BBVA RESEARCH

Economic Watch
Mexico

September 11, 2013
Economic Analysis

Fiscal Reform: in the right direction, but not enough

- **The reform includes unemployment insurance and a universal pension, the later financed through increased taxes and public debt, with additional receipts of 1.4% of GDP and public deficit of 1.5% in 2014. Given that the reform is estimated to have only a moderate effect on increasing formality in the economy and very little on investment, the potential effect on GDP is not expected to be very high.**
- **The reform is estimated to have a significant impact on annual inflation, with an additional temporary increase of at least 0.7 percentage points.**
- **Given the limited increase in receipts and higher deficit and public debt, the fiscal reform would not appear to do much for Mexico's credit rating.**
- **The elimination of the tax benefits in the housing sector will help tax receipts, but will have a negative effect on growth in the sector.**

Appraisal:

- The proposed fiscal reform presented yesterday by the government contains a series of measures that appear to move in the right direction. However, it is insufficient in various ways. First, it does not resolve one of the basic problems: the country's low level of tax receipts. If approved, the reform will increase receipts by under two percentage points of GDP. This will mean that Mexico will continue to have the lowest revenue figures in the OECD and among the worst in Latin America.
- The federal government recognizes that the reform will increase receipts by an additional 1.4 percentage points of GDP. Of this figure, one percentage point will be transferred to states and municipalities and around half a point has to be used to finance the minimum universal pension. In other words, the reform will not generate additional funds to increase public investment at federal level, which is a necessary condition for increasing the country's productivity.
- The reform falls short of what is required, as it does not consider applying VAT to food and medicines. This is not positive, as VAT exemption is a regressive measure that benefits those who consume most. VAT is also a tax with a high potential revenue-raising capacity. It would therefore have been better to apply VAT and use the revenue to provide assistance for the purchase of food and medicines for low-income families.
- Much of the reason for the low level of tax receipts in Mexico is the high rate of evasion and the government's limited capacity to raise revenues. The government should accompany this reform with measures to improve the execution of tax collection, thus increasing the probability of detecting and penalizing companies and individuals that resort to tax evasion.
- However, the reform also includes a number of positive points. The first is the countercyclical mechanisms that allow expenditure to increase at the lowest point of the economic cycle and generate savings when the cycle is high, without endangering fiscal stability. We also consider the unemployment insurance a good move, as it will provide a safety net for workers while promoting a more formal economy.

- Finally, eliminating the scheme for fiscal consolidation is a good measure, as in practice it had become a scheme for fiscal evasion by some companies. Similarly, eliminating a significant number of tax exemptions will result in increased revenue receipts.
- The current proposed reform represents progress in reducing tax evasion and avoidance, but there is still much to do in this area, as it is at the core of fiscal weakness. When the reform is approved, we will have keep an eye on the efficiency of expenditure, its transparency and the financial sustainability of the social programs announced, the effective implementation of the structural balance rule, and in general the fiscal sustainability of the federation, the states and the municipalities.

I. Components of the fiscal reform initiative

On Sunday, September 8, the Federal Government presented its fiscal reform initiative. Despite the country's fiscal stability in recent years, which has allowed it to maintain low levels of fiscal deficit and a public debt of under 40% of GDP, mainly in local currency (Chart 1), this reform was broadly expected by the market. This is mainly because of the high rate of dependence on oil revenues (33% of budget income comes from this item), low tax receipts in international terms (Chart 2), the large size of the informal economy (60% of all workers), and significant social needs. The main elements of reform can be summed up as follows:

New taxes on consumption:

- Creation of special new taxes (IEPS) on fossil fuels, pesticides and soft drinks; as well as changes to VAT: standardization of the border tax rate (from 11% to 16%); elimination of exemptions (for education services, public entertainment, except for the theater and the circus, the long-distance public transport service, interest payments on mortgages and temporary imports); and taxation of zero-rated products (VAT on home rental and purchase, chewing gum, pet food and jewelry).

New taxes on income:

- Increase in income tax from 30% to 32% for people with income of over 500,000 pesos. A limit is also to be introduced to the annual total of personal allowances equivalent to twice the minimum annual wage or 10% of the taxpayer's gross income, whichever is lower.
- Taxes on dividends and capital gains in the stock market, at a rate of 10%.
- Modernization of the collection of royalties from mining, water and the radio spectrum.
- The special regimes will be eliminated or limited, including the following: the elimination of the Consolidation Regime; the immediate allowance for investment; the Simplified Regime; the allowance for operations with related parties; and the allowance for consumption in restaurants.

