U.S. - MEXICO FOUNDATION

ENHANCING MEXICO'S COMPETITIVENESS THROUGH FISCAL POLICY RECOMMENDATIONS

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CONTENT

ACRONYMS

BEA	U.S. Bureau of Economic Analysis
BEPS	Base Erosion and Profit Shifting
CAGE	Cultural, Administrative, Geographical, and Economic
CIT	Corporate Income Tax
CPEUM	Constitution of the United Mexican States
CFF	Mexico's Fiscal Federation Code1
DTAAs	Double Taxation Avoidance Agreements
EVs	Electric Vehicles
FDI	Foreign Direct Investment
FEZs	Free Economic Zones
GDP	Gross Domestic Product
IPR	Intellectual Property Rights
ISR	Mexico's Corporate Income Tax
IEPS	Mexico's Excise Tax on Production and Services
ISAN	The Tax on New Automobiles
IT	Information Technology
NOL	Net Operating Loss
OECD	Organization for Economic Co-operation and Development
PTU	Employees' statutory profit-sharing
R&D	Research and Development
RBV	Resource-based view
TCE	Transaction Cost Economics
U.S.	United States of America
UNCTAD	United Nations Conference on Trade and Development
VAT	Value-Added Tax
WTO	World Trade Organization

EXECUTIVE SUMMARY

Nearshoring is gaining prominence due to trade tensions, disruptions in supply chains, and political instability, offering a wide range of benefits.

Nearshoring is the practice of relocating business activities or processes to a nearby or geographically closer location, typically in neighboring countries or regions, rather than distant offshore destinations.[1] The practice has gained prominence due to several geopolitical and economic factors. By reallocating certain processes or activities, firms can benefit from enhanced supply chain control, market expansion, efficiency optimization, resource acquisition, and strategic asset utilization.

Nearshoring practices are attractive for host countries due to their impact on Foreign Direct Investment (FDI), economic growth, and job creation.

This practice presents a mutually beneficial scenario where companies gain cost advantages and market proximity, while host countries experience economic growth, job opportunities, and technology transfer. For example, it is estimated that nearshoring can help Mexico add an additional 3% to its GDP in the next five years.[2] Countries will seek and compete to attract nearshoring by offering incentives like tax benefits, specialized economic zones, skilled labor forces, robust intellectual property regimes, and strategic trade policies.

Several factors have enhanced the attractiveness of Mexico as a nearshoring destination of U.S. activities, mainly those relocating from Asian economies.

The imposition of tariffs on China by the United States in 2018 prompted certain enterprises to explore alternative markets to alleviate expenses. The United States-Mexico-Canada Agreement heightened the demand for a higher regional value content in goods to qualify as North American-made. Maritime transportation costs resulted in transportation expenses surging over fivefold. Lastly, the onset of the conflict in Ukraine curtailed the supply of raw materials, obliging global businesses to seek out alternative

[1] Fernández-Miguel, A. et al. 2022. Disruption in Resource-Intensive Supply Chains: Reshoring and Nearshoring as Strategies to Enable Them to Become More Resilient and Sustainable.
[2] Deloitte. July, 2023. Nearshoring in Mexico.

suppliers.[3] However, despite Mexico's strategic position and economic integration with North America, the country has only absorbed a relatively small share of that lost by China.[4]

Countries that aim to attract nearshoring should meet macroeconomic stability, tax incentives, skilled labor availability, infrastructure quality, and law enforcement.

Desirable destinations possess well-established development frameworks, including robust, well-developed transportation networks, ports, and telecommunications, enhancing supply chain resilience. Moreover, transparent and stable governance, R&D investment, intellectual property protection, and strong institutions are crucial for reducing uncertainties in nearshoring decisions. In this regard, high-income countries have demonstrated more effective attracting and retaining investment.[5] Mexico can still improve its performance on key institutional and labor elements, including using more tax incentives to drive economic growth.

In 2022, Mexico occupied the 30th position out of 38 countries on the International Tax Competitiveness Index.

Amongst the 38 countries, the U.S. ranked 22nd, falling below Japan, above Slovenia, and only eight positions ahead of Mexico. Mexico outshines the U.S. with its highly competitive property tax, securing a notable ninth rank globally in this tax category.

Interestingly, the U.S. displays its least competitive aspect in this tax category. Mexico's favorable tax system offers an opportunity to formulate a tax incentive strategy, allowing U.S. investors to explore the benefits of property-related factors in their offshore and nearshoring decisions.

Mexico's FDI potential from the U.S. is promising; however, it should also consider diversifying its trade partners, mainly focusing on Europe.

Despite Mexico's success in becoming the first U.S. trade partner as of June 2023, displacing China, 14 out of more than 51 countries engaged in investment activities in Mexico have shown a consistent decline in FDI over the past decade. Seven of these 14 countries are from Europe. It's worth noting that despite the rise in U.S. FDI in Mexico, the amount is on par with

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[3] Ibid
[4] Deloitte. July, 2023. Nearshoring in Mexico.
[5] International Monetary Fund. Foreign Direct Investment in Developing Countries. Finance & Development.

the newly acquired FDI by Texas in 2022. Texas is the second-largest recipient of FDI in the U.S., showcasing the economic potential that individual U.S. states have compared to an economy the size of Mexico.

States within the U.S. could pose competition for FDI in Mexican bordering and manufacturing regions, especially in the automotive sector.

The U.S. has consistently ranked as the number one worldwide FDI destination, with the participation of manufacturing accounting for $5.3 billion or 65% of 2022 Greenfield investment expenditures. This is mainly driven by the computer and electronic products sector, which contributed $1.8 billion. California, New York, and Texas emerge as the dominant FDI beneficiaries, collectively contributing 46% of the entire new FDI influx in the U.S. These three states exhibit numerous commendable practices, such as a skilled workforce, robust infrastructure, efficient connectivity, and strategic location.[6] For example, the U.S. has implemented tax incentives to encourage reshoring the electric vehicle battery supply chain, leading to increased job creation and enhanced supply chain resilience.[7] Mexico will introduce a range of tax incentives for nearshoring, including those aimed at benefiting specific sectors such as pharmaceuticals, aerospace, electronics, and microprocessors. It will be necessary to analyze the impact these incentives have in the long term and whether they can compete with states in the United States.

When contrasted with alternative nearshoring locations, Mexico offers certain incentives and continues to have the potential to explore innovative tax schemes.

Northern and Eastern Europe, particularly in regions such as the Baltics and the Balkans, have emerged as alluring nearshoring prospects for Western European nations. This trend is exemplified by Lithuania, which boasts advantageous tax rates, Special Economic Zones, and a robust Intellectual Property Regime, solidifying its appeal as a prime destination. Similarly, with a significant manufacturing trade partnership with the U.S., Pakistan has established Special Technology Zones and strategic trade policies targeting the growing electric vehicle market, accentuating the evolving landscape of nearshoring. In this context, Mexico could consider

[6] Investment Monitor. July, 2022. The big three march on: How Texas, New York and California dominate US FDI.
[7] Rocky Mountain Institute. May, 2023. The EV Battery Supply Explained.

exploring tax incentives that align with the dynamic global economy, mainly centered around innovation and technological advancement.

In October 2023, the Mexican Government introduced new tax incentives to boost investments in response to nearshoring activities. These tax incentives are aimed at companies contemplating relocating within Mexico, specifically focusing on ten critical sectors, including electronics, semiconductors, batteries, engines, and pharmaceuticals, among others. These incentives encompass accelerated investment deductions and an additional deduction for worker training expenses.

In addition, it has been identified that Mexico could enhance its competitiveness as a nearshoring destination by exploring the adoption of the following recommendations oriented to its fiscal framework:

1. Review the Interest Deduction Limit
2. Repeal Deduction Limits on Worker Payments
3. Reduce the Time Frame to Return Credit Balances of Contributions
4. Explicitly include a Research and Development (R&D) deduction within authorized deductions

It will be interesting to assess how tax incentives aimed at attracting nearshoring will be applied in all states and municipalities in Mexico. However, given that the recommendations outlined earlier are geared towards encouraging nearshoring activities, they can bring about significant changes in the country's economic landscape and contribute to Mexico's fiscal sustainability, economic prosperity, and the overall well-being of its population.

1. NEARSHORING: FIRM'S DECISION-MAKING AND COUNTRY DEVELOPMENT

Amidst the backdrop of COVID-19 and subsequent global political disruptions, there has been a notable surge in the reconfiguration of economic activities worldwide. Particularly, U.S. firms have begun contemplating and gradually implementing the relocation of certain economic activities previously outsourced to Asian countries. This strategic realignment of value chain processes, driven by reduced geographical distance, is commonly referred to as nearshoring.[8]

Although a universally agreed-upon definition remains elusive, scholarly literature converges on its primary attribute - the shortened distance of specific production, trade, or inventory processes to enhance effectiveness and efficiency, ultimately aimed at maximizing profits or minimizing costs through the process of relocation.[9] In this section, we delve into the role of nearshoring in firms' decision-making and its impact on the development of countries.

1.1 Enhancing Efficiency through Proximity and Value Chain Reconfiguration

Nearshoring is the practice of relocating business activities or processes to a nearby or geographically closer location, typically in neighboring countries or regions, rather than distant offshore destinations.[10] The literature on this practice acknowledges that the globalization of supply markets and the evolving international competitive landscape have contributed significantly to the well-known fragmentation and dispersion of value chains.[11] Companies are reconfiguring their value chains and relocating specific value-added activities and tasks to suitable destinations to achieve higher efficiency and effectiveness.[12]

[8] OECD. Regional Development in the New Global Environment. "Which relocation strategies for resilient regional development? The case of nearshoring." Presentation.
[9] Ibid.
[10] Fernández-Miguel, A. et al. 2022. Disruption in Resource-Intensive Supply Chains: Reshoring and Nearshoring as Strategies to Enable Them to Become More Resilient and Sustainable.
[11] Slepniov et al. 2013. "Nearshoring practices: An exploratory study of Scandinavian manufacturers and Lithuanian vendor firms", Baltic Journal of Management, Vol. 8: 1 pp. 5 – 26.
[12] Ibid.

Nearshoring offers a solution to the cost-risk versus distance dilemma, as companies select locations not solely based on cost savings but also considering lower risks.[13]

Existing studies highlight four primary reasons for companies going overseas: market-seeking, efficiency-seeking, resource-seeking, and strategic asset-seeking.

In this context, scholars distinguish three main challenges vendors face: competency-related challenges, management of the entry phase, and operational aspects of running the contract.[14]

Outsourcing and offshoring scenarios vary significantly based on ownership and distance dimensions, resulting in dynamic and distinct strategies. Activities are categorized into in-house and outsourced activities from an ownership perspective.[15]

There are two main theories for framing these activities:

Resource-based view (RBV)

At its core, RBV seeks to explain how a firm's sustainable competitive advantage arises from its unique and valuable resources.[16] According to the theory, a resource is considered valuable if it enables a firm to exploit opportunities or neutralize threats in its external environment. These resources can be tangible assets, such as state-of-the-art technology, physical infrastructure, or access to distribution channels, and intangible assets, such as patents, brand reputation, organizational culture, or knowledge-based capabilities.

The RBV provides a valuable lens through which firms can strategically assess their resources and capabilities while considering nearshoring to optimize their supply chain, enhance competitiveness, and exploit new market opportunities. It enables firms to make informed decisions regarding which processes to nearshore, where to nearshore them, and

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[13] Fernández-Miguel, A. et al. 2022. Disruption in Resource-Intensive Supply Chains: Reshoring and Nearshoring as Strategies to Enable Them to Become More Resilient and Sustainable.
[14] Jenster, P., Pedersen, H.S., Plackett, P. and Hussey, D. 2005, Outsourcing-Insourcing: Can Vendors Make Money from the New Relationship Opportunities?, Wiley, Chichester.
[15] Slepniov et al. 2013. "Nearshoring practices: An exploratory study of Scandinavian manufacturers and Lithuanian vendor firms", Baltic Journal of Management, Vol. 8 Iss: 1 pp. 5 – 26.
[16] Barney, J.B. (1991), "Firm resources and sustained competitive advantage", Journal of Management, Vol. 17 No. 1, pp. 99-120.

how to leverage their unique resources to gain a sustainable competitive advantage in the context of nearshoring practices.

Transaction Cost Economics (TCE)

TCE is a prominent economic theory that seeks to explain the organization and governance of economic activities. At its core, TCE centers around the notion that economic transactions incur costs beyond the market price of goods or services. These additional costs, known as transaction costs, arise due to information asymmetry, opportunism, uncertainty, and bounded rationality among individuals and organizations engaged in exchanges.[17]

The author of TCE[18] identifies two primary types of transaction costs: those associated with conducting transactions within a firm (intra-firm) and those linked to transactions between independent firms (inter-firm). TCE asserts that firms exist as governance structures to mitigate transaction costs, and the balance between the efficiency of internal coordination and the costs of external market transactions determines their boundaries.

The primary distinction between these two approaches lies in their unique contributions: RBV significantly enhances our understanding by emphasizing the pivotal role of a firm's core-related resources and capabilities in establishing and sustaining a competitive advantage over time. On the other hand, TCE focuses on distinguishing between intra-firm and inter-firm transaction costs while striving to achieve an optimal level of internalized activities. Despite these dissimilarities, both theoretical perspectives hold relevance in describing the intricacies of firm decision-making, particularly concerning the nearshoring of specific processes within their supply and value chains.

1.2 Distance in Nearshoring: Exploring Proximity and Psychic Factors

Companies have three choices in locating their activities concerning proximity to headquarters: 1) Close proximity (domestically), 2) A moderate distance referred to as nearshoring, which involves a narrow geographical scope, and 3) A significant distance known as offshoring, with a broad geographical scope. Additionally, the literature examines the concept of "psychic" distance, a crucial dimension encompassing factors that impede

[17] Williamson, O.E. 1975. Markets and Hierarchies, The Free Press, New York, NY.
[18] Ibid.

the understanding of foreign environments[19], and this element is integral to the Cultural, Administrative, Geographical, and Economic (CAGE) distance framework.[20]

The CAGE framework of distance encompasses four key attributes: cultural distance, involving factors like religious beliefs, race, social norms, and language; administrative or political distance, containing colony-colonizer links, common currency, and trade arrangements; geographical distance, considering physical distance, target country size, access to waterways and the ocean, topography, and transportation and communications infrastructures; and economic distance, accounting for disparities in wealth and variations in the cost and quality of financial and other resources between two countries.[21]
An illustrative example lies in comparing Spain and Mexico with Germany and Mexico. While the physical distance between Spain and Mexico may be similar to that between Germany and Mexico, cultural factors, such as language and religion, contribute to a smaller psychic distance between Spain and Mexico. Consequently, fiscal integration between countries can aid in reducing psychic distance through practices such as Double Taxation Avoidance Agreements (DTAAs) with various countries and due dates for reporting corporate and individual taxes.

1.3 Nearshoring as a Response to Global Disruptions

COVID-19 and the Global Supply Chain

The COVID-19 pandemic significantly impacted the global supply chain, exposing worldwide vulnerabilities in production strategies and supply chains. A lack of critical medical supplies and pharmaceuticals highlighted the need for companies to prioritize domestic production, reduce reliance on risky sources, and reevaluate lean manufacturing strategies that minimize inventory in global supply chains. To address these challenges, businesses must enhance the resilience of their supply chains without compromising competitiveness. This involves identifying vulnerabilities and mapping entire supply chains beyond the first and second tiers,

[19] Johanson, J. and Vahlne, J.-E. (1977), “The internationalization process of the firm – a model of knowledge development and increasing foreign market commitments”, Journal of International Business Studies, Vol. 8 No. 1, pp. 23-32.
[20] Ghemawat, Pankaj. "Distance Still Matters: The Hard Reality of Global Expansion." Harvard Business Review 79, no. 8 (2001): 137-147.
[21] Ghemawat, Pankaj. "Distance Still Matters: The Hard Reality of Global Expansion." Harvard Business Review 79, no. 8 (2001): 137-147.

categorizing suppliers based on risk levels, and diversifying the supply base by spreading production among multiple sources in different regions.[22]

Additionally, advancements in automation and new processing technologies offer opportunities to improve supply chain efficiency, reduce costs, and enhance flexibility. However, companies must carefully consider the trade-off between product variety and capacity flexibility to respond better to shifts in demand. Despite the weaknesses exposed by the pandemic, globalization should not be abandoned.

A new vision that leverages global capabilities while improving robustness is crucial for navigating the new era of supply chain management.[23]

Nearshoring can be a strategic approach for companies seeking to achieve greater supply chain robustness while maintaining competitiveness in the face of global challenges. It can foster closer collaboration with suppliers, easier communication, and better cultural alignment, addressing some of the cultural and administrative distance aspects mentioned in the CAGE framework. These factors can contribute to a more reliable and efficient supply chain, which is particularly crucial during times of crisis.

Global Political Disruptors

Nearshoring practices have gained significance due to various geopolitical and economic factors.[24] Escalating trade tensions and tariffs between countries have disrupted supply chains, prompting companies to opt for nearshoring to reduce exposure to trade conflicts. Political instability and conflicts in specific regions have also led to nearshoring decisions as companies seek more stable and secure production locations.

Changes in trade agreements and alliances have influenced trade dynamics, motivating companies to consider nearshoring to maintain preferential market access. Additionally, geopolitical risks, national security concerns, and supply chain resilience have driven companies to prioritize nearshoring to mitigate risks and ensure greater control over their supply chains. Factors such as labor cost and skill availability, environmental sustainability, and market demands further contribute to adopting

[22] Willy C. Shih. "Global Supply Chains in a Post-Pandemic World." Harvard Business Review, September-October 2020.
[23] Ibid.
[24] Fernández-Miguel, A. et al. 2022. Disruption in Resource-Intensive Supply Chains: Reshoring and Nearshoring as Strategies to Enable Them to Become More Resilient and Sustainable.

nearshoring strategies, highlighting the multifaceted nature of supply chain decision-making.[25]

Climate Change as a Driver of Nearshoring

Climate change is driving companies to reevaluate their supply chain strategies.[26] Nearshoring is becoming increasingly attractive to enhance environmental sustainability, build supply chain resilience, adapt to changing weather patterns, manage transportation costs, and meet consumer demands for eco-friendly products.[27] As climate change continues to impact the global economy, nearshoring practices will likely gain further momentum in pursuing a more sustainable and resilient supply chain landscape.

For example, climate change can significantly impact the beer supply chain, affecting water resources, agricultural production, transportation, consumer preferences, and regulatory landscapes.[28] To ensure resilience and sustainability, beer manufacturers may need to adopt adaptive strategies and invest in more climate-conscious practices throughout their supply chains. This can drive nearshoring practices for several reasons:

- **Raw materials:** As climate change intensifies, extreme weather events such as hurricanes, droughts, and floods increase in frequency and severity, leading to supply chain disruptions for industries like breweries. To mitigate risks and ensure a stable supply of raw materials, breweries may choose to source ingredients from nearby regions or countries, reducing reliance on distant and vulnerable suppliers.

- **Water**: The sustainable availability of input is a crucial resource in beer production, and climate change can lead to water scarcity in certain regions. Breweries may choose to locate or invest in facilities closer to areas with abundant water resources, allowing them to

[25] Willy C. Shih. "Global Supply Chains in a Post-Pandemic World." Harvard Business Review, September-October 2020.
[26] Seuring, S., & Müller, M. (2008). From a literature review to a conceptual framework for sustainable supply chain management. Journal of Cleaner Production, 16(15), 1699-1710.
[27] Carter, C. R., & Rogers, D. S. (2008). A framework of sustainable supply chain management: moving toward new theory. International Journal of Physical Distribution & Logistics Management, 38(5), 360-387.
[28] Unleashed Inventory Management Software. "The Beer Supply Chain in 2023 and Beyond".

secure a steady supply for their operations and reduce the environmental impact of transporting water over long distances.

- **Transportation:** Transporting raw materials, finished products, and packaging materials over long distances can contribute significantly to greenhouse gas emissions. As companies face increasing pressure to reduce their carbon footprint and comply with environmental regulations, nearshoring can help minimize transportation-related emissions and support more sustainable supply chain practices.

1.4 Enhancing Opportunities for Low and Middle-Income Countries

Nearshoring can provide a mutually beneficial arrangement where companies can take advantage of cost efficiencies and market proximity while high, low, or middle-income countries benefit from economic growth, job creation, and technology transfer. However, companies and host countries must establish transparent and sustainable business practices to ensure long-term success and positive outcomes for all stakeholders involved. The main reasons why nearshoring is desired and incentivized by middle-income economies are the following:

- **Job Creation and Economic Growth**: Nearshoring brings FDI and business opportunities to low and middle-income countries. Companies setting up operations in these countries are expected to create jobs for local populations, leading to improved employment rates and economic development. Moreover, FDI is considered to stimulate various sectors and increase competitiveness in targeted industries.

- **Technology Transfer and Knowledge Sharing**: Regardless of the sector, most foreign companies -mainly based in high-income countries- bring advanced technologies, management practices, and expertise to the host country. This helps transfer knowledge and skills to the local workforce, promoting human capital development. Some countries develop policies to incentivize specific sectors and even establish hiring quotas for the local workforce.

- **Infrastructure Development**: Infrastructure facilitates efficient transportation, communication, and logistics, reducing costs and ensuring smoother operations in geographically closer production locations. The development of infrastructure benefits at a city, regional, and even country level, enhancing competitiveness within a country and across countries of a region.

1.5 Development considerations about nearshoring

Impact of foreign investment on wage inflation

Recent trends highlight that nearshoring regions are dynamic and diverse, contrary to a homogenous perception. Traditionally, companies from Western European countries -mostly high-income- turned to emerging economies like the Czech Republic, Hungary, Poland, and the Baltic countries for nearshoring due to lower tax burdens, cost advantages, and various incentives. After a certain period, the once emerging economies, such as the Czech Republic, Estonia, and Hong Kong, transitioned into developed economies, experiencing wage inflation and advancements in technology and environmental practices.[29] Thus showing the potential of FDI and exposes possible cost-related implications of wage inflation in attracting and retaining more foreign investment.

Furthermore, nearshoring has evolved beyond routine transactional manufacturing tasks and now includes more knowledge-intensive and proprietary functions, such as research and development (R&D) and innovation, resulting in global fragmentation and dispersion of these critical processes. From a country perspective, economies are increasingly competing to attract and retain high-value processes in the supply chain, particularly those closely linked to the knowledge-based economy. However, on the other side, firms may be cautious about selecting countries where the transition from low-income and middle-income to high-income status is likely to occur in the short term due to its potential impact on investments.

Domestic policies in high-income countries

Research concludes that attracting FDI from high-income to low-income and middle-income countries is more complex and that there is a significant variance in this second group. The latter generally question the

[29] Slepniov et al. 2013. "Nearshoring practices: An exploratory study of Scandinavian manufacturers and Lithuanian vendor firms", Baltic Journal of Management, Vol. 8 Iss: 1 pp. 5 – 26.

situation where a complete relocation of operations may result in economic decline in a region (Bettis et al., 1992) and social turbulence, as it can lead to unemployment and other adverse socio-economic consequences in developed countries. M. Storper's theory emphasizes that the impacts of globalization on regional economies are complex and multifaceted. While some regions may converge due to increased connectivity and access to global markets, others may experience divergence if they cannot capitalize on globalization's benefits or face challenges hindering economic growth.

Storper also highlights the potential for divergence under globalization. Despite the idea of convergence, certain regions may experience widening disparities in economic performance and development. This can happen when globalization benefits specific locations, industries, or skilled labor markets more than others. As a result, some regions might experience significant growth while others face stagnation or decline, leading to spatial economic disparities. In this regard, countries may opt for policies that restrict the exit of domestic sources of employment.

Nearshoring as outsourcing and its opportunities for domestic growth

Nearshoring offers international firms a way to harness the advantages of geographically distributed activities, such as market access, efficiency gains, access to resources, and leveraging strategic assets, without the need for direct ownership. This approach not only supports transparent partnerships with domestic firms but also creates an environment conducive to enhancing the capabilities of local companies through knowledge exchange, skill transfer, and technology sharing.

By engaging in nearshoring partnerships, domestic firms can gain access to international markets, expand their reach, and benefit from foreign firms' expertise and innovation. Additionally, nearshoring enables contractual flexibility, allowing companies to adapt swiftly to changing market conditions and operational needs, fostering agility and resilience in the face of uncertainties. Ultimately, nearshoring can be a win-win strategy, strengthening international and domestic firms through collaborative and mutually beneficial relationships.

1.6 Enablers of Foreign Direct Investment

Various macroeconomic factors substantially influence nearshoring decisions, shaping the business landscape, costs, and prospects of a location. Such factors are pivotal considerations for companies seeking operational relocation. The subsequent section encompasses existing conditions that foster foreign investment. These elements are intertwined with the host country's developmental stage, spanning a spectrum from incentives, market, and institutional structures to the presence of skilled labor in key sectors and infrastructure quality.

An attractive nearshoring hub typically has a well-established developmental framework, including skilled labor, robust infrastructure, a stable economy and institutions, and tax incentives.

Labor Skills: Labor costs play a vital role in nearshoring decisions. Low and competitive labor costs in a potential host country can make nearshoring economically attractive. Additionally, the availability of skilled labor and workforce stability are crucial factors impacting a company's ability to find suitable talent for its operations.

Regarding talent suitability, Table 1 provides a summary of the proportion of skills-to-jobs that are mismatched, both over and underqualified. Mexico exhibits the highest indicators in two categories, potentially resulting in productivity losses. However, in the second category of overqualification, Mexico's low indicator presents opportunities for attracting and retaining high-skilled jobs.

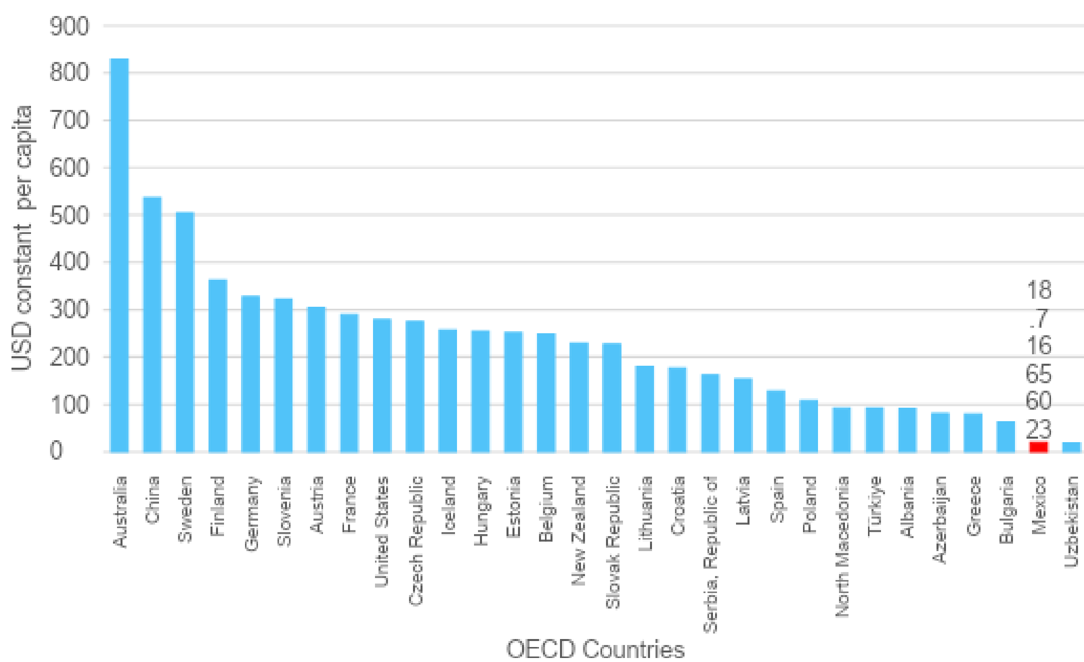
Table 1. Mismatch of skills for jobs in selected OECD countries

Country	Qualification mismatch	Overqualification	Under qualification
Mexico	**50.5**	**38.7**	**11.8**
Turkey	43.0	29.1	14.0
Spain	41.0	21.6	19.3
Canada	38.2	15.5	22.7
Lithuania	34.7	22.3	12.3
OECD – Total	**34.4**	**16.5**	**17.8**
Korea	32.9	12.1	20.7
United States	32.9	15.8	17.2
Czech Republic	16.7	8.1	8.6

Source: OECD, World Indicators of Skills for Employment.

Infrastructure: The quality of infrastructure, including transportation networks, ports, and telecommunications, is essential for efficient supply chain management. Countries with well-developed infrastructure can be more appealing for nearshoring. It also entails the safety of their connectivity and its resilience to the effects of climate change.

Graph 1. Total investment in land transportation infrastructure per capita



Source: OECD, Indicators of Investment in Infrastructure.

