



MEXICO

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MINISTRY OF FINANCE

January 4, 2005

Economic Program for 2005

- ✓ *The Income Law and the Expenditure Decree for 2005 were published by the Administration the 24th of November and the 20th of December, respectively.*
- ✓ *Important modifications to the Income Tax Law were approved and they will contribute to improve the economy's competitiveness.*
- ✓ *The public deficit target of 0.22 percent of GDP is higher than that proposed by the Administration, but it still implies further consolidation of public finances.*
- ✓ *The changes made to the Expenditure Decree for 2005 will make public spending more complicated in 2005*
- ✓ *The Executive presented a Constitutional Controversy after the House of Representatives refused to admit and process observations to the Expenditure Decree.*
- ✓ *The Constitutional Controversy was accepted by the Supreme Court and the application of some budgeted expenditures was suspended.*

- The public deficit target for the year is Ps. 17 billion, equivalent to 0.22 percent of GDP. This amount is higher than the proposal sent to Congress, but lower than the original public deficit target for 2004. Nevertheless, the Administration will make the necessary efforts to contain expenditures and to avoid exceeding the deficit target established in the original proposal sent to Congress.
- The Revenues Law considers Ps. 74 billion more than the amount originally proposed.
- The additional resources result from a higher oil price assumption, increased non-oil tax revenues, and a larger fiscal deficit.
- The economic program includes important changes to the tax code which are expected to improve the economy's competitiveness while strengthening tax collection.
- The main changes to the Corporate Income Tax Law are: a reduction in the tax rate; broadening geographic areas in which the immediate deduction of investment applies; increased percentage for consolidation purposes (which places Mexican corporations in a leveled plain field with foreign firms); and the gradual substitution of purchase accounting for tax purposes to cost of goods sold.

- The main change to the Income Tax Law for Individuals in 2005 is the reduction of the top tier tax rate to 30 per cent. Furthermore the following changes will be effective in 2006: a reduction of the income tax brackets to two; a single deduction for a fixed annual amount of Ps. 76 thousand which substitutes the salary credit; and, the creation of the employment subsidy and the wage equalization subsidy.
- States are granted the faculty to levy a tax of between 2 and 5 percent on the same tax base as the Federal income tax. It is important to point out that the consumption tax proposed by the Administration would have generated a larger amount of revenues for States, had it been approved.
- Debt with banks will be deductible from the asset base for the purposes of the Asset Tax Law.
- The proposed changes to PEMEX's tax regime were approved by the House of Representatives and the discussion was postponed in the Senate. The Senators are expected to continue discussing and to improve the enterprise's fiscal regime in 2005.
- The House of Representatives reduced the following expenditures: the budgets of the Federal Government's departments; the transfer to IPAB; and, the allocations necessary to cover carryovers from past fiscal exercise advances (Adefas). These spending cuts are based in unrealistic assumptions about the evolution of expenditures, and will make spending more complicated in 2005.
- On November 30th the Administration submitted observations to the Expenditure Decree for the House of Representatives to consider. However, the House of Representatives rejected the Executive's observations and returned the Budget Decree to the Executive.
- The Executive published the Federation's Expenditure Decree for 2005 on the 20th of December, and filed a Constitutional Controversy in the Supreme Court on the 21st which will define the Executive's attributions on the budget approval process.
- The Constitutional Controversy filed is based on two arguments. The first is that the House of Representatives denied the Executives right to observe the budget for the first time in history. The second is to determine if the House of Representatives can modify the budget without limitations above the Constitution and the Law.
- The 22nd of December the Supreme Court accepted the Constitutional Controversy and suspended some budgeted expenditures. The Supreme Court is expected to rule on the House of Representatives' denial to admit the Executive's observations and on the Hose of Representatives modification faculties. The forthcoming ruling by the Supreme Court will set a legal precedent which will be very valuable for the Mexican democracy.

Macroeconomic Assumptions for 2005

Congress modified the oil price assumptions for 2005, as well as the public deficit target. The oil price assumption for 2005 was modified from US\$23 per barrel to US\$27 per barrel. Similarly, the public deficit target was revised, from 0.14 percent of GDP to 0.22 percent of GDP.