Incentives for increasing the level of formality:

- Temporary lower income tax and social security contributions for new businesses or those that move into the formal economy.
- Reduction in social security contributions for low-income workers (earning the minimum wage).

New programs:

- Unemployment insurance with benefits paid for six months, reduced monthly from 60% to 40% of the last wage.
- Introduction of a universal pension of 1,092 pesos per month, which will provide a basic benefit to people over the age of 65 who have a monthly income of 15 times the minimum wage or less and who do not receive a contributory pension (from the IMSS, ISSSTE or another social security institution).

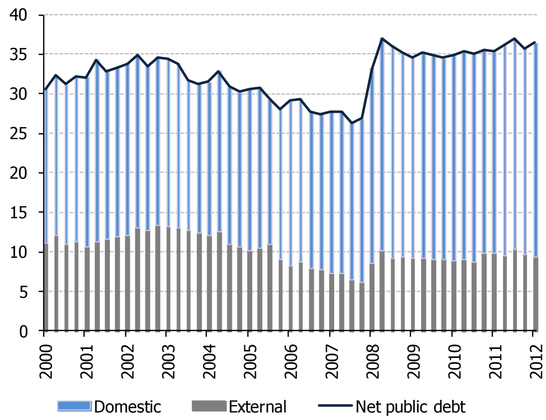
New Pemex tax regime:

- The aim is to reduce the company's tax burden by applying a tax regime similar to that of other companies, so that its net profit increases, thus boosting investment. The aim is for the new tax regime to be introduced gradually, as it is applicable to new projects. Thus this measure will not have any effect on the 2014 budget.

Simplification:

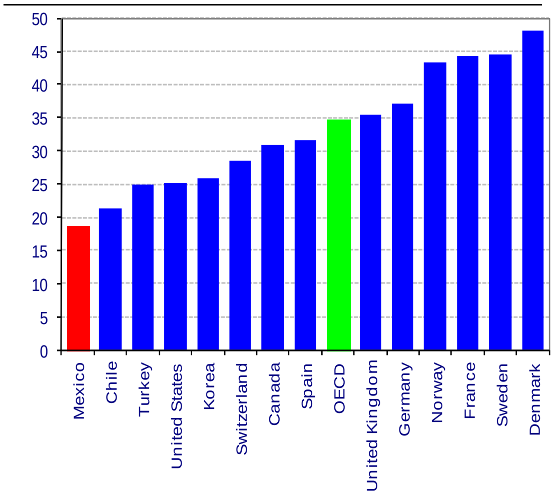
- Elimination of the IETU, the tax on cash deposits; a simpler and more limited new income tax law that eliminates 77% of the preferential regimes and 47% of special treatments.

Chart 1
Public debt (% of GDP)



Source: BBVA Research with SHCP data. Refers to PSBR

Chart 2
Tax burden in selected OECD countries, 2011 (% of GDP)

