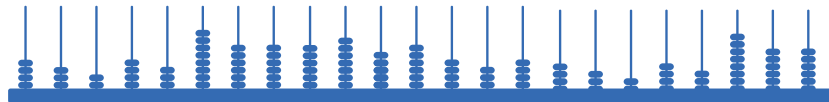




# FISCAL FEDERALISM

The fight for budgetary power

# Fiscal Federalism



## SYNTHESIS

Tensions between federal and local governments are not new in Mexico, but the beginning of the current administration in the country has intensified the relations of a group of governors with the President. These confrontations are anchored, fundamentally, in the disproportionality of the fiscal system and the political control that the federal executive power achieves thanks to the budget. Unlike other six-year terms, the current one has been marked by statements from local executives who threatened to break the federal fiscal pact, which would have consequences for public finances that are difficult to calculate.

The COVID-19 crisis, in addition to being unexpected, will be remembered as the greatest of recent global challenges in health, economics, and public finance. Particularly in Mexico, this pandemic has exposed a series of fiscal anomalies and weaknesses. If in itself, the pandemic represents threats to the health and economy of millions of individuals, as well as to the stability of public finances in industrialized countries, in Mexico the challenges to fight a problem of this magnitude seem significantly more complex, due largely to the pending tasks of the Mexican political system.

Although Mexican federalism has already been diagnosed as a dysfunctional federal system that disproportionately distributes powers by the level of government, leaving the federation with large instruments of control and encouraging the states' fiscal and competence laziness, the coronavirus contingency made the fragility of public finances visible and exacerbated the already existing tensions between the executive heads of each level of government. Among the OECD countries, Mexico collects the least in proportion to GDP. In 2018<sup>1</sup>, the country collected an equivalent of 16.1% of its GDP, a portion well below the OECD average, which is equivalent to 34.3%.

The coronavirus contingency **made the fragility of public finances visible** and exacerbated the already existing tensions between the executive heads of each level of government.

<sup>1</sup> The latest revenue database available that the OECD has corresponds to 2018. OECD. Revenue Statistics - OECD countries. Available at: <https://tinyurl.com/yd7dn4pb>

Image:<http://www.elhospital.com/temas/Mexico,-el-mas-experimental-do-en-la-region-para-atender-una-pandemia+133714>



### REVENUE IN OECD COUNTRIES

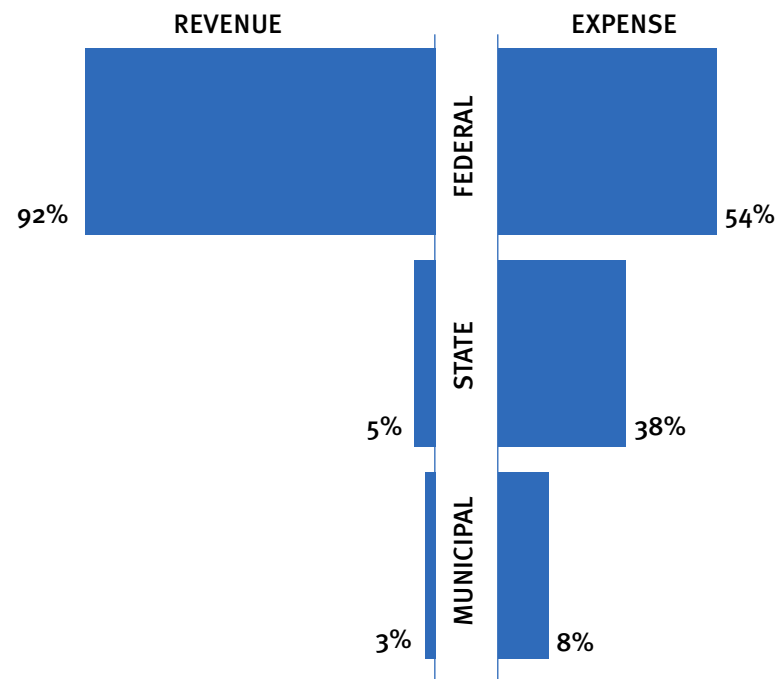
% Revenue percentage relative to GDP		% Revenue percentage relative to GDP		% Revenue percentage relative to GDP	
OECD AVERAGE	34.3	FRANCE	46.1	UNITED KINGDOM	33.5
JAPÓN	N/A	DENMARK	44.9	ESTONIA	33.2
AUSTRALIA	N/A	BELGIUM	44.8	SLOVAKIA	33.1
		SWEDEN	43.9	CANADA	33
		FINLAND	42.7	NEW ZEALAND	32.7
		AUSTRIA	42.2	ISRAEL	31.1
		ITALY	42.1	LATVIA	30.7
		LUXEMBOURG	40.1	LITHUANIA	30.3
		NORWAY	39	SOUTH KOREA	28.4
		NETHERLANDS	38.8	SWITZERLAND	27.9
		GREECE	38.7	TURKEY	24.4
		GERMANY	38.2	UNITED STATES	24.3
		ICELAND	36.7	IRELAND	22.3
		HUNGARY	36.6	CHILE	21.1
		SLOVENIA	36.4	MÉXICO	16.1
		PORTUGAL	35.4		
		CZECH REPUBLIC	35.3		
		POLAND	35		
		SPAIN	34.4		