| Macroeconomic Framework, 2004-2005 | | |
|--|-------------|-------------|
| | 2004 | 2005 |
| Gross Domestic Product | | |
| Real % growth | 4.0 | 3.8 |
| Nominal (billion pesos) | 7,350.4 | 7,934.4 |
| GDP deflator | 4.7 | 4.0 |
| Inflation | | |
| Dec./Dec. | 3.9 | 3.0 |
| Nominal exchange rate ^{*/} | | |
| Average | 11.3 | 11.6 |
| Interest rates (28 day Cetes) | | |
| Nominal average, % | 6.7 | 7.8 |
| Real, % | 2.9 | 4.8 |
| Current account | | |
| Million dollars | -8,887.8 | -14,237.4 |
| % of GDP | -1.4 | -2.1 |
| Public Balance | | |
| Traditional balance, % of GDP | -0.3 | -0.2 |
| PSBR, % of GDP | 2.6 | 2.2 |
| Support Variables | | |
| US, GDP | | |
| Real % growth | 4.4 | 3.7 |
| US industrial production | | |
| Real % growth | 5.1 | 5.0 |
| US inflation | | |
| Dec./Dec. | 2.3 | 2.2 |
| Oil (Mexican oil mix) | | |
| Average price (US\$/barrel) | 29.2 | 27.0 |
| Average oil export volume (mb/d) | 1,857 | 1,900 |
| External interest rates | | |
| LIBOR, % | 2.1 | 3.2 |

e/ Estimates.

*/ In a floating exchange rate regime, this assumption is not intended as a forecast of the nominal exchange rate. However, it is a necessary assumption in order to estimate certain budget items.

Revenues Law for 2005

For 2005, Congress approved public sector's total resources of Ps. 1,818.4 billion. This amount is PS. 74 billion higher than that in the proposal sent to Congress. The increased resources in the Revenues Law are the following:

| Changes to the Revenues Law for 2005 (Million pesos) | |
|---|--------------------|
| I. Original Proposal | 1,744,370.6 |
| II. Changes | 74,071.1 |
| Higher oil related revenues (from 23.0 to 27.0) | 41,683.3 |
| Fees | 49,509.1 |
| Gasoline excise taxes | -19,148.5 |
| Royalties | 9,436.2 |
| PEMEX's own revenues | 1,886.5 |
| Higher tax related revenues | 25,713.0 |
| Income tax | 17,980.0 |
| Asset tax | -5,667.0 |
| VAT | 13,400.0 |
| Higher fees from public entities | 327.1 |
| Ministry of Foreign affairs | 1.3 |
| Ministry of Energy | 0.4 |
| Ministry of Transportation | 325.4 |
| Higher public deficit (from 0.14 to 0.22) | 6,347.7 |
| III. Approved Revenues Law (I + II) | 1,818,441.7 |

Congress modified the Income Tax Law as proposed by the Administration. The approved changes improve the structure of the tax system through simplifications and reductions in rates.

The main changes in the corporate income tax are:

- Tax rates will decline to 28 percent in 2007. In 2005 and 2006 the tax rates will be 30 and 29 percent, respectively.
- Inventory purchase accounting for tax purposes will be gradually substituted for cost of goods sold. The accounting rules on cost of sales deductions of inventories are established in a new section of the tax code. Furthermore, transitory rules have been set for a period which can last up to 12 years, depending on the inventory turnaround index of each corporation.
- Corporations will be allowed to deduct mandatory profit sharing to employees from their taxable income.
- Investment in renewable energy generation machinery and equipment will be 100 percent deductible.
- Corporate groups will be allowed 100 per cent consolidation.
- Immediate deduction of investment will now be allowed in broader geographic areas.

- A mechanism to avoid the deduction of interest payments of highly leveraged firms was introduced.

It is important to point out that shifting back to cost of goods sold accounting for tax purposes matches the inventory deduction with the revenues received. This change improves the fairness of the system and coincides with international practice. Purchase accounting of inventory deduction for tax purposes was established as a tax incentive for corporations when inflation was high. However, this mechanism has generated distortions in tax collection as taxes did not directly correspond to profitability. The adoption of the new system will be phased-in during a period of up to 12 years because it could represent an additional burden for certain tax payers. The reduction in tax rates and deduction of mandatory profit sharing to employees compensate the burden of the gradual shift to cost of goods sold accounting for tax purposes.

Debt with banks will be deductible from the asset base for the purposes of the Asset Tax Law.

The main changes to the income tax regime for individuals are the following:

- The top bracket income tax rate will fall to 30 percent in 2005.
- The following changes will become effective in 2006:
 - A single tax rate of 25 percent will apply to all taxpayers with annual income up to Ps. 2.5 million. The tax rate increases to 29 percent rate for those taxpayers with annual incomes over Ps. 2.5 million in 2006. The top tax rate will fall to 28 percent in 2007.
 - A single annual tax deduction of up to Ps. 76 thousand.
 - The salary credit will be substituted for a monthly employment subsidy for low income workers.
 - Another subsidy also will be given to guarantee that workers earning less than 10 minimum wages per year will not be negatively affected by these modifications.

Furthermore, States are granted the faculty to levy a tax of between 2 and 5 percent on the same tax base as the Federal income tax.

