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Cotton and the VAT Tax in Mexico's Maquiladora Industry UPDATE

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Report Highlights:

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This report updates and corrects information submitted in GAIN Report MX3317 Cotton and the VAT Tax in Mexico's Maquiladora Industry.

General Information:

Introduction

Mexico continues to make strides in its production and commercial capacity. Currently, Mexico is one of the leaders in cost effective manufacturing, along with China and India. Mexico is currently the 11th strongest economy in the world, based upon consumer purchasing power. In fact, Mexico's economy is expected to grow 4.25 percent to 4.75 percent in the next ten years and will surpass all other Latin American countries and Brazil. This economic growth has been spurred by rapid expansion in the maquiladora industry in the last twenty years especially along the tax/duty free region of Mexico along the U.S. border. Border cities rely heavily on the industry—for instance, 60 percent of all the jobs in Ciudad Juarez are occupied by this sector.

Defining this industry is any manufactured good that is assembled, packaged, processed, or produced. Although producing a wide array of products, including electronics, toys, automobiles, and processed foods, the primary sector of manufacturing has been the garment industry and the utilization of U.S. cotton. In this very important trading sector, Mexico is the second largest producer of jeans in the world. Products such as jeans, t-shirts, men's trousers (khakis), plain woven shirts, and wool suits are exported primarily to the United States, Canada, Japan, and countries that have free trade agreements with Mexico. Footwear is also a rapidly growing market with 83 percent of shipments to the United States. Additionally, Mexico is the sixth largest exporter of furniture, where cotton plays an important role. Mexico does not have the agricultural capacity at present in domestic cotton production to satisfy demand, and must import the majority of its raw product for consumption from outside sources. Raw U.S. cotton production increased in 2012, which helped spur additional exports of specialty and industrial fabrics by 22 percent. For Mexican manufacturers, these products are considered to be shipped and processed on a "temporary basis," as they are usually manufacturing and exported back to the United States and other countries within a short time period. Typical U.S. cotton products desired by Mexican manufacturers include:

- Synthetic fibers, utilizing rayon made from wood pulp
- Fabrics using polyester dyes
- Woven, or taffeta fabrics (wedding dresses, linings)
- Fabrics with artificial fibers
- Fabrics with 85 percent denim
- Wool products and fabrics
- Silks, for garments to be exported
- Yarns, both polyester and cotton

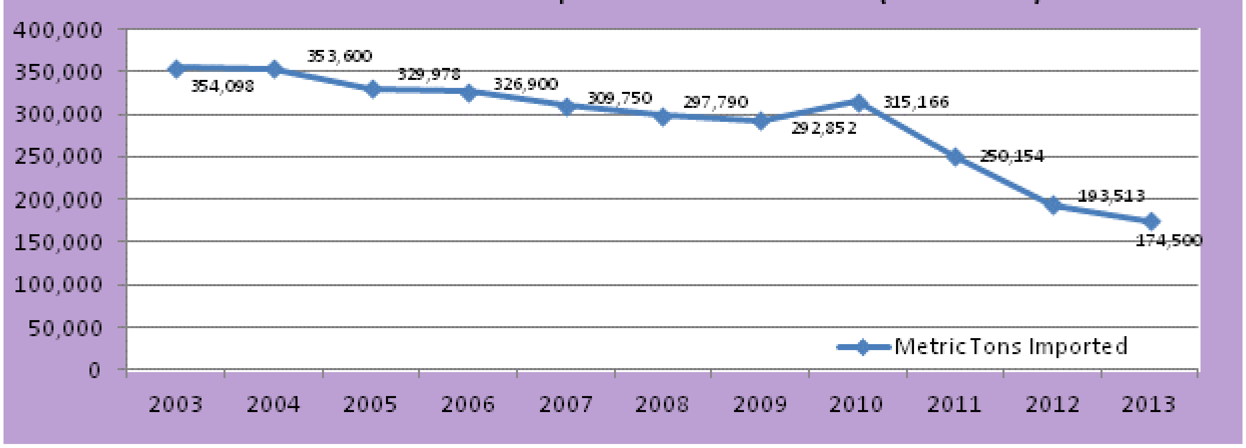


Table 1. 2003-2013 Cotton Exports from U.S. to Mexico (Metric Tons)

Source: U.S. Census Bureau Trade Data. Note: 2013 Data is a measurement from January to September

Table 2. U.S. Cotton Exports based on product 2010-2012

Product	2010	2011	2012	% Change
Raw Fiber	1,447,022	1,149,655	888,149	22.7
Carded/Combed Fiber & Waste	49,932	41,998	30,461	24.7
Total Textile & Apparel (including yarn, thread, and fiber)	691,145	658,183	626,310	4.8

Source: Source: Economic Services, National Cotton Council, November 2013.