Source: In-house product with data from the OECD.

It was already known that the weakness of public finances would worsen due to the demographic modification that the country would undergo in the coming decades when the percentage of the elderly grew and implied public spending on pensions and healthcare significantly higher than currently, but the SARS-COV 2 virus put governments in immediate trouble, forcing them to expand public spending to face the health hazard. In this context, a group of governors, dissatisfied with the actions of the federal government, proposed to review the federal fiscal pact, to achieve its budgetary autonomy and, based on it, executing budgetary and temporally sustainable public policies that do not depend on the political ups and downs that sometimes reconcile and sometimes confront federal and local governments. Despite the potential long-term benefits that fiscal deconcentration would have, in the short term, the damages associated with breaking the current fiscal system are many.

Federalism implies decentralizing power and, among the different powers that are deconcentrated, that related to tax policy is one of the most important, if not the most important, since the ability to articulate public policies depends directly on the budget of each entity and the federation. Paradoxically, the

REVENUE VS EXPENSE BY GOVERNMENT LEVEL (1998-2019)



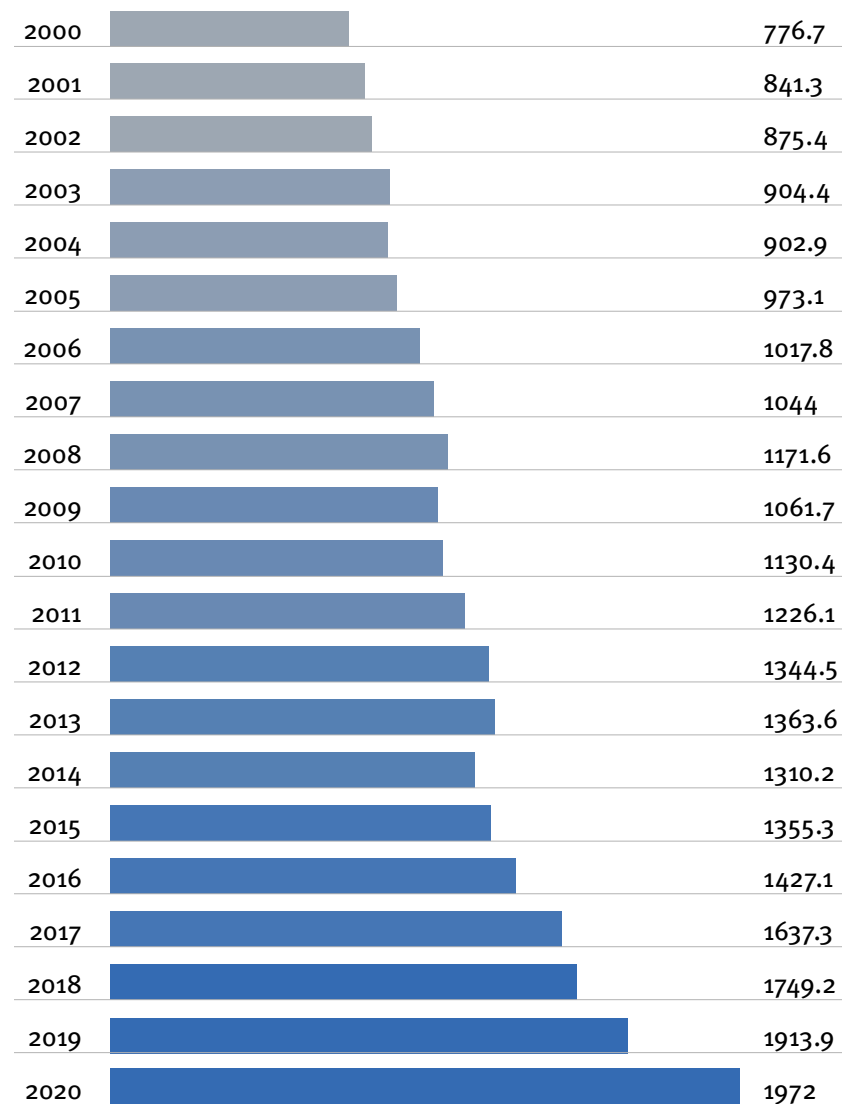
Source: In-house product with data from INEGI and SHCP (National Institute of Statistics and Geography and Secretariat of Finance and Public Credit for their acronyms in Spanish, respectively).