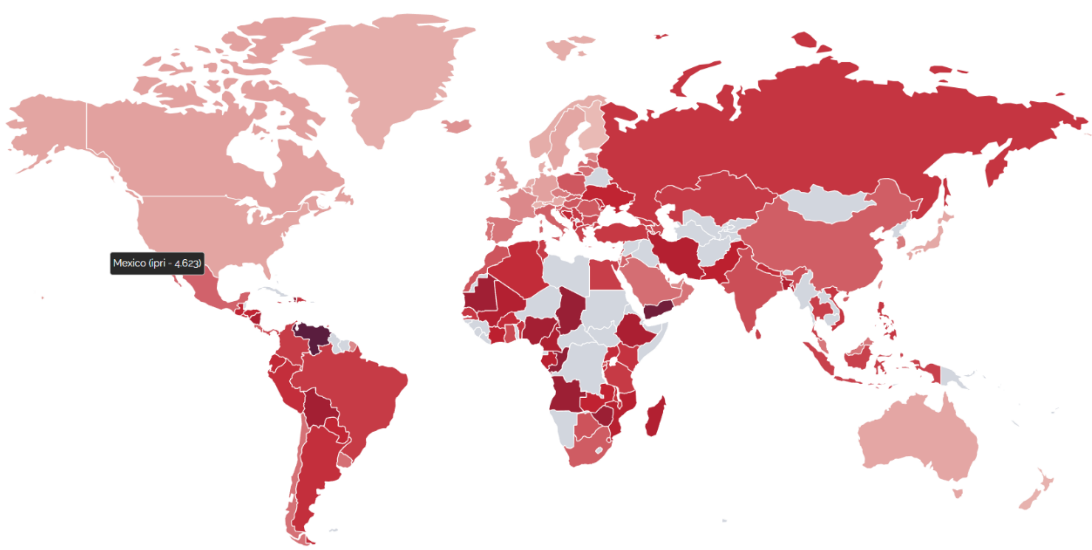
Institutions-governance: It refers to the rule of law and the certainty that is provided to investors. It also provides a conducive environment for business operations and reduces operational risks. Companies seek countries with transparent and stable governance to reduce uncertainties and risks—for example, intellectual property protection and fiscal stability. The protection of Intellectual Property Rights (IPR) mainly signifies leadership in fostering innovation, especially during the Fourth Industrial Revolution.

These property rights are instrumental in stimulating creativity and progress and play a pivotal role in combating corruption. The correlation between the IPR and the Corruption Perception Index at .954 highlights the significance of robust property rights frameworks in promoting transparency and integrity in nearshoring practices and global business operations.[30]

Figure 1 displays Mexico's position compared to the rest of the world with a score of 4.623, below the scores of Chile and Uruguay, scoring 6.138 and 6.086, respectively. Additionally, the figure illustrates a relatively high IPR concentration in North America, excluding Mexico, Western Europe, and Australia. Despite its potential, Mexico encounters several challenges concerning IPR, such as:

- Enforcement and piracy
- Lack of awareness about its importance for business
- Inadequate legal framework for the digital age
- Border control issues such as entry of counterfeit products
- Data protection and cybersecurity

Figure 1. International Property Rights Index by Country



Source: International Property Rights Index by the Property Rights Alliance.

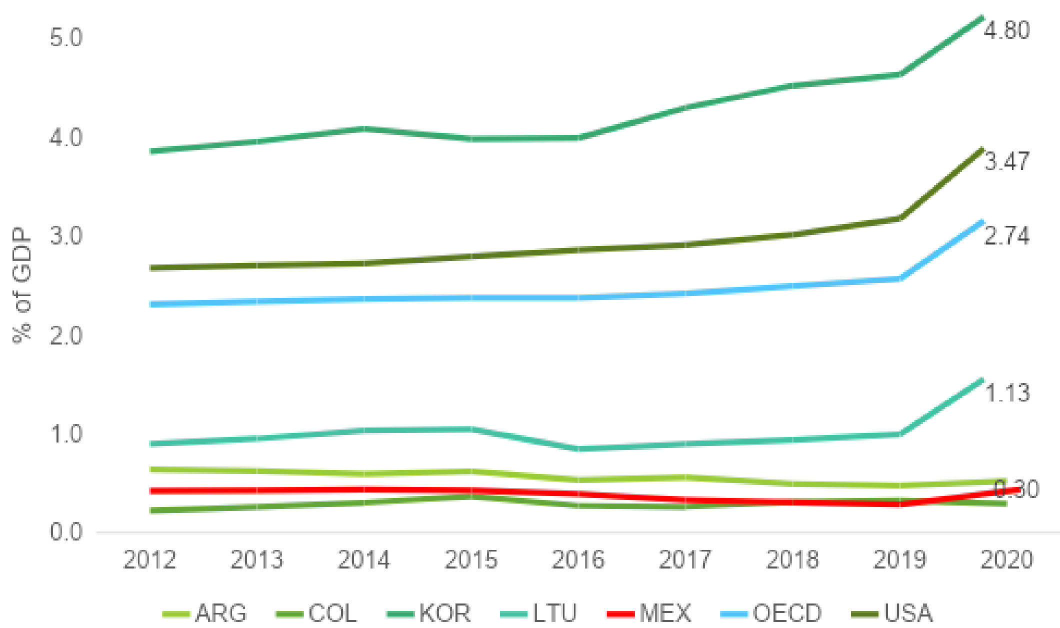
R&D: nearshoring R&D activities can contribute to a company's competitive advantage by leveraging global talent, accessing new markets, enhancing innovation capabilities, and achieving cost efficiencies. Moreover,

[30] International Property Rights Index by the Property Rights Alliance.

Nearshoring allows companies to tap into different regions' expertise and innovation capabilities. Governments can facilitate collaboration between the private sector, academia, and research institutions.

Graph 2 presents the share of GDP spending on R&D in selected OECD countries. Notably, South Korea and the U.S. stand out as leaders, surpassing the OECD average. However, apart from these two countries, the overall trend remains relatively stable. Specifically, Latin American countries such as Argentina, Colombia, and Mexico lag in R&D investment, with their shares nearly converging at 0.30% in 2020. Additionally, Lithuania's moderate share is noteworthy as it has enabled the country to attract benefits from hosting Nordic FDI.

Graph 2. Share of GDP Spending on R&D



Source: OECD, Gross domestic spending on R&D.

Currency exchange rates: Exchange rate fluctuations can significantly affect the cost advantage of nearshoring. A stable or favorable exchange rate can improve cost predictability and reduce currency risk for foreign companies operating in the host country. Currency exchange rates are critical in nearshoring decisions, as they directly impact the cost competitiveness, profitability, and financial stability of companies operating in foreign countries. Companies need to monitor and assess exchange rate movements and consider exchange rate dynamics when evaluating the viability of nearshoring locations. These are some examples of how exchange rates affect the decision-making of nearshoring:

- **Cost of labor**: One of the primary reasons companies consider nearshoring is to take advantage of lower labor costs in the host country. However, the cost advantage can be affected by currency exchange rates. If the local currency of the host country depreciates against the company's home currency, the cost advantage of nearshoring increases. This means that the company's home currency can buy more units of the host country's currency, making labor and other costs in the host country relatively cheaper.

- **Long-Term Contracts and Agreements**: Nearshoring often involves entering into long-term contracts and agreements with local suppliers, partners, and customers. Exchange rate stability is essential for companies to predict costs accurately and plan their financial commitments over the contract duration. Companies may seek host countries with stable exchange rates or implement contract clauses to address currency fluctuations.

- **Competitive Positioning**: Exchange rates can also influence a company's competitive positioning in the international market. If the host country's currency appreciates significantly, it may erode the cost advantage of nearshoring. Conversely, a favorable exchange rate can improve the company's pricing competitiveness against competitors operating in higher-cost regions.

Graph 3 displays the evolution of pre- and post-pandemic exchange rates of 1 USD in Mexican pesos. The exchange rate peaked during the first and second quarters of the COVID-19 pandemic, which meant that goods and investments in Mexico were more competitive in that period. The following months show a stabilization of the exchange rate, and starting in the second half of 2022, the Mexican peso has increased its value.

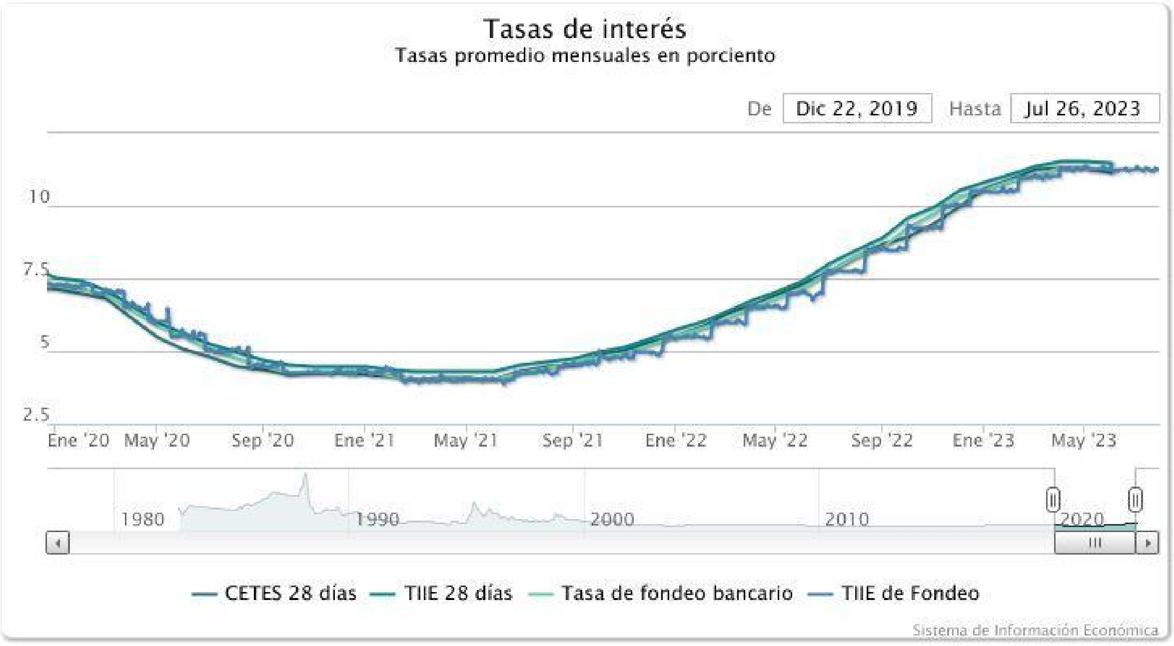
Graph 3. Evolution of Exchange Rate USD/MXN, Jan-18 to Jul-23

Source: Bank of Mexico, System of Economic Information.

Interest rates: This element plays a significant role in the financial aspect of nearshoring decisions. Higher rates can increase the cost of borrowing for companies looking to finance their nearshoring investments. This can make nearshoring projects more expensive, impacting the overall financial feasibility of relocating operations. Conversely, lower interest rates may encourage companies to pursue nearshoring as funding new projects or expansions becomes more affordable.

Interest rates are relevant for nearshoring decisions as they can significantly impact the cost of financing in a foreign location, influencing the attractiveness and feasibility of nearshore investments. Graph 4 illustrates the evolution of average interest rates before and after the pandemic. From the onset of the pandemic until May 2021, the stock market experienced the advantage of lower interest rates, resulting in a positive surge in the demand for debt for investment. However, starting from 2022 to the present, interest rates have risen due to inflationary pressures.

Graph 4. Evolution of Average Interest Rates, Dec-19 to Jul-23



Source: Bank of Mexico, System of Economic Information.

Tax incentives: Taxation plays a crucial role, as it directly and indirectly affects the costs and profits of foreign firms that decide to invest in a host country. According to the literature, taxation is a general category that describes the tax system for firms and individuals, the tax rates of each tax, discounts and credits, fiscal stability and transparency, and tax regimes. Countries and regions within can fit themselves alongside a spectrum of simplification-sophistication. (See Appendix 1.1. for the difference and relevance between tax structures and rates).

According to the United Nations Conference on Trade and Development (UNCTAD)[31], many countries have actively encouraged FDI by implementing measures to facilitate the entry of foreign investment projects, guaranteeing repatriation of investment and profits, and providing mechanisms for settling investment disputes. Tax incentives are also a part of these efforts.

[31] United Nations Conference on Trade and Development (UNCTAD). Tax Incentives and Foreign Direct Investment: A Global Survey, 2000.

However, the role of incentives in promoting FDI has been debated, with mixed results in their effectiveness. While they are not the primary factor in attracting investment (which is influenced more by fundamental determinants such as market size, raw materials, and skilled labor), tax incentives can play a more significant role for certain foreign investors, like export-oriented or footloose investors[32]. Additionally, tax incentives may have a more pronounced impact when comparing countries with similar attractive features.

FDI incentives are defined as measurable advantages governments give to specific enterprises or categories of enterprises to encourage desired behavior. These incentives aim to increase the rate of return of FDI projects or reduce their costs and risks, including other objectives such as:

Encourage regional investment and development: This may include supporting rural development, creating industrial centers away from major cities, and reducing over-urbanization and environmental hazards.

Promote sectoral investment. In specific sectors or industries that are considered crucial for development. For example, mining, industrial parks, export-led activities, and new technologies.

Boost performance enhancement. Such as export promotion, employment/skills training, domestic value-added, and the location of headquarters. Free trade zones are an example of these kinds of incentives.

Attract transfer of technology. Some countries have specific incentives directed towards R&D activities and technology projects. These incentives may include:

- Tax-exempt technology development funds
- Tax credits for R&D expenditures
- Exemptions for import duties and sales taxes on machinery and equipment used for technology projects

[32] Footloose investor: foreign investor who can easily move their operations or capital across international borders in response to changing economic conditions, market dynamics, or government policies. These investors are not tied down to specific locations due to factors such as heavy physical infrastructure requirements or strong dependencies on local resources.

Several instances of **tax incentives** include:

- Lowered tax rates applied to profits
- Tax holidays, which entail exemptions from taxation for a designated period
- Accelerated depreciation methods
- Reduced tariffs on imported machinery and raw materials
- Deductions from gross earnings to calculate income tax
- Investment and reinvestment allowances
- Deductions from social security contributions

High-income countries often employ financial incentives such as grants and subsidized loans. In contrast, low-income and middle-income countries tend to use fiscal incentives that do not require upfront government funds. Among fiscal incentives, tax incentives are crucial in reducing the tax burden on enterprises and encouraging investment in specific projects or sectors.

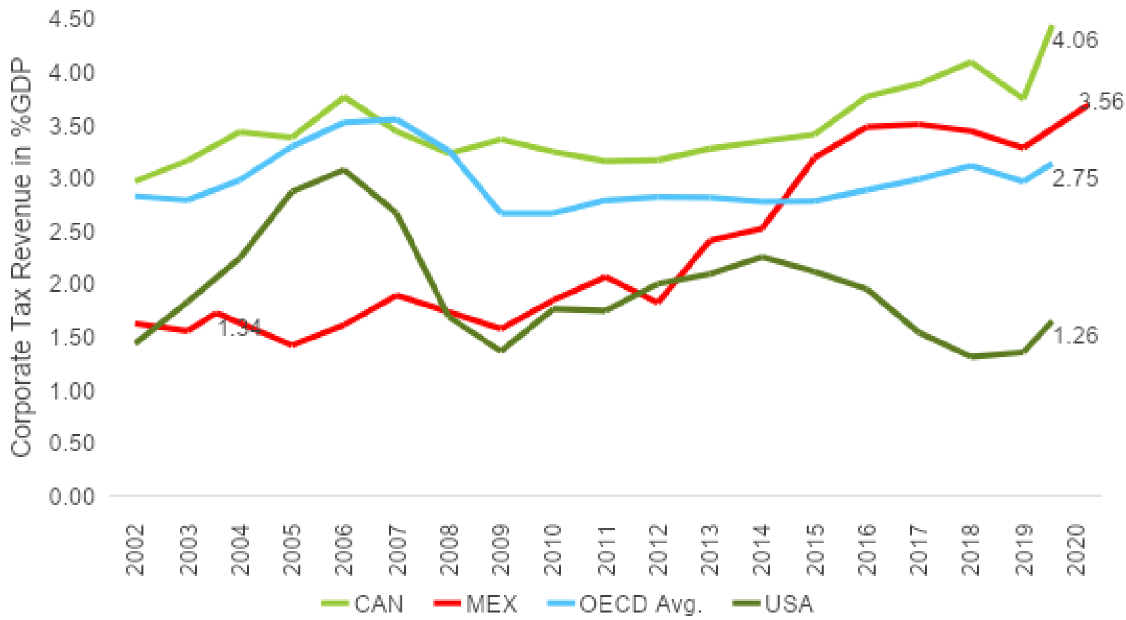
Tax incentives are typically subject to certain conditions, and governments design special incentive regimes outlining the tax benefits and critical restrictions. While tax incentives are recognized as significant policy tools to attract FDI, their effectiveness can vary depending on the circumstances and targeted types of investments.

Research on FDI highlights that favorable tax policies and incentives can attract foreign companies to establish operations in specific locations. However, the decision-making process is not solely based on tax rates, types of taxes, or incentives; it also considers the seamless integration of tax systems with the countries expected to attract investment.

Moreover, tax-related decisions also consider the "value for money" that firms receive from their tax contributions. This refers to how these lawful tax payments are reflected in improving factors described as "Conditions of development" in the earlier section, such as enhanced public services, infrastructure, services, and human capital.

Graph 5 displays the evolution of Corporate Taxes in North America, expressed as a share of GDP and compared to the OECD average. Mexico and Canada's shares surpass the OECD average and are at least 3 percent higher than the USA's (1.26%). Notably, Mexico's trend has shown a sustained increase since 2012, with a brief stabilization period between 2016 and 2019.

Graph 5. Evolution of Tax Revenue from Corporate Tax, expressed in %GDP



Source: OECD, Tax on Corporate Profits.

Mexico's primary source of tax revenue is derived from Taxes on income, profits, and capital gains, followed by taxes on goods and services. Conversely, the lowest contributions come from tax categories on property, payroll, workforce, and social security contributions. Notably, from 2010 to 2020, individual tax revenue exceeded that of corporate tax. Both sources of revenue have similar contributions as a share of GDP, amounting to 3.7 and 3.6 percent, respectively.

Table 2. Mexico's tax revenue as share of GDP by tax category

	Billion MXN					% of GDP				
	1990	2000	2010	2019	2020	1990	2000	2010	2019	2020
Total tax revenue	**102.0**	**767.2**	**1 716.2**	**3 995.7**	**4 148.7**	**12.1**	**11.5**	**12.8**	**16.3**	**17.8**
1000 Taxes on income, profits and capital gains	**34.7**	**276.5**	**683.6**	**1 694.1**	**1 768.2**	**4.1**	**4.1**	**5.1**	**6.9**	**7.6**
1100 Of individuals	..	..	313.5	829.5	872.6	..	..	2.3	3.4	3.7
1200 Corporate	..	..	246.7	803.6	832.1	..	..	1.8	3.3	3.6
1300 Unallocable between 1100 and 1200	34.7	276.5	123.4	61.0	63.4	4.1	4.1	0.9	0.2	0.3
2000 Social security contributions	**17.2**	**138.2**	**277.5**	**552.1**	**576.0**	**2.0**	**2.1**	**2.1**	**2.3**	**2.5**
2100 Employees	..	..	..	..	..	..	..	..	..	..
2200 Employers	..	..	..	..	..	..	..	..	..	..
2300 Self-employed or non-employed	..	..	..	..	..	..	..	..	..	..
2400 Unallocable between 2100, 2200 and 2300	17.2	138.2	277.5	552.1	576.0	2.0	2.1	2.1	2.3	2.5
3000 Taxes on payroll and workforce	**1.8**	**11.2**	**36.9**	**101.3**	**105.5**	**0.2**	**0.2**	**0.3**	**0.4**	**0.5**
4000 Taxes on property	**1.9**	**14.0**	**39.0**	**79.3**	**79.2**	**0.2**	**0.2**	**0.3**	**0.3**	**0.3**
4100 Recurrent taxes on immovable property	1.0	9.9	25.7	50.5	52.7	0.1	0.1	0.2	0.2	0.2
4200 Recurrent taxes on net wealth	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
4300 Estate, inheritance and gift taxes	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
5000 Taxes on goods and services	**44.8**	**319.6**	**651.9**	**1 504.3**	**1 544.2**	**5.3**	**4.8**	**4.9**	**6.2**	**6.6**
5100 Taxes on production, sale, transfer, etc	44.2	310.3	630.1	1 486.8	1 527.7	5.2	4.6	4.7	6.1	6.5
5110 General taxes	26.6	189.6	504.5	933.3	987.5	3.2	2.8	3.8	3.8	4.2
5111 Value added taxes	26.6	189.6	504.5	933.3	987.5	3.2	2.8	3.8	3.8	4.2
5120 Taxes on specific goods and services	17.5	120.7	125.6	553.4	540.1	2.1	1.8	0.9	2.3	2.3
5121 Excises	10.1	86.2	86.1	471.0	469.0	1.2	1.3	0.6	1.9	2.0
5200 Taxes on use of goods and perform activities	0.7	9.3	21.8	17.5	16.5	0.1	0.1	0.2	0.1	0.1
5300 Unallocable between 5100 and 5200	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
6000 Other taxes	**1.6**	**7.7**	**27.4**	**64.7**	**75.7**	**0.2**	**0.1**	**0.2**	**0.3**	**0.3**
Non-wastable tax credits										
Non-wastable tax credits against 1000	..	..	40.3	50.6	50.5	..	..	0.3	0.2	0.2
Transfer component	..	..	9.7	1.3	0.5	..	..	0.1	0.0	0.0
Tax expenditure component	..	..	30.6	49.4	50.0	..	..	0.2	0.2	0.2

Source: Ministry of Finance, Economic Department, processed by OECD. Revenue Statistics 2022, The Impact of COVID-19 on OECD Tax Revenues.

2. TAX REGULATION IN MEXICO: DESCRIPTION AND CHALLENGES

Mexico stands out as a country that offers advantages due to its strategic geographical location, economic relationship with the U.S., and open economy that guarantees access to international markets—all of the above benefit foreign investment to establish itself in Mexico.

However, there are different schemes to establish investment in Mexico, from the incorporation of companies to direct investment in existing companies. The Foreign Investment Law and its regulations (national coverage) and the International Investment Agreements (international coverage) are among the main instruments that regulate investment in Mexico.

Also, Mexican companies that have foreign investment in any proportion are registered in the National Registry of Foreign Investment (*Registro Nacional de Inversiones Extranjeras*, RNIE), as well as individuals and legal entities that habitually conduct commercial acts in Mexico and trusts that grant rights in favor of foreign investment.

Under the Political Constitution of the United Mexican States (CPEUM), all nationals (Mexicans) are obligated to contribute to the country's public expenditure in the manner provided by law. Likewise, the principle of legal symmetry and the recognition of rights and obligations to foreigners bind them to pay taxes in the country if they meet the requirements established by law.

In Mexico, contributions are classified into four different groups: taxes, social security contributions, improvements, and duties, the first two being the most common. Social security contributions (related to human capital) are characterized as contributions made for the benefit of social security provided by institutions that supplement the state in fulfilling its obligations in this area.

On the other hand, taxes are those contributions payable by natural persons (individuals) or legal entities (companies) that carry out specific legal acts or events outlined in the regulations; these, in turn, are classified into two large groups: direct and indirect taxes. Direct taxes are those that tax wealth, income, or the increase in the patrimony of individuals. That is to say, they tax what is owned or possessed, such as income. An example of this tax is the income tax (ISR), which, according to data from the Ministry of Finance, represented 59.64% of the collection in fiscal year 2022.

Indirect taxes, conversely, are not levied on wealth or assets but on the goods and services consumed, with a primary taxpayer and a secondary taxpayer, who is obliged to pass on the tax as an intermediary. The clearest examples of these are the Value Added Tax (VAT), the Excise Tax on Production and Services (IEPS), and The Tax on New Automobiles (ISAN). These taxes accounted for 35.52% of total revenue in 2022.

In summary and as mentioned in Chapter 1, the taxes discussed above mainly account for tax revenue collection in 2022 and 2023, as shown in Table 3.

Table 3. Tax Revenue Collection, Mexico. 2022-2023

YEAR	MONTH	TOTAL TAX REVENUE	TAX INCOME (CORPORATE AND PERSONAL)	VAT	IEPS
2022	January	379,832	213,537	112,237	41,459
2022	February	280,259	161,682	83,939	19,154
2022	March	460,827	328,686	95,492	14,416
2022	April	337,036	200,455	108,734	12,764
2022	May	292,258	166,761	107,297	3,205
2022	June	301,992	188,457	113,851	- 16,081
2022	July	291,993	165,068	129,796	- 18,796
2022	August	280,655	166,927	108,997	- 11,514
2022	September	277,607	161,732	83,881	15,787
2022	October	269,511	160,411	75,158	13,975
2022	November	295,967	161,788	96,078	19,248
2022	December	344,683	198,337	106,343	23,915
2023	January	432,529	253,174	123,342	41,795
2023	February	309,317	184,746	87,807	21,426
2023	March	411,373	284,913	82,207	27,649
2023	April	448,232	281,340	121,248	29,300
2023	May	323,067	174,034	100,024	33,463
TOTAL		**5,737,138**	**3,452,048**	**1,736,431**	**271,165**

Amounts in millions of Mexican Pesos.
Source: Ministry of Finance.

2.1 Direct Taxes: Income Tax (ISR)

It is considered a direct tax, i.e., levied directly on the taxpayer and their increase in assets (income) or wealth. Now, according to the Income Tax Law, individuals and corporations (companies) residing in Mexico are obliged to pay the tax concerning all their income, regardless of the location of the source of wealth from which it originates, residents abroad with a permanent establishment and residents abroad with income from a source of wealth in Mexico. In other words, the Law taxes both residents in Mexico and residents abroad, and in particular, the latter in the two following cases:

1. When they have a permanent establishment in the country; and,
2. When they obtain income with a source of wealth in national territory.

It is essential to mention that the state, through the imposition of ISR, is governed under the tax principles of worldwide income and source of wealth; this is to obtain the taxing power concerning the persons who are considered residents in the country and those who are not but obtain income within the national territory. (See Appendix 2.1. for Tax Principles of Worldwide Income and Source of Wealth)

Derived from the concept of tax residency, in a globalized world, it has been observed that different operations or structures, such as nearshoring, could result in double tax residency or double taxation on the same income. Likewise, the configuration of a permanent establishment in the country could cause double taxation for those foreign residents who decide to invest or bring capital to Mexico.

One of the advantages of Mexico is that there are currently approximately sixty-two treaties to avoid double taxation with different countries, which allow the exchange of goods and services to enjoy the elimination of international double taxation. Most of these treaties are based on the OECD Model Convention, so they consider the same type of operations and income obtained to create benefits and avoid double taxation between countries.

Likewise, the Mexican tax legislation contemplates mechanisms to avoid this double taxation, such as crediting corporate taxes paid abroad against the tax payable by the Law (ISR).

This crediting can be given to companies in two cases: 1) taxes paid on dividends and 2) taxes paid on other income taxed in Mexico. It is essential to mention that specific requirements must be met to apply this crediting mechanism, which are as follows:

1. Accumulate as income the tax paid abroad and the income that generated it.
2. Comply with the crediting limitation (up to the tax that would have been paid in Mexico.
3. Carry out the tax crediting within the following ten fiscal years in which the tax was generated abroad until it is exhausted.
4. That the tax paid abroad has the nature of income tax.

For example, an American company distributing a dividend to a Mexican company would imply taxation in both countries; for the Mexican resident company (which pays the tax in the U.S. and Mexico), it would be a double taxation on the same income. In this sense, the provision for crediting income tax paid abroad could be applied, crediting the corporate tax paid in the U.S. against the tax determined in Mexico up to the amount resulting from applying the local Mexican provisions to such dividends. In other words, up to the tax that could have been incurred in Mexican territory.

As previously mentioned, the Income Tax Law taxes corporate entities (companies) and individuals, whether they are residents abroad or in Mexico, as subjects of the tax. Now, concerning the purpose (what is taxed by the Law), it would be sufficient to consider the name of the tax. However, the law refers to tax "income" and not to "revenues," which could be understood as profits or benefits.

Now, taxation in Mexico focused on companies is standardized for all industries, except the manufacturing or maquila industry, which could have a different tax treatment with certain benefits.

Although income is taxed under the Income Tax Law, it is not the taxable base of the tax since the law allows decreases and deductions of certain concepts, providing a mechanism for determining the taxable base, called "taxable income."

This means that, although the purpose of ISR is to tax the taxpayer's positive increase in net worth, the truth is that, for purposes of its determination, it is necessary to observe those components (positive and negative) that together allow defining the taxpaying capacity of the companies. In such a way that what results from this sum of positive and negative components is the base on which the general ISR tax rate in Mexico will be applied, which currently and since the fiscal year 2010 is at 30%, this taxable base or tax result is obtained as follows:

(+) Accruable income

(-) Authorized deductions

(-) Employees' statutory profit sharing (PTU)

(=) Taxable income

(-) Tax loss carryforwards from prior years

(=) Tax result

As can be seen, the only positive component is the taxable income, and the negative elements are the authorized deductions, PTU, and losses pending reduction from previous years.