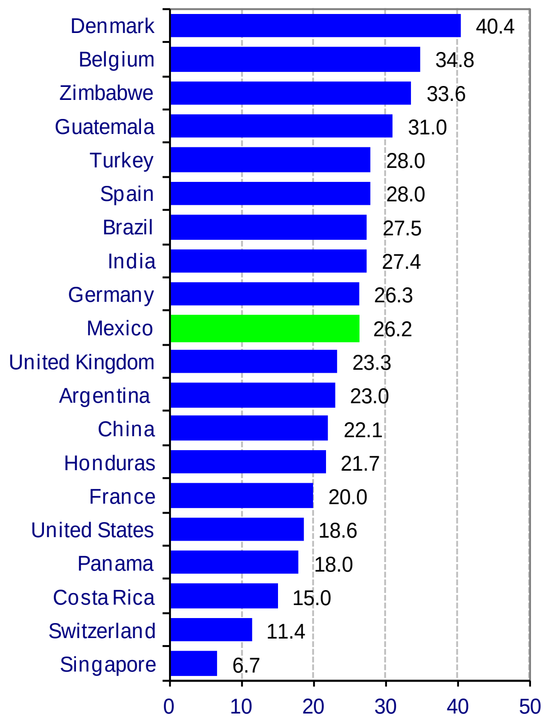


Source: BBVA Research with OECD data. Mexico includes public revenue from Pemex

Despite Mexico's tax burden being one of the lowest in the world, the problem does not appear to be related to the level of taxes, but rather the enormous volume of funds that does not enter the public coffers as a result of the level of informality, tax evasion and avoidance in the economy. For example, the personal income tax rate is within the global average (Chart 3). Studies by El Colegio de México and El Colegio de la Frontera Norte calculate that tax evasion and avoidance in Mexico amount to the equivalent of 2.2% of GDP. At the same time, according to the budget for 2013 fiscal expenditure, the federal government recognizes that this year it will not collect the equivalent of 3.8% of GDP due to fiscal exemptions, allowances, special regimes and subsidies. Reducing evasion and avoidance would increase tax revenue without increasing the burden on the captive population, which is also inside the formal sector and more productive.

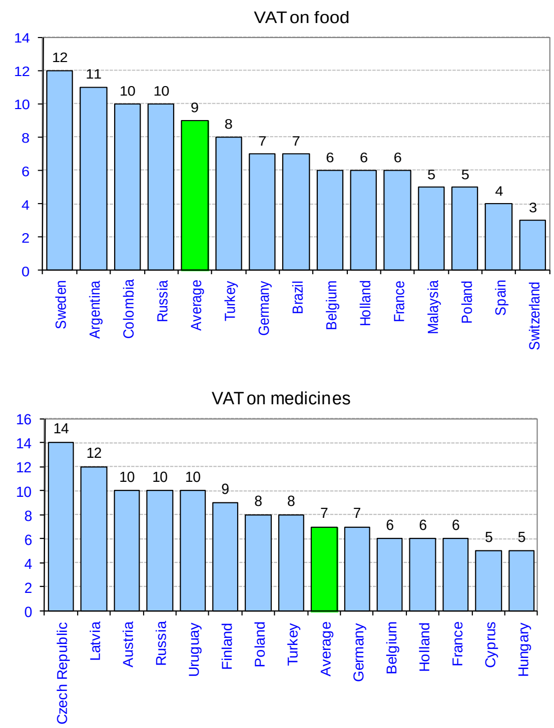
One of the elements not included in the reform, and which is regressive, is the tax on consumption of food and medicine, which currently are zero rated in Mexico. The global trend with respect to taxation on food and medicines appears to be for a reduced VAT rate, with an average tax around the world of 9% for food and 7% for medicines, rather than the general higher tax rate for other goods (Chart 4). Income collected in this way could allow compensation for the most disadvantaged population through direct subsidies, with the remainder used for other purposes.

Chart 3
Effective personal income tax rates for income of USD 100,000 per year in selected countries, 2011 (%)



Source: BBVA Research, with data from KPMG's Individual Income Tax and Social Security Rate Survey, 2011

Chart 4
Tax rates on food and medicines in selected countries, 2011 (%)



Source: BBVA Research, with information from the Indirect Tax Guide, KPMG Mexico

II. The reform has a limited effect on tax receipts and economic activity

The fiscal reform proposal will not generate recessive effects, as it is progressive: it eliminates unjustifiable tax privileges, and is less aggressive than initially expected. However, it is also an insufficient reform in terms of tax receipts. According to the government's own estimates, tax receipts will increase by only 1.4% of GDP, then steadily rise to an additional 3% in 2018. Thus Mexico will still be the OECD country with the lowest tax revenues (Chart 2) and one of the lowest in Latin America.

The current reform proposal represents progress in the reduction of tax evasion and avoidance, which will be key for boosting the country's development. However, it is crucial that there should be progress in this area, as it lies at the core of fiscal weakness. Fiscal reform could even lead to lower than expected receipts if solid and precise measures are not implemented to reduce tax evasion. It is estimated that with a 22% rate of tax evasion, tax receipts would only reach an additional 1.2% of GDP, below the estimate in the reform.

It is important to note that the proposed reform has a negative effect on the middle class, as it introduces various obligations and restricts tax rights, which would have direct consequences on demand and the size of the internal market.