However, U.S. exports to Mexico have steadily decreased in the last ten years, as increased production in Mexico over the past few years has supported Mexico's maquiladora industry, as well as shifting international trends. In 2013, Mexico's domestic cotton production decreased based on reduced international prices and the producers switching to other crops. Additionally, world cotton production for 2013/2014 is expected to decrease 6 percent from 2012-2013 to 117.4 million bales, due to price and shifts to alternative crops. World trade in 2013/2014 cotton is expected to be reduced by 17 percent from last year based on a combination of lower exportable supplies and reduced demand from China. Yet, in the last few years, China's demand for U.S. cotton has surpassed Mexico's imports based on a policy of stockpiling. Largely due to the Central American Free Trade Agreement (CAFTA), Honduras and the Dominican Republic are the primary importers of U.S. raw cotton.

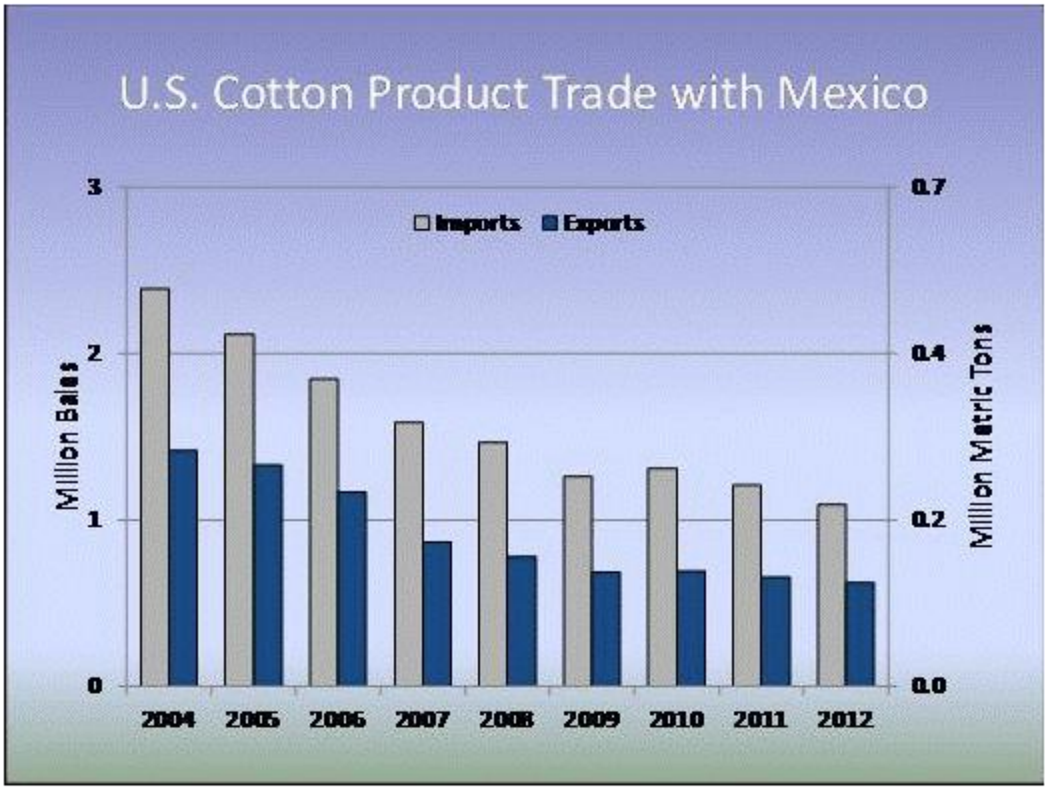
Table 3. Mexico Cotton Supply and Use (in Millions of Bales [1])

Year	Beginning Stocks	Production	Area Harvested (1000 ha)	Imports	Domestic Use	Exports	Ending Stocks
2011/2012	0.60	1.18	192	1.0	1.7	0.34	0.71
2012/2013	0.71	1.09	157	0.95	1.8	0.23	0.70
2014 Projected	0.70	0.79	118	1.2	1.9	0.15	0.62