On the other hand, and based on what was previously mentioned, ISR is a tax that, by its nature, is paid annually and within the first three months following the closing of each fiscal year.

Within the different obligations of the companies, this mechanism is proposed for the prepayment of the annual income tax through such payments, using for such purposes a profit from the immediately preceding fiscal year. Under this procedure, it is intended to anticipate the annual tax payment based on a percentage derived from the last tax profit obtained in the previous five years, called the "profit coefficient." This profit coefficient is determined by dividing the previous year's taxable income by the nominal income (taxable income minus inflation). It is used as a parameter or estimate of the probable profit obtained in the year. It should be noted that these prepayments are made every month and must be paid no later than the 17th day of the month immediately following the month to which they correspond.

The mechanics for determining the provisional payments are as follows:

(+) Nominal revenues for the period (month)

(*) Utility ratio

(=) Profit basis for provisional payment

(-) PTU paid (OCT paid)

(-)Tax loss carryforwards

(=) Taxable income for provisional payment

(*)ISR rate (30%)

(=) ISR for the period (provisional payment)

Enterprises or companies are obliged to pay the tax, considering for such purposes the total income in cash, goods, services, credit, or any other type of income obtained during the fiscal year.

As defined at the beginning, income should be understood as any positive increase in the net worth of individuals or legal entities. However, the Law itself contemplates cases in which the increase in a company's net worth does not mean income per se, such as a capital increase or the recognition of profits generated by subsidiaries. This income is known as income not subject to income tax. The Law excludes it for economic and commercial purposes since it refers directly to contributions or payments made by the company's shareholders in connection with the operation of the company.

Likewise, the Law contemplates other types of income, which it calls "non-cumulative". These include concepts that fall within the definition of what should be understood as income. However, due to their economic nature, they should not be added to the base to determine the tax. For example, dividends or profits that a legal entity in Mexico receives from another resident in the country will be non-cumulative because they have already been covered through their payment of an ISR when another company distributed them; therefore, they should not be added to the base as a cumulative income for the legal entity that receives them.

In summary, income for income tax purposes is classified as depicted in Table 4.

Table 4. Income Classification in Mexico for Tax Purposes

CONCEPT	EXAMPLES
Accruable income	– Positive increases in cash equity credit, goods and services – Annual adjustment for cumulative inflation
Non-object revenue	– Capital increases – Payment of loss by its shareholders – Premiums earned on subscription of shares – Method of Participation
Non-cumulative income	– Dividends or profits received from residents in Mexico – Income from economic support granted by the state

Source: Own elaboration with information from the Income Tax Law, Mexico.

It is essential to mention that, for tax purposes in Mexico, inflation is an important factor in the determination of the annual tax since, according to legal regulations, the generalized increase in prices (inflation) must be recognized when taxpayers grant credits or have debts pending collection or payment, respectively.

It should be noted that there are two cases in which inflation impacts the determination of the tax, and following them, there may be an annual adjustment on credits or debts.

- Annual cumulative inflation adjustment (cumulative income): When the taxpayer has more debts than the credits it grants, it generates cumulative income for inflation since it is favored by being financed with debts not modified over time in their principal value.
- Deductible annual inflation adjustment (authorized deduction): On the contrary, when a taxpayer grants more credits than the debts it holds, it generates a yearly deductible inflation adjustment since it is affected by the increase in prices and because it is financing third parties without seeing a favorable modification to the principal value of its granted credits.

However, in Mexico, there are different moments in which it is obliged to accrue and declare the increased income:

1. At the moment in which the fiscal vouchers (invoice or invoice) are issued;
2. The good is delivered or shipped, or the service is rendered, and:
3. The collection of what has been agreed upon is collected or is enforceable.

If any of these scenarios occur for any company, income must be accrued for the monthly provisional payments and annual tax purposes.

To understand the components of obtaining companies' tax results in Mexico, it is essential to analyze them individually.

a) Employees' statutory profit sharing (PTU)

PTU is a constitutional right that arises from the need to recognize that the effort and working capital must participate in the profits generated by the employees.

The PTU is a mechanism to improve the distribution of wealth and to distribute the profit to those who generate it, which is why, as an obligation of the persons who have employees in their charge, 10% of the tax profits generated must be distributed year after year.

There are exceptions to this obligation, and the following individuals do not have to comply with this obligation:

1. Newly created companies, during their first year of operation;
2. Newly created companies dedicated to the development of new products during their first two years of operation;
3. Extractive industry companies during the exploration period.

Concerning this participation, and since it is a mandatory payment by operation of law, the law allows the portion paid to employees to be deducted from the taxable income earned during the year.

It is necessary to clarify that although the PTU paid can be deducted from the taxable income, it is not an authorized deduction but a reduction that directly affects the taxable income the taxpayers generate.

b) Authorized deductions

Authorized deductions are all those expenditures (expenses, costs, and investments) that the law allows to be deducted from taxable income because they are strictly indispensable for the operation and performance of the activities of a business or company.

The reduction of these expenditures is restricted to those the Law allows and where it complies with the requirements and formalities established therein. Therefore, the Law does not encourage the rejection of the reduction of all expenditures made by the taxpayer. Still, it requires that these be those that the Law establishes and considers necessary for the operation and obtaining of income by the taxpayer, as well as that they meet the indispensable requirements to prove them.

These authorized deductions are as follows:

1. Refunds, discounts, or rebates received
2. Cost of goods sold
3. Net expenses
4. Investments
5. Bad debts
6. Labor-management contributions
7. Interest payable
8. Deductible annual inflation adjustment (credits greater than debts)
9. Pension fund contributions

The taxpayer can deduct practically any expense, cost, or investment in this order of ideas. However, it must comply with specific requirements such as issuing a tax receipt that covers the operation (invoice), keeping accounting records of the operation, and being strictly indispensable, among others.

Now, it is essential to identify the difference between a cost, an expense, and an investment:

- Cost: Cost is the value of the resources (either cash or goods) that are delivered as a consideration in exchange for a good or service acquired by companies or enterprises to convert them into income. For tax purposes, the cost of goods sold includes the amount of goods acquired, returns, discounts and rebates, and expenses incurred to obtain the goods and make them ready for sale.

- Expense: Any expenditure related to the taxpayer's activity and not part of the cost or investments.

- Investment: For tax purposes, investments are all those fixed assets, expenses, and deferred charges (intangibles), as well as expenditures made in pre-operating periods. Unlike costs and expenses, investments are partially made deductions since they are made through applying maximum percentages authorized by law per year.

In this sense, the expenses, investments, and costs that meet the tax requirements of the Law will constitute authorized deductions, which will form a fundamental part of the determination of income tax since they intervene as a direct decrease in the taxable base (taxable income). (See Appendix 2.2. for further information about Authorized Deductions by Concept).

It should be noted that certain deductions have requirements that must be complied with; otherwise, the expenses could be considered non-deductible. Likewise, the Law contemplates payments that by operation of law will not be deductible at any time, or their deductibility will be deferred.[33]

b.1) Interests

Entities may deduct the interest they pay to calculate their taxable income and, ultimately, their tax burden. Deductions of interest borne by corporations are limited depending on the purpose of the debt security from which they arise:

- Interest on Borrowed Capital: Interest paid on borrowed capital is deductible if the borrowed funds have been invested for business

[33] Article 28 of the Income Tax Law: non-deductible expenses.

purposes and are strictly indispensable for the operation of the business.

- Unpaid Accrued Interest on Loans from Individuals: In the case of unpaid accrued interest on loans derived from credits granted by individuals, the totality of such claim will not be deductible.
- Thin Capitalization: Interest derived from the taxpayer's debts exceeding three times its stockholders' equity arising from debts contracted with related parties residing abroad will not be deductible.
- Net interest: Net interest (interest payable minus interest receivable) that exceeds 30% of the result of adding to taxable income the accrued interest payable in the year, as well as the total amount deducted in the year for fixed assets, expenses, and deferred charges, will not be deductible.

b.2) Bad debts

Bad debts refer to debts that a company or entity owns that cannot be recovered due to nonpayment by the debtors. The Income Tax Law allows companies to deduct losses from bad debts if certain specific requirements are met:

- Prescription of credits: Losses for uncollectible credits can be deducted when the statute of limitations period corresponding to the credit has expired. In other words, if the time established by law has elapsed and the debtor has not made payment, the receivable is considered uncollectible, and a deduction is allowed.
- Notorious practical impossibility of collection: In addition to the statute of limitations, the law allows the deduction when there is a "notorious practical impossibility of collection." This situation arises when it is demonstrated that the debtor cannot make payment, even before the statute of limitations expires. The law establishes several cases in which a notorious practical impossibility of collection is considered to exist:
    - When the debtor is declared bankrupt or in bankruptcy.
    - For credits greater than 5,000 pesos that do not exceed thirty thousand Investment Units (UDIS) if collection is not achieved within one year from the delinquency.

- For credits greater than thirty thousand UDIS, when collection efforts are exhausted, and a final resolution issued by the authorities is obtained.

In the latter two cases, the taxpayer must inform the debtor in writing of the deduction to be made for the debtor to accrue the amount of the debt as uncovered income in its records.

b.3) Employee benefits

In this respect, there are advantages concerning their taxation, one of which is that their income from benefits granted by employers will be exempt from paying ISR up to a certain amount, depending on their concept.

The Law establishes conditions for these exempt benefits to have an impact in the form of tax deductions for companies:

- Exempt income for workers: According to the Income Tax Law, certain benefits provided to workers are exempt from paying income tax up to certain limits. For example, social security is an income exempt from income tax for the worker, as well as benefits granted annually, such as a Christmas bonus. This means that workers do not have to pay taxes on this income until it reaches a specific amount determined by law.
- Limited deductibility for employers: In connection with exempt benefits provided by employers to workers, the law establishes that payments made by employers that are also exempt income for workers will not be deductible in full. Instead, they will only be deductible up to a certain amount calculated by applying a factor of 53% or 47%, as applicable:
    - If the benefits granted by the company to the employees exceed the benefits of the previous fiscal year, the amount that can be deducted will be up to 53% of those exempt benefits.
    - If the benefits do not increase from one tax year to another, the deductible amount will be up to 47% of those exempt benefits.

As can be seen, some deductions are unattractive to foreign investment since they "limit" the free destination of costs, expenses, and investments and undoubtedly affect mainly the commercial decision-making process but also increase the tax base. (See Appendix 2.3. for Tax Obligations and Tax Attributes).

c) *Transfer prices*

According to information generated by various international organizations such as the World Trade Organization (WTO), it is known that around 80% of global trade is generated through value chains, mainly operated by multinational business groups. This volume of local and international transactions between countries generates essential opportunities for business groups to create and optimize channels established and used to increase business operations, revenues, and profits, optimize costs, and reduce risks for these groups.

When two independent persons or companies carry out transactions between them involving, for example, the purchase/sale of a good or product, the provision of a service, the use and enjoyment of a technological platform or trademark, or any other transaction involving the collection or payment of a price, amount or consideration, within a free market, both parties will analyze and negotiate the conditions related to each of the transactions. Such an operation assumes that each party will agree to carry out the commercial transaction on a self-benefiting basis; therefore, the substance of such a transaction is carried out by free market conditions.

However, when such persons or companies are part of a national or multinational business group, there may be conditions exogenous to the participants that lead to the negotiations between them not corresponding to the individual benefit of each of the parties but to a collective or group benefit, unilaterally affecting the obtaining of real profits or earnings associated with the agreed transaction. From a tax perspective, such circumstances could modify, voluntarily by the business corporations, the basis of income or expenses decided upon by the parties.

To verify the nature of transactions between companies or individuals that are part of the same corporate group, commonly referred to as related parties, Mexico has established a regulatory framework that allows the authorities to verify that transactions between related parties where the agreed amount, price or consideration agreed between them (i.e., the transfer price between them) has been determined according to market circumstances, or as would have been agreed by independent third parties in similar or comparable transactions.

Currently, the Income Tax Law provides valuation mechanics upon which taxpayers who carry out transactions between related parties must verify whether their transfer prices comply with the arm's length principle. Such mechanics or transfer pricing methods are consistent with worldwide guidelines, so Mexico, in essence, has taken as a technical basis for reviewing intercompany transactions (when the operation is in multinational corporate groups) internationally approved processes.

The fundamental premise on which the transfer pricing rules are based is that intercompany transactions must be carried out as if they were agreed with or between independent third parties, leading to a much more in-depth review beyond the price, amount, or consideration agreed upon.

In this regard, foreign investors need to remember the term "mark-to-market transactions" to establish in advance, within their technical and financial projects, the value of their transactions with related parties so as not to generate contingencies with the Mexican tax authorities.

The global regulatory framework on transfer pricing has undergone significant changes in recent years, mainly due to the publication of the Base Erosion and Profit Shifting (BEPS) program issued by the OECD in 2016.

The proposal to reach more standardized compliance processes at an international level and the development of new documentation mechanisms with much more detailed and complete information on the operation of business groups has been well received within the international community, and Mexico has not been the exception.

Mexican transfer pricing regulations were among the first at the international level to incorporate the recommendations issued by the OECD. This has allowed Mexico to be one of the countries where more experience has been generated in developing, implementing, and controlling intercompany transactions.

These processes have led the country to become a benchmark in the region in this area. For this reason, multinational and national business groups in Mexico have faced and continue to face significant challenges concerning the speed with which Mexican tax authorities take global references in regulatory, taxation, and dispute resolution processes.

Mexican companies that actively participate in intercompany operations must have more significant interaction in the processes carried out centrally in different jurisdictions where their parent companies or the companies with the highest hierarchy within the internal structures of the groups to which they belong may be located. Documentary supports, internal financial information, projections, and strategic plans, among other aspects, cannot be alien to the knowledge of the administrations of Mexican companies since the times in the audit processes and the amount of information that the authorities would compile as a result of the agreements signed with other tax jurisdictions, place the companies in complex circumstances with possible areas of internal opportunity for the management of the regulatory compliance in transfer pricing matters. (See Appendix 2.4. for Transfer Pricing Auditing and Obligations).

d) *Effective income tax rates*

As a result of the 2020 tax reform, the following provision was added to the Federal Tax Code (*Codigo Fiscal de la Federación, CFF*): "*Article 33.- The tax authorities, to better comply with their faculties, shall comply with the following:*

I. They will provide free assistance to taxpayers and citizens seeking to:

i) To periodically and generally inform taxpayers of the Income Tax Law, reference parameters concerning profits, deductible concepts, or effective tax rates presented by other entities or legal entities that obtain income from the performance of their activities based on the industry to which they belong.

The dissemination of this information will be done with the purpose of measuring tax risks."

As a result, the tax authority, in order to facilitate and encourage voluntary compliance by taxpayers, has published these effective income tax rates at which it considers that, by sector or industry, taxpayers should find on average.

The authority itself defines this effective tax rate as "...that which is calculated with the information stated in the last annual income tax return corresponding to the fiscal year in question, by dividing the amount of income tax incurred in the corresponding fiscal year by the accruable income of such year...”

In short, the effective rate represents the percentage at which taxpayers should tax their income concerning their deductions and abatements.

2.2 Indirect Taxes

As mentioned at the beginning of this chapter, indirect taxes are those levied on the goods and services consumed, with a primary taxpayer and a secondary taxpayer, who is obliged to pass on the tax as an intermediary. In other words, they are applied directly to expenses and consumption.

Indirect taxes in Mexico are VAT, IEPS, and ISAN. These taxes in Mexico are mainly characterized by the fact that they are levied on specific acts or activities:

- VAT: Sale of goods, rendering of services, use or enjoyment of goods, and imports of goods.
- IEPS: Sale and importation of particular goods and rendering of special services.
- ISAN: Sale of new automobiles and importation of automobiles.

However, these activities are mainly conditioned to one guideline: that they are carried out within the national territory. Therefore, we could say that, unlike income tax, which is based on the principle of worldwide income to tax taxpayers, indirect taxes are only levied on those who carry out acts or activities within the territory. Their taxing power does not depend on a tax residence or place of incorporation but on the tax principle of territoriality.

The tax principle of territoriality or source is a criterion of taxation that responds to the idea that the state can tax and exercise its taxing power within the limits of its territory; that is to say, it can tax every person who performs certain acts within the country. The tax laws in Mexico operate exclusively in the national territory and only for actions carried out within it.

To understand what is intended to be taxed in Mexico through these indirect taxes, it is necessary to understand the nature of each one, why and what precisely each tax is levied, and the existing rates and quotas for each one.

a) Value Added Tax (VAT)

VAT is a tax directly levied on consumption and acts or activities carried out in Mexican territory, specifically, the sale of goods, the rendering of services, the temporary use or enjoyment of goods, and the importation of goods.

According to the mechanics of the Law, this tax is covered by the final consumers, and the taxpayer is obliged to transfer it to the authority, replacing the latter in its collection task.

It is essential to mention that the mechanics for the determination of the tax is through the application of "crediting," which consists of subtracting the creditable tax (the one paid by the taxpayer to a third party) from the amount resulting from applying to the values indicated in the Law the corresponding rate according to the case (the VAT charged), either 0% or 16%.

In Mexico, there are three different VAT rates and goods or services that are exempt from paying this tax:

- 16% rate: This is the general rate and applies to all types of goods or services, except those that apply 0% or are exempt from payment.

- 0% rate: This rate represents a benefit for specific sectors and industries in Mexico, mainly the primary economic sector since the VAT on particular acts or activities will always be zero, having the right to credit all the tax transferred on expenses incurred and taxed at 16%; some of the goods and products that are considered for this rate are animals and non-industrialized vegetables, patent medicines, products intended for human consumption, water, books, precious metals, milling, milk pasteurization, agriculture, and livestock, among others.

- Exempted: unlike the 0% rate, the acts and activities exempted from VAT do not represent a direct benefit but an indirect benefit since the consumer is granted exemption from the tax; however, the person who obtains tax-exempt income loses the right to credit the tax transferred for the expenditures made and identified with those acts. For example, medical services provided by specialists are exempt from VAT. However, the doctor who obtains the income loses the right to credit VAT on his expenses that are taxed (16% or 0%) and related to his activity. Other activities exempted from the tax payment are the sale of land, the sale of used personal property, books sold by their author, teaching services, interest collected from banks, and the sale of books, among others.

b) Special Tax on Production and Services (IEPS)

The IEPS is a unique and extra fiscal tax, i.e., its purpose is not merely taxation or tax collection. According to the Supreme Court of Justice of the Nation, additional fiscal taxes "[...] In addition to the collection purpose that taxes have to defray the public expenditure of the Federation, they can also serve as effective instruments of the financial, economic, and social policy that the State is interested in promoting, guiding, channeling, encouraging or discouraging certain activities".

In the case of the IEPS, it is intended to tax the sale and importation of goods considered harmful to society, whether health or ecological, and the provision of certain services of the exact nature.

The goods taxed by this tax are as follows:

1. Alcoholic beverages and beer
2. Alcohol, denatured alcohol, and uncrystallizable honey
3. Tobacco, cigars and cigarettes
4. Automotive fuels
5. Energizing drinks
6. Flavored drinks
7. Fossil fuels (propane, butane, diesel, turbosine, etc.)
8. Pesticides
9. Non-staple foods

It is also levied on services related to betting games and raffles and services provided through a public telecommunications network.

This tax is payable on the 17th day of the month immediately following the month to which the transactions correspond. Likewise, the IEPS has different rates and fees depending on the good that is sold or imported or the service provided, as shown in Table 5.

Table 5. IEPS Rates

GOODS OR SERVICES	MINIMUM RATE	MAXIMUM RATE
Beverages with alcohol and cherry	26.5%	53%
Manufactured tobacco and cigarettes	30.4%	160%
Concentrated beverages, popsicles, essential syrups, or flavor extracts	25%	
Flavored beverages, concentrates, and powders. syrups, essences, flavor extracts	$ 1.3996	
Automotive fuels	$4.9987	$6.5055
Fossil Fuels (Propane, butane, diesel, and jet fuel and other kerosene)	$8.9451	$60.1766
Pesticides	6%	9%
Non-basic foods (snacks, chocolates and derivatives, iced sweets, others)	8%	
Games and sweepstakes	30%	
Public networks and telecommunications	3%	

Source: Ministry of Finance.

c) *Tax on New Automobiles (ISAN)*

This tax is particular in the subjects it taxes since its only purpose is to collect the tax when a new automobile is sold for the first time to the consumer by the manufacturer, assembler, authorized distributor or dealer, or in its case, the definitive importation of automobiles into the country provided that it is imported by persons other than those listed above.

The application of this tax consists of a rate depending on the price range of the automobile, except for cargo trucks, to which a 5% tax rate will be applied directly to its price or value.

Table 6. ISAN Rates

Lower limit	Upper limit	Fixed fee	Rate to be applied on the excess of the lower limit
0.01	313,163.32		2%
313,163.33	375,795.92	6,263.16	5%
375,795.93	438,428.76	9,394.94	10%
438,428.77	563,693.73	15,658.19	15%
563,369.74	From	34,447.90	17%

Source: Ministry of Finance.

d) *Taxation of human capital*

One of the most critical assets of a company is its working capital or personnel. In Mexico, labor relations are regulated by the Federal Labor Law, the Social Security Law, and the Law of the National Workers' Housing Fund (*Instituto del Fondo Nacional para la Vivienda de los Trabajadores*).

These laws establish an obligation of employers to grant individual employment contracts to each person with whom they have a subordinate employment relationship; however, not having such a contract does not mean that workers have not acquired labor rights for those with whom they have a subordinate employment relationship. One of the primary obligations of an employer in Mexico is to pay social security contributions to its employees, which are considered contributions. Now, it is essential to mention that because of the income earned by the workers and paid by the employer, three main contributions are generated:

1. Social Security contributions
2. Income tax withholdings for wages and salaries
3. State payroll tax

Income tax withholdings for wages and salaries are withholdings that employers are obliged to make to their employees and are made and caused in the month of payroll payment to the employee. These withholdings may vary according to the income level of the employees and may range from a rate of 1.92% to 35%.

On the other hand, the state payroll tax or personal income tax is a local tax. It may vary according to where the subordinate personal work is performed or where the employer has activities, ranging from 1% to 3% (see Appendix 2.5. for Minimum Wages and Social Security Contributions).

e) Local taxes

Under the Mexican Constitution, Mexicans must contribute to the public expenses of the federation, the states, Mexico City, and the municipality where they reside proportionally and equitably as provided by law.

In this sense, the federal states are empowered and can collect additional contributions in addition to federal taxes. Each state, by its constitution, Income Law, and Treasury Law, establishes taxes payable by individuals. The most relevant are payroll tax, lodging tax, prize-winning tax, gambling games online, property acquisition tax, tax for commercial and industrial activities, and green taxes. (See Appendix 2.6. for selected local taxes).

2.3 Tax Incentives

a) Tax incentive for the northern and southern border region

In 2018 and 2020, decrees were issued granting fiscal stimulus in Mexico's northern and southern border regions. Both stimuli are focused on improving the economy of the areas; however, they were issued for different reasons.

The stimulus in the northern border region was issued with the primary objective of reducing violence, increasing employment in the border region, and improving competitiveness to the U.S. market. This incentive is effective until December 31, 2024. It consists of granting taxpayers who obtain income in the northern border region a tax credit equivalent to one-third of the ISR caused in the fiscal year and the provisional payments only for this income. It is important to mention that as a requirement to apply this incentive, taxpayers must obtain at least 90% of their income in this zone, and it must be income from business activities (commercial, industrial, agricultural, or livestock).

In addition, the decree grants a tax credit equivalent to 50% of the VAT rate to those taxpayers who carry out acts or activities within the territory located in the northern border region; that is, the rate is reduced from 16%

to 8%. The northern border region is comprised of 43 municipalities located in six states. (See Appendix 2.7.)

On the other hand, the Stimulus Decree for the Southern Border Region was issued to promote the economic and social development of an area considered politically and economically marginalized and promote the competitiveness and well-being of the region's inhabitants. This stimulus has the same benefits as the stimulus for the northern border region, comprised of 23 municipalities in four states. (See Appendix 2.7.).

b) Stimulus region welfare

On June 5, 2023, a stimulus program came into effect to encourage investment in a region of the country called the Isthmus of Tehuantepec, promoting competition in international markets and the mobilization of merchandise. The participating municipalities are, in total, five: two from the State of Oaxaca (Salina Cruz and San Blas Atempa) and three from Veracruz (Coatzacoalcos, San Juan Evangelista, and Texistepec).

The stimulus consists of reducing costs and facilitating the operation of companies to turn them into a tool that reduces inequality in the region, as well as attracting new investments in the development of priority and productive vocations, focusing on the electrical and electronics, automotive, auto parts and transportation equipment, medical devices, pharmaceutical, agribusiness, electric power generation, and distribution equipment, as well as metals and petrochemicals industries.

Now, the tax incentive consists of the following:

1. The tax credit granted to the companies is not considered as accumulated income for income tax purposes.
2. Tax credit equivalent to 100% of the ISR during three fiscal years for those taxpayers that obtain income in the participating municipalities and for the listed activities.
3. Tax credit of 50% to 90% of the ISR in the three fiscal years after the first three fiscal years.
4. Immediate deduction of investments up to 100% of the original amount during six fiscal years.
5. Tax credit of 100% of the VAT during the four years following the effective date of the tax incentive.

As can be seen, this tax incentive is designed to encourage investment in Mexico and support economic growth in the southern part of the country. It is an attractive benefit for certain sectors and industries since it practically grants a tax credit of 100% of the taxes (VAT and ISR) for three years and the reduction of these in subsequent years.

c) Tax incentives for nearshoring activities

On October 11th, 2023, a Decree was published granting tax incentives to key export industry sectors, consisting of the immediate deduction of the investment in new fixed assets and the additional deduction of training expenses.

Tax incentives are appointed for companies and individuals engaged in the production, elaboration, or industrial manufacturing of goods exported. These goods include food products, fertilizers, electronic components, medical machinery, engines, and electrical and electronic equipment, among others (see Appendix 2.8. for benefited sectors).

The tax incentive allows taxpayers to immediately deduct the investment in new fixed assets acquired by December 31, 2024. The deduction percentages vary depending on the type of goods, and these percentages are applied instead of those established in the Income Tax Law.

The maximum percentages allowed for the deduction of investments are:

1. **For specific types of assets**:
   - 86% for electric vehicles such as cars, buses, trucks, forklifts, and trailers.
   - 86% for aircraft used for agricultural fumigation.
   - 88% for personal computers, servers, printers, and related equipment.
   - 89% for tools and molds.
   - 89% for machinery and equipment used in research and technology development.

2. **For machinery and equipment used in different activities**:
   The percentage varies depending on the critical activity in which they are used. These percentages range from 56% to 83%.

Furthermore, taxpayers who opt for this incentive must keep the investments in use for at least two years, with some exceptions. Additional incentives are established for increasing employee training expenses, allowing for an extra deduction equivalent to 25% of the increase in training expenses incurred for each worker. This increase is calculated as the positive difference between the training expenses in the fiscal year in question and the average training expenses incurred in the fiscal years 2020, 2021, and 2022, even if there were no training expenses in those years.

The decree imposes restrictions on certain taxpayers, such as those with firm tax credits, tax issues, tax presumptions, those who are in temporary procedures for restricting digital seal use, and others.

2.4 Foreign Trade Taxes

Mexico is currently an active member of the World Trade Organization and the World Customs Organization and, therefore, has customs guidelines similar to those of the other member countries; however, the range of incentives for companies producing and manufacturing export goods or providing export services is interesting and attractive due to the reduction of tariffs that can be obtained. In addition to the diversity of Free Trade Agreements and Treaties subscribed by the country and the tariff benefits that this entails, it is interesting and attractive for the reduction of tariffs that can be obtained, including the non-payment of taxes such as VAT and IEPS. (See Appendix 2.9. for the fundamental concepts of Foreign Trade Taxes and Promotion and Investment Programs).

The taxes mainly related to foreign trade operations are as follows:

Value-Added Tax (VAT): The VAT Law establishes the obligation to pay value-added tax to individuals or legal entities that import and sell goods or services in Mexico. In the case of the importation of tangible goods, the customs value used to determine the General Import Tax (IGI) will be considered, plus the amount of the latter tax and other taxes payable on the importation. Finally, from the sum of these concepts, the VAT will be determined by applying a rate of 16%.

Tax on New Automobiles (ISAN): The obligation to pay taxes on new automobiles applies to individuals or legal entities that definitively import automobiles into the country as long as they are persons other than the manufacturer, assembler, authorized distributor, or dealer in the vehicle industry. ISAN is payable in the case of the definitive importation or sale of new automobiles. Individuals and corporations that dispose of new automobiles and definitively import automobiles into the country are obligated to pay the tax on new automobiles established in the ISAN Law.

Special Tax on Production and Services (IEPS): Obliges to pay the excise tax on production and services to those who definitively import goods such as alcoholic beverages, beer, and cigars, among others mentioned in this law, into Mexican territory. IEPS on the importation of alcoholic beverages, cigarettes, and gasoline.