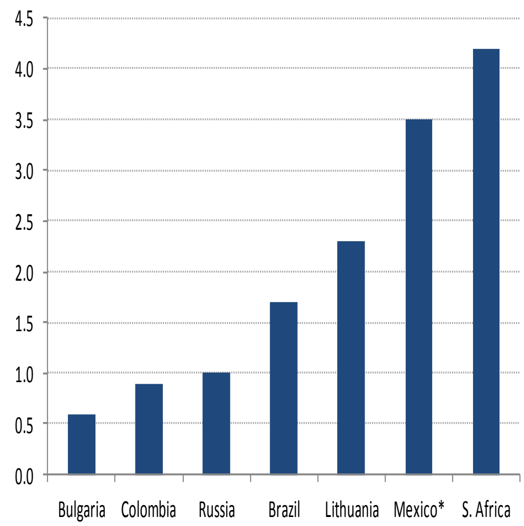
The proposed reform could bring with it other significant impacts on the country's economic activity. For example, the immediate allowance was an instrument to create incentives for investment in Mexico outside the main metropolitan areas. If this is withdrawn, it may create an incentive to focus productive activities in the major cities. The reduction of the allowance on car purchases from 175,000 to 130,000 pesos could reduce their number. The greater restriction on the regime under which assembly companies ("maquiladoras") operate could have an initial negative impact on job creation and exports. At the same time, the reduction in benefits for real-estate trusts (Fibras) and real-estate infrastructure companies (Sibras) and the reduction of the personal exemptions and allowances on the purchase, sale, rental and interest on housing could affect the real-estate market. Finally, the elimination of the VAT exemption on long-distance public passenger transport could reduce the flow of domestic trips and affect the tourist sector.

Table 1
Estimated additional tax receipts (% of receipts and of GDP)

Measure	Percentage of receipts against expected 2013 figure	Percentage of GDP
IEPS special taxes	2.6	0.6
Personal income tax	1.6	0.3
Border VAT	1.5	0.3
Corporate income tax	0.4	0.1
Royalties	0.4	0.1
Total	**6.5**	**1.4**

Source: BBVA Research with SHCP data

Chart 5
Fiscal deficit 2014: Economies with a BBB rating from Standard and Poor's



Source: BBVA Research with data from IMF and Bloomberg
*In the case of Mexico includes 2% of Pemex investment

III. Economic policy criteria: greater deficit and public debt

The economic policy criteria set out growth of GDP of 1.8% for 2013 and 3.9% for 2014. In public finances, with the aim of providing a countercyclical stimulus to support the economy and employment, a fiscal deficit of 0.4% of GDP has been planned for 2013 and of 1.5% in 2014, not including PEMEX investment. This deficit is expected to reduce gradually to a balanced budget by 2017. The fiscal reform aims to modify the current fiscal balance rule in Article 17 of the Federal Law on the Budget and Fiscal Responsibility to include a ceiling to current expenditure in order to generate savings in the high part of the economic cycle. Currently the fiscal balance rule allows for a fiscal deficit of zero when the economy grows at its potential, although it allows an increase in the deficit in exceptional conditions. Such an increase requires advance specification of the path for returning to the target of long-term fiscal balance. Under the proposed amendment to the Law on the Budget and Fiscal Responsibility, if the economy grows above its potential level a ceiling is added to growth in current expenditure, with the aim of generating savings and improving the fiscal balance. Crucial to this rule is the establishment of a reasonable potential growth level, as if a very high level is set, the public finances will remain in deficit for a prolonged period and generate a fiscal risk for the economy.

IV. The effect of the reform on inflation: even without VAT on food and medicines, the proposed changes will have a significant effect on inflation

When assessing the potential impact of the fiscal reform proposal on inflation, two factors have to be taken into account: both the proposed creation of new special taxes (IEPS) on fossil fuels, pesticides and soft drinks, and modifications to VAT.