fiscal coordination system centralized fiscal policy in Mexico, leaving the federation with the task of collecting most of the total revenue<sup>2</sup>. On average, between 1998 and 2019, the federation collected 92% of all tax revenue, while states and municipalities together only 8%. In contrast, spending is increasingly federalized. 54% of it is exercised by the central government, 38% by the federal entities, and 8% by the municipalities. Additionally, the real growth in total income has increased federalized spending significantly each year.

A second dimension of the subject is the way in which the total federalized income is distributed among local governments. The fiscal coordination system has both a proportional and a compensatory character, although, in reality, the proportionality in the Mexican system is less and less. The first seeks to return to the entities, in aliquot amounts, the income that was transferred to the federation in the first instance. The second, on the contrary, seeks to allocate more resources to the regions that show the most import-

<sup>2</sup> The federation is responsible for collecting taxes related to highly mobile taxable factors, while local haciendas are responsible for those with little mobility. In this sense, the main taxes that the federal treasury collects are: ISR, IVA, IEPS, ISAN (Income tax, Value Added Tax, Special Tax on Production and Services, New Vehicle Tax by their abbreviations in Spanish, respectively) and Foreign Trade Tax.

**FEDERALIZED SPENDING EVOLUTION IN BILLIONS OF PESOS  
(2000-2020)**



Source: In-house product with data from INEGI and SHCP (National Institute of Statistics and Geography and Secretariat of Finance and Public Credit for their acronyms in Spanish, respectively).

ant underdevelopment in their socioeconomic indicators. Specifically, federal participation, in theory, seeks to allocate resources based on the contributions that the states make to the central government, although in reality the formula for the distribution of participations<sup>3</sup> also has a compensatory component<sup>4</sup>. On the other hand, federal contributions do not have a formula that clearly establishes the way to distribute resources, but their allocation depends on sectoral priorities. Contributions are purely compensatory transfers.

Ultimately, the states do not receive the same level of resources that they initially contributed to the federation. In other words, there is a clear redistributive effect in budgetary terms. This phenomenon has strongly unbalanced the proportionality between contribution and tax reception. In the period from 2008 to 2017, the ten states<sup>5</sup> that provided the most tax taxes to the federation contributed 86.47% of the total of these.

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<sup>3</sup> CEFPE (Center for Public Finance Studies abbreviated in Spanish). Criteria used for budgetary allocation to states and municipalities in the Fiscal Coordination Law. Available at: <https://tinyurl.com/y8o8zsoz>

<sup>4</sup> Art. 2 of the Fiscal Coordination Law. Available at: <https://tinyurl.com/ycgrcmth>

<sup>5</sup> The states that contributed the most taxes were Mexico City, Nuevo León, Tamaulipas, Estado de México, Veracruz, Jalisco, Colima, Baja California, Michoacán and Chihuahua.

