ECONOMIC ANALYSIS

Lower corporate taxes in the US would not reverse Mexico's competitive advantage in manufacturing

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- **Mexico would continue to be more competitive than the United States in the production of manufactured goods even if the latter were to cut its corporate tax rate from 35% to 20%**
- **The difference in labor costs alone is a sufficient factor for Mexico to remain more competitive than the US**
- **In addition, even though state corporate taxes in the US are an allowable federal tax deduction, still represent an additional fiscal cost. Moreover, the depreciation of the Mexican peso observed since April 2016 is also a factor that contribute to maintaining Mexico's higher competitiveness in manufacturing**
- **For these reasons, we consider that Mexico should not respond by cutting its corporate tax rate. In the event that the Mexican government decided to cut the rate from 30% to 20%, tax revenue would show a permanent contraction equal to 1.2% of GDP; this would eliminate the primary fiscal surplus planned for 2018**
- **A measure of this kind would be irresponsible in the current context in which the government is carrying out a process of fiscal consolidation and especially when considering the low historical levels of tax collection seen in Mexico.**

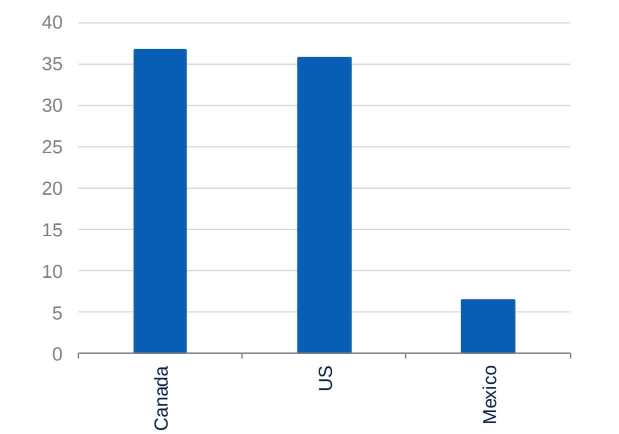
The proposed tax reform currently being discussed in the US envisages a cut in the corporate tax rate from 35% to 20%. The concern is that, since this rate is 30% in Mexico, the country will no longer be competitive relative to the United States and, therefore, will begin to lose FDI. In our opinion, these fears are ill-founded. The tax rate is not the only or even the main determining factor in decisions on where to invest. If that were the case, why have all the companies in the United States not moved out to the five states where the corporate taxe rate is zero? Why are there many more firms in California, whose rate is 9%, than in Wyoming where such taxes are zero? Nevertheless, if this tax reform were to be implemented in the United States, it is important to recognize that Mexico would lose some of its competitive advantage in the production of manufactured goods vis-à-vis the US, but it would still remain more competitive.

In relation to such a tax proposal in the United States, two pertinent questions arise: What effect will it have on the FDI in Mexico coming from the US? Should the Mexican government respond by cutting its corporate tax rate too?

As for the first question, our estimates indicate that even if this tax cut were to be implemented in the US, Mexico would still be more competitive in manufacturing production. Consequently, FDI should not be substantially affected. Such lack of a significant impact is due to the following reasons:

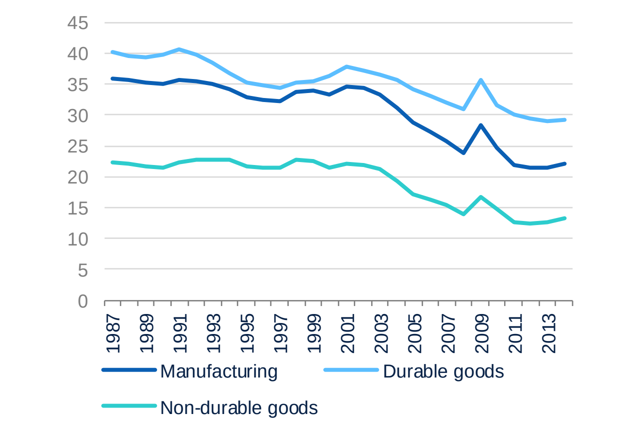
i) Manufacturing labor costs in the US are on average nearly six times higher than in Mexico (Figure 1). Meanwhile, manufacturing labor costs in the US as a percentage of the total industry revenue in 2014, the latest figure available, were 22.1% (Figure 2). We did some calculations to determine whether this labor costs differential would offset the US tax cut and in which country it would be more profitable to produce if the US corporate tax rate were to be cut to 20%, 10 pp lower than Mexico's rate. We find that the difference in labour costs alone is a sufficient factor for Mexico to still be more competitive than the US (Figure 3). In the most conservative scenario, it would be at least 10% more profitable to produce manufactured goods in Mexico than in the US. That is, Mexico would lose some of the advantage in manufacturing competitiveness that it has against the US, but it would continue to maintain a clear advantage. The assumptions that were used to obtain and then compare profits net of taxes between the two countries are shown in Table 1.