We calculate that the effect on inflation of the proposed IEPS taxes would be around 0.2 pp (Table 2). The changes proposed to VAT can be divided mainly into the following: a) bringing the border rate into line with that in the rest of the country; and b) eliminating exemptions[1] and applying VAT to products that until now had a zero rate[2] will have a more significant effect on prices. The level of this impact will depend on how the companies pass on the changes to end consumers, and this will be sensitive to the point in the economic cycle (higher/lower strength, more/less transfer). In the estimate we assume a range of between 40% and 70% for the possible transfer of the change in prices resulting from the elimination of exemptions or the application of VAT to certain products. We calculate that the effect on inflation of the proposed modifications to VAT could be at between 0.5 and 0.9 pp (Table 3). Thus the total combined inflationary effect of the new IEPS taxes and modifications to VAT could be between 0.7 and 1.1 pp. However, these calculations do not include the effect on prices of applying VAT to housing rental and purchase, which could be significant, due to its major weight in the national consumer price index (INPC).

To sum up, although it may appear that the decision not to introduce VAT on food and medicines could mean that the proposed measures have a limited effect on inflation, the most likely outcome is that this effect is in fact significant. However, the effect will be one-off, and we do not anticipate second-round effects, so it should not have an impact on monetary policy. Thus, we continue to expect an additional cut of 25 bps in the Banxico reference rate to 3.50% at the close of the year.

Table 2
New special taxes (IEPS)

	Proposal	INPC weight	Estimated effect on inflation
Sugary drinks[1]	1 peso per liter	1.29	0.12
Green tax (on carbon containing fuels)[2]	70 pesos per cubic tone	5.97	0.09
Pesticides	not specified	0.10	0.00
Total (sum)			0.21

1 We take into account the weightings in the INPC of canned soft drinks and juices; we assume 70% is passed on to the consumer
2 We take into account the weightings in the INPC of domestic natural gas, domestic LP gas and low and high octane gasoline; we assume they are passed on 100%

[1] Education services, public spectacles (except theater and the circus), long-distance public transport services, mortgage interest payments and temporary imports.

[2] Application of VAT to home rental and purchase and chewing gum; and the elimination of the zero tax rate on food for pets and on jewelry.

Table 3
Changes to VAT

	Approximate weight	Estimated effect on inflation (pass-through) 40%	70%
a. 16% Border rate (up from 11%)	6.80	0.12	0.21
	INPC weight		
b. Elimination of VAT exemptions or application of the 16% VAT rate			
Tuition	5.11	0.33	0.57
Non-urban public transport	0.42	0.03	0.05
Pet food	0.14	0.01	0.02
Public shows[1]	0.20	0.01	0.02
Chewing gum[2]	0.00	0.00	0.00
Total (sum)		0.50	0.87
Total (sum) less tuition		**0.17**	**0.30**
		20%	40%
Rent	3.38	0.11	0.22
Owner's equivalent rent	14.15	0.45	0.91
Effect of the elimination of housing sales and rent VAT exemption		**0.56**	**1.12**

1 We take into account half of the weighting of "other leisure and sports entertainment"
2 We take into account a tenth of the weighting of "sweets, caramel and honey"

V. Limited effects in terms of generating an improved sovereign risk rating

Based on the importance that rating agencies have given to the extension of the tax base and reduced dependence on oil revenues as an element for improving the sovereign debt rating, the measures proposed by the Fiscal Reform appear to have limited effects on generating a better credit rating. In fact, the increase in the fiscal deficit to levels of 3.5% of GDP in 2014 puts Mexico above various countries with the same sovereign rating in this respect (Chart 5), which is relevant in a context in which the soundness of public finances has been considered as one of the comparative advantages of the Mexican economy.

VI. Unemployment insurance: a stabilizer for the economy during recessions that does not generate problems for the public finances

The initiative considers an unemployment insurance for those who: have contributed to the social security systems for at least 2 years within a 3-year period, have been unemployed for at least 45 days, do not receive other income for retirement, as a pension, another unemployment aid, or any other similar support, and participate in the employment promotion, placement services and skills training schemes offered by the Federal Government for reentry to the labor market. The benefit may be received for up to 6 months and only once within a period of 5 years. The amount shall be established according to the average wage of the last 24 months of contributions. The first payment will be for 60% of this average wage, the second 50%, and for the four following payments 40%.