The IEPS is caused by importing goods such as beverages with alcoholic content, cigarettes, and gasoline and is determined by applying the general rates established by the Law.

General Import and Export Taxes (IGI and IGE): Introducing and extracting goods to the national territory will generate the General Import Tax and General Export Tax. This tax will be calculated according to the General Import and Export Tax Tariff. It will depend on the correct tariff classification of the goods the customs broker determines and the customs regime in question.

The General Import Tax may be:

- Ad-valorem: when expressed in percentage terms
- Specific: when expressed in monetary terms per unit of measurement
- Mixed: when it is a combination of the two previous ones

Prerogatives: These are the contributions established by Law for using or exploiting goods in the Nation's public domain and for receiving services rendered by the State in its public law functions. (See Appendix 2.10. for information and documentation regarding activities of importing and exporting in Mexico)

a) Free Trade Agreements

Mexico currently has a network of 14 Free Trade Agreements with 50 countries (FTAs), 30 Agreements for the Reciprocal Promotion and Protection of Investments (RPPIs) with 31 countries or administrative regions, and nine limited-scope agreements (Economic Partnership

Agreements and Partial Scope Agreements) within the framework of the Latin American Integration Association (ALADI).

The following are among the main objectives for signing trade treaties and agreements:

- Removing trade barriers
- Promoting fair competition conditions
- Increasing investment opportunities
- Providing protection - intellectual property
- Laying down a controversial solution plan
- Promoting bilateral, trilateral, regional, and multilateral cooperation

Setting up preferential tariffs, provided that the assets 1) qualify as being sources from the region, according to the rules of origin signed in the Treaty, and 2) they have the documentation proving their origin.

b) Transfer prices

In the case of operations between related parties, it is worth mentioning that for the importations made in Mexico by an affiliated company, it must prove that such relation does not affect the price and, consequently, the tax basis for determining taxes to the foreign trade.

The customs legislation defines a relation between persons, for this Law, in the following cases:

- If one is in the position of Director or responsible for one company or another
- If they are legally acknowledged as business partners
- If they have an employer and worker relation
- If a person has ownership, control, or possession, directly or indirectly, of 5% or more of the shares, stocks, contributions, or outstanding shares and with a right to vote in both
- If one of them has direct or indirect control of the other
- If a third party directly or indirectly controls both people
- If together they control directly or indirectly a third party
- If they are from the same family

In a sale between two related persons, the circumstances of the sale must be analyzed, and the value of the transaction shall be accepted when this relation has not influenced the price when the following is proven:

- The price was adjusted according to the standard pricing practices where the seller adjusts the sale prices for buyers unrelated to him.
- With the price, all the costs are recovered, and a benefit consistent with the global benefits obtained in a representative period with the sale of goods of the same kind or class is made.

It is worth noting that the circumstances mentioned above correspond to an analysis from the customs standpoint, which involves an analysis of each of the imported products or supplies between the related parties.

Also, the implications regarding the transfer prices are from the income tax standpoint, as was already mentioned, which, unlike the customs standpoint, only addresses the analysis of transactions for every good. In turn, from the income tax standpoint, any transaction between related parties can be the transfer of tangible or intangible goods, including technology, brands, services, and financing, among others.

3. COMPARATIVE ANALYSIS IN SELECTED COUNTRIES AND REGIONS

This section brings together essential information about using tax incentives, including various strategies, systems, and tax rates to attract FDI from wealthier economies to those with moderate or lower incomes, using nearshoring practices.

The first case study focuses on the North American region, particularly exploring the dynamic connection between the United States (U.S.) and Mexico. This case is significant due to the notable income gap between these neighboring countries, the extensive shared border, and the opportunities that emerge from their proximity. We approach this case from a unique angle, examining how U.S. States play as potential competitors for FDI attraction to Mexico as a whole and individual Mexican States (mainly those with manufacturing economic advocacy).

The second case study takes us through North and Eastern Europe, shedding light on the economic interactions between Baltic and Balkan countries and their Nordic (high-income) counterparts. Investigating this region holds particular significance for Mexico for several compelling reasons. First, the close geographical proximity to Western Europe is a crucial factor. Second, a considerable number of these countries share characteristics of middle and middle-high-income economies, much like Mexico and other Latin American peers.

Additionally, these nations underwent liberalization policies during the 1990s and 2000s, aligning with Mexico's developmental path, further exacerbated in the first decade of the 2000s, particularly between 2005 and 2006, in which most OECD countries reduced their Corporate Income Tax rates[34]. Moreover, what further enhances their relevance is their successful pursuits in nearshoring Information Technology (IT) and innovation-driven economic activities. Lithuania and Estonia are two countries that exemplify this; the latter is recognized for its high competitiveness due to favorable tax rates[35].

[34] Nida Abdioglu et al. 2016 “The Effect of Corporate Tax Rate on Foreign Direct Investment: A Panel Study for OECD Countries”. SS. 599/610.
[35] Tax Foundation, October 2022. “International Tax Competitiveness Index 2022”.

Lastly, the third case delves into the FDI patterns and appeal emanating from Pakistan, offering a noteworthy reference for nearshoring practices when juxtaposed with Mexico. This comparison is grounded in Pakistan's significant FDI connections with the U.S. and its standing as a middle-income economy. Furthermore, its geographical and economic proximity to China and a robust tax framework add to its relevance. Through this case, we can discern diverse strategies beyond tax incentives that can bolster FDI, like embracing an industrial policy harmonized with high-income investment trends (for example, Electric Vehicles, EVs) and its prioritization of trade-oriented infrastructure (i.e., transportation, rails, and connectivity).

3.1 North America: United States – Mexico

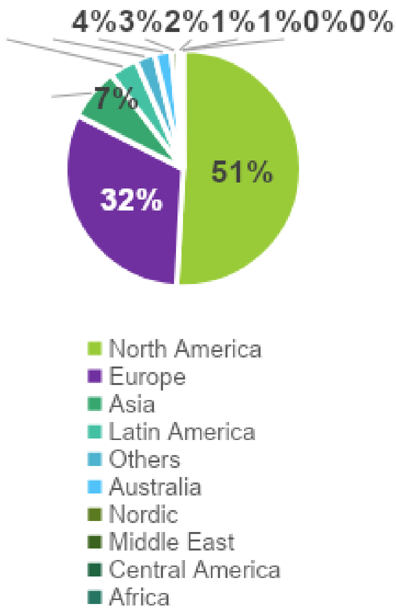
Mexico as FDI Recipient

The North American region, consisting of two high-income countries (Canada and the United States) and one upper middle-income country (Mexico), ranks as the world's most competitive economic zone. In 2019, these countries collectively generated a GDP value of $24.4 trillion USD, with the U.S. accounting for 88%, Canada 7%, and Mexico 5% of the total. The region has a combined population of 489.08 million inhabitants. All three countries are members of the OECD and rank among the top 20 economies in the world based on GDP value in 2023 U.S. dollars, with the U.S. in 1st place, Canada in 9th, and Mexico in 14th place (between Australia 13th, and Spain 15th).[36]

To start assessing Mexico’s FDI and evolution, Graph 6 illustrates the cumulative FDI inflows from 2014 to 2022 by their respective regions of origin. The data reveals a significant nearshoring relevance for Mexico: over half of Mexico's FDI is derived from the U.S. and Canada, with a substantial portion stemming specifically from the U.S. This strong economic connection with North America underscores Mexico's role as an attractive nearshoring destination for two of the largest economies in the world.

[36] International Monetary Fund. GDP Current Prices. Billions of U.S. Dollars.

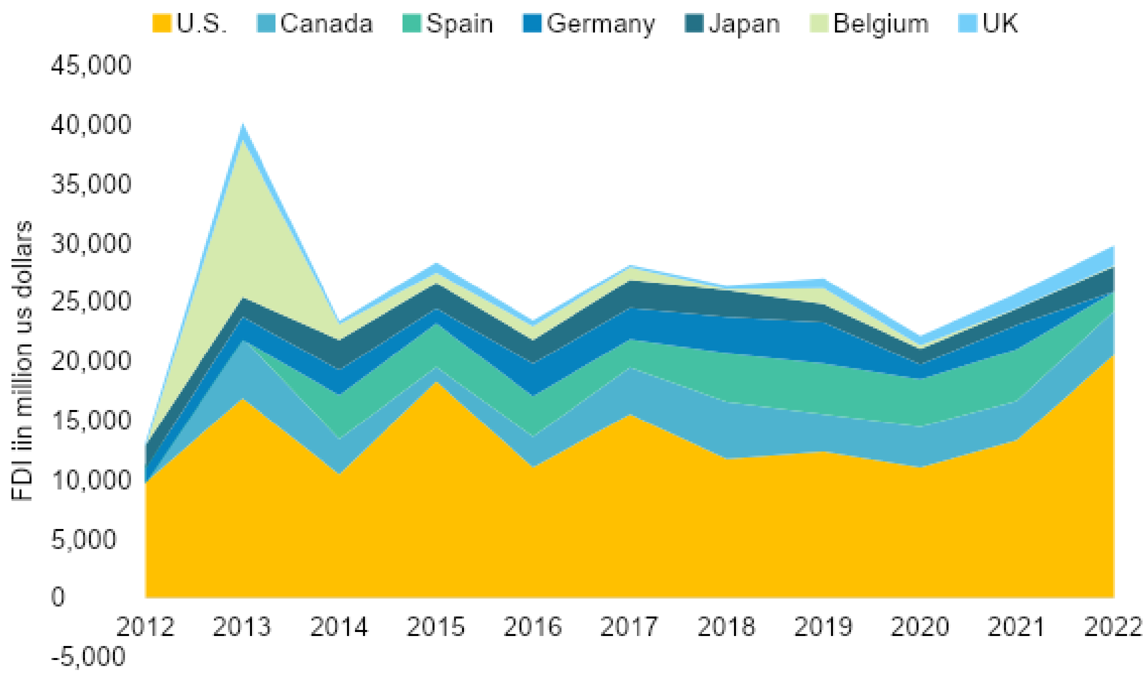
Graph 6. FDI Share in Mexico by World Region (2014-2022)



Source: Ministry of Economy, Mexico.

When analyzing the top FDI contributors in Mexico, it is evident that the U.S. leads the group among a roster of over 50 investing nations by directing the highest amount of FDI. Notably, the annual FDI inflows have displayed a persistent pattern, hovering within the range of 25 to 30 million USD per year, registered as new investments. Graph 7 shows a discernible trend emerging as the U.S. share has grown. This surge has corresponded with a notable decrease in FDI contributions from Europe, particularly Spain and Germany, indicating a shifting landscape of investment preferences. (See Appendix 3.1.)

Graph 7. Evolution of FDI in Mexico from top contributors



Source: Ministry of Economy, Mexico.
Note: Top contributors were determined based on the countries whose share of FDI from 2014-2022 accumulated 80% of total FDI into Mexico.

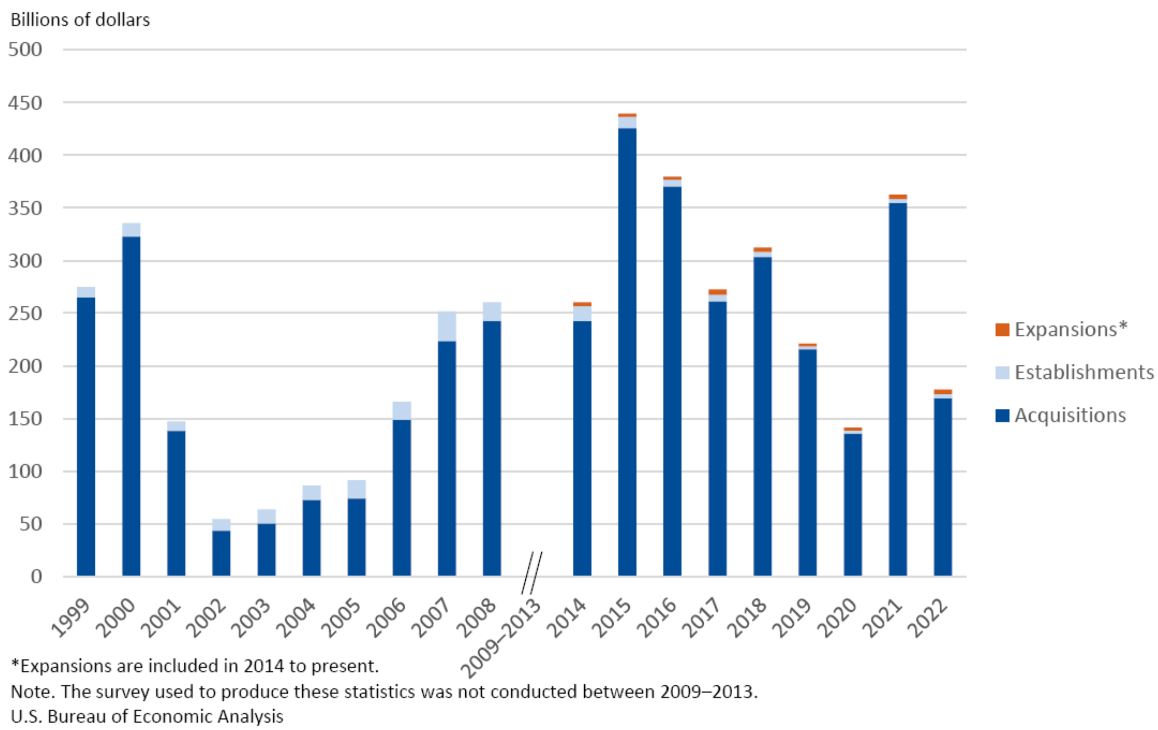
In conclusion, this section explored which countries are the most relevant FDI contributors in Mexico, focusing on the U.S. and the trends between the two. Further analyses are recommended to understand the causes for FDI withdrawal from other partner countries -mostly European- and the opportunities for integrating investment strategies with the U.S. and Europe, as these two regions share the most significant value of shared foreign investment. The following section deepens the analysis of U.S. FDI, given that the country consistently ranks as the number one worldwide FDI destination. The section aims to explore the country's role concerning Mexico, not only as an FDI source but as a possible competitor.

U.S. as FDI Recipient and Investor

The Bureau of Economic Analysis (BEA) of the U.S. categorizes FDI by acquisition, establishment, or expansion. According to the BEA, from 1999 to 2022, the largest type of new FDI in the U.S. has been acquisitions. In

2022, the new FDI from acquisitions totaled $177 billion, which was 51% lower than in 2021 ($362.6 billion). An estimated $8.1 billion came from Greenfield investment expenditures, in which manufacturing accounted for $5.3 billion or 65%, mainly led by computer and electronic products ($1.8 billion). As shown in Graph 8, the U.S. average annual new FDI has been greater in the 2014-2022 period than between 1999-2008.[37]

Graph 8. New FDI by type, 1999-2022



Source: New Foreign Direct Investment in the United States, 2022. Bureau of Economic Analysis.

Graph 9 contrasts U.S. investment abroad and FDI in the U.S. by region. It depicts the source and destination of investment in billions of dollars across high, low, and middle-income regions. For instance, it reveals that the U.S. holds a robust economic partnership with Europe, among the displayed regions, with similar investment value either in FDI received and invested abroad.

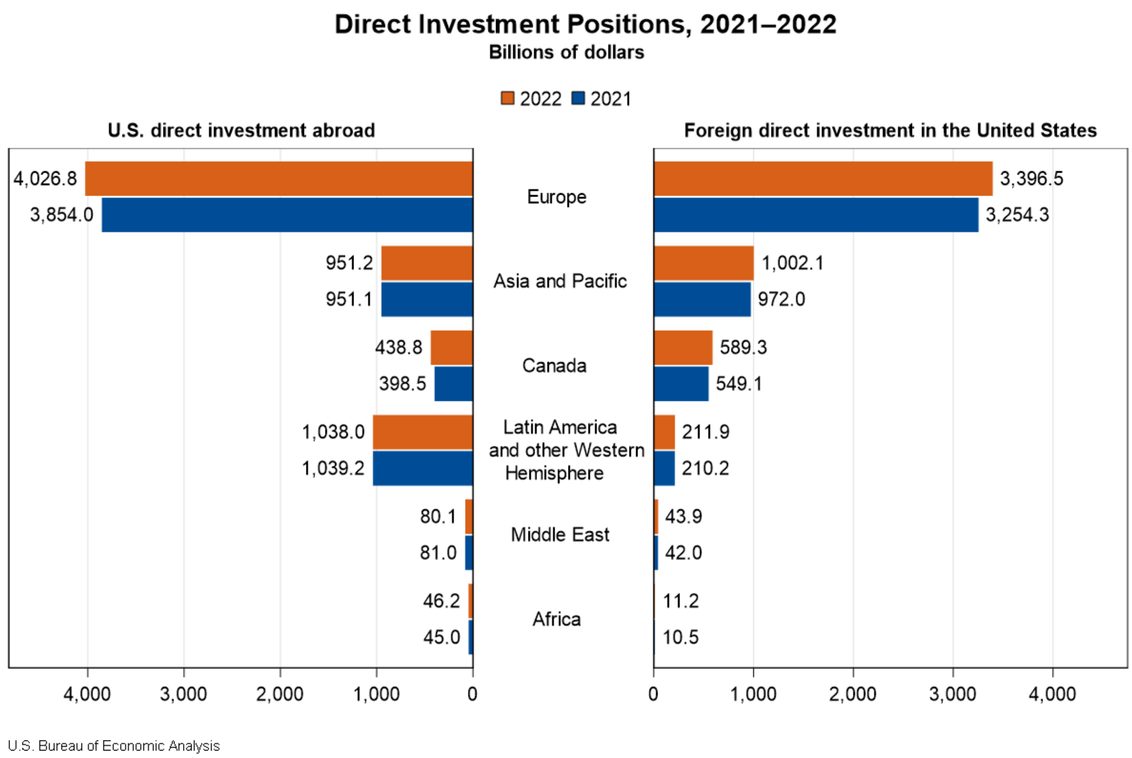
For the U.S.-Mexico trade dynamic analysis, it is also relevant to highlight that the U.S. FDI to Latin America is 8.3% higher than that to Asia-Pacific

[37] New Foreign Direct Investment in the United States, 2022. Bureau of Economic Analysis.

but is nearly four times smaller than the investment between the U.S. and Europe. These observations provide the basis for at least two hypotheses:

- The high value of direct investment between high-income regions (U.S. and Europe) suggests that certain development conditions could outweigh the proximity of closer regions to the U.S., such as Latin America (e.g., availability of skilled labor, IPR protection, technology development, etc.).
- Despite the geographical proximity between Latin America and the U.S., the direct investment is only higher by 8.3% compared to the Asia Pacific region. This indicates that factors other than physical distance have held more weight in investment decisions.

Graph 9. Direct Investment from and in the U.S. by region, 2021-2022



Source: Bureau of Economic Analysis, Direct Investment by Country and Industry, 2022.

As previously mentioned, the U.S. has consistently held the position as the primary recipient of FDI stock since 1990, signifying its central role in the FDI landscape.[38] This emphasizes the importance of examining the possible competition that might arise from various U.S. States to attract FDI resources, particularly in relation to the states in the Mexico-U.S. border, which offer a stimulating business environment for cross-border manufacturing[39] (see Appendix 3.2. about Trade between the U.S.-Mexico Border).

Before analyzing U.S. trends on FDI and its impact on Mexico's FDI opportunities, it is relevant to provide more context regarding U.S. domestic factors that could be considered when assessing the trade partnership between the U.S. and Mexico. First, the U.S. economic, trade, and labor policies, such as the Infrastructure Investment and Jobs Act (IIJA, 2022), have underscored the relevance of improving domestic conditions for attracting FDI and boosting the domestic economy, particularly for the creation and relocation of manufacturing jobs in the U.S.[40]

Only in 2019, 10.1% of U.S. employment was attributable to FDI, contributing significantly to domestic economic development. Not to mention the relevance that FDI has shown, positively impacting manufacturing productivity of 7.8%.[41] This indicates a shared interest with Mexico in attracting and maintaining FDI that translates into more and better jobs in the manufacturing sectors, representing a possible competition between these two countries.

U.S. States as FDI Recipients and Local Fiscal Policy

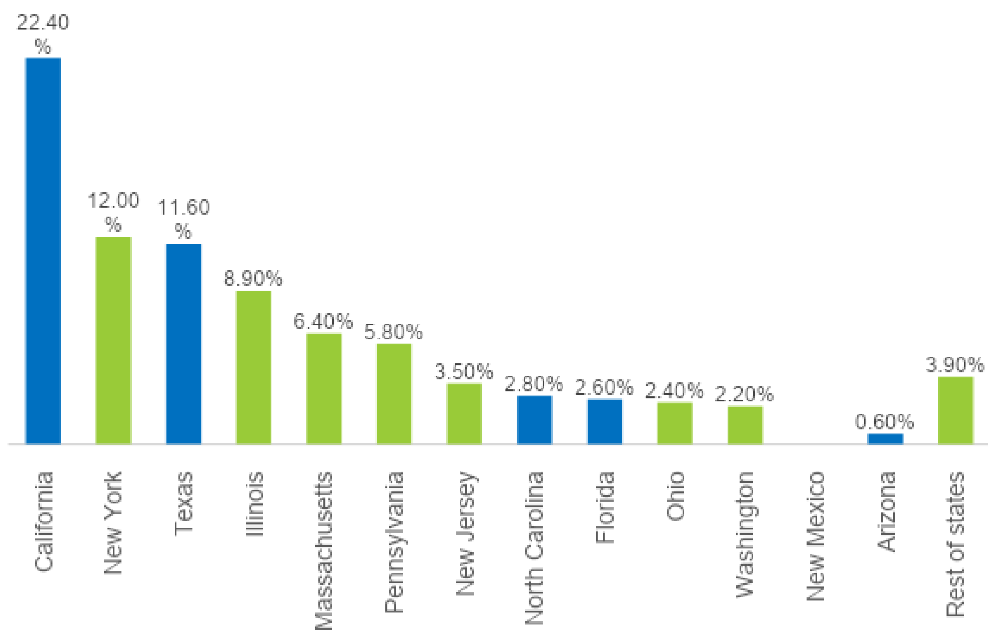
Based on the vital contribution of FDI to the U.S. economy, the following paragraphs describe FDI destinations across U.S. states, including a general description of the structure in these states, the tax and non-tax related conditions that enhance FDI attractiveness of top recipient states (California, Texas, New York, among others), with focus on U.S.-Mexico

[38] IMF Blog. United States is World's Top Destination for Foreign Direct Investment. December, 2022.
[39] Federal Reserve Bank of Dallas. "Cross-Border Manufacturing Rises from Pandemic Lows". On the Record: A conversation with Fabiola Luna.
[40] Economic Policy Institute. "Botched policy responses to globalization have decimated manufacturing employment with often overlooked costs for Black, Brown, and other workers of color." January 31, 2022.
[41] Investment Research Select USA. FDI and Employment. The Role of FDI in Supporting U.S. Jobs, 2022. Select USA Brief.

bordering states (California, Texas, Arizona and New Mexico) and a selected group of Southern States[42] (Florida and North Carolina).

Graph 10 displays the share of new FDI in 2022 across the U.S. states. Those highlighted in blue indicate the subgroup of states bordering Mexico and U.S. southern states relevant to this analysis. As shown below, California, New York, and Texas emerge as the dominant FDI beneficiaries, collectively contributing to 46% of the new FDI influx in the U.S. Of these top three states, two share a border with Mexico (California and Texas), considered a strategic location for reaching out to two potential regions for business and industrial development.

Graph 10. Share of new FDI first-year investment in 2022, per U.S. State



Note: In blue, the bordering states with Mexico, including New Mexico, which did not report new FDI in 2022, and two Southern States: Florida and North Carolina.
Source: Bureau of Economic Analysis. New FDI in the United States in 2022, by state.

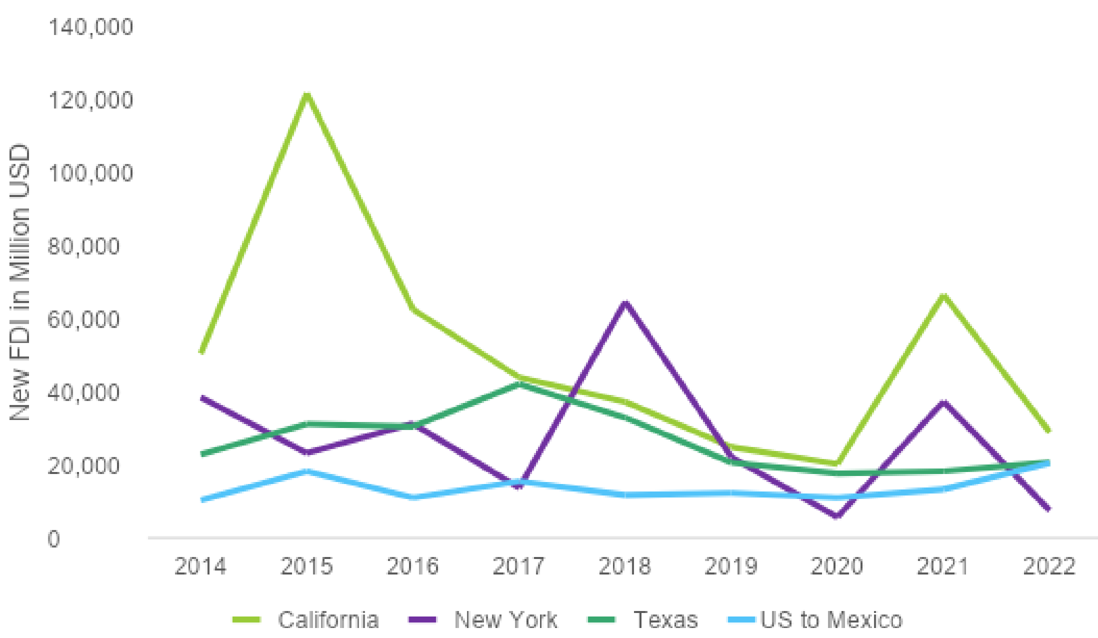
When assessing the evolution of FDI by state, California, New York, and Texas have been traditionally the three states that received the highest amount of new FDI (Graph 11). In addition, Graph 13 adds the U.S. FDI inflow

[42] The U.S. federal government defines the South as the West South Central (Texas, Oklahoma, Arkansas and Louisiana), East South Central (Mississippi, Alabama, Tennessee and Kentucky) and South Atlantic (Florida, Georgia, South Carolina, North Carolina, Virginia, West Virginia, Maryland and Delaware).

to Mexico to achieve a more accurate perspective of the U.S. strategic trade partnership with Mexico.

However, the year 2022 witnessed U.S. FDI inflow into Mexico reaching a level comparable to the newly acquired FDI by Texas, surpassing that of New York. Interestingly, this year also marked California's lowest FDI reception since 2020. Notably, the two states with the most substantial FDI share have demonstrated a less consistent pattern of change, in contrast to Texas, exhibiting a relatively steady FDI attraction trend similar to that of Mexico, with changes occurring within a narrower range.

Graph 11. New FDI in top U.S. destinations vs U.S.-Mexico FDI, 2014-2022



Source: Ministry of Economy, Mexico, and Bureau of Economic Analysis, U.S.

To understand the tax landscape and potential incentive setups in these specific groups of U.S. states, tax revenue data divided by tax categories was analyzed for each group. This data was expected to provide insights regarding the tax policy of each group of states through their revenue dependability. The findings are distilled and presented in Table 7. Notably, a clear trend emerges when examining the subgroup of U.S.-Mexico Bordering States and the two selected Southern States of interest (Florida and North Carolina, both based on positive share of FDI), which average share of tax revenue in almost all tax categories (except Sales taxes) is smaller than the U.S. national and the average of the top 80% FDI recipients.

This trend is evident concerning Corporate Income Tax (CIT) Revenue, making up a small 1.8% of state revenues, in contrast, with a 3.3% average CIT rate when considering the 51 states. Regarding the other tax categories, Property and Sales taxes constitute, on average, between one-fourth and one-third of tax revenue. The comparison might indicate a possible differentiated strategy, led by the U.S. bordering states with Mexico, which might have the incentive to offer lower CIT rates (for example, in Texas, the CIT rate is 0%) due to competition with Mexican states. These states balance their funding by increasing revenue from consumption-driven sources.

Table 7. Tax revenue by tax in selected state groups

STATE GROUP	TAX REVENUE				
	Corporate Income Tax	Property Tax	Sales and Gross Receipts Taxes	Individual Income Tax	Other Taxes
Avg. U.S. N=51	3.3%	32.2%	23.8%	22.8%	17.9%
Avg. Border + Southern N=6	1.8%	30.9%	33.8%	14.3%	19.2%
Avg. Top 80% FDI N=11	3.0%	34.0%	24.8%	20.1%	18.0%

Source: Tax Foundation and Bureau of Economic Analysis. New FDI in the United States in 2022, by state.

Regarding tax policy and incentives, the literature agrees that CIT rates affect FDI. However, there is no clear consensus for rejecting a null hypothesis[43].

