax plan
- Even though it eliminated several differences with the one from House of Representatives (the House), the bill still contains significant divergences, such as the date for the enactment of the corporate tax cuts
- Now the bill has to go through a reconciliation process to then be voted by both chambers before getting to President Trump's desk for enactment
- We expect the bill to be enacted at the beginning of next year, as Republicans could pass it even without the Democrats' vote
- We expect this bill to have a limited impact on the levels of activity given that the economy is already at full employment
- In this context, we believe it could push inflation levels higher which could imply a more aggressive Fed
- In terms of the Mexican economy, we believe that the tax plan is a serious threat for investment in the country, as it creates incentives for companies based in Mexico to move their fiscal residence to the U.S.
- Meanwhile, the most pressing issue is that the government funding provided by the latest *continuing resolution* expires this Friday, December 8

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Republicans push fiscal reform. During the early hours of Saturday, the U.S. Senate approved its fiscal plan with 51 votes in favor and 49 against, after the House approved its own version with 227 votes in favor and 205 against last November 16. The next step in this process is a reconciliation process between the two proposals in a joint committee to reach a single version of the bill that will have to be voted on in both chambers before getting the president's signature.

Some key differences remain in both proposals. We highlight depreciation policy phasing out (expiring after 2022 according to the proposal of the House and phasing out between 2022-2026 in the Senate), as well as the enactment date of the tax cuts: (1) The House of Representatives wants them enacted as soon as FY18, which began last October; while (2) the Senate wants the enactment for fiscal year 2019, which will begin in October 2018, as shown in the following table.

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Main differences between Senate and House fiscal reform proposals

	House of Representatives	Senate	Potential compromise
Individual taxes			
Individual tax rates	4 brackets max. rate 39.6%	7 brackets max. rate 38.5%	Similar to Senate
Alternative minimum tax	Repeal	Increase exemptions, phaseouts	Representatives' proposal
Standard deduction	Double the amount for couples	Expanded to \$2,000, increase income limits	Representatives' proposal
Estate tax	Double the state exemptions, repeal estate tax after 2024	Double the state exemptions, no estate tax repeal	Senate proposal
Individual tax relief			
Personal exemptions	Repeal deductibility	Repeal deductibility	Repeal deductibility
Indexing tax thresholds	Chained to CPI	Chained to CPI	Chained to CPI
Itemized deductions	Repeal deduction of state/local income tax and home equity interest; limit mortgage interest deduction to \$500k principal	Repeal deduction of state/local income tax and home equity interest; no mortgage interest limitation	Similar to Senate
ACA Individual Responsibility*	Not included	Reduce payment to zero	Reduce payment to zero
Small business taxes			
Pass-through income	25% rate (9% rate for first \$75k)	23% deduction of non-service income, \$500k threshold	Similar to Senate
Pass-through losses	Not included	Disallow active pass-through losses over \$250k (\$500k joint)	Senate proposal
Corporate taxes			
Corporate rate	20% rate (effective 2018), repeal corporate AMT	20% rate (effective 2019)	20% rate (effective 2019), repeal corporate AMT
Depreciation policy	100% expensing, ex. utilities & real estate (expires after 2022)	100% expensing, ex. utilities (phases down 2022-2026)	Senate proposal
Interest deductibility	Limit net interest deduction to 30% of EBITDA, ex. utilities & real estate	Limit net interest deduction to 30% of pre-tax income	Senate proposal
Net operating losses	Limit net operating loss deduction to 90% of income	Limit net operating loss deduction to 90% of income	Limit net operating loss deduction to 90% of income
Domestic corporate tax			
Taxation of foreign income	100% of exemption (territorial system)	100% of exemption (territorial system)	100% of exemption (territorial system)
Deemed repatriation	14% tax on untaxed profits in liquid assets, 7% on illiquid	14.5% tax on untaxed profits in liquid assets, 7.5% on illiquid	Senate proposal
Minimum tax on foreign income	10% minimum tax on "high return" income	12.5% minimum tax on global intangible low-tax income (GILTI) and deduction for foreign intangible income generated in US	Senate proposal
Transfer of intangible assets	Not included	Tax benefits for transfers of intangible property to US	Not included