Unemployment benefit will be financed by adjusting the percentage of the amount of employers' contributions to the housing sub-account from 5% to 2% of the workers' base wage. The remaining 3% will be divided into two parts: 2/3 will go to the mixed sub-account of the worker's individual account, and 1/3 to a Solidarity Fund. The benefit received by an unemployed will come initially from his/her mixed sub-account, and when these funds are exhausted the Solidarity Fund will be used. If there is not enough in the Fund, the unemployed are guaranteed an income equivalent to the minimum wage for a maximum period of 6 months. Contributions are calculated as from January 1 2013, so a person may comply with the requirements until 2015.

Based on estimates by the National Survey of Occupation and Employment (ENOE), without taking into account the use of the mixed sub-account, and assuming an outlook for labor turnover similar to that in 2012 and 2013, this fund is estimated to have an annual surplus of 3.8 billion pesos. Taking into account the use of the mixed sub-account, the surplus could be higher. In other words, if the Unemployment Insurance Bill is approved as proposed, the Solidarity Fund could accumulate funds to be used during periods of high unemployment in the formal sector.

The following table shows this flow of resources, with adjustments for population growth and considering the longest possible time that the beneficiary could be allowed to find a formal job.

Table 4
Initial estimate of the cost and financial resources for unemployment insurance
Millions pesos at June 2013 prices

Year	2014	2015	2016	2017	2018	2019	2020
Annual cost of unemployment insurance							
		19,640	20,810	22,010	23,220	24,450	25,690
Beneficiaries per year (thousands)							
		2,038	2,059	2,080	2,101	2,121	2,140
Annual flow to the Solidarity Fund (1% of contribution base of all workers with social security)							
	+17,500	+17,600	+17,800	+18,000	+18,200	+18,400	+18,500
Financing of unemployment insurance							
Mixed sub-account		3,970	6,020	8,110	10,240	12,410	14,610
		20.2%	28.9%	36.8%	44.1%	50.8%	56.9%
Solidarity Fund		15,660	14,790	13,900	12,980	12,040	11,080
		79.7%	71.1%	63.2%	55.9%	49.2%	43.1%
Balance in Solidarity Fund							
	17,500	19,440	22,450	26,550	31,770	38,130	45,550

Note: Takes into account people who on average have been unemployed for at least 45 days, the same period required for eligibility under the Unemployment Insurance Bill. Assumes a 50% use of the Mixed Fund in housing.
Source: BBVA Research, based on data of labor turnover and hiring rate from the loss of a formal job to a new formal job, based on the construction of ENOE 2012-2013Q2 panels, INEGI.

Among the positive points of unemployment insurance is that it would serve as an economic stabilizer during recessions; it would not generate problems in the public finances; it would assist in job finding; it would not represent an increase in labor costs for employers and would generate an incentive to formality, but this last effect is relatively limited. Among the negative points is that it would largely be financed from the housing sub-account, so workers would see their capacity to buy homes reduced.

VII. Unemployment insurance, the Incorporation Scheme for entering the social security system, and the reduction in contributions for low-income workers have positive but limited effects on reducing informality

In general the nature of informality can be analyzed in two ways. 1) The first suggests that informal workers are part of the secondary or disadvantaged sector of a segmented market, which implies employment is rationed. 2) The second way of looking at it is that informal workers decide voluntarily to work in the informal sector as it has certain advantages, such as greater flexibility and no taxes.

Table 5
Possible policies to reduce informality, according to the labor market analysis

1. Segmented labor market	2. Voluntary labor market
• Creation of jobs by governments • Loans and services for business development of informal businesses • Creation of basic infrastructure and services for families of informal workers	• Strengthen the rule of law • Reduce the regulatory or tax burden on companies • Generate incentives for workers and employers to choose formality

Source: BBVA Research, based on Chen (2013) and Perry et al. (2007)

In the case of Mexico it is not clear which approach dominates. Figures from the ENOE show a relatively high movement between informality and formality, and vice versa, which suggests a voluntary component. However, workers with similar characteristics earn on average more in the formal than the informal sector, which indicates certain segmentation. Thus both visions could be valid, depending on the characteristics of the workers, the sectors or the regions where they work. Thus depending on the context, the recommendations that are given for one or other approach could be acceptable for the case of Mexico. The proposals to combat informality indicated in the fiscal reform bill mainly involve generating incentives so that workers and employees can choose formality; in other words, they fall within the proposals applicable to a voluntary labor market.