Source: World Agricultural Supply and Demand Estimates, USDA; December 2013

Based on predicted declines in production, and as the world's *third* largest cotton producer, the United States is predicted to export *10.4* million bales in 2013/14, which is a *more than 20 percent* decline from the previous year. However, for Mexico, projections suggest to a 20 percent import increase to 1.2 million bales for 2013/14 based on reduced domestic production. The United States remains the main supplier for the maquiladora industry which accounts for almost all cotton imports. For processed cotton textiles, Mexican exports to the United States in 2012 were 1.1 million bales, a reduction of 9.7 percent from the previous year, as China continues to be the largest supplier of cotton textile exports for the eighth consecutive year. Despite increased consumption internationally in the last three years, fluctuating prices of cotton for 2013/2014 can present challenges for the maquiladora industry.

Figure 1. U.S.-Mexico Cotton Trade



Source: Economic Services, National Cotton Council, November 2013.

Additionally, shifting trends in cotton production, coupled with Chinese sales of its massive stockpiles, growing competition in textile production from emerging economies such as India, and fluctuating prices could require significant adjustments for Mexico's maquiladora industry, as well as for U.S. cotton exporters. However, a more pressing issue facing the industry that also presents challenges is the tax restructuring recently enacted by President Enrique Peña Nieto and his administration. Such overhauls could be burdensome for manufacturers and could reduce U.S. cotton exports based on new regulations and overhauls.

Increasing Gross Domestic Product

The value added tax, or VAT (*Impuesto al Valor Agregado* or IVA, in Spanish) has developed into a controversial subject for cotton producers and the maquiladora industry. According to the Government of Mexico, oil revenues fund approximately one-third of the federal budget and tax revenue is considered the lowest as a percentage of gross domestic product among 34 members of the Organization for Economic Cooperation and Development (OECD). Revenues gained from the VAT are designed for many social programs, including public pensions, a social security fund, and food security interventions. The proposal, while known since early 2013 but publicly announced September 8th, is slated to gain an estimated 39 billion pesos (3.34 billion USD) in revenue by placing a tax on a wide variety of items and services, affecting both consumers and producers. The VAT includes a tax on pet food, perceived unhealthy or "junk food," increases to 16 percent the sales tax on the border [2] , and a new tax regime on the maquiladora industry. Based on the 2013 reduced U.S. cotton exports to Mexico, and the restructured tax program, the maquiladora industry could see a large transformation in its structure, and could negatively affect U.S. cotton exports.

The maquiladora industry is worried about these changes and many believe that the new tax laws will hurt businesses. According to Coparmex (Mexican labor association), the tax reforms will negatively affect businesses and raise costs on average up to 8 percent. Based on the new structure, companies within this sector, including textiles, could pay a 115 percent greater rate of income tax for 2014. Efforts have been made by the Government of Mexico to close loopholes and avoid double taxations for foreign holdings.

How the tax affects the maquiladora industry

The new tax reforms are meant to improve Mexico's growing industries in consumer goods, with an effort at increasing the tax base of foreign companies with holdings in Mexico. The textile industry is very important to Mexico, as 1.2 percent of Mexico's GDP is derived from this production, as well as accounting for 7.1 percent of all maquiladora production. The following are some of the changes set by the Enrique Peña Nieto Administration:

- The original flat tax law, or IETU2 (*Impuesto Empresarial a Tasa Única*), a single rate minimum income tax for corporations will be eliminated, as well as a cash deposits tax (*Impuesto a Depósitos en Efectivo*, or IDE) for companies; both originally enacted in 2008.
- Corporate tax rate to be set at 30 percent and individuals with annual income above 500,000 pesos will have to apply a new rate of 32 percent. Additionally, the corporation (either domestic or foreign) will pay an additional 10 percent tax on dividends in distributing its profits to domestic or foreign shareholders, and the reform limits salaries and benefits maquiladoras can deduct from income taxes and changes price-transfer regulations between parent company and subsidiaries.
- A 16 percent rate on imported materials and machinery is installed, and 90 percent of invoiced revenues must be derived from exports. This terminates the previous loophole of being able to avoid taxes by assuming international holding titles which utilized temporary imported goods.
- Transnational corporations can request reimbursement on the 16 percent tax rate, which is for temporary imports or products such as materials, and machinery. However, at least 30 percent of the value of the machinery and equipment utilized in the manufacturing process will be Mexican owned, with an emphasis to improve tax regulation on Mexico shelter companies.
- Specifically, companies will be able to claim reimbursements, including receiving an IVA refund for incurred costs on certain imported products. Not many details are known at this time, but eliminating the original deduction will not occur until early 2015. Additionally, according to the National Council of the Maquiladora Industry (INDEX), 60 to 70 percent of foreign-owned maquiladoras operating in Mexico could deduct the income taxes (*Impuesto Sobre la Renta*, or ISR) as a result of these changes.