Source: Goldman Sachs

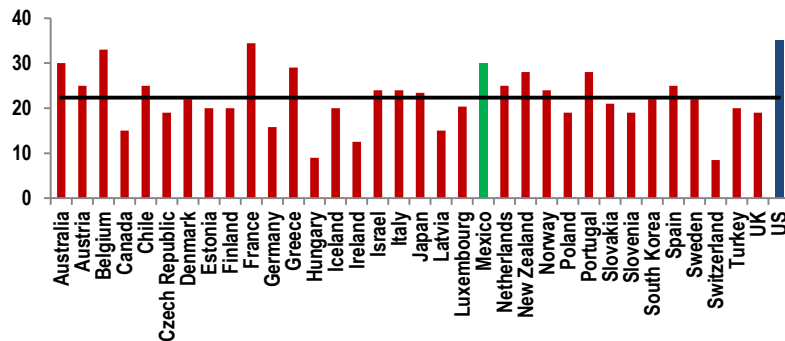
*ACA – Affordable Care Act, better known as Obamacare

If the reconciled version is approved in both chambers before the end of the year, to which we assign a high probability, some of the parts that make it would take effect as soon as at the beginning of next year. However, if the Senate version is approved, the corporate tax rate cut would be delayed until FY19. For individuals, the effects would not be seen until they file their taxes of 2018 in the first months of 2019. It is worth mentioning that for the approval of a reconciled version, Republicans have a greater margin in the House, while in the Senate they must obtain at least 50 votes (they have 52 seats and Democrats have 48). In Saturday's vote to pass the Senate version, only one Republican senator voted against, so Republicans hardly need the support of the Democrats to pass the reform.

In our opinion, Congress will reach an agreement as soon as the end of the year. While there are many differences around deductions, as well as the time when the corporate tax reduction would come into effect, we do not see irreconcilable differences between the two versions. Also, there are some political interests behind this since the midterm election will be held in less than a year from now. Although the markets are responding very well to the tax reform process in the US, we are concerned about two things: (1) The boost to economic activity could be limited given that the economy is already at full employment, so it could only result in inflation pressures, which would force the Fed to be more aggressive than anticipated in hiking interest rates; and (2) the impact on the Mexican economy.

We expect a negative impact for the Mexican economy. We believe that the tax reform in the US is an important risk for the Mexican economy since it can involve the creation of incentives for companies that declare taxes in Mexico, where the rate is 30%, to change their fiscal residence to the US to pay a lower rate. This will depend on the effective rate paid by companies in Mexico after the last fiscal reform, which decreased the deductibles significantly. Therefore, we saw an increase in the effective rate to levels close to 30%. In this context, we believe that fiscal changes would be required in Mexico as early as next year. The problem is that there is not a lot of leeway because of threefold: (1) In Mexico, the Revenue Law for 2018 has already been approved; (2) the reduction of corporate taxes could pose a risk of tax revenues, probably jeopardizing Mexico's public finances. Against this backdrop, this could be a good opportunity for the government make a fiscal reform to apply VAT taxes to food and medicines –which is a long-awaited measure-; and (3) elections will take place next year, so it will not be discussed until next September, when the new Congress is in place, otherwise this will be an issue for the next administration.

Corporate tax rate in OECD countries
%



Source: Banorte; OECD; CBO

The most pressing issue right now is that the government funding provided by the latest continuing resolution expires this Friday, December 8. Congress is discussing an additional short term continuing resolution to keep the government operating for two more weeks (December 22) until an agreement is reached. In the House of Representatives, Republicans could pass this extension without Democrats' help. However, 60 votes are required for approval in the Senate (Republicans have only 52). Among the clauses expected to be included in the budget, we highlight the funds for reconstruction after the natural disasters and new funding for the children's health program. Also, Democrats have been pressing for protection for immigrants known as *Dreamers*. Tensions have increased between the Democrats and President Trump and the chances of an agreement not being reached have increased.

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