Mexico: 2020 Fiscal Budget

- **The 2020 Fiscal Budget, generally speaking, is reasonable, though the economic assumptions underlying the budget appear too optimistic.**
- **A significant issue is the assumption of a rebound in oil, which is key to achieving greater revenues for Pemex and the Federal Government. Oil production is assumed to increase 15%, even though support for the company is fairly widely seen as falling short – including by rating agencies. Moreover, the company's capacity to form risk and production sharing agreements with private players was curtailed even further, with the recently announced private participation being limited to service contracts, which have not yielded the expected results in the company's previous attempts to use them.**
- **The budget assumes 2020 growth at 1.5%–2.0%, with the low point of that range falling above private sector consensus, and our own forecast.**
- **Although a primary surplus is forecast, it is lower than earlier planned, falling from 1.3 to 0.7% of GDP. This will be difficult to achieve in a weaker economic growth environment .**
- **It is unclear whether the Budget will be strong enough to avert another rate cut in sovereign debt and it is still to be seen what rating agencies feel about the specifics of the document. At this point in time, both Fitch and Moody's have questioned whether support for Pemex is enough.**
- **On the revenue side, the budget introduces measures to diminish tax evasion and avoidance that, though justified from a fiscal policy perspective, could have negative effects on economic activity and prices; their effectiveness will be seen as time progresses.**
- **On the expenditure side, an important reallocation is made according to the changes made in the structure of the public sector, seeking to prioritize the President's top programs, although the specific amounts for these projects are not currently identified.**
- **Real public sector fixed investment, which is one of the items that could have the greatest impact on economic activity, is set to fall by 5.4% in 2020. This is not encouraging for an economy where the last two monthly gross fixed investment prints came in just below 8% and 9% y/y.**

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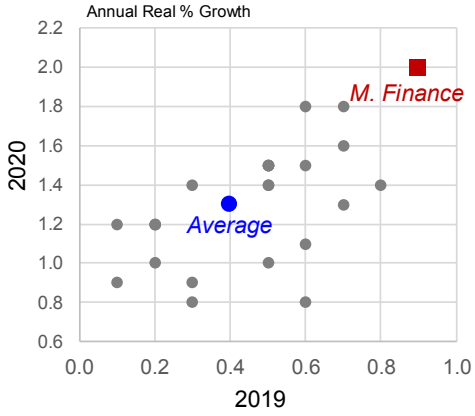
Graph 1
GDP Growth Perspective



OPTIMISTIC MACROECONOMIC FRAMEWORK

Overall, the macroeconomic framework presented by the Minister of Finance is broadly realistic, but it draws attention to the difference between 2020 GDP forecasts among private sector analysts and that proposed by the Ministry, between 1.5% and 2.5% and a 2.0% midpoint, that is used for tax revenues estimates and other calculations. This forecast is above the average of the market analysts and even surpasses the most optimistic in the latest survey available in the market, as can be seen in Graph 1.

The Ministry of Finance underpins its forecast of a bounce-back in economic activity driven by the expected increase of oil exports, induced by factors such as the potential investment generated by the USMCA ratification; the possible effect on consumption and investment of an interest rate cut by Mexico's Central Bank; and some other measures announced recently. It is important to point out that some slowdown signs are now observed in the US, and even the Ministry's macroeconomic framework considers a significant deceleration of US economy, from 2.5% in 2019 to 1.8% in 2020, which is even lower compared to the Ministry's forecasted growth for Mexico's GDP. On the other hand, the USMCA's ratification still seems uncertain, despite optimistic comments by Mexico's negotiators, because of the reluctance of the Democratic legislators in the US. The expected decline in Banxico's benchmark rate, together with the measures previously announced by the Ministry, will hardly have a relevant impact on private consumption and investment, as long as heightened uncertainty prevails. It should be pointed out that market forecasts already incorporate all this information—including almost an additional 200bps of cuts that the TIIE curve is already pricing.