Graph 12 displays the share of FDI by state and CIT rate to identify any relationship between these two variables. Even though there is no clear pattern between FDI share by state and CIT rate, the data in Graph 14

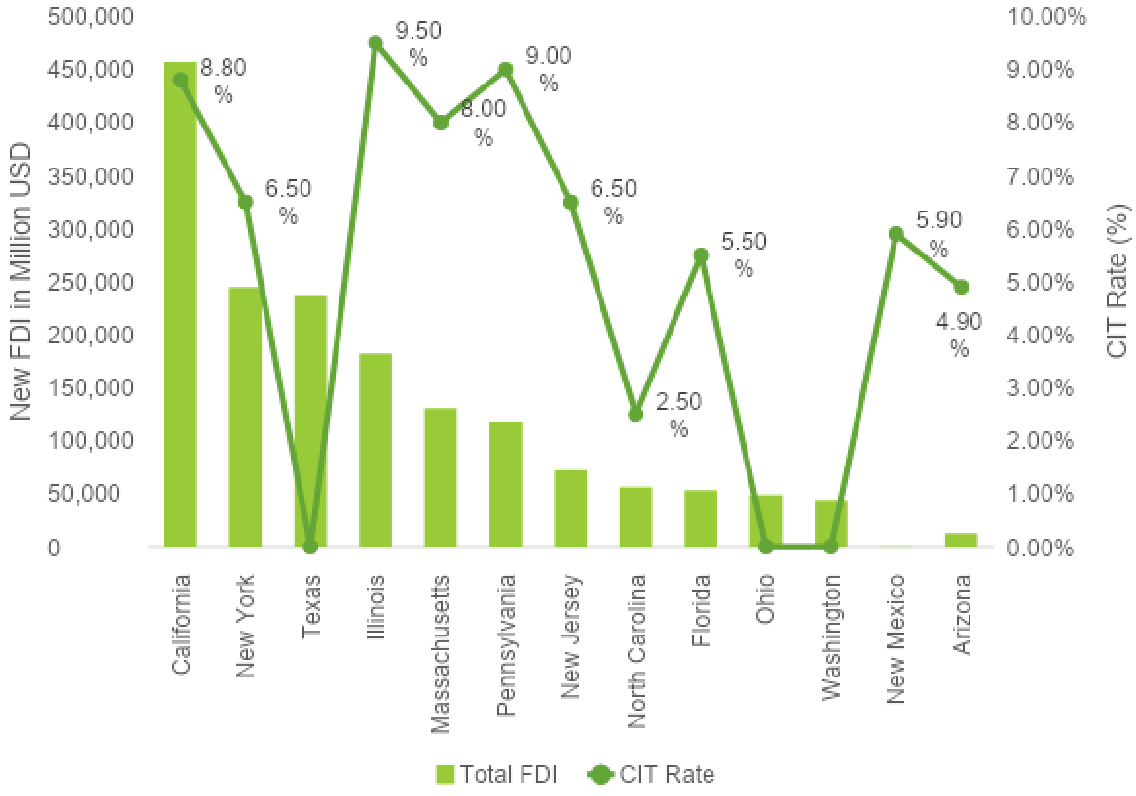
[43] The null hypothesis in which the effect of a change in CIT rates neither affects positively or negatively changes in FDI.

shows that at least seven states with higher CIT rates also have lower FDI shares.

California and New York portray the exceptions. Both states share the two highest CIT rates but also the highest FDI shares. Challenging the hypothesis that higher CIT rates could inhibit FDI attraction. On the other hand, Texas, another bordering state with Mexico, stands out as its CIT rate is 0%. However, despite this tax benefit, the state's FDI share is closer to New York's, whose average CIT rate is 6.5%.

Both situations suggest that factors other than just CIT rates play a role in investors' decisions about where to do nearshoring or offshoring.

Graph 12. New FDI by state accumulated and CIT Rate (2023)



Note: Total FDI accumulated from 2014-2022.
Source: Tax Foundation and Bureau of Economic Analysis. New FDI in the United States in 2022, by state.

Besides CIT rates, the analysis also considers other indirect taxes set at a state level, which could influence investor decision-making. Table 8 provides a comprehensive overview of the primary and excise tax rates across selected U.S. States. Upon examination of Table 9, it becomes evident that states employ varied tax strategies. Certain states may offset a lower CIT rate by imposing higher sales taxes and excise tax rates on specific goods (such as gasoline and tobacco). It is also relevant to note that, unlike Mexico, the U.S. lacks a Value-Added Tax (VAT); however, states have the authority to establish sales taxes that can be likened to a VAT. A notable distinction is that VATs are collected at each production stage, whereas retail sales taxes are solely collected at the point of final sale.[44]

Table 8. Summary tax rates and excise tax rates in selected U.S. States

Tax	National Average	Avg. Top 3 States New FDI	Avg. Border States	Avg. South
Corporate Income Tax	6.00%	5.11%	4.64%	5.25%
State & Local Sales Tax Rates	7.12%	8.51%	8.28%	7.68%
State Gasoline Tax Rates (Cents per gallon)	$0.25	$0.27	$0.27	$0.24
State Cigarette Excise Tax Rates (Dollars per 20-Pack)	$1.94	$2.88	$2.07	$1.20
State Spirits Excise Tax Rates (Dollars per Gallon)	$8.41	$4.05	$3.69	$8.46
State Wine Excise Tax Rates (Dollars per Gallon)	$1.07	$0.23	$0.74	$1.42
State Beer Excise Tax Rates (Dollars per Gallon)	$0.33	$0.18	$0.24	$0.51
State & Local Cell Phone Tax Rates	12.06%	15.06%	12.82%	12.00%
Property Taxes (as a Percentage of Owner-Occupied Housing Value)	1.04%	1.28%	0.93%	0.79%

Note: Top 3 New FDI: California, New York, and Texas. Border States: California, Texas, Arizona, and New Mexico. Southern States: Alabama, Arkansas, Delaware, Florida, Georgia, Kentucky, Louisiana, Maryland, Mississippi, North Carolina, Oklahoma, South Carolina, Tennessee, Texas, Virginia, and West Virginia. **Source:** Tax Foundation.

For a more detailed assessment, Table 9 displays the tax and excise tax rates in selected U.S. States from the two groups: one with the states whose aggregated FDIs accumulate 80% of total FDI in the U.S. and one of those that share a border with Mexico. The color code indicates a five-level scale from low(yellow) to high (red) of each tax rate and excise tax rate per state.

[44] Brookings Institute. "A Value-Added Tax for the United States: Part of the Solution". July 22, 2010.

As a result, states will opt for different taxation strategies. Also, bordering states with Mexico reflect moderate to low rates in both tax categories.

Table 9. Tax rates and excise tax rates in selected U.S. States

Note: The color code indicates a five-level scale from low(yellow) to high (red) of each tax rate and excise tax rate per state.

TAX	TOP 80% FDI IN THE U.S.										
								U.S. - MEX BORDER STATES			
	New York	Illinois	Massachusetts	Pennsylvania	New Jersey	North Carolina	Florida	California	Texas	New Mexico	Arizona
Corporate Income Tax	6.50%	9.50%	8.0%	8.99%	6.50%	2.50%	5.50%	8.84%	0%	4.80%	4.90%
State & Local Sales Average Tax Rates	8.52%	8.82%	6.25%	6.34%	6.60%	6.99%	7.02%	8.82%	8.20%	7.72%	8.37%
State Gasoline Tax Rates (Cents per gallon)	$0.08	$0.42	$0.24	$0.00	$0.11	$0.39	$0.04	$0.54	$0.20	$0.17	$0.18
State Cigarette Excise Tax Rates (Dollars per 20-Pack)	$4.35	$2.98	$3.51	$2.60	$2.70	$0.45	$1.34	$2.87	$1.41	$2.00	$2.00
State Spirits Excise Tax Rates (Dollars per Gallon)	$6.44	$8.55	$4.05	$7.41	$5.50	$16.40	$6.50	$3.30	$2.40	$6.06	$3.00
State Wine Excise Tax Rates (Dollars per Gallon)	$0.30	$1.39	$0.55	NA	$0.88	$1.00	$2.25	$0.20	$0.20	$1.70	$0.84
State Beer Excise Tax Rates (Dollars per Gallon)	$0.14	$0.23	$0.11	$0.08	$0.12	$0.62	$0.48	$0.20	$0.19	$0.41	$0.16
State & Local Cell Phone Tax Rates	18.88%	22.65%	10.45%	16.62%	9.14%	9.04%	15.02%	14.42%	11.89%	12.32%	12.66%
Property Taxes (as a % of Owner-Occupied Housing Value)	1.40%	2.08%	1.14%	1.49%	2.23%	0.82%	0.91%	0.75%	1.68%	0.67%	0.63%

In conclusion, this section identifies valuable insights for an enhanced Mexico's FDI policy:

The notion of transitioning the U.S. from solely being viewed as an investor to an FDI competitor is worth exploring, especially considering that two U.S. States sharing a border with Mexico attract a significant portion of FDI. This suggestion could pave the way for an industry-level evaluation centered on the prospective job distribution between the two nations.

Analysis of the tax systems across states and state groups reveals that those attracting substantial FDI predominantly hinge on property and sales tax categories, with CIT being less dominant (except for California and New York). This presents an opportunity to consider crafting distinct tax policies for the Mexican States along the U.S. border, encouraging potential inter-state competition.

Additionally, it is advisable to delve into non-tax-related incentives that contribute to the appeal of states characterized by high CIT rates and excise tax rates for FDI. States such as California, New York, and Texas, boasting specialized economies, exhibit numerous commendable practices examined in Chapter 1. Investors' decision-making criteria have prominently included factors like a skilled workforce, robust infrastructure, efficient connectivity, and strategic location.[45]

- **Infrastructure and Accessibility**: States with well-developed infrastructure, transportation networks, and access to significant markets often have an advantage in attracting FDI. Investors value efficient logistics and connectivity.
- **Skilled Workforce**: States with a well-educated and skilled workforce are more attractive to foreign investors. Access to a pool of qualified and trained workers can contribute to the success of FDI projects.
- **Research and Innovation Hubs**: States that are home to research universities, technology parks, and innovation clusters are more likely to attract FDI, especially in industries that require access to cutting-edge research and development.

[45] Investment Monitor. The big three march on: How Texas, New York and California dominate US FDI, July 2022. World Trade Center Los Angeles, Foreign Direct Investment in California 2023. Global Business, Local Benefit Foreign Contributions to the New York Economy, November 2017.

The following section will dive into the role of federal tax policies in the U.S. and its impact on FDI. It highlights possible recommendations for Mexico's intention of enhancing FDI from U.S. firms.

U.S. Federal Fiscal Policy

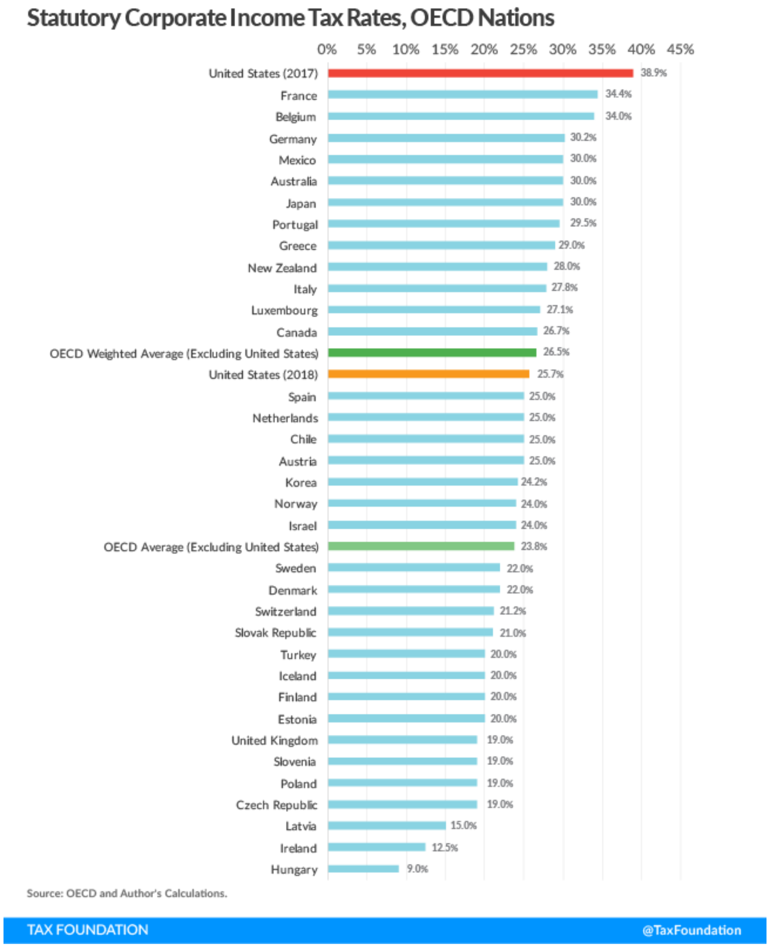
Until 2017, the U.S. CIT rate was the highest among the OECD countries; the U.S. and Mexico's rates remained in the top five. By 2018, the U.S. decreased the CIT rate from 38.9 to 21.0, below the OECD weighted average that excluded the U.S.[46][47] The reform positioned the U.S. in a more competitive position with trade partners such as Canada, Spain, and the Netherlands, among Mexico's most important investors (see Graph 13).

The U.S. tax reform legislation of that period made the country more competitive and marked a shift in the country's taxation system from a 'worldwide' approach to a 'territorial' one. This change primarily impacted the taxation of corporations, where the taxation process depends on whether the income has a connection to the U.S. and the extent of their presence within the country.

Before the change, non-U.S. corporations conducting business in the U.S. were subject to a 35% CIT rate on income generated from U.S. sources that were effectively connected to their business (referred to as effectively connected income or ECI). The CIT rate on ECI was also permanently reduced from 35% to a flat 21% rate. At the same time, certain types of U.S.-source income, such as interest, dividends, and royalties, that are not directly linked to a non-U.S. corporation's business continue to be taxed on a gross basis at a rate of 30%.

[46] It officially was reduced to a flat 21% for tax years starting after December 31, 2017.
[47] The effective CIT rate in 2023 is 21% as indicated in the PwC Worldwide Tax Review.

Graph 13. CIT Rates in OECD Countries, Before and After U.S. Reform



Source: Tax Foundation.

Table 10 provides a comparative analysis of tax structures and rates in the United States and Mexico. Regarding consumption taxes, U.S. States utilize individual state sales taxes, allowing states to foster competitive advantages. However, it's important to note that Mexico's employment tax can soar to as high as 35%, potentially diminishing its competitive edge. Conversely, Mexico gains a competitive advantage by not levying excise taxes.

Table 10. Selected Federal U.S. and Mexico Tax Rates

Tax Description	U.S.	Mexico
Income Tax		
Corporate Income Tax (CIT)	21.0%	30.0%
Employment Tax		
Social Security and Health Taxes	15.3%	Estimated 35%*
Consumption Tax		
Value-added Tax (VAT)	NA	16.0%
Selected Excise Taxes		
Pistols & Revolvers	10.0%	NA
Other Firearms	11.0%	NA
Ammunition	11.0%	NA
Indoor Tanning	10.0%	NA
Tackle Boxes	3.0%	NA
Arrow Shafts	55¢ per shaft	NA
Air Transportation	7.5%	\$20.52 – \$71.18/flight**
Truck Bodies	12%	NA
Liq. Natural Gas	24.3¢/gallon	NA
Surface Coal	4.4% or \$0.55/ton	\$2.41/ton
Withholding Tax Rates (Resident) Dividends/Interests/Royalties	NA	NA
Withholding Tax Rates (Non-Resident) Dividends/Interests/Royalties	30%/30%/30%	10%/4.9-35%/1-35%

Costs in U.S. dollars.
*Social security costs depend on the salary and benefits employees receive and are paid by both the worker and the employer. Social security costs approximately 35% of the worker's salary.
**TUA (Airport Single Fee): this contribution is charged for the right to use the airports and is charged per flight.
Source: Mexico's Income Tax Law, Tax Foundation, Selected U.S. Federal Taxes, 2023, and Pwc Worldwide Tax Summaries.

Other federal tax incentives in the U.S. are the Principal Corporate Deductions[48]. As discussed in Chapter 2, the tax deduction is a specific allowance that reduces the taxable income for an individual or a business entity. It serves as an incentive for FDI by effectively lowering the investor's tax liability. When a country offers tax deductions as part of its tax incentives regime, it allows investors to deduct certain expenses or costs associated with their investment from their taxable income. This reduces the overall tax burden, potentially leading to higher after-tax returns on

[48] PWC. Worldwide Tax Summaries, United States, August 2023.

investment. Some examples of these deductions in the U.S. are the following:

Table 11. Principal corporate deductions, U.S.

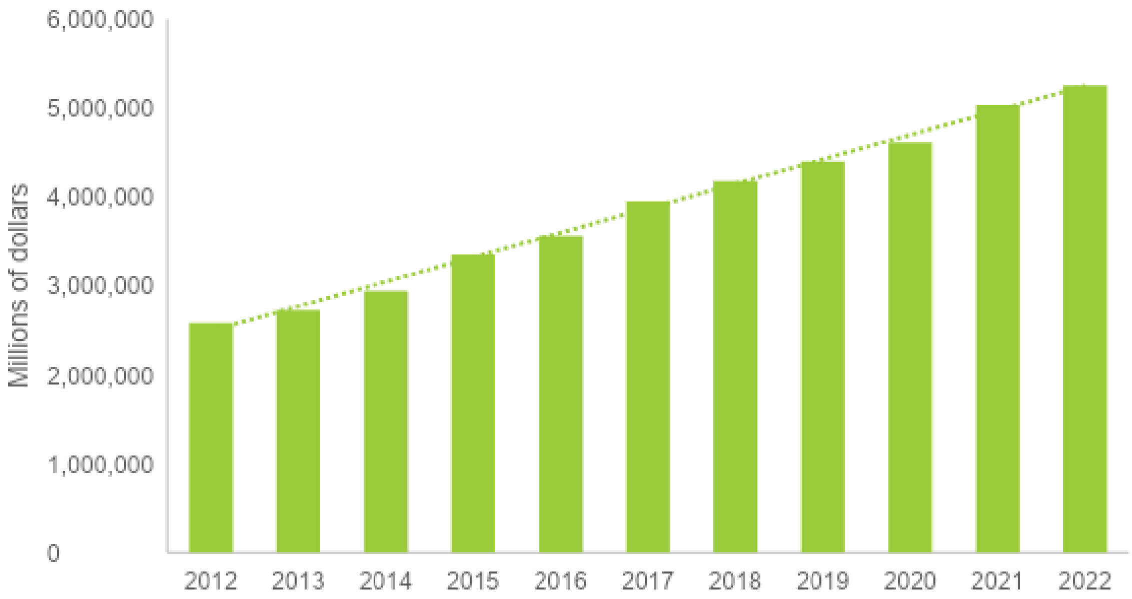
Deductions	Description
Depreciation and amortization	Often using the modified accelerated cost recovery system, different types of tangible property have varying recovery periods, like three, five, seven, ten, 15, 20, 27.5, and 39 years. The cost of intangible assets is amortized over 15 years.
Depletion	For natural resource properties other than timber and specific oil and gas properties, depletion may be computed on a cost or a percentage basis, limited to 50% of taxable income from the property.
Start-up expenditures	Expenditures are generally amortized over 15 years.
Interests	The current law restricts business interest expense deductions for taxpayers based on a formula that considers business interest income, 30% of 'adjusted taxable income' (ATI), and floor plan financing interest. It encompasses both foreign and U.S. persons and related and unrelated parties. ATI, similar to earnings before interest, taxes, depreciation, and amortization (EBITDA) for years before January 1, 2022, or earnings before interest and taxes (EBIT) for years after that date, is used to calculate this limitation. Disallowed business interest expenses can be carried forward indefinitely.
Bad Debt	Bad debts arising from a trade or business can be deducted in the year when the debt becomes entirely worthless.
Charitable contributions	Deductions for allowable charitable contributions may not exceed 10% of taxable income computed without regard to certain deductions, including charitable donations.
Employee benefit plans	Employers can deduct contributions to qualified retirement plans, and employees' taxes are deferred until they receive the benefits.

Deductions	Description
Foreign-derived intangible income (FDII)	Until 2026, the law allows a deduction of an amount equal to 37.5% of a domestic corporation's FDII plus 50% of the global intangible low-taxed income amount included in the gross income of the domestic corporation. After 2025, the deduction is reduced to 21.875% and 37.5%, respectively.
Research and experimental (R&E) expenditures	These expenses must be capitalized and amortized over five years from the midpoint of the tax year they were incurred, while R&E expenses related to foreign research are amortized over 15 years.
State and municipal taxes imposed on businesses are deductible expenses for federal income tax purposes.	Not all the taxes are deductible, but Corporations may deduct state corporate income tax paid against federal taxable income, lowering the effective federal corporate income tax rate and some excise taxes.

Source: PWC. Worldwide Tax Summaries, United States.

In addition, during 2020 and 2021, several COVID pandemic relief measures were put in place. These included tax relief for businesses. The relief measures encompassed a five-year net operating loss (NOL) carryback, alterations to interest deduction limits, quicker Alternative Minimum Tax refunds, relief from payroll taxes, a temporary suspension of certain aviation excise taxes, a tax credit for employee retention, and a technical correction for 'qualified improvement property' related to the 2017 tax reform act. These measures were temporary and have expired, but helped the U.S. sustain total levels of FDI, as shown in Graph 14.

Graph 14. Total U.S. FDI, 2012-2022



Source: Bureau of Economic Analysis. Foreign Direct Investment in the United States: Positions by Detailed Industry of U.S. Affiliate, 2012-2022.

However, with the Inflation Reduced Act (IRA)[49] of 2022, Corporations with financial accounting profits exceeding 1 billion dollars could be subject to a minimum tax of 15%. This means that, regardless of their deductions and other tax considerations, they would need to pay at least 15% of their accounting profits, potentially inhibiting new FDI in the U.S. territory and opening an opportunity for neighboring countries to attract this investment.

Also, those companies engaging in stock buybacks could face a special tax of 1% on such transactions. This could impact the decision to conduct stock buybacks, as an additional cost would be added to this activity. The tax excludes stock contributed to retirement accounts, pensions, and employee stock ownership plans (ESOPs).

In contrast, to promote a clean energy economy, the IRA has tax incentives[50] for those companies involved in electricity production, carbon capture, alternative vehicles and fuels, and energy efficiency in residential

[49] Tax Foundation. Details & Analysis of the Inflation Reduction Act Tax Provisions, August 2022.
[50] Internal Revenue Services. Credits and Deductions Under the Inflation Reduction Act 0f 2022.

and commercial properties. The idea of these incentives is to encourage investment in more sustainable technologies and practices.

U.S. Fiscal Competitiveness and Opportunities for Mexico

According to the 2022 International Tax Competitiveness Global Ranking, estimated by the Tax Foundation, the U.S. held the modest 22nd position among 38 countries. It was positioned below Japan, above Slovenia, and merely eight ranks ahead of Mexico, placed 30th in the ranking (see Table 12). Among the tax indicators considered in this assessment, the U.S. demonstrates its competitiveness in consumption tax, closely trailed by individual taxation.

This insight underscores the significance of the sales tax, which functions as a competitive tool (though less extensive than the average Value-Added Tax) within the framework of U.S. international competitiveness. Notably, the absence of a unified Value-Added Tax grants states the authority to forge distinct and competitive tax systems. This, in turn, provides investors with a choice among diverse tax systems, each tailored to individual state regulations.

Conversely, Mexico stands out for its remarkably competitive property tax, securing the ninth place globally in this particular tax category. Intriguingly, the U.S. exhibits its least competitive tax category in this regard. This advantageous facet of Mexico's tax system holds the potential for shaping a tax incentive strategy, enabling U.S. investors to delve into the advantages of property-related considerations in their offshore and nearshoring deliberations. Maximizing this opportunity could position Mexico favorably to attract U.S. investors to its bordering states, fostering enhanced economic engagement.

Finally, it's important to emphasize the significance of Baltic nations like Estonia, which has consistently secured its position as the leading OECD country for nine consecutive years owing to a range of favorable attributes within its tax framework. Particularly noteworthy is the pertinence of these attributes in the context of nearshoring strategies, as they effectively reduce the tax burden, thus fostering an environment conducive to FDI. Some of the tax benefits in Estonia are the following:

- **Competitive Corporate Tax Rate**: Estonia's corporate tax rate of 20 percent applies only to distributed profits, making it an attractive choice for foreign businesses seeking to establish a presence.
- **Simplified Individual Taxation**: The flat 20 percent tax rate on individual income, excluding personal dividends, benefits both domestic and foreign individuals, facilitating nearshoring activities and skilled workforce engagement.
- **Advantageous Property Tax**: Estonia's property tax focuses solely on land value, reducing tax-related costs for businesses acquiring real estate for nearshoring operations.
- **Territorial Tax Incentive**: With a territorial tax system exempting 100 percent of foreign profits from domestic taxation, Estonia encourages companies to reinvest and repatriate earnings.

Table 12. International Tax Competitiveness Index, 2022

Country	Overall Rank	Overall Score	Corporate Tax Rank	Individual Taxes Rank	Consumption Taxes Rank	Property Taxes Rank	Cross-Border Tax Rules Rank
Estonia	1	100.0	2	1	14	1	14
Latvia	2	89.9	1	4	26	5	9
New Zealand	3	89.7	32	7	1	2	21
Switzerland	4	82.9	11	9	4	36	2
Czech Republic	5	81.9	6	5	25	6	11
Luxembourg	6	80.6	26	14	6	14	5
Hungary	7	77.9	5	6	38	18	3
Lithuania	8	76.9	3	11	31	7	24
Turkey	9	76.6	20	8	13	23	8
Israel	10	76.0	17	30	10	10	10
Australia	11	75.5	29	20	9	4	23
Sweden	12	74.2	8	18	22	8	12
Slovak Republic	13	74.1	21	3	29	3	34
Netherlands	14	71.3	25	22	16	22	4
Germany	15	70.2	30	26	15	11	6
Canada	16	69.3	27	31	8	25	16
Norway	17	69.0	15	23	23	16	13
Austria	18	68.6	23	32	17	15	7
Costa Rica	19	67.5	36	33	7	12	17
Finland	20	67.4	9	28	21	20	22
Japan	21	67.3	33	16	5	27	26
United States	22	66.8	22	21	3	29	35
Slovenia	23	66.1	7	12	32	26	20
Belgium	24	65.1	14	13	24	31	19
Korea	25	64.1	34	27	2	33	33
United Kingdom	26	62.9	10	24	34	34	1
Chile	27	61.9	13	34	11	13	38
Poland	28	59.3	12	10	35	32	29
Greece	29	59.2	19	17	30	30	25
Mexico	30	58.4	28	29	12	9	37
Iceland	31	57.9	16	19	28	28	31
Colombia	32	57.8	38	2	18	24	36
Denmark	33	57.3	18	36	20	19	30
Spain	34	56.9	31	25	19	37	18
Ireland	35	55.6	4	37	36	17	32
Portugal	36	51.4	37	35	27	21	28
Italy	37	49.1	24	15	37	38	27
France	38	45.3	35	38	33	35	15

Source: 2022 *International Tax Competitiveness Index.*

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Source: Tax Foundation.

The following section deepens the analysis of the Baltic region through the experience of Lithuania. It also complements our assessment of tax incentives with the knowledge of the Balkan Countries which have aligned their policies towards their consideration as potential European Union (EU) members, which would imply benefits that range from accessing the EU market to trade agreements enhanced FDI, among others.

3.2 North and Eastern Europe: Lithuania and the Balkan Countries

Northern and Eastern Europe (the region includes the Baltics and the Balkans) have emerged as attractive nearshoring destinations for Western European countries. This section focuses on the nearshoring strategies of Scandinavian firms, specifically in the Baltics.[51] Scandinavian companies, frequently opting for function sourcing, especially in manufacturing, are exploring new opportunities within the EU member states and Asia. Given the relatively close geographical proximity of the Baltic countries, the concept of psychic distance becomes a crucial factor influencing the decision-making process for nearshoring locations.[52]

This section focuses on the nearshoring practices of three Scandinavian firms that offshore and nearshore some of their operations to Lithuania. The country becomes relevant in our study due to the tax incentives and economic reforms that were implemented to attract FDI; for example:

- Competitive Corporate Tax Rates
- Special Economic Zones and Free Economic Zones
- Double-Taxation Agreements with Nordic Countries
- Tax incentives for R&D
- Strong Intellectual Property Regime (targeted for Nordic innovations)
- Skilled labor force in technology and engineering

Table 15 compares the general tax structure in Lithuania with selected countries. Lithuania and Canada have the smallest Corporate Income Tax (CIT) rates and offer other incentives, such as reduced Withholding Tax Rates for residents and non-residents. Complementary data from the OECD reveals that Lithuania's tax revenue as a share of GDP decreased from 2.72 percent in 2008 to 0.81 percent in 2011.[53]

[51] Dmitrij Slepniov, Sigitas Brazinskas, Brian Vejrum Wæhrens, (2013),"Nearshoring practices: An exploratory study of Scandinavian manufacturers and Lithuanian vendor firms", Baltic Journal of Management, Vol. 8 Iss: 1 pp. 5 – 26.
[52] Ibid.
[53] OECD. Tax on Corporate Profits.