Tax collection efficiency gains on income and value added taxes are expected to compensate the cost of the reduction in income tax rates and the added deductions to the asset tax base.

The Federation's Expenditure Decree for 2005

Congress made important expenditure redistributions to the proposal of the Administration.

Expenditure reductions amounted to Ps. 38 billion.

| Reductions approved for 2005 (Millions of pesos) | |
|---|-----------------|
| Total | 37,773.2 |
| 1. Autonomous items | 5,800.0 |
| Legislative branch | 300.0 |
| Senate | 150.0 |
| House of Congress | 150.0 |
| Judicial Power | 5,500.0 |
| 2. Administrative Items | 13,834.5 |
| Presidency | 216.5 |
| Interior Ministry | 665.3 |
| Ministry of Foreign Affairs | 930.0 |
| Ministry of Finance and Public Credit | 1,205.2 |
| Ministry of Defense | 817.6 |
| Ministry of Agriculture | 414.8 |
| Ministry of Communications and Transportation | 428.7 |
| Ministry of the Economy | 239.6 |
| Ministry of Education | 4,549.8 |
| Ministry of Health | 909.3 |
| Ministry of Navy | 279.3 |
| Employment and Social Prevision Ministry | 108.1 |
| Ministry of Ecology | 793.8 |
| Attorney General's Office | 673.5 |
| Ministry of Energy | 41.3 |
| Ministry of Social Development | 775.1 |
| Ministry of Tourism | 82.2 |
| Ministry of Civil Service | 81.4 |
| Agrarian Courts | 13.0 |
| Federal Fiscal and Administrative Tribunal | 29.5 |
| Public Security | 327.5 |
| Judicial Advisory | 1.8 |
| CONACYT | 251.2 |
| 3. General Items | 16,051.3 |
| Social security contributions | 3,300.0 |
| Economic and Wage Provisions | 1.3 |
| Adefas (Carry over from previous fiscal exercises) | 6,750.0 |
| Program to Support Banking Sector Savers and Debtors | 6,000.0 |
| 4. Entities Under Direct Budgetary Control | 3,829.8 |
| ISSSTE | 388.4 |
| IMSS | 1,786.6 |
| CFE | 468.5 |
| LFC | 173.6 |
| PEMEX | 1,012.7 |

Increases in expenditures amounted to Ps. 112 billion.

| Expenditure Increases Approved for 2005 | |
|--|------------------|
| (Millions of pesos) | |
| Total | 111,844.3 |
| 1. Autonomous items | 274.4 |
| Legislative branch | 69.7 |
| House of Congress | 69.7 |
| Federal Electoral Institute | 200.0 |
| National Human Rights Commission | 4.7 |
| 2. Administrative Items | 68,354.8 |
| Presidency | 0.0 |
| Interior Ministry | 78.9 |
| Ministry of Foreign Affairs | 475.0 |
| Ministry of Finance and Public Credit | 4,342.5 |
| Ministry of Agriculture | 11,670.0 |
| Ministry of Communications and Transportation | 17,120.0 |
| Ministry of the Economy | 1,724.9 |
| Ministry of Education | 12,128.0 |
| Ministry of Health | 5,477.6 |
| Employment and Social Prevision Ministry | 52.2 |
| Agrarian Reform Ministry | 1,996.4 |
| Ministry of Ecology | 8,319.1 |
| Attorney General's Office | 100.6 |
| Ministry of Energy | 100.0 |
| Ministry of Social Development | 2,484.8 |
| Ministry of Civil Service | 40.0 |
| Agrarian Courts | 100.0 |
| Federal Fiscal and Administrative Tribunal | 200.0 |
| Public Security | 444.8 |
| CONACYT | 1,500.0 |
| 3. General Items | 37,747.8 |
| Social security contributions | 300.0 |
| Adult education contributions | 6,396.4 |
| Contributions to Federal Entities | 2,755.5 |
| Program to Support the Strengthening of Federal Entities | 20,386.0 |
| Revenues sharing to states and municipalities | 7,909.9 |
| 4. Entities Under Direct Budgetary Control | 5,467.3 |
| ISSSTE | 168.2 |
| CFE | 5,299.1 |