In addition, oil production forecast for 2020 in the macroeconomic framework plays a key role in estimating oil revenues growth, as it is expected to increase 13% in comparison to that estimated for year-end 2019 (which in itself incorporates a relevant jump from current levels), reaching an average of 1.951 thousand barrels per day. This upturn seems very optimistic as oil production continues to decline due to the depletion of the most productive fields found in the past, as well as the lack of sufficient and adequate investment in the areas of greatest opportunity. Additionally, the Pemex Business Plan contemplated resources from the Federal Government for MXN $111 billion, but the Ministry of Finance proposal includes only MXN $86 billion, according to comments in the media by Secretary Arturo Herrera, which will most likely negatively affect Pemex's chances to reach its production target.

Macroeconomic Framework 2019-2020

Variable	2019		2020
	Approved	Estimate	
GDP			
Real growth %	1.5 - 2.5	0.6 - 1.2	1.5 - 2.5
Punctual	2.0	n.a.	2.0
Nominal (billion pesos, punctual)	24,942.1	24,852	26,254.1
GDP deflator	3.9	4.5	3.6
Inflation (%)			
Dec. / Dec.	3.4	3.2	3.0
Nominal Exchange Rate (pesos per dollar)			
End of period	20.0	19.8	20.0
Average	20.0	19.4	19.9
Interest Rate (CETES 28-day, %)			
Nominal end of period	8.3	7.8	7.1
Nominal average	8.3	8.0	7.4
Current Account			
Million dollars	-27,326	-22,876	-23,272
% of GDP	-2.2	-1.8	-1.8
Oil (Mexican Basket)			
Average price (dollars/barrel)	55	55	49
Oil production platform (kbd)	1,847	1,727	1,951
Gas			
Average price (dollars MMBtu)	2.8	2.3	2.4

Source: SHCP. n.a.: not available

The non-oil tax revenues forecast presented seems conservative and reasonable, growing 3.7% in real terms in 2020. Pemex's oil revenues, on the other hand, might seem optimistic, expecting an 18.7% growth in real terms. These revenues depend both on international oil prices, for which an estimate is presented consistent with market prospects, and on production, which is the one that looks too optimistic.

HAS THE FISCAL STANCE WEAKENED?

To ensure its pledge of fiscal discipline, the Ministry of Finance had previously proposed achieving a higher primary surplus target than that just announced. In the Budget presented, the primary surplus target for 2020 is reduced to 0.7% of GDP from the previously planned 1.3%. Likewise, it proposes requesting Congress' authorization for a greater economic deficit, in order to compensate for the decrease in the price of oil, pointing to a deficit of 2.7% of GDP.

The Ministry of Finance expects a 3.7% growth, in real terms, in tax revenues, which is consistent with the 2.0% growth in GDP. If economic growth is weaker than anticipated by the Ministry and/or oil production does not increase at the expected rate, then lower revenues would be obtained, and fiscal goals will be compromised unless additional cuts in public spending are put into effect.

Although, at the macro level, it can be perceived that fiscal discipline is being respected by maintaining overall fiscal balances, such as the primary surplus and the economic deficit of the public sector within acceptable ranges, inasmuch as economic agents perceive that public spending is allocated to unproductive and unsustainable activities, and if assumptions are deemed too optimistic, a broad conception of a weaker public finances position will emerge.

THE PLAN AIMS TO WITHDRAW A HIGHER-THAN-ANTICIPATED AMOUNT OF THE STABILIZATION FUND RESOURCES IN ORDER TO COMPENSATE FOR LOWER REVENUES AND MEET THE FISCAL TARGETS.

For 2019, the General Economic Policy Guidelines envisages lower budgetary revenues as a result of an adjustment to the macroeconomic framework, particularly a downward revision in oil production and growth estimates. Regarding oil revenues, they are expected to be 0.5% of GDP lower than programmed, due to weaker oil production and a lower exchange rate compared to those expected in the Revenues Law for 2019. In addition, tax collection is expected to be 0.2% of GDP lower than approved, as a result of weaker-than-anticipated economic activity and an increase in the payment of value-added tax (VAT) refunds. Against this background, the government has announced the withdrawal of MXN $129.6 billion resources from the stabilization fund (FEIP), equivalent to 43% of the fund's total resources, in order to compensate for lower revenues and thus be able to meet the fiscal target of a 1.0% of GDP primary surplus.