On the contrary, those same ten states received, as a whole, 53.85% of the total participation and 42.49% of the contributions.

On the other hand, the ten states that contributed the least<sup>6</sup> to the federation, as a whole, transferred 2.75% of total taxes but received 17.39% of total participation and 26.91% of contributions. Only the income taxes collected in the aforementioned period represented 54.40% of all the country's tax revenue and the ten states<sup>7</sup> that contributed the most by this concept transferred the equivalent of 86.59% of the total, while the ten entities that contributed the least did so in a proportion of 2.86%.

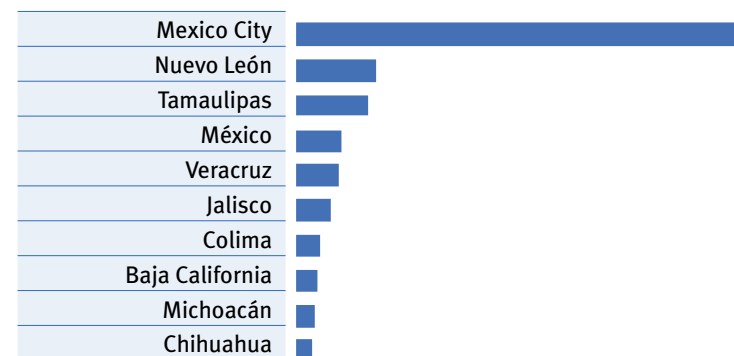
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<sup>6</sup> The states that contributed the least taxes were Campeche, Zacatecas, Oaxaca, Chiapas, Hidalgo, Baja California Sur, Guerrero, Durango, Nayarit and Tlaxcala.

<sup>7</sup> The entities that contributed the most taxes were Mexico City, Nuevo León, Estado de México, Jalisco, Coahuila, Guanajuato, Baja California, Chihuahua, Querétaro and Veracruz.

## REDISTRIBUTION OF TAXES THROUGH FEDERAL PARTICIPATION AND CONTRIBUTIONS

FEDERAL ENTITY	TAXES	PARTICIPATIONS	CONTRIBUTIONS
Mexico City	49.27%	11.88%	3.34%
Nuevo León	8.54%	4.75%	3.73%
Tamaulipas	7.61%	2.86%	2.98%
Mexico	4.70%	12.55%	10.33%
Veracruz	4.60%	5.81%	6.64%
Jalisco	3.50%	6.38%	5.10%
Colima	2.45%	0.69%	0.91%
Baja California	2.12%	2.85%	2.22%
Michoacán	1.94%	3.13%	4.19%
Chihuahua	1.74%	2.94%	3.04%
Coahuila	1.40%	2.39%	2.44%
Guanajuato	1.31%	4.03%	4.16%
Sonora	1.19%	2.95%	2.61%
Puebla	1.09%	4.22%	5.17%
Querétaro	1.08%	1.68%	1.68%
Sinaloa	1.07%	2.48%	2.92%
Quintana Roo	0.77%	1.31%	1.42%
Aguascalientes	0.68%	1.13%	1.30%
Tabasco	0.60%	3.54%	2.62%
San Luis Potosí	0.55%	1.97%	2.64%
Yucatán	0.47%	1.65%	1.98%
Morelos	0.41%	1.41%	1.67%
Campeche	0.40%	1.21%	1.21%
Zacatecas	0.39%	1.33%	2.06%
Oaxaca	0.38%	2.58%	5.10%
Chiapas	0.37%	4.04%	5.64%
Hidalgo	0.36%	1.95%	2.89%
Baja California Sur	0.27%	0.68%	0.88%
Guerrero	0.24%	2.24%	4.35%
Durango	0.22%	1.30%	2.08%
Nayarit	0.17%	1.02%	1.42%
Tlaxcala	0.12%	1.04%	1.28%