In the case of workers, the bill proposes unemployment insurance, which as we saw above, is in general positive, but requires the addition of other instruments to promote greater formality. For companies, the proposal is to create an Incorporation Scheme, where whose who participate will receive discounts in tax payments and social security contributions for the first few years, in exchange for compliance with tax reporting obligations. The discount for income tax will be 100% in the year of entry to the scheme and will reduce steadily over the following 5 years, until it finally disappears in the seventh year. Taxpayers registered under this new scheme will have access to social security services. As in the case of taxes, they will receive discounts in the payment of social security contributions, which will reduce over the years after their entry into the scheme. The effect of the Incorporation Scheme on promoting formality could be limited, and the incentives offered may not be very attractive for some companies; apart from this, penalties will not be increased. Thus only a limited number of companies may opt for the new scheme.

Another proposal is to reduce social security contributions for low-income workers. The reduction in social security contributions for workers who receive the minimum wage will be 10% of their income. This could encourage informal workers who mainly work in companies in the formal sector to convert into formal employees. According to ENOE figures 6.4 million informal workers earn the minimum wage or less. Given that 43% of all informal workers work in the formal sector, the policy proposed could generate some incentives for around 2.7 million informal workers, or some 9% of the total.

Overall, the policies proposed would encourage more formality to a certain extent, but their scope appears limited. Greater incentives are required for companies and individuals to choose formality. Measures have to be applied that reduce the capacity of some companies to avoid paying taxes, reduce companies' labor costs and open up greater possibilities for companies in the informal sector to grow and access credit.

VIII. The universal pension: a positive social security scheme

The Universal Pension will provide a basic benefit for people over the age of 65 who have a monthly income of up to 15 times the minimum wage[3] and who do not currently receive a contributory pension (from the IMSS, ISSSTE or another social security institution).

The amount of the pension is 1,092 pesos per month, and is part of the Minimum Welfare Line calculated by the National Council for Evaluating Social Development Policy (CONEVAL). This amount will be adjusted every year in accordance with inflation.

The Universal Pension will be granted to all Mexicans who are resident in the country and to foreign nationals who have resided in Mexico for at least 25 years. In addition, a gradual adjustment will be introduced to the age established as a requirement for receiving the Universal Pension, by a revision every five years designed to reflect the increase in the life expectancy of Mexicans.[4]

To conserve the right to receive the Universal Pension, beneficiaries must follow health guidelines and be registered in the National Population Registry.

In addition, with the aim of making the use and destination of funds transparent, as well as to make the Universal Pension financially sustainable, the Federal Government will provide individualized funds to a trust administered by the Bank of Mexico, for people over the age of 18. Mechanisms will also be established to promote complementary saving. The funds contributed to the trust will be individualized, as information will be available to identify them fully, and they will be registered at a Retirement Fund Administrator. The amount of this contribution will be determined according to actuarial and demographic studies prepared in accordance with the Regulation of the Law on the Universal Pension.

Currently, the Federal Government grants a pension of 525 pesos per month to all people aged over 65 who do not receive a contributory pension, through the Elderly Adult Pension Program. A transition period is therefore planned so that the current pension granted is increased until it reaches the level of the Universal Pension.

We consider that the Universal Pension could generate some incentives for labor informality, as one of the eligibility requirements for the benefit is not to be receiving any contributory pension from the social security system. However, given the low level of the benefit to be received (equivalent to the Minimum Welfare Line, which is currently 1,092 pesos per month), such incentives will be limited.

We estimate that the annual fiscal cost of the Universal Pension, taking into account solely the transfers for people over the age of 65 without a contributory pension, will be around 0.55% of GDP.

IX. The housing sector: the elimination of the tax benefits in the housing sector will increase tax revenues, but at the cost of growth in the sector.

Although the fiscal changes affecting the housing market involve growth in tax revenues, they will also put pressure on the sector. These changes have their greatest effect on the demand side, which would have to support most of the tax burden. Mortgage loans will be more expensive because of the elimination of the allowance for interest payments and because they will also be subject to VAT. At the same time, housing sales and rentals will be more expensive because of VAT.