One of the primary issues facing maquiladoras is not higher tax rates, but rather not having consistent cash flow as a result of paying these taxes. Can companies pay the high tax and expect a refund in enough time to cover expenses? Starting January 1, 2014, the maquiladora industry will not make deductions as had been done in the past, which provided companies with sufficient finances for operating costs. Many argue that eliminating these deferrals will reduce investment and deter growth in the maquiladora sector, while others state the reforms will

help reduce fraud and improve the government's tax base. Global law firm Baker conveyed that maquilas could pay upwards to 85 percent more in taxes for 2014. Other experts stated 80 percent of financial investments made by businesses were obtained as a result from their deferrals, which could be in the millions of dollars.
In November, the Ministry of Finance confirmed that the 100 largest companies operating within Mexico, which account for 60 percent of exports, will actually be exempt from the VAT on temporary imports. This represents less than 2 percent of all maquilas in operation in the country, and those companies engaged in textile production will not be exempt from the new program. Furthermore, the Ministry of Economy and the Tax Administration Service came to an agreement that companies listed on the New Trusted Shipper Program (*Nuevo Esquema de Empresas Certificadas*, or NEEC [3]) may also be exempt from the VAT tax on temporary imports. It is unclear how many textile or spinning companies would be exempt in this case.
For businesses involved in the textile industry, adapting to the VAT tax with continued fluctuating cotton prices can present challenges. Approximately 85 percent of the thousands of companies in this sector are considered small enterprises, exporting over 6.7 billion dollars annually. From this amount, about 1 billion is obtained from cotton products including yarns and fabrics. The manufacture of textile inputs (from raw cotton or synthetic materials) is approximately 70 percent of production, with the 30 percent produced as finished textile products. The sector is vastly important for employment; the textile and clothing industries in August of this year employed 428,000 workers, 10 percent of all manufacturing related employment in the country. Critics state this tax restructuring would raise operating costs and negatively affect employment with reduced exports. For the textile producers and spinning companies that produce inputs for larger manufacturers, ending the VAT exemptions could negatively impact small companies with weak cash positions.

Assessment

The government of Mexico wants to discourage the importation of tax-free materials that are sold in Mexico rather than shipped out of the country as a final product. For textile companies that rely on high volumes U.S. cotton, meeting the new tax regime requirements could be difficult, accessibility to Mexican domestic cotton might not be consistent. 2012 droughts and crop failures in the states of Coahuila and Durango reduced production by 7,000 acres, with an estimated reduction of 39,000 hectares in 2013/2014 from last year's reporting period. Therefore, textile maquiladoras will continue to rely heavily on U.S. cotton imports
Fluctuating cotton markets, reduced domestic production coupled with the restructuring of the Mexican tax law will provide unique challenges to the textile maquiladora industry. Despite opposition from various interest groups, the tax restructuring should increase Mexico's GDP, but could be a deterrent for international investment. U.S. exporters, distributors, and multi-national production companies with maquilas will have to pay special attention to the law, and what it will mean for their company.

For More Information

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Other Relevant Reports Submitted by FAS/Mexico: Report Number	Subject	Date
MX3317	Cotton and the VAT Tax in Mexico's Maquiladora Industry	12/12/2013
MX3031	Cotton and Products Annual	3/27/2013
MX3028	Mexico GE Cotton Permits	3/26/2013
MX3303	Cotton Production Up as Domestic Consumption Drops	12/21/2012

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[1] Bales are measured in 480 pound bales

[2] The majority of textile production maquilas are located in the states of Guanajuato, Jalisco, and Queretaro and not in the border cities where other manufacturing is prevalent.

[3] The NEEC is a program that focuses on compliance and to speed up and reduce inspections while eliminating the introduction of illicit and illegal goods