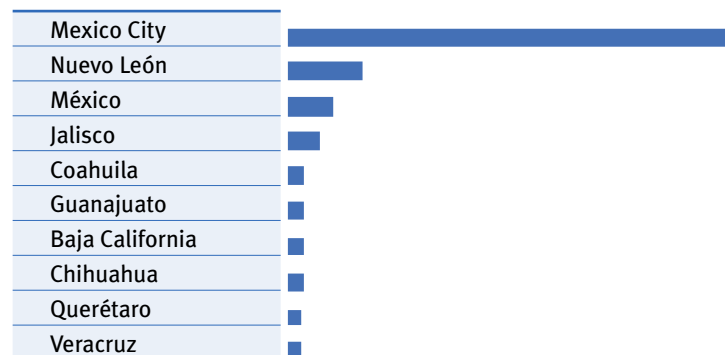
Source: In-house product with data from INEGI (National Institute of Statistics and Geography by their acronym in Spanish).

**In the period from 2008 to 2017, the ten states that provided the most tax taxes to the federation contributed 86.47% of the total of these. On the contrary, those same ten states received, as a whole, 53.85% of the total participation and 42.49% of the contributions.**



## INCOME TAX CONTRIBUTION BY FEDERAL ENTITY

FEDERAL ENTITY	INCOME TAX
National	100.00%
Mexico City	57.63%
Nuevo León	9.15%
Mexico	5.40%
Jalisco	3.94%
Coahuila	1.99%
Guanajuato	1.92%
Baja California	1.76%
Chihuahua	1.72%
Querétaro	1.55%
Veracruz	1.54%
Puebla	1.44%
Tamaulipas	1.43%
Sinaloa	1.36%
Sonora	1.14%
San Luis Potosí	0.88%
Michoacán	0.81%
Quintana Roo	0.74%
Tabasco	0.62%
Aguascalientes	0.60%
Yucatán	0.58%
Morelos	0.49%
Chiapas	0.46%
Hidalgo	0.43%
Zacatecas	0.36%
Campeche	0.35%
Durango	0.34%
Baja California Sur	0.30%
Oaxaca	0.30%
Guerrero	0.22%
Colima	0.20%
Nayarit	0.19%
Tlaxcala	0.17%



Source: In-house product with data from INEGI (National Institute of Statistics and Geography by their acronym in Spanish).

The ten states that contributed the most by this concept transferred the equivalent of 86.59%.

It should be noted that of the ten entities that have contributed the most in the aforementioned period, nine are geographically located in the center and north of the country. Likewise, the governors of four of these ten states have demanded a rethinking of the federal fiscal pact (Nuevo León, Tamaulipas, Jalisco, and Chihuahua). Conversely, six of the ten states that contributed the least with tax revenue are in the center and south of the country. This phenomenon is not accidental but responds to a series of structural inequalities between the different regions of Mexico.

Among the main regional differences related to the socio-economic reality of people, the divergence relative to the quality of life in each place, effective access to opportunities and social mobility stand out. While in the north of the country, on average, 24.4% of the population lives below the poverty line, in the south the average poverty is 59.9% (Coneval, 2019). In states such as Nuevo León, the educational gap<sup>8</sup> is 10.1%, while in Chiapas it reaches 29.2%<sup>9</sup> (Coneval 2019). Concerning access to opportunities, there is

<sup>8</sup> The educational gap refers to the segment of the population over 15 years of age that has not completed middle school.

<sup>9</sup> CONEVAL (National Council for the Evaluation of Social Development Policy abbreviated in Spanish). Measurement of poverty. Available at: <https://tinyurl.com/y45m3rk8>

also no doubt of the average, since the south presents a lack of 68% of access to social security while the central north 53.2%, the northwest 50.7%, and the north 39.4%. In other words, the further north an individual is, the more social protections they enjoy. In relation to deficiencies due to access to basic services in housing, the south reports 45.2%, while the north barely reaches 6.6%. Likewise, in the south, 38% of the population lacks access to food, a percentage far from that found in the north of the country, equivalent to 16.8%.