Table 15. Comparative tax summary with selected countries

TAX DESCRIPTION	CENTRAL AND EASTERN EUROPE		NORTH AMERICA		
	Lithuania	Czech Republic	Mexico	Canada	United States
Corporate Income Tax	15	19	30	Fed: 15 State: 8-16	Fed: 21 State: 0-12
Value-Added Tax	21	21	16	5-15	NA
Withholding Tax Rates (Resident)	0	15/0/0	10/08/NA	NA	NA
Withholding Tax Rates (Non-Resident) *	15/10/10 or 0	15/15/15	10/4.9-35/5-35	25/25/25	30/30/30

*Dividends/Interests/Royalties. **Source**: PwC Worldwide Tax Summaries.

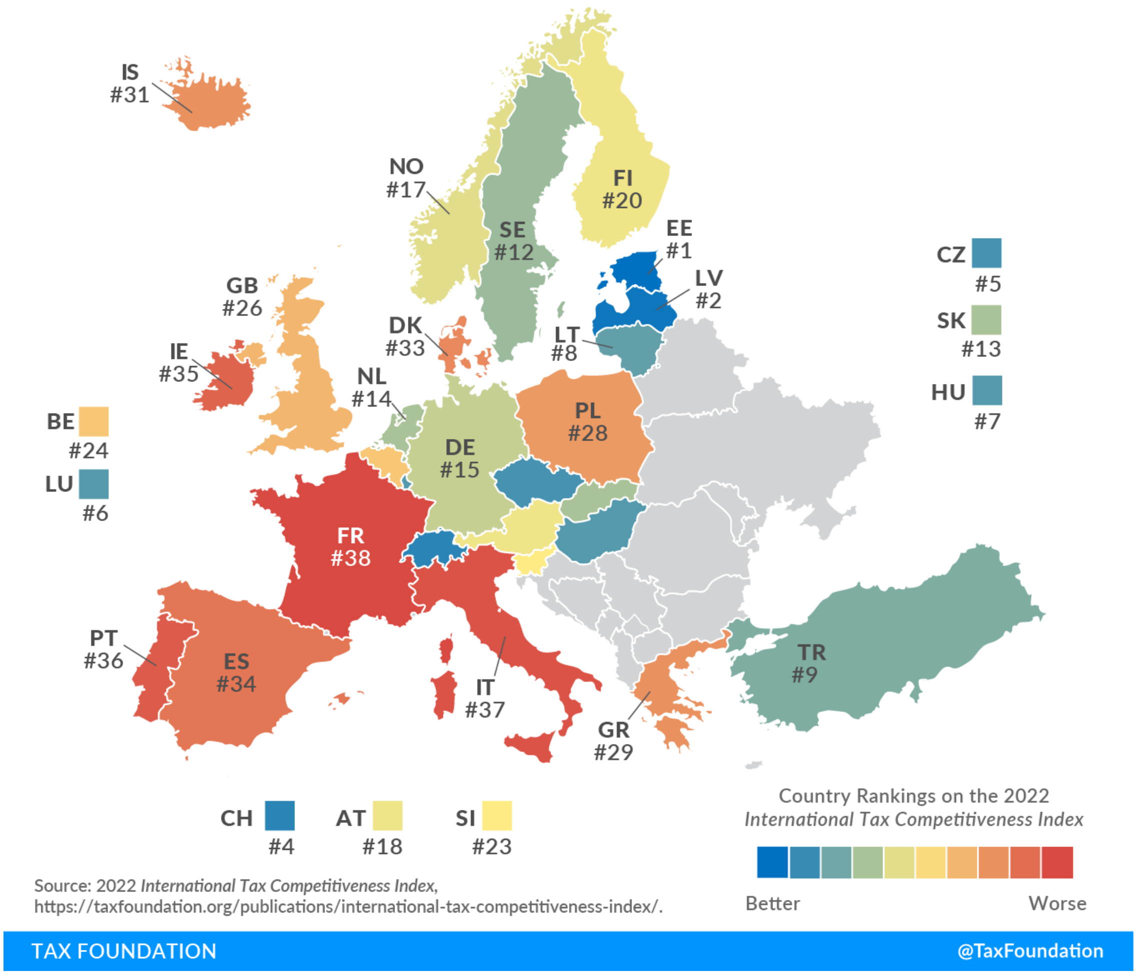
Tax structure and reform in Lithuania

Like U.S. States that receive the most significant shares of FDI, Lithuania has a taxation strategy that favors the business environment for investment. The country ranks as the 8th most competitive tax system among the 38 OECD countries. Some of the strengths of the Lithuanian taxation system are (i) the tax treatment the government imposes on machinery, buildings, and intangibles; (ii) one of the lowest CIT rates in the OECD group (15% versus the 23.6% average of the OECD); and (iii) stable predictability over labor-related taxes.[54]

Lithuania's tax revenue relies primarily on consumption taxes (38.4%), with the presence of a 21% VAT, followed by social insurance taxes (32.0%), individual taxes (23.4%), and corporate taxes (5.2%).[55] The small burden on CIT is a feature that Lithuania shares with other relatively small (in territory, population, and thus market size) countries. Estonia, Latvia, Czech Republic, Hungary, and Luxemburg share a similar tax structure -and the best rankings of the European group- in their aim to become hosts of investments that might not necessarily take the form of physical capital.

[54] Tax Foundation. Taxes in Lithuania.
[55] Ibid.

Figure 2. European OECD Country Tax Rankings, 2022



Source: Tax Foundation.

Since the 1980s to the date, the worldwide average CIT rate has decreased. Over 40 years, the weighted (by GDP) average CIT rate went from 46.55% to 25.43% in 2022.[56] From Lithuania's independence in 1990 to the early 2000s, the CIT rate remained 10-12% lower than the worldwide average. However, between 2000 and 2005, Lithuania paved its road towards a global private-enterprise economy. In 2004, the country gained several memberships (NATO, WTO, and EU) and reduced its CIT rate to 15%. These reforms, along with a developed infrastructure, IT network, and highly-skilled labor force, positioned the country's advantaged

[56] Tax Foundation. Corporate Tax Rates around the World, 2022. December 13, 2022.

geographical position for attracting investments from Western European and Nordic countries. This successful trajectory also led to their OECD membership in 2018 and to reaching their second-highest percentage of FDI net inflows as a share of GDP with a total of 7.9% in 2020, the highest record registered before was in 1998 (8.2%).[57]

Most recent tax reforms include[58]:

- **Reduced CIT Rate:** Small enterprises and agricultural businesses can avail themselves of a lower CIT rate of either 0% or 5%, contingent upon specific criteria being fulfilled. Companies boasting less than ten staff members and generating gross annual revenues below EUR 300,000 can take advantage of this reduced CIT rate.
- **Transfer Pricing Regulations**: The key amendment introduces the option to utilize a simplified transfer pricing method for intra-group services transactions with low-value addition. This new approach allows for applying a 5% mark-up on costs linked to such services, eliminating the necessity for a formal benchmarking study.
- **Real Estate**: A provision introduced a tax exemption for real estate owned by or transferred to representative offices of entities enjoying a special status under international law or other entities aligned with the Republic of Lithuania's global cooperation objectives. Thus becoming an attractive host of international organizations for development.

Appendix 3.3. extracts the effect of the reformed tax system in Lithuania's business environment, particularly in boosting its geographically strategic position for Scandinavian companies that decided to carry out nearshoring activities in Lithuania. The Appendix aims to identify other non-tax incentives or industrial strategies that firms consider when reallocating their processes to a closer location to the headquarters.

Conclusions from the Lithuanian experience

Lithuania's tax reforms offer valuable insights into the evolution of a tax system that favors nearshoring and economic development in highly valuable industries.

[57] PwC. Worldwide Tax Summaries. Lithuania.
[58] PwC. Worldwide Tax Summaries. Taxes on Corporate Income, Lithuania.

Lithuania's decision to reduce its CIT rate to 15% significantly impacted FDI inflows and yielded several key benefits. By lowering the CIT rate, Lithuania created a more attractive and competitive business environment that encouraged multinational corporations to consider the country a destination for their investments. The reduced CIT rate enhanced Lithuania's competitiveness on the global stage, enabling both foreign and domestic companies to invest in various sectors, with a focus on high-value activities, for example, service industries, chemical industry, information technology, financial services and service centers, transportation, biotechnologies, and R&D.[59]

Other tax incentives and policies collectively contribute to Lithuania's investor-friendly environment, fostering openness, transparency, and attractive conditions for both domestic and foreign investors alike, are the following[60]:

- **Equal Treatment for All**: Lithuania's legal framework guarantees parity between foreign and domestic investors, ensuring that both groups receive fair treatment under the law.
- **No Special Permit Required**: Investing foreign capital in Lithuania does not necessitate a special permit from government authorities, simplifying the process for foreign investors to engage in economic activities.
- **Broad Economic Accessibility**: With only a few exceptions, most economic sectors in Lithuania are open for investment, providing extensive opportunities for foreign investors to explore various industries.
- **Free Economic Zones (FEZs)**: The Lithuanian government has established seven FEZs to encourage investment. These zones offer tax benefits and streamlined services through one-stop-shop facilities.

Lithuanian companies succeed in manufacturing and delivering more value-added products and services when collaborating with Nordic firms.

Collaborating with companies from technologically advanced and economically developed countries like Sweden, Denmark, Norway, and

[59] PwC. Worldwide Tax Summaries. Taxes on Corporate Income, Lithuania.
[60] Lloyds Bank. Foreign Direct Investment in Lithuania. Updated July 2023.

Finland can provide Lithuanian firms with cutting-edge technologies, knowledge, and expertise.

This collaboration enables them to enhance their capabilities, produce higher-quality products, and deliver more value to their customers. Nearshoring from these neighboring countries allows Lithuanian companies to tap into these advanced markets and leverage their strengths to improve their competitiveness.

Subcontracting emerged as a clear dominant strategy, with Sweden taking a significant lead, followed by Denmark and Norway.

Subcontracting is a prevalent nearshoring strategy that offers various benefits. Lithuanian companies can focus on their core competencies while outsourcing specific tasks or processes to firms in Sweden, Denmark, Norway, or other neighboring countries. This approach helps them streamline operations, reduce costs, and maintain a flexible production process. Moreover, Sweden's lead in subcontracting suggests it may provide a conducive business environment and strong expertise in certain areas, making it an attractive partner for nearshoring collaborations.

Compliance with quality requirements was ranked as the most important, followed by lead time and technological (process) requirements.

Quality, lead time, and technology are critical considerations in nearshoring decisions. Companies aim to ensure that the products and services delivered by their nearshore partners meet the high-quality standards customers expect. Additionally, shorter lead times help maintain competitive advantage by reducing time-to-market and meeting customer demands promptly. Technological requirements are equally important as they impact the efficiency and effectiveness of the manufacturing process.

Prioritizing these factors in nearshoring allows companies to control the production process, mitigate risks, and deliver products that meet market demands effectively.

The following section provides more evidence about the tax-related practices and incentives of other European countries that aim to attract and retain FDI as a driver for domestic development and a source of employment and economic growth. This situation is relevant for Mexico, as the country still holds a significant income gap across its regions. In 2023, Mexico reported that 50.8% of its population was in poverty conditions -including extreme and moderated.[61]

Nearshoring and Tax Incentives in the Balkan Region

Tax incentives play a significant role in attracting FDI to the Western Balkan countries, which are considered comparative cases for addressing Mexico's opportunities (see Appendix 3.4.). Governments often offer these incentives to foreign companies to encourage investment and stimulate economic growth. The combination of reduced tax rates, tax holidays, investment deductions, and other benefits create a favorable business environment. Table 13 lists the main incentives adopted by these countries, mainly focused on employment opportunities for local workers and technological investment.

Table 13. List of tax incentives in the Western Balkan Countries

Taxation in Western Balkan Countries Slovenia, Croatia, Serbia, Montenegro, Macedonia, and Albania
Tax holidays, exemptions, and similar incentives ● Special Economic Zone (SEZ) or areas of particular concern, reduced CIT (starting at 10%) ● Tonnage tax in substitution of CIT for specific industries ● Tax Holidays for investments (from 0 to 10 percent in 10 years) ● Tax Holidays for concessions ● Full local CIT exemptions based on the origin of employees ● Free zones with permit exemptions and reduced CIT ● Non-profit organizations exempt from CIT ● CIT progressive breakdowns for small and medium-sized firms **Tax allowances, tax credits, or similar incentives** ● Tax credits in underdeveloped areas (similar to SEZ) ● Investment allowance in equipment and intangible assets (30% of the amount)

[61] Government of Mexico. "INFORME ANUAL SOBRE LA SITUACIÓN DE POBREZA Y REZAGO SOCIAL 2023".

Taxation in Western Balkan Countries Slovenia, Croatia, Serbia, Montenegro, Macedonia, and Albania
• R&D allowance (from 20 to 150 percent, depending on the tax base and amount) • Specific regions allowance (30-40% of the amount) • Employment-related reliefs for disabled employees • Education and training costs for employees (up to 100%) • Progressive tax credits for small and medium-sized firms

Tax Regime Harmonization can strategically attract FDI by reducing physical distance with investor countries.

The Balkan countries adopted tax regimes similar to the EU's through a process of harmonization and alignment with EU tax laws and regulations. As part of their efforts to join the EU or enhance economic cooperation with the block, these countries underwent reforms and implemented tax policies aligned with EU standards. This process aimed to create a more unified and consistent regional tax environment and enhance economic integration with the EU.[62]

As the final part of this chapter, the following section analyzes a third case from a South Asian country that shares a border with two of the largest economies in the world (China and India); this is the case of Pakistan. Like Mexico, the country's FDI relies on U.S. investment and its market size (250 million inhabitants), making it attractive as an off and nearshore destination for business development.[63]

3.3 South Asia: Pakistan

Pakistan is a South Asian country that enjoys a strategic location for trade and manufacturing due to its proximity to India, China, and Middle-Eastern countries. Pakistan can be seen as a reference for nearshoring practices compared to Mexico due to several factors, including its strong ties with the U.S. regarding FDI. The U.S. has consistently contributed to Pakistan's FDI, with American companies pledging substantial investments of over $1.5

[62] Peci, Bedri. 2016. "Tax Reforms in Selected Balkan Countries: The Case Study of Kosovo." Applied Economics and Finance 3, no. 4.
[63] PwC. Worldwide Tax Summaries. Pakistan.

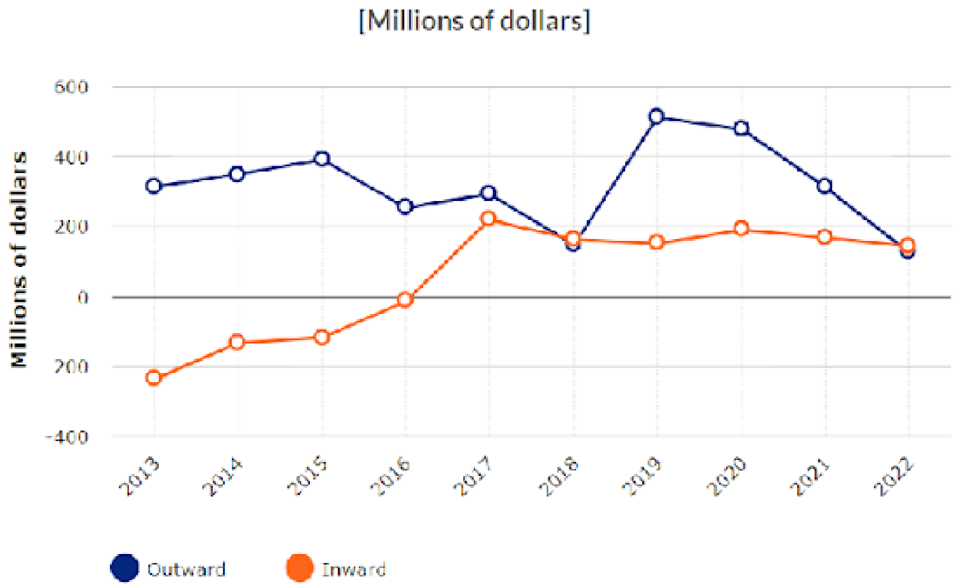
billion across various sectors in recent years.[64] Moreover, in 2020, the country moved upward 28 positions in the World Bank's Doing Business Report, thus positioning itself as an emerging attractor of FDI.[65]

Additionally, Pakistan's attractiveness for FDI is evident in sectors such as fast-moving consumer goods, agribusiness, financial services, franchising, information and communications technology (ICT), renewable energy, and healthcare services. These areas align with the diverse sectors often engaging in nearshoring activities, reflecting Pakistan's potential as a destination.[66] The dynamic investment landscape and strong sectoral presence in ICT make Pakistan a relevant point of reference for nearshoring practices, especially in comparison to Mexico.

As shown in Graph 15, the U.S.' inward investment -or FDI- into Pakistan was $144.0 million in 2022, a decrease of 14.3% from 2021.[67] However, despite the recent decline, FDI grew consistently between 2013 and 2017. Since then, the investment trend has remained relatively stable. The activity of U.S.-based majority-owned Multinational Enterprises (MEs) has also had an important impact on Pakistan employment, accounting for 14.3 thousand jobs in 2020, compared to 0.6 thousand job positions from Pakistan-based majority-owned affiliates of U.S. MEs.[68]

[64] U.S. Department of State. 2021 Investment Climate Statements: Pakistan.
[65] Ibid.
[66] Ibid.
[67] BEA. Pakistan - International Trade and Investment Country Facts. U.S. Direct Investment Position with Pakistan.
[68] Ibid.

Graph 15. U.S. Direct Investment in Pakistan, millions of dollars



Source: Pakistan - International Trade and Investment Country Facts. Bureau of Economic Analysis.

Moreover, Pakistan's example results in a relevant case study because of its manufacturing advocacy, contributing 7% of total exports in the last quarter of 2022. The U.S. is the leading destination for Pakistani exports (20% in 2022).[69] In the same period, manufacturing accounted for 13% of the GDP; the highest participation of the sector in the country's economy was in 1994 with 16%.[70] Due to Pakistan's levels of FDI and manufacturing industry, similar countries such as Bangladesh and Nicaragua, the latter a Central American country, are also strategic in nearshoring for the North American markets.[71] Lastly, recent statistics from the Pakistani government indicate positive economic activity. The exports of 9 out of 10 commodities increased in July 2023, compared to the same period of 2022.[72]

[69] PAKISTAN BUREAU OF STATISTICS. Quarterly Review of Foreign Trade (October-December, 2022).
[70] World Bank. Manufacturing Value Added as Share of GDP. World Bank national accounts data, and OECD National Accounts data files.
[71] Macrotrends. Pakistan Foreign Direct Investment 1970-2023.
[72] PAKISTAN BUREAU OF STATISTICS. ADVANCE RELEASE ON EXTERNALTRADE STATISTICS FOR THE MONTH OF JULY, 2023.

Tax Structure and Incentives in Pakistan

FDI stands as a critical conduit for international capital movement, carrying pronounced implications, particularly for countries in low and middle-income countries such as Pakistan, India, and Indonesia. For these nations, FDI serves as a vital source of foreign investment and plays a crucial role in facilitating the transfer of technological expertise and knowledge, with an essential effect on employment, mainly from MEs. As mentioned in Chapter 1, research concludes that attracting FDI from high to low and middle-income countries is more complex and that there is a significant variance in this second group.[73] In this context, tax incentives become crucial for reducing the cost of starting a new business in the host country.

Table 14 compares the tax structure between Pakistan and the previous countries of analysis, Lithuania and Mexico, each representing a competitive region for nearshoring. Pakistan shows tax rates and structure similar to Mexico's. Regarding Pakistan's CIT, the country has a different rate based on company type. Small businesses can enjoy a reduced 20% CIT rate, while banking companies can face a 39% rate. Similar to Mexico, deductions become relevant for determining the effective CIT rate (the proportion of income paid after tax credits, deductions, and other applicable benefits). Lastly, regarding the VAT rate, Mexico and Pakistan are more competitive than Lithuania, probably underscoring the manufacturing advocacy of both economies.

Table 14. Tax structure and rates in selected countries

Tax Description	Northern Europe	South Asia	Latin America
	Lithuania	Pakistan	Mexico
Corporate Income Tax	15	29	30
Value-Added Tax	21	13-18	16
Withholding Tax Rates (Resident) Dividends/Interests/Royalties	0	15/15/0	10/08/NA
Withholding Tax Rates (Non-Resident) Dividends/Interests/Royalties	15/10/10 or 0	15/10/15	10/4.9-35/5-35

Source: PwC Worldwide Tax Summaries.

[73] Mottaleb, Khondoker Abdul, 2007. Determinants of Foreign Direct Investment and Its Impact on Economic Growth in Developing Countries. Civil Service College, Dhaka.

Like the countries above, Pakistan has implemented tax reforms to improve its attractiveness for foreign investment. These incentives are intended to favor the energy sector and small companies, mainly those in the manufacturing industry. Some examples of Pakistan's tax incentives are the following[74].

- The income tax rate applicable to capital gains from the sale of securities obtained before July 1, 2013, has been lowered from 12.5% to 0%.
- The production, transmission, and distribution of electricity are now exempted from the scope of federal sales tax.
- Small companies benefit from a reduced rate of 20%.
- Income earned by a zone enterprise established within 'special economic zones' is exempt from taxation for ten years (tax holidays).
- Salary disbursements are considered valid deductions when calculating business income (similar to incentives implemented by Balkan countries).

As a strategic partner for U.S. and Indian investments, the Government of Pakistan has established sector-oriented incentives to attract FDI from the country (targeting cinema and technology). The following are some examples of tax incentives under local tax law[75]:

- Income from cinema operations has been exempted from tax for five years from the commencement of its operations
- Profits and gains derived by venture capital companies and venture capital funds are exempt till 30 June 2025
- Creation of Special Technology Zones' (STZs):
    - o Dividend income and long-term capital gains from investments in zone enterprises by a venture capital fund are eligible for a ten-year exemption starting from the license issuance (tax holiday).
    - o Profits and gains arising from the development and operations of the zones by a zone developer are exempt for ten years starting from the date of signing the development agreement.

[74] PwC. Worldwide Tax Summaries - Significan Developments. Pakistan.
[75] PwC. Worldwide Tax Summaries - Tax credits and incentives. Pakistan.

- o Profits and gains generated by zone enterprises, as defined in the STZ Ordinance, are eligible for a ten-year exemption starting from the license issuance date by the authority.

Leveraging Tax Incentives to Drive Nearshoring

In the context of nearshoring, taxes emerge as a paramount consideration. The tax environment of a prospective nearshore destination profoundly influences the cost structures and profit potentials for multinational firms. As such, a favorable tax regime can significantly enhance the attractiveness of a country for nearshoring initiatives. As a result of this notion, Pakistan readjusted with two main initiatives, an investment regimen that was liberalized in 1997[76]:

- In 2013, Pakistan introduced an Investment Policy that further liberalized investment policies in most sectors to attract foreign investment.
- In 2015, an economic cooperation agreement was signed with China, the China-Pakistan Economic Corridor (CPEC). While the CPEC holds considerable potential, funding sufficiency and political implementation challenges have surfaced, underscoring the pivotal role of robust and stable infrastructure in ensuring the success of nearshoring initiatives.

Other policy initiatives that target specific sectors of interest for maintaining a positive trade balance (more exports than imports) are the following[77]:

- Automotive Policy 2016
- Strategic Trade Policy Framework (STPF) 2015-18
- Export Enhancement Package 2019
- Alternative and Renewable Energy Policy 2019
- Merchant Marine Shipping Policy 2019 with 2020 updates
- Electric Vehicle Policy 2020-2025
- Textile Policy 2021

[76] PwC. Worldwide Tax Summaries. Pakistan.
[77] U.S. Department of State. 2021 Investment Climate Statements: Pakistan.

These policies and programs often encompass tax advantages, reimbursements, tariff reductions, the establishment of specialized infrastructure, and services aimed at facilitating investments.[78] Under the current global economic landscape, many countries face the challenge of reshaping their tax policies under a post-pandemic recovery scenario, which might lead to a temporal increase in the tax burden on corporate activities and a possible contraction in foreign investment.[79] For example, in Pakistan's Finance Act of 2023, the government reintroduced[80]:

- A 10% final tax (income tax) on bonus shares issued by companies
- An additional retroactive (3 years) tax on income, profits, and gains (up to 50%)

Conclusions from the Pakistani experience

Tax reforms and sustained liberalization policies adopted by Pakistan have enhanced strategic partnerships with the largest economies in the world, the U.S. and China.

In Pakistan's context, taxes' influence on FDI has been underscored. It becomes evident that multinational corporations, driven by profit maximization, exhibit a heightened sensitivity to tax-related factors. International organizations such as the American Business Council of Pakistan, formed in 1984 and integrating 66 members, advocate for proposing tax reforms and trade policies that enhance foreign trade and mitigate taxation issues (e.g., the extension of the Super Tax, initially foreseen to last a year). Some of their recommendations include adopting technology for enhanced transparency and business protection.[81]

Pakistan's targeted policies, such as the Electric Vehicles Policy, underscore the importance of sector-specific incentives, which can lead to nearshoring.

Extracting valuable lessons from Pakistan's experience fostering nearshoring activities reveals the significance of targeted policies aimed at specific economic sectors. A notable case in point is the Electric Vehicles Policy 2020-2025, implemented by the Pakistani government to promote

[78] Ibid.
[79] OECD. "Tax and fiscal policies after the COVID-19 crisis". October 14, 2021.
[80] PwC. Worldwide Tax Summaries. Pakistan.
[81] The American Business Council of Pakistan. The Future of Partnership. 2017 Annual Report.

the adoption of electric vehicles (EVs). This policy strategically incentivizes the import of EVs, foreseeing in Pakistan not only manufacturing activities but also market development. Exploring these opportunities for Mexico will be essential for enhanced investment and technological partnership.[82]

Institutional transparency and a strengthened legal framework for IPR are crucial for domestic enterprises and foreign investment.

Similar to Mexico, Pakistan's experience underscores the importance of addressing regulatory impediments to foster a conducive environment for nearshoring activities. Foreign investors have consistently emphasized the need for Pakistan to fortify legal safeguards for foreign investments, strengthen intellectual property rights protection, and establish unequivocal and coherent policies to uphold contractual commitments and resolve tax-related disputes.[83] By heeding the call to alleviate regulatory complexities and ambiguities, countries can effectively enhance their appeal to foreign investors and position themselves as sought-after destinations for nearshoring activities.

After the exposition and analysis of the three cases in this chapter that explore various approaches to attract nearshoring practices, the subsequent chapter offers conclusions and recommendations regarding tax incentives and reforms. These findings are derived from the comprehensive analysis in Chapters 2 and 3.

[82] Startup Pakistan. "Pakistani Auto Industry Attracts Mexican Auto Companies". September 27, 2021.
[83] Sustainable Development Policy Institute. "Excessive regulations hurdle to foreign investment". January 22, 2020.

4. CONCLUSIONS AND RECOMMENDATIONS FOR MEXICO'S FISCAL POLICY

Chapter 1 introduced a theoretical framework to provide a comprehensive understanding of nearshoring from both the private (firm) perspective – exploring when firms relocate processes closer to their headquarters – and the public or developmental approach. This approach delves into how nearshoring, as a private practice influencing FDI, can yield advantages for the host country. The discussion encompasses considerations for achieving desired outcomes such as heightened employment, accelerated technological transition, and improved productivity.

In examining the factors that facilitate or shape FDI attraction, an extensive body of literature highlights the diverse array of measures, policies, and country attributes that influence the fluctuations of FDI within host nations. This scrutiny reveals that taxes, encompassing their structure and rates, play a pivotal role in delineating the overall business environment of the host country. Nonetheless, beyond the realm of taxation, the importance of additional factors emerges, driven by their influence on bolstering the security of foreign investments and refining the precision of cost and profit projections.

Chapter 2 provided a broad perspective on the tax framework in Mexico, indicating that the country has aligned itself with international policies set forth by the OECD.

Furthermore, it described a detailed list of incentives that can help attract FDI, which we can summarize in the following:

- **Loss Carry Forward:** Mexico's Tax Law contemplates the possibility of reducing "tax losses." The mechanism to reduce them involves calculating the taxable income for the year, subtracting authorized deductions and employee profit-sharing, and then deducting the accumulated tax losses pending reduction. The result is the taxable profit. These tax losses can be carried forward and offset for up to the next ten years from the year they were generated, and this right is personal to each taxpayer.
- **Investment Deductions:** Investment deduction exists in Mexico with certain limits, and the rates vary depending on each asset or deferred expense and the activity it is used for. It can range from 3% to 100% of

the investment. There are more than 40 maximum rates for these cases. It includes all types of assets used for the company's operation and deferred charges such as software or intangible assets.