The implementation in the previous decade of the allowance for interest paid on mortgage loans was a measure that contributed to the boom in the real-estate market. The measure entered into force in 2004 and the loans placed by the banks and Sofoles grew considerably (Chart 6). Although growth in mortgages was also boosted by other factors, these allowances had a positive impact on demand for housing and also for loans. The proposed reform now considers limiting this allowance to loans of up to 250,000 investment units (i.e. around 1,250,000 pesos), thus reducing incentives for people to take out bigger mortgage loans.

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3 Equivalent to income lower or equal to 28,800 pesos per month. The proposal is that the income should be verified by a sworn declaration.

4 The Universal Pension will be paid starting at the age resulting from applying a factor of 0.87 to the general life expectancy at birth, calculated by the National Population Council, and published in the Official Bulletin of the Federation.

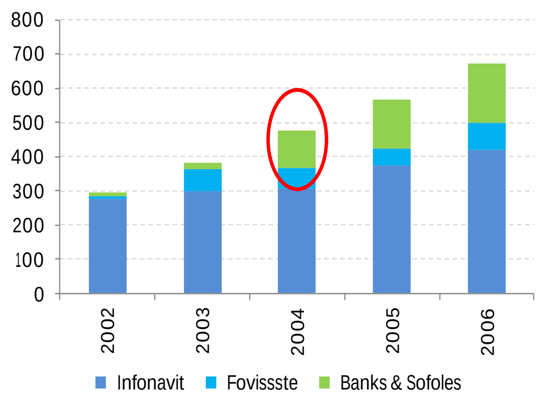
Currently the sale of a home does not generate value added tax. The same is true of home rental, as well as interest on mortgage loans. The tax reform proposes eliminating this exemption, not only for purposes of increasing revenue, but also to eliminate a regressive tax practice, as the main beneficiaries of this exemption are higher-income households.

In housing purchases, this would have a negative effect both on the sale of homes and the origination of new mortgage loans,[5] as part of the tax would be passed on to the buyer. In fact, it would contribute to the existing contraction in the housing market. A demand-side response would be to opt for other housing solutions such as self-construction and loans for refurbishment. However, it has to be taken into account that these alternatives would only be feasible if they were not financed with consumer loans, as interest payments in this case would be higher than a mortgage loan with VAT.

In the case of home rental, as in the case of purchase, the measure proposed is progressive, is the objective. In addition, with an incipient rental market where real-estate companies are already interested in the sector, additional tax revenues would be obtained that would otherwise simply not be collected. However, it is also true that demand for this form of housing would also decline in the different market segments, as at least part of the increase would be passed on to the tenants.

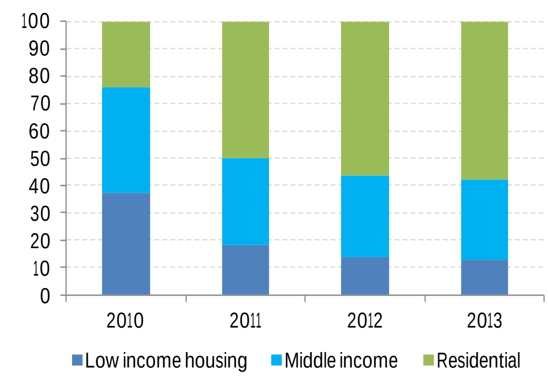
The elimination of tax benefits for housing on the demand side would have the positive effect of increasing tax revenues, but a negative effect in terms of the performance of the real-estate market. One way of offsetting this effect is the program of housing subsidies aimed at the low-income population, and the boost to housing construction through financing by development banks. However, it is not clear that subsidies would offset the increase in housing prices and the cost of mortgage loans. Similarly, more finance for housing construction would increase supply, but the higher purchasing cost would limit its effect on the market. With a real-estate market where average residential housing is increasing its share, the aim of raising tax revenue is very likely to be achieved, although it would contribute to a slowdown in the real-estate market.

Chart 6
Loans granted by institution (thousands)



Source: BBVA Research with AMFE, ABM, Infonavit and Fovissste data

Chart 7
Distribution of loans by value of home (% of total)



Source: BBVA Research with Federal Mortgage Society (ABM) data

[5] VAT on mortgage interest payments would only be applied to loans originated starting in 2014, with the aim that the prudential risk measures of credit institutions can assume this increase. Otherwise, there would be a risk of mortgage loans already granted in the system increasing, given that their initial conditions did not take into account the increased monthly payments by the borrowers.