**The south presents a lack of 68% of access to social security while the central north 53.2%, the northwest 50.7%, and the north 39.4%**



**DEFICIENCIES IN ACCESS TO SOCIAL SECURITY, BASIC SERVICES IN HOUSING AND FOOD IN MEXICO  
BY GEOGRAPHIC REGION**

NORTH REGION				CENTRAL REGION				SOUTHERN REGION			
B.C	45.2	8.9	14.1	GUANAJUATO	57.1	11.9	20.7	GUERRERO	78.1	58.6	35.6
SONORA	41.0	10.7	21.5	QUERÉTARO	52.1	12.7	13.9	OAXACA	77.9	58.3	27.9
CHIHUAHUA	42.1	5.0	17.7	HIDALGO	70.8	25.6	22.7	CHIAPAS	83.6	57.1	22.3
COAHUILA	30.4	3.9	18.3	EDO. MÉX.	59.2	10.3	19.8	VERACRUZ	67.5	42.1	27.0
NUEVO LEÓN	34.6	2.4	12.2	MORELOS	66.5	19.9	24.6	TABASCO	69.1	46.0	46.8
TAMAULIPAS	43.4	8.9	16.7	TLAXCALA	67.8	10.1	20.2	CAMPECHE	61.5	39.0	27.4
PROMEDIO	39.4	6.6	16.8	CDMX	48.3	2.9	13.9	YUCATÁN	54.2	38.4	19.4
				PUEBLA	72.1	26.6	20.8	Q. ROO	51.7	21.8	17.9
				PROMEDIO	61.8	15.0	19.6	AVERAGE	68.0	45.2	28.0

NORTH WESTERN REGION				CENTRAL NORTHERN REGION			
B.C.S.	41.1	13.2	17.8	JALISCO	49.8	8.1	15.1
SINALOA	45.5	14.9	24.5	AGS.	42.3	2.5	13.0
NAYARIT	56.1	17.2	18.9	COLIMA	48.9	10.5	21.6
DURANGO	48.1	5.7	18.8	MICHOACÁN	69.5	17.7	21.1
ZACATECAS	62.6	10.4	16.6	S.L.P.	55.5	26.4	17.0
PROMEDIO	50.7	12.3	19.3	PROMEDIO	53.2	13.0	17.5

Lack of access to social security
Lack of access to basic services in housing
Lack of access to food

Source: In-house product with data from CONEVAL (National Council for the Evaluation of Social Development Policy abbreviated in Spanish).

When speaking of social mobility, in other words, the possibility that individuals have to ascend or descend in the Mexican social structure, very significant asymmetries are perceived by the region once again. Although, in general, social mobility in Mexico is difficult to achieve. For example, 49% of people born at the base of Mexico's socioeconomic pyramid stay there all their lives; It should not be overlooked that the possibilities of changing the socioeconomic status of an individual vary according to the territory. In the South, approximately 7 out of 10 people born in the poorest group remain in that place until they die, while in the North only 3 out of 10 do <sup>10</sup>. As observed, the south maintains little margin for upward social mobility, and the north, on the contrary, is more like industrialized countries that allow a large part of their most disadvantaged population to improve their status over time. This heterogeneity largely justifies the compensatory nature of the distribution of public resources among the federal entities.

A breakdown of the fiscal order in normal times would introduce enormous uncertainty about the possibilities that the underdeveloped entities would have to guarantee basic services to their population, but do-

ing so in times of crisis means collapsing the country, leaving it in a state of frankly insurmountable budgetary fragility. Probably, the pandemic creates an opportunity to open a public and political debate that gives rise to a tax convention in which the new rules of the fiscal pact are not negotiated in zero-sum terms, but rather seek to establish equitable conditions for entities and municipalities of the country by granting them resources, but also powers that facilitate political oversight and improve the conditions of the country's public finances.



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<sup>10</sup> CEEY (Espinosa Yglesias Center of Studies abbreviated in Spanish). Social Mobility Report in Mexico 2019. Available at: <https://tinyurl.com/yb5f6x3o>