Figure 1. Labor compensation per hour in the manufacturing industry in 2012 (USD)



Source: BBVA Research based on BLS data

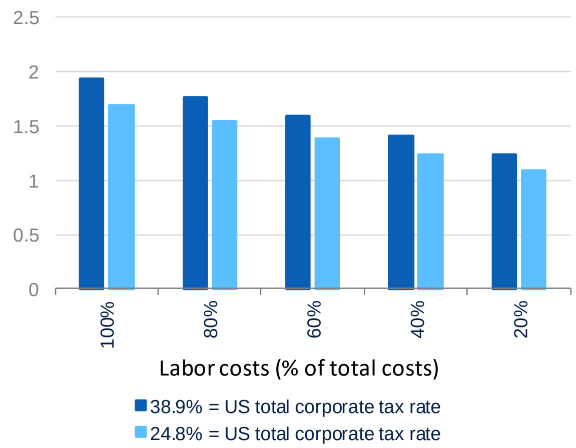
Figure 2. Labor costs as a percentage of nominal revenues in the US manufacturing industry



Source: BBVA Research based on BLS data

ii) We also have to bear in mind that the peso's depreciation of more than 10% since April 2016 (the Trump-related risk) would almost offset the US tax cut. This depreciation also means that Mexico would still be more competitive than the US even if the tax cut were to take place.

Figure 3. Profits after taxes in Mexico / Profits after taxes in the US (Ratio)



Source: BBVA Research

Table 1 Assumptions used to obtain profits after corporate taxes in the United States and Mexico

	US firm			
Item	Current corporate taxes		Corporate taxes with fiscal reform	
	Set up in the US	Set up in Mexico	Set up in the US	Set up in Mexico
Income	$100	$100	$100	$100
Total costs	$50	To be calculated	$50	To be calculated
Labor costs	X%*50	(X%/5.6)*50	X%*50	(X%/5.6)*50
Non-labor costs	(100%-X%)*50	(100%-X%)*50	(100%-X%)*50	(100%-X%)*50
State tax rate	6% ó $3	-	6% ó $3	-
Federal tax rate	35%	35%	20%	30%
Profits after the federal and state tax rates	($100-$50-$3)*0.65 = $30.55	($100-$50-$3+50*(X%-X%/5.6))*0.65	($100-$50-$3)*0.80 = $37.6	($100-$50-$3+50*(X%-X%/5.6))*0.70