Public Finances 2019-2020 (Billion pesos of 2020)

	2019		2020	Differences between 2020 vs 2019			
	Approved	Estimate		MXN billion		Real annual variation (%)	
	(1)	(2)	(3)	(3-1)	(3-2)	(3/1)	(3/2)
Budgetary Revenues	5,487.3	5,513.7	5,511.9	24.6	-1.9	0.4	0.0
Oil	1,082.3	945.2	987.3	-94.9	42.2	-8.8	4.5
Federal Government	539.2	461.1	412.8	126.4	-48.4	-23.4	-10.5
Pemex	543.0	484.0	574.5	31.5	90.5	5.8	18.7
Non-oil	4,405.0	4,568.6	4,524.5	119.5	-44.0	2.7	-1.0
Federal Government	3,554.2	3,706.5	3,659.9	105.7	-46.6	3.0	-1.3
Tax	3,429.6	3,373.4	3,499.4	69.9	126.0	2.0	3.7
Income Tax	1,814.3	1,792.4	1,846.2	31.9	53.8	1.8	3.0
Value Added Tax (VAT)	1,030.7	972.3	1,007.5	-23.2	35.2	-2.2	3.6
Excise Tax (IEPS)	453.5	483.1	515.7	62.2	32.7	13.7	6.8
Others	130.8	125.5	130.0	-0.8	4.5	-0.6	3.6
Non-Tax	124.6	333.1	160.5	35.9	-172.6	28.8	-51.8
Institutions and Enterprises[1/]	850.9	862.1	864.6	13.8	2.5	1.6	0.3
Net Paid Expenditures[2/]	6,009.1	6,007.9	6,059.0	49.9	51.1	0.8	0.9
Programmable	4,269.8	4,295.4	4,395.2	125.4	99.8	2.9	2.3
Current expenditure	2,624.2	2,645.5	2,670.1	45.9	24.6	1.7	0.9
Personal services	1,294.6	1,292.9	1,320.1	25.5	27.2	2.0	2.1
Subsidies	537.5	553.7	520.9	-16.6	-32.8	-3.1	-5.9
Other operating expenses	792.1	798.8	829.0	36.9	30.2	4.7	3.8
Pensions	908.8	908.8	965.2	56.4	56.4	6.2	6.2
Investment expenditure	736.8	741.2	759.9	23.0	18.7	3.1	2.5
Physical investment	669.6	670.5	634.4	-35.1	-36.1	-5.2	-5.4
Subsidies	19.7	23.1	21.0	1.3	-2.1	6.8	-9.0
Financial investment and others	47.6	47.6	104.4	56.8	56.8	119.5	119.5
Non programmable	1,751.0	1,682.8	1,701.1	-49.8	18.4	-2.8	1.1
Financial Cost	775.8	741.8	732.9	-42.9	-8.9	-5.5	-1.2
Non-Earmarked Transfers	952.6	927.7	944.3	-8.4	16.6	-0.9	1.8
Adefas	22.5	13.3	24.0	1.5	10.7	6.6	80.7
Public Balance	-521.8	-494.2	-547.1	-25.3	-52.9	4.8	10.7
Primary Surplus	254.0	247.6	185.8	-68.2	-61.8	-26.9	-25.0

1/ Includes IMSS, ISSSTE & CFE. Source: Ministry of Finance.
2/ Net of contributions ISSSTE & subsidies, transfers and fiscal support to direct control entities and productive state enterprises.

For 2020, budgetary revenues are projected to exhibit zero growth in real terms compared to those estimated for 2019. On the one hand, the reallocation within oil revenues is reflected in an increase of Pemex's own resources at the expense of lower Federal Government oil revenues. In this respect, the Economic Program prioritizes the provision of MXN $86 billion resources to Pemex, which will stem from a MXN $40 billion equity contribution within the budget, and a reform proposal to the Hydrocarbon Revenue Law in order to reduce Pemex's profit-sharing duty from 65% to 58% (a MXN $46 billion tax relief). However, this support falls short compared to that envisaged in Pemex's Business Plan of MXN $66 billion and MXN $45 billion, respectively. On the other hand, tax revenues are expected to be 3.7% higher in real annual terms compared to those expected for 2019. Within tax collection, the income tax system and the value-added tax (VAT) are expected to increase by 3.0% and 3.6% in real annual terms, respectively. In our assessment, growth assumptions underlying revenue projections pose a downside risk for tax collection due to the high probability of registering weaker growth than that expected in the budget. In addition, the government's ability to increase tax collection through greater administration efficiency and by reducing loopholes that allow tax avoidance and tax evasion schemes, seems somewhat optimistic. It should be noted that, although the Economic Program indicates that the revenue policy for 2020 is aimed at increasing the government's fiscal space without increasing existing taxes or creating new ones, the Revenue Law Initiative presents a series of measures aimed at strengthening tax collection, where the following stand out:

1) Income tax payment from leasing activities: It is proposed to establish that, in property leases trials, where the tenant is required to pay past-due rents, the legal authority will not authorize payments to the landlord unless the landlord has proved to have issued Digital Tax Certificates (CFDI).

2) Sales tax to foreign digital businesses: Adjustments to the institutional framework aimed at collecting value-added tax on imports from digital platforms and online purchases.

3) Tax facilitation on catalog sales: Simplified scheme of retention, which consists in determining income tax to be paid on the difference between the suggested retail price and the purchase price.

4) Increase in the interest withholding rate: The withholding rate applied to capital that pays interest was updated, from 1.04% to 1.45%.

EXPENDITURE POLICY PRIORITIZES SECURITY, ENERGY AND WELFARE PROGRAMS.

The Ministry of Finance explains that, by 2020, it will seek to revive the domestic demand with investment in public infrastructure, prioritizing the use of resources aimed at reducing inequality, favoring spending on security, social welfare and the energy sector, as well as for investment projects with high economic impact. The budget estimates that net total expenditure will increase by 0.8% in real terms compared to that approved for 2019, while investment spending will do so by 2.5%, mainly due to higher financial investment, which is expected to increase by 119% in real terms.

In the 2020 Budget Project there is a nominal decrease of 90.5% in the resources assigned to the Ministry of Interior, compared to what was approved in 2019. Those resources were actually transferred to create a new institution, the Ministry of Security and Citizen Protection, which is the one supervising the new National Guard.

Among the main changes in expenditure of administrative branches, the most noteworthy are the real annual increase of 72.0% for the Ministry of Energy, which includes greater spending on infrastructure in order to achieve the reactivation of Pemex; and the real annual increase of 56.5% for the Ministry of Public Function. The Legal Office of the Federal Executive exhibited a 25.1% increase in real annual terms. Finally, Ministry of Welfare, which is involved in most of the government's social programs, grew by 11.0%. On the other hand, those Ministries that registered significant cuts to their spending were Tourism; Agricultural, Territorial and Urban Development; and the Office of the President of the Republic.

Main changes in the Expenditures of the 2020 Fiscal Budget by administrative branch

Administrative Branches	PPEF 2020 vs PEF 2019*
Larger increases	
Energy	72.0%
Public service	56.5%
Legal Office of the Federal Executive	25.1%
Welfare	11.0%
Large decreases	
Tourism	-44.7%
Agrarian, Territorial and Urban Development	-43.7%
Office of the Presidency	-43.5%
Labor and Social Welfare	-35.8%

*Real Variation

It's worth noting that the Ministry of Communications and Transport budget considers the following infrastructure projects: the modernization of Mexico's City airport, for which MXN $1.14 billion were allocated, the extension of the underground (MXN $500 billion) and the railway at the Isthmus of Tehuantepec. Regarding the Ministry of National Defense, MXN $5.4 billion were programmed for the construction of the Santa Lucia Air Base and its interconnection with the Mexico City airport. For the energy sector it is only specified that the Ministry of Energy budget includes a provision of MXN $46.3 billion resources for capitalizing Pemex. Within the Ministry of Tourism, the development of the Mayan Train project, for which development MXN $2.5 billion were budgeted, stands out. It is noteworthy that the specific items for these priority projects are not clearly identifiable. It is worth bearing in mind that the injunctions currently stalling the commencement of work at the Santa Lucia airport risk further slowing execution of public investment, which could in turn have direct and indirect impacts on both investment and growth, as Mexico City's existing airport already is struggling with over-saturation.

In the case of expenditure of public entities under direct budgetary control (IMSS and ISSSTE), an increase of 6.0% in real annual terms is estimated. As for the state productive enterprises (Pemex and CFE), the budget envisages an increase in total spending of 5.2% real terms compared to that approved for 2019.