Public Finance Projections for 2005

| Public Finance Projections, 2005 | | | | | | |
|---|------------------|------------------|-----------------|--------------|--------------|--------------|
| (Millions of pesos) | | | | | | |
| | Project | Approved | Difference | % of GDP | | |
| | | | | Project. | Approved | Diff. |
| Economic Balance | -11,108.0 | -17,455.7 | -6,347.7 | -0.14 | -0.22 | -0.08 |
| Non-budgetary balance | 0.0 | 0.0 | 0.0 | 0.00 | 0.00 | 0.00 |
| Budgetary balance | -11,108.0 | -17,455.7 | -6,347.7 | -0.14 | -0.22 | -0.08 |
| Budgetary revenues | 1,713,262.6 | 1,780,986.0 | 67,723.4 | 21.59 | 22.45 | 0.85 |
| Oil related | 575,283.6 | 616,966.9 | 41,683.3 | 7.25 | 7.78 | 0.53 |
| Federal Government | 393,973.1 | 433,769.9 | 39,796.8 | 4.97 | 5.47 | 0.50 |
| Pemex | 181,310.5 | 183,197.0 | 1,886.5 | 2.29 | 2.31 | 0.02 |
| Non-oil related | 1,137,979.0 | 1,164,019.1 | 26,040.1 | 14.34 | 14.67 | 0.33 |
| Federal Government | 820,295.2 | 846,335.3 | 26,040.1 | 10.34 | 10.67 | 0.33 |
| Tax related | 763,376.4 | 789,089.4 | 25,713.0 | 9.62 | 9.95 | 0.32 |
| Non-tax related | 56,918.8 | 57,245.9 | 327.1 | 0.72 | 0.72 | 0.00 |
| Public entities | 317,683.8 | 317,683.8 | 0.0 | 4.00 | 4.00 | 0.00 |
| Net paid expenditures | 1,724,370.6 | 1,798,441.7 | 74,071.1 | 21.73 | 22.67 | 0.93 |
| Programmable expenditures | 1,218,192.6 | 1,297,103.8 | 78,911.2 | 15.35 | 16.35 | 0.99 |
| Payment deferrals | -20,000.0 | -20,000.0 | 0.0 | -0.25 | -0.25 | 0.00 |
| Accrued programmable | 1,238,192.6 | 1,317,103.8 | 78,911.2 | 15.61 | 16.60 | 0.99 |
| Non-programmable | 506,178.0 | 501,337.9 | -4,840.1 | 6.38 | 6.32 | -0.06 |
| Financing costs | 227,616.3 | 221,616.3 | -6,000.0 | 2.87 | 2.79 | -0.08 |
| Revenues sharing | 264,561.7 | 272,471.6 | 7,909.9 | 3.33 | 3.43 | 0.10 |
| Adefas and others | 14,000.0 | 7,250.0 | -6,750.0 | 0.18 | 0.09 | -0.09 |

Automatic Stabilizers to Economic Shocks

As in previous years, the Expenditure Decree contains clear guidelines that detail the changes to the budget in case revenues exceed or under-perform relative to the target established in the Revenue Law for the year.

In case revenues exceed the target, the adjustment mechanism is as follows:

- If the oil price exceeds the US\$27 per barrel assumption, the proceeds from the excess yield utilization fee (formerly ARE) will be equally distributed between investment projects by PEMEX (50%) and investment projects by the States (50%).
- Excess revenues derived from non-oil related tax collection, and other oil related Federal Government revenues will be distributed according to the following: 25% to the Oil Stabilization Fund, 25% to improve the public sector balance, and the remaining 50% for investment projects by PEMEX.

In case revenues are lower than expected, the following adjustments will take place:

- If the shortfall is caused by lower than expected oil related revenues, these resources will be compensated from the Oil Stabilization Fund.
- If the underperformance of revenues is due to other factors, it will be compensated by expenditure cuts, which will avoid cutting social expenditures.

It is important to highlight that if the shortfall is lower than Ps. 15 billion, the executive will carry out the necessary adjustments and inform the House of Representatives of their implementation. If the shortfall is equal or exceeds Ps. 15 billion, the Executive will send the proposal of the composition of the expenditure cut to the House of Representatives within 15 days of the announcement. The House of Representatives will then have 15 days to propose changes to the spending cut composition. The Executive will take the proposed changes into consideration and inform of the final composition. If the Representatives fail to propose changes within 15 days the original proposal will be maintained.

Constitutional Controversy

The 21st of December the Executive filed a Constitutional Controversy in the Supreme Court with two objectives. The first is to obtain recognition on the right that Executive has to make observations on the budget approved by the House of Representatives. The second is to determine if the House of Representatives can modify the budget without limitations.

The Constitutional Controversy argues that the House of Representatives rejection of the observations is unconstitutional and goes against the division of powers in the Constitution. Furthermore, the Constitutional Controversy argues that the House of Representatives modifications to the budget are unconstitutional.

On December 22nd the Supreme Court admitted the Constitutional Controversy and suspended some budgeted expenditures. In the forthcoming months the Supreme Court is expected to rule on the Executive's and on the House of Representatives' budgetary attributions.