- **Investment Tax Credit:** In Mexico, there are tax incentives that, in specific sectors, allow for a reduction of up to 100% of the CIT to be paid. Additionally, these incentives also enable accelerated deductions of investments in assets. The main incentives include:
  - Tax incentives for the northern and southern border
  - Stimulus region welfare
- **Reduced Taxes on Dividends and Foreign-Source Interest:** In Mexico, there is no distinction in tax treatment between nationals and foreigners; however, there is the possibility of applying reduced rates through the observance of treaties to prevent double taxation.
- **Deductions for Qualified Expenses:** In Mexico, various deductions are available, each with specific limits in some cases. These deductions encompass returns received, discounts or bonuses granted, cost of goods sold, expenses, investments, uncollectible credits, losses due to unforeseen circumstances, social security contributions, accrued interest, and the deductible annual inflation adjustment.
- **Zero or Reduced Tariffs:** Mexico presently boasts a network of 14 Free Trade Agreements (FTAs) with 50 countries, 30 Bilateral Investment Treaties (BITs) with 31 countries or regional administrations, and nine limited-scope agreements (Economic Complementation Agreements and Partial Scope Agreements) within the framework of the Latin American Integration Association (ALADI). These trade agreements significantly reduce or exempt trade tariffs and facilitate international trade.
- **Value Added Tax (VAT) Credits:** Currently, in Mexico, there is a certification for VAT and Special Tax on Production and Services (IEPS), the main benefit of which is the ability to apply a tax credit equivalent to 100% of the VAT/IEPS that must be paid for the temporary importation of goods or inputs intended for the production, transformation, or repair of goods for export. This benefit applies to various schemes, including the maquiladora programs (IMMEX), fiscal deposit for the assembly and manufacturing of

vehicles, production, transformation, or repair within a supervised facility, and strategic supervised facility.

In summary, Chapter 2 has outlined the key considerations for foreign companies looking to establish themselves or enter into partnerships in Mexico. These include:

- **Compliance with Mexican Regulations:** It is crucial to thoroughly review Mexican regulations governing the incorporation of a company and ensure compliance with requirements related to foreign investment.
- **Financial Planning:** Foreign companies should develop well-defined financial projections for their ventures' initiation and ongoing operations in Mexico.
- **Taxation Rates:** Carefully examine the tax rates that apply to the services or merchandise offered in the Mexican market.
- **Tax Obligation:** Clearly define the tax obligations the company will be subject to while operating in Mexico.
- **Market-Value Transactions:** Ensure transactions with related companies adhere to market values.

Chapter 3 delivered a comprehensive overview of using tax incentives to attract FDI from wealthier economies to those with moderate or lower incomes, mainly through nearshoring practices. The case studies presented have highlighted the importance of various factors in shaping FDI attraction strategies.

The first case study emphasized the unique dynamics between the United States and Mexico, underlining the significance of their proximity, income disparity, and the role of individual Mexican and U.S. States in FDI competition. This case showcases the multifaceted nature of FDI attraction within a North American context.

The second case study explored the economic interactions between Baltic and Balkan countries and their Nordic counterparts in Eastern Europe. It drew attention to their geographical proximity to Western Europe, similar income characteristics to Mexico, and their successful embrace of IT and innovation-driven economic activities. These countries' experiences serve as valuable references for Mexico in diversifying FDI strategies.

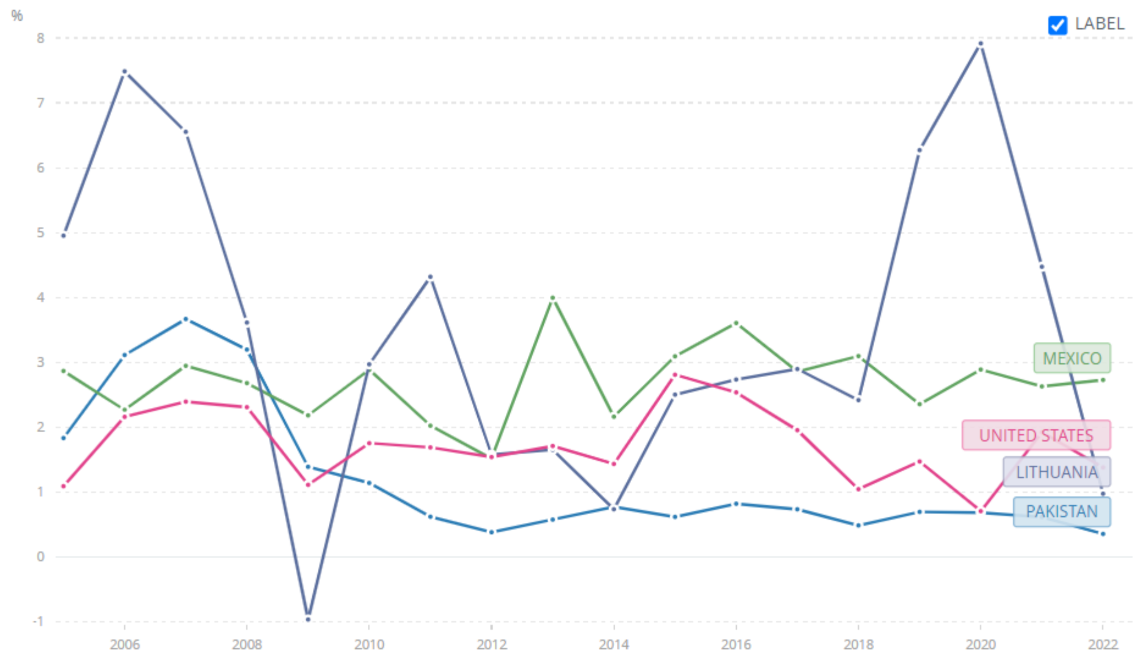
Finally, the third case study delved into Pakistan's FDI patterns and appeal, offering insights into nearshoring practices compared to Mexico. Pakistan's connections with the U.S., middle-income status, proximity to China, and favorable tax framework contribute to its relevance. This case highlights the importance of aligning industrial policies with high-income investment trends and prioritizing trade-oriented infrastructure complementary to tax incentives in attracting FDI.

In light of the above, we can conclude the following about Chapter 3:

Mexico's consistent and modestly increasing FDI as a percentage of GDP makes it a stable nearshoring destination.

The U.S. holds the highest attraction for foreign investment in millions of dollars. However, when examining FDI net inflows as a percentage of GDP, the U.S. demonstrates significant responsiveness to fluctuations in FDI, peaking in 2020 and dropping below Mexico's levels in 2022. Conversely, Mexico has maintained a relatively steady FDI share of GDP. However, it has yet to reach its peak in 2013 and is likely to exceed expectations by the end of 2023 after the investment announcement from several companies (i.e., Tesla). Notably, in 2022, Mexico's FDI share surpasses that of the U.S., Lithuania, and Pakistan, as demonstrated in Graph 16. This stability in retaining and even enhancing FDI during specific periods positions Mexico as a notable and growing nearshoring destination.

Graph 16. FDI, net inflows (% of GDP)

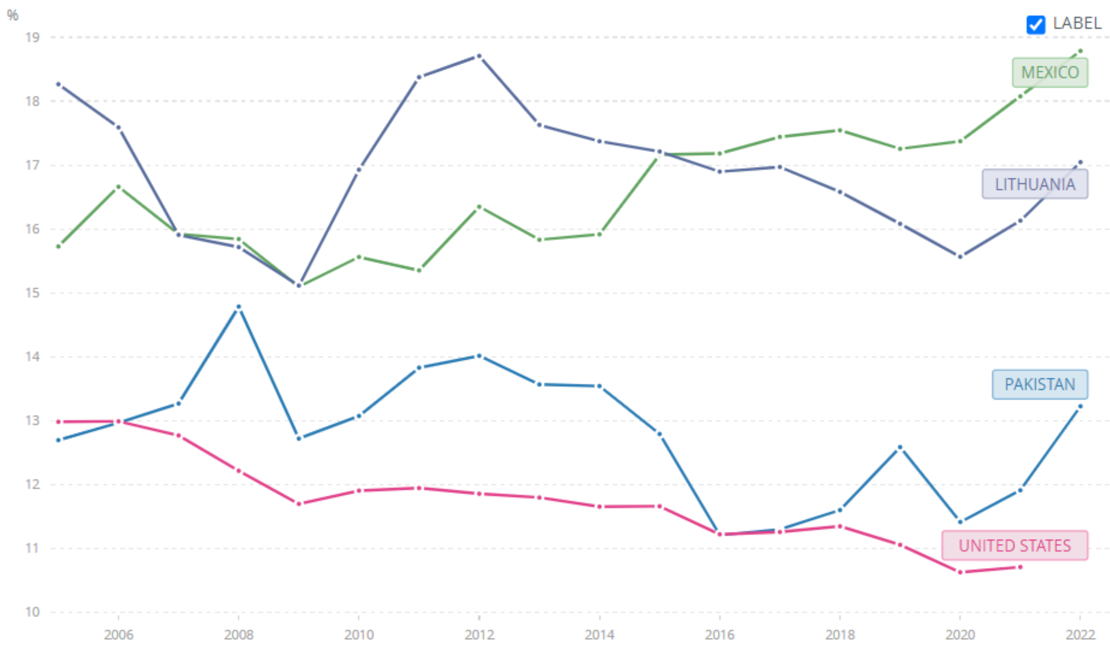


Source: World Bank Data. International Monetary Fund, International Financial Statistics and Balance of Payments databases, World Bank, International Debt Statistics, and World Bank and OECD GDP estimates.

Mexico's strong manufacturing position results from past liberalization tax and industrial policies demonstrating its economic prowess on the global stage.

The comparison of manufacturing value added as a percentage of GDP across countries reveals Mexico's economic strength as it maintains a significant nearly 6% advantage over the United States. Surprisingly, this places the U.S. below countries like Pakistan and Lithuania in this specific economic indicator. Notably, Lithuania's strategic efforts in liberalizing tax and industrial policies have enhanced its competitiveness in the manufacturing sector, as discussed in Chapter 3. Furthermore, the observed trend depicted in Graph 17 indicates a discernible level of specialization between Mexico and Lithuania, particularly evident in their respective automotive industries. Mexico appears to benefit from a strong presence of American and Japanese influences, while Lithuania likely draws from Swedish influence. This specialization is pivotal in both countries' prominence in this economic indicator.

Graph 17. Manufacturing, value added (% of GDP)

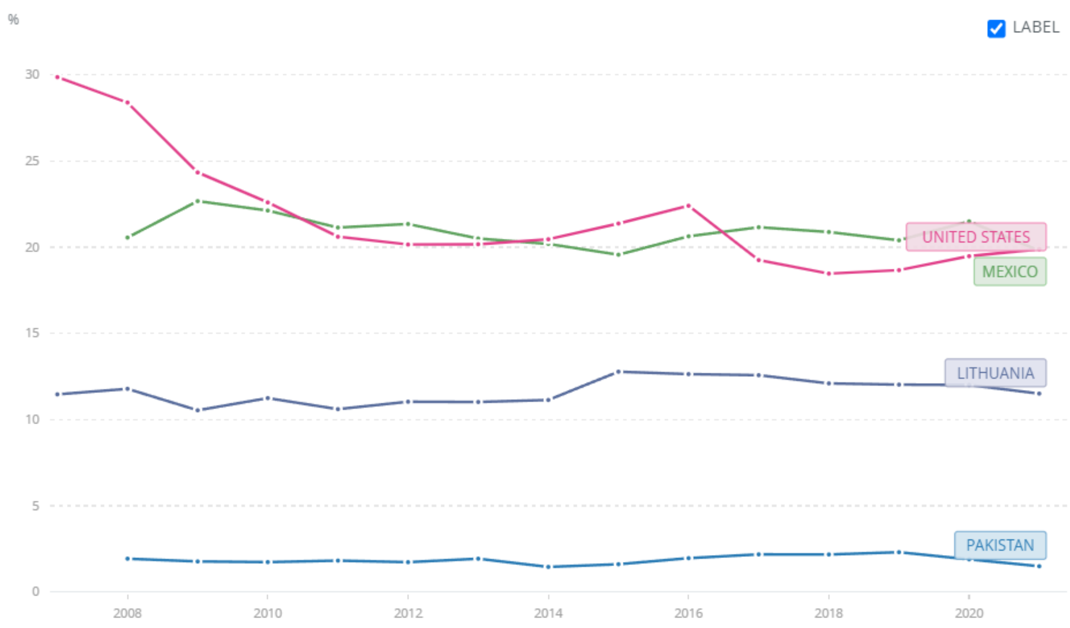


Source: World Bank Data. World Bank national accounts data, and OECD National Accounts data files.

The nearshoring potential is evident as the U.S. poses competition to Mexico in high-technology exports, as shown by a countercyclical trend between the two nations.

In the context of high-technology exports, the U.S. emerges as a strong competitor to Mexico. The data reveals an intriguing dynamic where the U.S. has experienced a fluctuating trajectory in high-technology exports, with a recent upward trend since 2018. In contrast, Mexico has displayed relative stability in high-technology export trends. Mainly noteworthy is the counter-cyclical pattern observed where an increase in the indicator for the U.S. corresponds with a decrease for Mexico and vice versa, warranting further investigation into the intricacies of their economic relationship.

Graph 18. High-technology exports (% of manufactured exports)

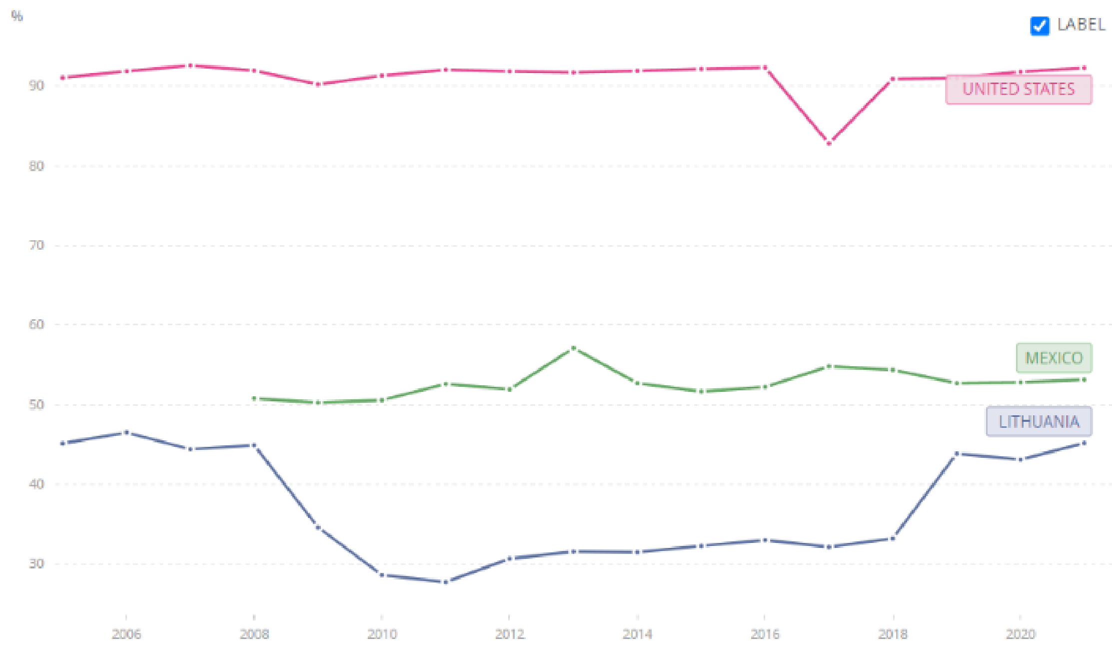


Source: World Bank Data. United Nations, *Comtrade* database through the WITS platform.

The variation in tax reliance suggests Mexico's potential to strengthen its attractiveness for nearshoring.

In summary, when considering income, profits, and capital gains taxes, the U.S. stands out as the country with the highest reliance on this tax category, followed by Mexico and Lithuania. Although Lithuania exhibited a period of decreased dependency on these taxes from 2009 to 2017, there was an upturn in 2018, possibly indicating increased corporate value and activity or a rise in CIT and capital tax rates. In contrast, Mexico positions itself moderately in terms of income, profit, and capital gains taxes, offering an opportunity for the country to enhance its appeal for nearshoring initiatives.

Graph 19. Taxes on income, profits, and capital gains (% of total taxes)



Source: International Monetary Fund, Government Finance Statistics Yearbook and data files.

Based on the comprehensive analysis presented in the preceding chapters, it is evident that Mexico holds a unique position in the landscape of FDI and nearshoring activities. Its stable and modestly increasing FDI as a percentage of GDP establishes it as a reliable nearshoring destination. Additionally, Mexico's consistent performance in retaining and even enhancing FDI during specific periods positions it as a notable and growing nearshoring hub. This stability, combined with its strong manufacturing sector, demonstrates Mexico's economic competence on the global stage.

To further bolster Mexico's attractiveness for nearshoring initiatives, it is recommended that the country also focus on enhancing its tax framework. While Mexico positions itself moderately in income, profit, and capital gains taxes, there is room for improvement to increase its competitiveness in attracting FDI. Streamlining tax processes, offering targeted incentives, and aligning tax policies with high-income investment trends can help Mexico solidify its position as a top nearshoring destination.

Moreover, considering the U.S. as a competitor and principal investor, Mexico should explore strategies to leverage its proximity to the U.S. market and foster synergies in technology-driven industries. Collaborative efforts and partnerships in research and development, innovation, and technology transfer can further enhance Mexico's appeal to companies seeking to nearshore their operations, especially when looking for a more high-skilled workforce.

Given the above, it is imperative to formulate specific recommendations considering the need for targeted improvements in Mexico's tax framework. By implementing these recommendations, Mexico could solidify its status as a top choice for companies seeking to relocate their operations and capitalize on its economic strengths, ultimately fostering sustainable economic growth and prosperity.

Recommendation 1. Review Interest Deduction Limit.

As a result of the efforts led by the OECD, Mexico has played a significant role in implementing the measures outlined in the BEPS Plan. A concrete example of this commitment can be found in the 2020 Fiscal Reform. During that period, provisions related to the digital economy and the limitation of base erosion through interest operations were introduced. These provisions reflect Mexico's dedication to adhering to the directives and objectives outlined in this plan.

One of the key provisions added to the Income Tax Law was the limitation on the deduction of interest payments made by taxpayers. This measure stemmed from the BEPS Plan, which identified that one of the most straightforward international tax planning techniques to shift profits involves making interest payments between related and independent parties. Furthermore, the BEPS Report indicated, based on academic studies, that multinational groups tend to accumulate higher levels of debt than their subsidiaries located in countries with higher tax rates. This practice has repercussions on developed and developing nations, with the latter facing even more significant risks.

For this reason, countries were advised to introduce a rule limiting the deduction of interest based on taxable profits before interest, depreciation, and amortization. As outlined in the Final Report, the recommended range for determining this ratio was between 10% and 30%. Mexico opted to set the maximum limit at 30% in its legislation. Simultaneously, regulatory harmonization was undertaken per the principles delineated in the BEPS Report. It was stated that these provisions should apply minimally to legal entities within multinational groups. Still, they could also be extended to domestic entities or those not affiliated with corporate groups.

As a result, this provision applies to all legal entities, establishing a minimum rule that applies uniformly to all taxpayers. Furthermore, it covers payments made to third parties, related parties, and members within the same corporate group, in line with the report's recommendations above. An alternative is provided, allowing countries to apply these rules to debts incurred before the tax year in which the provision takes effect, eliminating the need for transitional rules to address such situations. Consequently, this provision became effective for deductible interest starting from the 2020 tax year, irrespective of the origin of debts acquired in previous years. This decision was made considering the Mexican legal framework, ensuring that those with debts contracted before the implementation of this provision have a right of expectation, meaning that a law not in force at the time cannot be retroactively applied to them.

Additionally, the provision excludes debts acquired for financing public infrastructure projects, recognizing the typically high level of indebtedness associated with such initiatives. A non-exhaustive list of activities exempted under this exception is included. It is also specified that the provision does not apply to debts incurred for property development within the national territory to promote this sector.

On the other hand, the limitation on interest deductibility, as established in the adoption of the BEPS Plan, restricts the deductibility of interest to Tax EBITDA, which means that not all interest payments can be deducted in the current fiscal year. In the first year, this limitation can impact the annual adjustment calculation for inflation, as it does not consider the capital from which interest is derived as debt. This could result in an increase in the yearly deductible inflation adjustment (authorized deduction) or a decrease in the annual cumulative inflation adjustment (cumulative income). To mitigate the impact of inflation, in Mexico, companies can carry forward interest expenses that are not deductible for up to the following ten fiscal years.

Inflationary effects can influence the deductibility of interest because the actual value of the debt can change over time due to inflation. Since the deductibility limitation and the 'carry forward' are applied in nominal terms, high inflation rates can make the impact of non-deductible interest on the annual adjustment for inflation more significant in real terms.

In specific projects or businesses, the authorities acknowledge the necessity of exempting debts acquired for their operation or development from this limitation**. Establishing a business in Mexico often relies heavily on the initial investment, which is frequently facilitated through debt issuance, whether domestic or foreign.**

Consequently, it is crucial to reconsider the following aspects of this reform to promote schemes beneficial for FDI:

1. **Introduce a grace period for newly established companies** during their preoperative phase or while engaging in auxiliary activities related to their core operations, extending for up to two tax years. During this period, the interest deduction limit would not apply if their interest expenses arise from debts acquired to finance projects within the national territory.
2. **Establish comprehensive rules** for applying the interest deduction limit when consolidated deductions are made (interests paid by a group). Despite the procedure being covered in the Law, it directly refers to regulations issued by the tax authority, which have yet to be published, resulting in uncertainty. One potential benefit of this approach could be applying a higher exemption limit for deductible interest expenses, mainly when debts are acquired directly by a consolidated group, potentially resulting in more significant interest expenses.
3. **Modify the rights granted by fiscal incentives** such as the North and South Border Area Decree and the Welfare Decree. The goal is to incentivize newly established companies in these designated areas to stimulate economic growth in the Welfare Area and enhance competitiveness in the Border Areas. The fiscal incentive would consist of a more substantial exception than what is currently provided by law (20 million pesos) for deducting interest expenses, potentially increasing it to 30 million pesos, provided these expenses result from debts intended to finance investment projects.
4. **Eliminate the inflationary effects** in determining deductible interests; companies may face a more significant financial burden in

real terms as inflation increases the actual cost of non-deductible interest. This can affect the company's profitability, investment capacity, and financial decision-making. The company may need to allocate more resources to cover these non-deductible interests, which could limit its growth or investment capacity. Eliminating the inflationary effects on interest deductibility would promote business competitiveness in Mexico. Companies could make more efficient investments without worrying about the disproportionate tax impact of inflation on interest deduction.

Recommendation 2. Repeal Deduction Limits on Worker Payments.

Up to the tax year 2013, the Income Tax Law allowed people who have workers depending on them (employer) to make the deduction of the total amount of the different gainful concepts delivered to their employees, regardless of whether such elements were subject to taxation according to the Law, for the benefit of such workers. As a result, the tax authority considered that this taxation treatment resulted relatively asymmetric, as there were incomes that for the worker were completely exempt from income tax and, in turn, deductible for the employer, so it created damage for the federal tax authorities, as it did not collect it in a "symmetrical manner"[84] allowing taxpayers to deduct the total amount of payments that in turn were exempt income.

Consequently, according to the tax legislations, currently, the payments made by employers, which are also exempt income for the workers, will be non-deductible up to an amount that will result from applying a factor of 53 or 47%, as described in chapter 2 of the section of authorized deductions in Mexico.

In this context, it is paramount to consider a generalized fiscal reform focused on removing/ repealing the deduction limit of these payments for all taxpayers. This argument is supported by the fact that the current valid restriction can be considered detrimental and even contravenes fundamental principles outlined in the Constitution. These principles include fiscal proportionality, which rules that taxes must be proportional to the economic capacity of individuals, and tax equity, which is based on

[84] Tax symmetry is a taxation policy principle, non-legal but more dogmatic, that creates a link between taxpayers and the balance between income and expenses, so if a person must acknowledge an income that will be taxed, the counterparty making the payment must have a deduction.

the premise that taxes are similar to those in equivalent situations and differently to those with different circumstances.

This can be exemplified as follows: The regulations, as they are currently, do not allow the complete deduction of payments made for social security contributions, even though this expenditure is essential for achieving the company's purpose regarding its workers. In other words, the dues paid regarding social security, as a benefit for workers, are included in the salary of the workforce. Consequently, this payment involves a strictly indispensable cost for attaining purposes and activities.

In this sense, this expenditure must be acknowledged and considered entirely deductible. This is because this expense is indispensable for developing the employers' activities.

For all that, the repealing of this deduction limit is suggested. This is made to safeguard the constitutional principles rooted in the legislation and promote investments by removing obstacles that prevent the complete deduction of payments corresponding to payrolls and benefits of workers.

It's important to mention that this initiative has been extensively discussed and presented to authorities by various technical groups, such as the Mexican Institute of Public Accountants.

Recommendation 3. Shorten the time frame for Returning Credit Balances of Contributions.

As stated in Chapter 2 of this study, in Mexico, according to legislation (Fiscal Code of the Federation, Tax Income Law, and VAT Law), the generation of credit balances in favor of taxpayers is allowed.

Usually, these credit balances are granted naturally by the calculation and determination of taxes. In the case of VAT, the credit balances are generated when the VAT transferred to the taxpayer is greater than the VAT transferred by him when the creditable VAT (the one generated by expenses) is greater than the VAT charged (generated by income).

By contrast, the Income Tax in favor is given naturally by an excess of provisional payments made compared to the yearly determination. This is, the provisional amount of income tax of one payment at the expense of the annual account can exceed the number determined for yearly income tax, thus generating a credit balance.

In this sense, it should be noted that fiscal authorities are obliged to return the credit balances within the following forty business days from the day after the contributions return request has been submitted before the fiscal authorities, which sometimes exceeds the term.

This can be unfavorable for the investment of companies in Mexico, as those who, due to the nature of their activity, generate credit balances both for VAT and income tax may find their initial investment diminished by having to wait for a considerable period for the return of excess contributions paid or credit balances generated from their activities.

In this context, it is proposed to reduce to a term of twenty days for the return of credit balances in favor of taxpayers or improper payments for those newly created companies in Mexico, as well as for those people who are in a preoperative period or carrying out auxiliary activities to its main operation, up to three tax years, or, as the case may be until the preoperative period has ended; as long as those credit balances obtained by the contributions are intended for reinvesting in the operation of entities.

Recommendation 4. Explicitly include the Research and Development (R&D) deduction within the authorized deductions.

Deductions on R&D play a crucial role in fiscal frameworks by encouraging innovation, boosting competitiveness, creating jobs, and contributing to long-term economic growth. They are vital for governments to support research and development activities that drive technological progress and enhance a nation's economic well-being.

As depicted in Chapter 3, the countries that have attracted foreign investment exhibit a concentration of highly skilled labor, particularly in the technological sector, substantial investments in R&D and infrastructure, as well as robust safeguards for IPR, which are critical factors for countries aspiring to host advanced manufacturing and domestic technological progress.

In particular, the deductions presented in Table 15 have been implemented in those countries.

Table 15. R&D tax incentives in selected countries

Country	Tax Incentives
United States	• Deductions on Research and experimental (R&E) expenditure: These expenses must be capitalized and amortized over five years from the midpoint of the tax year they were incurred, while R&E expenses related to foreign research are amortized over 15 years.[85]
Lithuania	• Deductions on R&D investments and profits**:** Since 2018, there has been an additional incentive for companies investing in R&D – a reduced 5% rate of the CIT for commercialization of inventions created in R&D activities, including investing in technological renewal.[86]
Balkan Countries[87]	• R&D allowances: Justifiable costs of R&D allow for additional deductions from the tax base by 100%, 125%, or 150% of the cost amount, depending on the character of the research (Croatia)

Source: PwC Worldwide Tax Summaries.

Mexico could use R&D tax deductions to support strategic sectors such as technology, healthcare, energy, and advanced manufacturing. This can drive specialization and growth in these industries.

Implementing an R&D tax deduction in Mexico can promote innovation, attract investments, create high-quality jobs, and contribute to the country's long-term economic growth.

Therefore, it is recommended to implement a tax deduction for R&D activities that consider the following:

1. A percentage substantial and attractive to companies. This could range from 100% to 150% of qualified R&D expenses. A higher rate, such as 150%, can further incentivize investment in R&D.
2. Clear eligibility criteria and adequate oversight should also be in place to ensure that only genuine R&D activities qualify for the deduction. While a high deduction percentage is recommended, it's

[85] PwC Worldwide Tax Summaries.
[86] Ministry of Finance of the Republic of Lithuania. "Tax Incentives for Investment and Innovations".
[87] Tax Incentives in Western Balkan Countries Article · January 2010

essential to establish reasonable limits to prevent abuse and ensure fiscal sustainability.