Source: BBVA Research

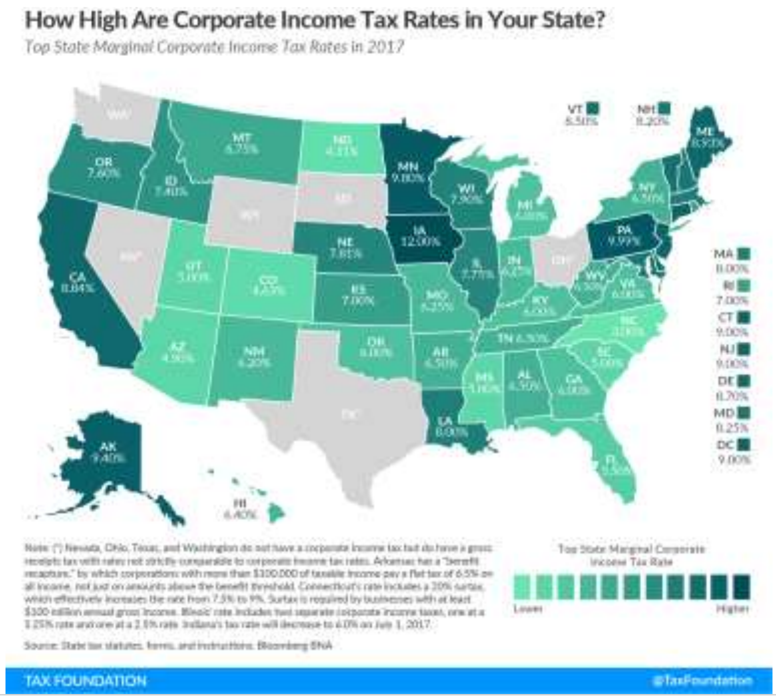
iii) We must also take into account the fact that the federal corporate tax is not the only tax faced by US firms; 44 states and Washington D.C. also have state corporate taxes ranging from 3% to 12%. If in addition to the proposed federal tax of 20%, we consider the average tax of the 50 states and Washington D.C. (6%), Mexico's competitive advantage in terms of profits after taxes widens further. Even though the state corporate taxes are an allowable deduction for the federal corporate tax[1], they still represent an additional fiscal cost for corporations.[2] The results shown in Figure 3 incorporate the average state corporate tax rate.

Due to these factors, if the US did cut its federal corporate tax rate to 20%, it would still be more profitable to produce manufactured goods in Mexico by at least 10% than in the US based on the assumptions used in the numerical exercise.

Moreover, the analysis should consider the tax rates actually paid, not the statutory rates laid down in the law. Effective tax rates are usually lower due to deduction, consolidation and other mechanisms. According to the US Congress Budget Office (CBO), the effective corporate tax rate in Mexico is 11.9%, whereas in the US such figure is 18.6%. In other words, a lower tax rate is actually paid in Mexico. In fact, when we look at effective rates, Mexico is not among the countries with the highest rates. This means that Mexico is more competitive than the US in terms of effective corporate tax rates, even by a wider margin than an analysis of statutory tax rates would suggest.

1: Taxable corporate profits at the federal level are equal to a corporation's receipts less **allowable deductions**—including the cost of goods sold, wages and other employee compensation expenses, interest, **nonfederal taxes**, depreciation, and advertising.
2: Consider a simple example in which a corporation had to pay taxes on profits of $50. It would have to pay on average a state corporate tax of $3 (6% of $50) that would be deducted from the federal corporate tax. Thus, it would pay a 35% federal tax on profits of $47 ($50 - $3), that is, $16.45. In total the corporation would not pay $17.5 (35% of $50) of federal corporate tax + $3 (6% of $50) of state corporate tax, but would pay $16.45 + $3 = $19.45.
That is, the state corporate tax represents on average an additional fiscal cost of 3.9pp over the 35% marginal federal corporate tax rate. In general terms, corporations end up paying 35% less of the marginal corporate tax (ie, 3.9% instead of 6%).

Figure 4. State corporate tax rates in the US
(% of net income)



Source: BBVA Research with state statutory tax data and Bloomberg BNA

For the aforementioned reasons, we consider that Mexico should not respond by cutting its corporate tax rate. In the event that the Mexican government decided to cut the rate from 30% to 20%, tax revenue would show an annual contraction of 16.9%, equivalent to 1.2% of GDP. Consequently, the implementation of such measure in Mexico would put at risk the attainment of a primary surplus of 0.9% of GDP for 2018. Furthermore, it would mean a permanent reduction in tax revenue. This would be irresponsible in the current context in which the government is carrying out a process of fiscal consolidation and especially when considering the low historical levels of tax collection seen in Mexico. Mexico's main fiscal problem is that revenue collection is very low as a share of GDP. It is the lowest in the OECD and lower than that of most countries with similar levels of economic development.

Summing up, i) there is no need to react to such possible tax change in the US since Mexico would still be more competitive, and ii) even if it wanted to react, there is not enough fiscal room to do it.

Nevertheless, our suggestion of no need to react to a potentially lower corporate tax rate in the US does not mean that it is not desirable to achieve a tax reform to reduce taxes on firms and increase them on consumption. But this is a discussion that should be had independently of the proposed tax reform in the US and always making sure that any change be at least neutral in terms of tax revenue.

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