3. A periodic review of the deduction percentage and the results regarding R&D investment and economic growth should be conducted. This allows adjustments to the deduction as needed to meet fiscal and financial objectives.

In addition to the fiscal framework modifications described above, it is suggested that a comprehensive analysis of U.S. States, focusing mainly on those with significant FDI, such as California, Texas, and New York, be performed to assess their respective tax incentive programs.

Table 16. Tax Incentives, California, New York, and Texas.

California	New York	Texas
• California Competes Tax Credit • California Research and Development Tax Credit • Sales and Use Tax Exemption • California Alternative Energy and Advanced Transportation Financing Authority (CAEATFA) Programs	• Excelsior Jobs Program • Start-Up NY • Regional Economic Development Councils (REDCs) • New York State Research and Development Tax Credit • Green Energy Incentives • Qualified Emerging Technology Company (QETC) Credits	• Texas Enterprise Fund • Texas Emerging Technology Fund • Texas Enterprise Zone Program • Texas Economic Development Act • Texas Sales Tax Exemptions • Texas R&D Tax Credit

Source: California doing business, California State Treasurer, Official Website of New York State, Texas Economic Development.

Potential Benefits and Possible Impact of the Recommendations

The following impacts represent the potential outcomes of the recommendations put forth in this document. These recommendations, addressing various aspects of fiscal policy and economic development in Mexico, can change the country's economic landscape. While some may lead to lower tax revenue in the short term, they are designed to generate substantial long-term benefits, including increased formal sector employment, the growth of domestic industries, and the transfer of environmental capabilities. In this overview, we explore how these potential impacts could contribute to Mexico's fiscal sustainability, economic prosperity, and the overall well-being of its populace.

Lower Tax Revenue in the Short Term, Higher Revenue in the Future: The proposed recommendations, such as a review of interest deduction limits, repeal of deduction limits on worker payments, and the introduction of an R&D tax deduction, might initially result in a reduction of tax revenue for the Mexican government. However, this short-term sacrifice can lead to long-term gains. For instance, the R&D tax deduction can incentivize local and foreign businesses to invest in research and development activities within Mexico. This, in turn, can spur innovation, attract multinational corporations, and ultimately boost economic growth. As these investments bear fruit, they can contribute to higher tax revenues in the future, expanding the tax base and potentially surpassing the short-term revenue decline.

Increased Formal Sector Employment: Removing deduction limits on worker payments can positively impact formal sector employment. By allowing businesses to deduct a broader range of payments related to their workers, companies are incentivized to provide more comprehensive employment packages, including benefits like health insurance, retirement plans, and bonuses. This, in turn, attracts talent to the formal job market, reducing informal labor and enhancing job security for workers and, thus, greater long-term revenue collection.

Fostering Local Industries: The recommendations encourage the growth of domestic industries by supporting research and development activities and making it more attractive for businesses to invest in Mexico. With an R&D tax deduction and less restrictive deduction limits, industries can develop new technologies, improve processes, and enhance product quality. This can boost the competitiveness of local industries, potentially leading to increased exports and reduced import reliance.

Transfer of Environmental Capabilities: The potential for a "pass of capabilities" in the environmental sector is a significant environmental and economic benefit. Mexico can accelerate its transition toward a more sustainable and eco-friendly economy by encouraging businesses to invest in environmental technologies and practices. This can lead to advancements in clean energy, waste reduction, and sustainable agriculture, contributing to environmental protection and long-term economic stability.

Increased Investment and Enhance Competitiveness: By introducing a grace period for newly established companies, comprehensive rules for applying interest deduction limits, and allowing newly created companies and those in preoperative periods to access credit balances promptly, the Mexican government can encourage more businesses to invest in the country. Also, as outlined in the recommendation proposal, eliminating the inflationary effects in interest determination could enhance the competitiveness of companies in Mexico, thereby attracting capital to the country through debt.

These benefits collectively contribute to Mexico's fiscal sustainability and economic prosperity. While there may be short-term challenges, the recommendations are designed to position Mexico for a more robust and sustainable financial future, aligning with international best practices and enhancing its competitiveness on the global stage.

Conclusively, conducting a dedicated study is imperative to accurately assess the long-term impact of Mexico's four fiscal policy recommendations. This study should rigorously follow the outlined steps, including gathering historical tax and employment data, defining key assumptions, calculating revenue changes unrestricted by limitations, contrasting them with current revenue, projecting long-term effects, and conducting sensitivity analyses for diverse scenarios. These meticulous steps are essential to comprehensively evaluate the recommendations' pivotal effects on tax revenue, job creation, and competitiveness.

APPENDIXES

Chapter 1

Appendix 1.1. Difference and relevance between tax structures and tax rates

Tax structures and tax rates are both key components of a country's taxation system, but they refer to different aspects of how taxes are levied and collected. The difference between tax structures and tax rates is relevant for FDI because it directly affects the attractiveness of a country as a destination for foreign investment. Consistency in tax policies reduces uncertainty and the risk of unexpected tax changes, making the investment climate more attractive.

Tax Structures: Refers to the overall design and arrangement of a country's tax system, including the types of taxes imposed, the methods of taxation, and the distribution of tax burdens across different sectors of the economy and income levels. It encompasses the various tax categories that contribute to government revenue. Some common tax categories within a tax structure include:

- Income Tax
- Corporate Tax
- Value Added Tax
- Property Tax
- Customs Duties
- Excise Tax
- Capital Gains Tax

Tax Rates: Refers to the specific percentages at which taxes are assessed on different taxable bases. These rates determine an individual or entity's tax liability to the government based on income, profits, or transactions. Tax rates can vary widely depending on the type of tax and the jurisdiction.

Chapter 2

Appendix 2.1. Tax principles of worldwide income and source of wealth

World income and source of wealth principle

The principle of worldwide income consists in the fact that the State may establish and collect taxes on income produced beyond its territory regardless of the source or place from which it originates if the persons presumed to be taxpayers have a personal relationship with the State.

In international doctrine, there are two common ways of linking persons with the taxing power of the state, the first being "residence" and the second being the place of birth or incorporation. In the case of Mexico, tax residence in the country is the natural link that relates us to the payment of taxes.

Likewise, there are mechanisms to increase the state's tax collection. One of them is to tax all income obtained within the national territory, regardless of whether or not one has a tax residence, linking the obligation to contribute with the tax principle of "source of wealth."

According to Arrioja Vizcaíno, a recognized doctrinarian in the practice of tax law in Mexico, by source of wealth, we must understand "...the place where the tax generating events occur, where the taxpayer (taxpayer) receives the income, yield, or profit taxed by the tax law or where such income, yield, or profit is derived. In such a way, when this site or place is in the national territory, the recipient of the economic benefit must pay the taxes or federal contributions that proceed by the applicable laws".

In this sense, the source of wealth represents the link that determines that those persons who obtain income or revenues within the national territory and do not have tax residency will also be obliged to pay ISR.

Residence in Mexico

It should be noted that the concept of "residence in the country" is defined in local legislation; however, international organizations such as the Organization for Economic Cooperation and Development (OECD) have modified and adapted it to a global tax framework.

Mexico, as part of the OECD, has adopted definitions very similar to those established in the Model Tax Convention on Income and Wealth (Model OECD Convention) and has considered that for a legal entity to be a tax resident in the country, it must comply with the following characteristics:

1. Establish in the country its effective place of management, or:
2. To have in national territory its principal administration of the business;

If any national or foreign company configures any of these assumptions, it will be considered a taxpayer for tax purposes. According to domestic legislation, both are configured if the country is where the person or persons who make or execute the decisions of control, direction, operation, or administration of the legal entity and the activities it performs are located. This means that having the administration or effective place of management of the business would be obliged to comply with the tax regulations in Mexico.

Permanent establishment (PE)

The permanent establishment (PE) is a legal figure or fiction that the tax authorities in Mexico and the world, specifically the members of the OECD, created to define the powers of taxation in the countries or states when their tax residents carry out business in another country through the establishment of fixed places. The OECD defines a permanent establishment as a designated place of business through which a company carries out all or part of its activity, including head offices, branches, offices, factories, and workshops. Mexico, as part of this organization, adopted the definition, making only one modification since it eliminated the "fixed place" character, expanding the assumptions in which a "PE" can be configured as “EP.”

This concept is relevant since the permanent establishment is one of the tax regimes under which foreign investors may be taxed without becoming tax residents in Mexico, i.e., without having their local administration or tax domicile in the country. These establishments differ from the regime applicable to residents in Mexico since they accumulate for these purposes exclusively the income they obtain in the country. Unlike residents in Mexico, who are bound to the worldwide income principle since they must accumulate the totality of the income they obtain, regardless of the location of the source of wealth from which it originates.

For emerging and developing economies such as Mexico, which receives FDI, the concept of permanent establishment is of great importance since a proportion of the tax resources that the state can collect will depend on it since the taxation in Mexico of foreign residents will depend on the configuration of the PE.

Appendix 2.2. Authorized deductions by concept

Concept	Maximum Deduction Percentage
Perks	**15%**
Constructions	**5%**
Office furniture	**10%**
Boats	**6%**
Cars	**25%**
Computers	**30%**
Equipment for electricity generation and transmission	**5%**

Metal production equipment	**6%**
Equipment for the manufacture of pulp, paper, and similar products	**7%**
Equipment for manufacturing motor vehicles and parts thereof and others	**8%**
Equipment for manufacturing, finishing, dyeing, and printing textile products	**11%**
Equipment and machinery for restaurants	**20%**
Equipment and machinery for other activities	**10%**

Source: Own elaboration with information from the Income Tax Law, Mexico.

Appendix 2.3. Tax obligations and attributes

Tax obligations

Like all taxpayers, corporations or companies have certain general obligations, such as keeping accounting records in a computerized system, filing annual income tax returns, making provisional payments, providing informative returns, conducting transfer pricing studies, and issuing tax receipts, among others.

Electronic Accounting

Electronic accounting is the obligation to keep accounting records and entries through electronic means, such as computer systems. This obligation is complemented by sending monthly financial statements to the Mexican tax authority.

Digital tax receipts via the Internet

The Comprobante Fiscal Digital por Internet (CFDI) is an electronic invoice that describes a good or service purchased, the date of the transaction, the cost, and the taxes corresponding to the payment of such transaction.

The CFDI endorses the operations carried out by individuals and companies before the tax authority, which is why it is essential when starting a company's activities.

Tax attributes

Tax attributes are property assets held by taxpayers in Mexico, which are exclusively for tax purposes:

Tax loss carryforwards: Tax losses result from subtracting from taxable income the authorized deductions, and ESPS is effectively paid when the latter two are greater. As a benefit to the losses incurred by taxpayers, the Law allows taxpayers to apply them or reduce them from taxable income generated for up to ten years following the year they were developed until they are exhausted. If losses are not reduced when they could have been, i.e., when profits are generated in years after the year the tax loss was obtained, the right to reduce such losses in subsequent years will be lost up to the amount that could have been reduced. Such tax losses may be reduced by calculating the annual tax in provisional payments.

Tax Net Income Account (CUFIN): A tax account that represents the accumulated tax profits that have already paid corporate income tax (ISR) and serves as a control of those profits that are tax-free for the distribution of dividends or profits to the partners or shareholders of the companies. Its purpose is to control accumulated balances of those revenues that have already been audited.

Capital Contribution Account (CUCA): This account controls the contributions made by the partners or shareholders of the companies, as well as the reimbursements of shares or capital. It is for tax use only and does not affect the capital accounting accounts.

Tax credit balances: By the corresponding laws (Income Tax Law, VAT Law, and Federal Fiscal Code), the generation of tax credit balances is allowed through two mechanisms:

1. The generation of credit balances is due to the mechanics of the Law. These credit balances occur naturally due to the calculation and determination of taxes.

   In the case of VAT, credit balances are generated when the VAT transferred to the taxpayer is greater than the VAT transferred by the taxpayer; that is when the creditable VAT (generated by expenses) is more significant than the VAT collected (generated by income).

   The ISR in favor is due to an excess payment in provisional payments compared to the annual determination, i.e., the provisional ISR payment, being a payment on account of the yearly fee, may exceed the determined number of annual ISR and thus generate a balance in favor of the taxpayer.

2. Generation of balances in favor due to overpayment (undue payments). These balances arise due to the payment of a non-existent tax or human error in determining taxes; this can occur in all taxes and does not depend directly on the mechanics of the Law but on the payment of the undue amount.

It is essential to point out that the tax authorities are obliged to return the balances in favor within the following 40 business days, counted from the day following the day the refund request is filed before the tax authorities.

Appendix 2.4. Transfer Pricing. Auditing and obligations

In Mexico, in recent years, audits by the tax authorities have covered all types of industries and taxpayers, regardless of their size, taking the amount of income generated as a measure. Likewise, there has been an increase in the number of audits of national groups or Mexican taxpayers that belong to multinational groups that carry out operations among themselves.

It is essential to mention that even though the review processes by the Mexican authorities are carried out following regulations based on completed fiscal years, there has been a clear tendency within the audits carried out by the tax authorities to review compliance with the transfer pricing regulations for each intercompany transaction executed during each of the fiscal years subject to review.

Mexico maintains criteria for resolving disputes, and the approach of advance pricing agreements in transfer pricing matters in operations exclusively agreed upon within the country and those involving transactions with foreign entities resident in countries where double taxation avoidance treaties have been signed. The use of APAs for operations other than maquila and multilateral agreement procedures, among others, have created an interesting area for taxpayers to prevent disputes or solve controversies from a proactive or reactive point of view.

Audit programs

An essential part of the processes carried out by the Mexican authorities to increase the level of collection in the processes involving transactions between related parties is based on established programs that facilitate the identification of possible areas of controversy.

The program of reportable schemes regarding intercompany transactions (which contemplates the obligation of taxpayers to inform the authorities of certain transactions carried out) has focused on making the tax authorities aware of intercompany transactions that lead to decreases or affectations to the local tax base.

Likewise, the effective rate program has significantly impacted the approach under which tax authorities verify compliance with the arm's length principle of intercompany transactions, contrasting the expected minimum tax amount with the profit margins obtained from transfer pricing analyses, which often have discrepancies.

Finally, and through the so-called master audit plan, priority industries or sectors are identified for the tax authorities, on which their knowledge of business structures and intercompany operations is broad and deep. Thus, we observe standardized transfer pricing questions to companies belonging to such industries or sectors based on the experience and technical knowledge the tax authority has obtained over the years.

Customary-related party transactions are subject to review

In recent years, the Mexican tax authority has identified certain transactions that taxpayers regularly carry out with their related parties in Mexico and abroad, which are recurrently questioned during the exercise of the authority's verification powers.

Charges for administrative, corporate, or executive services to local companies are usually reviewed from the standpoint of materiality, documentary support, and strict indispensability. The same applies to charges associated with intangible assets, such as trademarks and technology platforms.

The structuring of financial debt schemes received by Mexican entities from related parties is reviewed, considering the debtor's payment capacity and use of the resources obtained, among other aspects.

Companies with high intercompany operations, accounting and/or tax losses, and volatile profit margins in successive years, among other aspects, are considered high-risk elements for transfer pricing authorities.

Specifically, and to give some examples, in the industrial and manufacturing sector, schemes involving low local taxation associated with low-risk structures are questioned from the perspective of the local creation of added value associated with the same processes carried out by Mexican taxpayers, commercial relationships with customers or suppliers, as well as effects related to exchange rate fluctuations or commercial risks such as credits granted or received from customers and suppliers.

Obligations

Article 76 Section IX of the Income Tax Law establishes the obligation to obtain and keep specific documentation, commonly referred to as a transfer pricing study, which validates the above mentioned circumstances. It is worth noting that such documentation must be prepared annually, regardless of whether the nature of the transactions has not suffered changes or modifications in its operational or economic essence concerning previous fiscal years.

However, some taxpayers may be exempted from complying with such regulations, specifically those who do not reach a minimum amount of accruable income in the immediately preceding fiscal year (taxpayers who carry out business activities whose income does not exceed 13 million pesos; taxpayers whose income is derived from the rendering of professional services that do not exceed 3 million pesos; taxpayers whose income is derived from the rendering of professional services that do not exceed 3 million pesos).

Additionally, taxpayers must file an informative declaration of their transactions with domestic and foreign related parties no later than May 15 of the fiscal year immediately following the fiscal year that ended. This declaration includes descriptive information about the intercompany transactions carried out, the conclusions of the transfer pricing analysis, and certain tax information associated with the characterization of these transactions.

Appendix 2.5. Minimum wages and Social Security contributions

Minimum wages

In Mexico, there are two general minimum wages, one for the free zone of the northern border and the other for the rest of the country. As of 2023, it was increased by 20%, which will pay 207.44 pesos per day, and concerning the free zone of the northern border, workers will receive a minimum payment of 312.41 pesos per day.

It is essential to mention that, as part of a constitutional principle that is doctrinally called "living minimum," the minimum salary cannot be taxed by the Income Tax Law since every person has the right to receive remuneration exempt from the tax destined to their subsistence.

Social security contributions

Social security contributions are made for the benefit of social security, provided by institutions that supplement the State in fulfilling its obligations in this area. The most common contributions of this type are contributions to the Mexican Social Security Institute (IMSS) and contributions to the National Workers' Housing Institute (INFONAVIT), as well as employer contributions to the Retirement Savings System (Sistema de Ahorro para el Retiro (SAR)).

Contributions to the IMSS translate into employer contributions, which are paid to this institution and represent a cost to the company of approximately 25% of the workers' salaries. INFONAVIT contributions represent a 5% cost for companies concerning workers' wages.

Appendix 2.6. Selected Local Taxes

State	Payroll Tax	Lodging Tax	Prize Winning Tax	Gambling Games on line Tax	Property Tax	Commercial and Industrial Activities Tax	Green Taxes
Mexico City	3%	3.50%	7%	21%	2% al 4,5%		
Nuevo Leon	3%	3%	7%	21%	3%		
State of Mexico	3%	4%	7%	21%	2%		
Jalisco	2.75% al 3%	3%	7%	21%	2% al 3%		
Chihuahua	3.50%	4%	7%	21%	5%	2%	
Baja California	1.25%	4%	7%	21%	2%	2%	
Guanajuato	3%	4%	7%	21%	1.80%		$100 per generated ton of Co2
Coahuila	2%	5%	7%	21%	3%		
Tamaulipas	3%	2%	7%	21%	2%		
Queretaro	3%	3.50%	7%	21%	6,50%		$580 per generated ton of Co2

Source: States' Ministries of Finances.

Appendix 2.7. States and Municipalities comprised in the Tax Incentive for the Northern and Southern Borders

Northern Border

1. Baja California: Ensenada, Playa de Rosario, Tijuana, Tecate and Mexicali

2. Sonora: San Luis Rio Colorado, Puerto Penasco, General Plutarco Elias Calles, Caborca, Altar, Saric, Nogales, Santa Cruz, Cananea, Naco and Agua Prieta

3. Chihuahua: Janos, Ascension, Juarez, Praxedis G. Guerrero, Guadalupe, Coyame del Sotol, Ojinaga and Manuel Benavides

4. Coahuila: Ocampo, Acuna, Zaragoza, Jimenez, Piedras Negras, Nava, Guerrero and Hidalgo

5. Nuevo Leon: Anahuac

6. Tamaulipas: Nuevo Laredo, Guerrero, Mier, Miguel Aleman, Camargo, Gustavo Diaz Ordaz, Reynosa, Rio Bravo, Valle Hermoso and Matamoros

Southern Border

1. Quintana Roo: Othon P. Blanco
2. Chiapas: Palenque, Ocosingo, Benemerito de las Americas, Marques de Comillas, Maravilla Tenejapa, Las Margaritas, La Trinitaria, Frontera Comalapa, Amatenango de la Frontera, Mazapa de Madero, Motozintla, Tapachula, Cacahoatan, Union Juarez, Tuxtla Chico, Metapa, Frontera Hidalgo and Suchiate
3. Campeche: Calakmul and Candelaria
4. Tabasco: Balancan and Tenosique

Appendix 2.8. Benefited Sectors for Nearshoring Tax Incentives

The decree benefits sectors related to the production, processing, or manufacturing of various goods, including:

- Food: Products for human and animal consumption
- Agriculture: Fertilizers and agrochemicals
- Pharmaceutical: Raw materials for the pharmaceutical industry and pharmaceutical preparations
- Electricity: Batteries, accumulators, batteries, electrical conductors, plugs, contacts, fuses, and accessories for electrical installations
- Electronics: Components such as simple or loaded cards, circuits, capacitors, condensers, resistors, connectors, semiconductors, machinery for watches and electronic medical equipment
- Automotive: Gasoline, hybrid, and alternative fuel engines for cars, vans, and trucks, as well as electrical and electronic equipment, steering systems, suspension, brakes, transmission systems, seats, interior accessories, and stamped metal parts for land vehicles, trains, boats, and aircraft
- Aerospace: Internal combustion engines, turbines, and transmissions
- Medical Equipment: Non-electronic equipment and devices for medical, dental, and laboratory use, disposable medical materials, and optical articles for ophthalmic use
- Film and Audiovisual: The fiscal incentive is also granted to taxpayers producing cinematographic or audiovisual works exported and protected by copyright

Appendix 2.9. Foreign Trade Fundamental Concepts and Taxes

Among the fundamental concepts are the following:

Petition: Declaration in electronic document through which the entry or exit of goods into or out of the national territory is regulated, containing the information related to the goods, the traffic and customs regime to which they are destined, and the other data required to comply with the formalities for their entry into or exit from the national territory.

Import Taxable Base: The elements that make up the taxable base of foreign trade taxes are:

- Commercial value: Price paid or payable for the goods, i.e., the transaction value
- Incrementable: Costs incurred abroad, paid by the importer, which are not part of the transaction value, such as freight, insurance, handling, and any other cost inherent in the import
- Customs value: It comprises the transaction value sum and incremental costs. The customs value is the taxable base for the General Import Tax, Tax on New Automobiles, and the New Automobiles Tax.

Export taxable income:

- Commercial value: Price paid or payable for goods, i.e., transaction value

Customs Regimes: Destination given to goods introduced into or extracted from the national territory.

Customs File: It is made up of the customs declaration and other documents required for import or export, such as invoice, shipping document, declaration of value, Non-Tariff Regulations and Restrictions (if applicable), certificate of origin (if applicable), and others depending on the type of merchandise.

Tariff fraction: 8-digit numerical code determining General Import and Export Taxes, including Non-Tariff Regulations and Restrictions.

Free Trade Agreements: Bilateral or multilateral agreements to form a free trade zone to grant tariff preferences in signatory countries, including reducing barriers to the trade of goods.

Definitive import: The definitive import regime is the entry of goods of foreign origin to remain in the national territory for an unlimited period. The definitive regime will be subject to the payment of taxes on foreign trade, compensatory quotas, and compliance with non-tariff regulations and restrictions.

Temporary import: It is the entry into the country of goods to remain for a limited time and a specific function, provided that they return abroad in the same state or after having undergone a process of elaboration, transformation, or repair by an IMMEX company, automotive bonded warehouse, and Strategic Bonded Warehouse.

General Import Tax: The General Import Tax ("IGI"), also called foreign trade taxes, will be caused according to the tariff classification determined in the Tariff of the General Import and Export Tax Law.

Customs Processing Fee: The customs processing fee will be paid for customs operations carried out using a customs declaration or the corresponding customs document under the terms of the Customs Law.

Value Added Tax: Those who import goods will be obliged to pay VAT, in terms of the Value Added Tax Law.

Non-Tariff Regulations and Restrictions "RRNA": These are instruments to regulate the import, export, circulation, or transit of goods in the country. They function as an administrative act other than tariffs through which the competent authority imposes certain obligations and requirements for the import, export, circulation, or transit of goods in the country.

Mexican Foreign Trade Single Window (VUCEM): is a digital platform that allows taxpayers to carry out various foreign trade procedures. Its implementation aims to streamline the flow of information between the taxpayer and the authority to simplify the systems and processes related to foreign trade operations.

Appendix 2.10. Information and documents required before importing or exporting in Mexico

Before importing or exporting into Mexico, it is essential to have at least the following information and documentation that will allow the calculation of the applicable taxes and duties, including Non-Tariff Regulations and Restrictions according to the product to be imported or exported, and thus avoid delays and delays at customs, the storage of which represents additional costs for taxpayers:

1. To have an active importers' registry
2. To have the services of a customs broker
3. Determine the correct tariff classification
4. Choosing the appropriate customs procedure
5. Knowing the country of origin
6. Correct determination of the taxable base
7. To process the compliance with Non-Tariff Regulations and Restrictions even in advance.

Likewise, importers and exporters must transmit information related to their foreign trade operations through the Electronic Customs System (SEA), which will have total legal and evidentiary value and must be kept as part of the accounting in the form it was issued and obtained. The customs file must be transmitted electronically to the SEA and be integrated electronically considering at least the following documents: Petitions, commercial invoices, bill of lading, RRNA compliance, and documentation that determines and supports the origin of the merchandise to obtain tariff preferences.

The digital/electronic files will be stored in the digital folder for five years, except in the case of fixed assets, machinery, and equipment, which must prove the legal possession, stay, and importation at all times, even when exceeding five years or at least for the time that such goods are held.

Mexico has a variety of foreign trade promotion programs that benefit foreign investment, which are the following:

Foreign Trade Promotion Certifications and Programs that benefit foreign investments.

a) Manufacturing, Maquila, and Exportation Services Industry Program (IMMEX).

Initiative to encourage industrial, manufacturing, maquila, and service processes related to the creation, transformation, or repair of foreign-origin goods intended for exportation or the provision of exportation services. It offers various modalities, including Industrial, Services, Shelter, Outsourcing, and Comptroller.

IMMEX Modalities:

- Industrial: This modality involves industrial processes for creating or transforming exportable goods
- Services: It encompasses services provided to exportable goods or exportation services, such as supply, storage, distribution, reparation, outsourcing, and more
- Shelter: Foreign companies provide technology and materials without direct operation
- Outsourcing: Certified companies outsource manufacturing operations to third parties within their program
- Comptroller: Certified companies oversee manufacturing operations of controlled companies and handle tax and customs responsibilities

Benefits:

- Deferred Tariffs: General Import Tax (IGT) is deferred
- VAT and IEPS Certification: Required for temporary importations without paying VAT and/or IEPS
- 0% VAT Rate: Applicable to exportations of goods and services

- Cash Flow Improvement: Helps with financial planning

Main Requirements:

- USD 500,000 Export Sales: Or at least 10% of total invoicing for exportations
- Inventory Control System: Comply with Attachment 24 of Foreign Trade General Rules
- Yearly Report: Submit a yearly report to the Secretariat of Economy

IMMEX Subprograms	Benefits
Maquila Operation **“Safe Harbor”**	All income comes exclusively from maquila operations. Supplies and inventory for final product production must be imported on consignment. Machinery and equipment must be at least 30% owned by the foreign entity. The fiscal profit shall be determined considering the greater amount resulting from applying the following: • 6.9% of the total value of the assets used in the maquila operation during the tax year, including those owned by the person residing in the country, even if they have been granted for temporary use and enjoyment to such maquiladora. • 6.5% of the total amount of the operation costs and expenses of the operation under consideration, incurred by the person residing in the country, determined according to the financial information standards. Transfer Pricing Standards: • Crucial for compliance with Income Tax Law. • Properly determine and justify transfer pricing policies for transactions with related parties.

IMMEX Subprograms	Benefits
Shelter	Similar to maquila but for different clients residing abroad. Raw materials, machinery, or equipment provided by residents abroad. Additional Requirements for Shelter: • Identify operations and determine fiscal profit for each resident abroad. • Maintain documentation proving identification of companies residing abroad. • Submit provisional payment statements and annual tax returns. • Provide an informative statement of maquila operations annually

Source: IMMEX Program Guidelines.

b) Sectorial Promotion Program (PROSEC)

Program directed to legal entities producers of certain goods, through which they are allowed to import with preferential tariffs (General Import Tax) several assets to be used in the manufacture of specific products that are part of 24 productive sectors, regardless of whether the goods to be produced are intended for being exported or for the domestic market.

The list of the 24 sectors included in this Program are:

1. Electric Industry
2. Electronic Industry
3. Furniture Industry
4. Toy, Recreational Games, and Sports Items Industry
5. Shoe Industry
6. Mining and Metallurgical Industry
7. Capital Goods Industry
8. PhotoGraph Industry
9. Agricultural Machinery Industry
10. Various Industries
11. Chemical Industry
12. Rubber and Plastic Manufacturing Industry
13. Steel Industry
14. Pharmaceutical, Medication, and Medical Equipment Industry

15. Transportation Industry, except the Automotive and Auto parts Industry
16. Paper and Cardboard Industry
17. Wood Products Industry
18. Leather and Fur Industry
19. Automotive and Auto parts Industry
20. Textile and Clothing Industry
21. Chocolate, Candy, and similar goods Industry
22. Coffee Industry
23. Food Industry
24. Fertilizer Industry

Benefits

- Reduction or exemption of tariffs (General Import Tax)
- It gives certainty to the exporting sector regarding the tariff levels
- It promotes attracting local and regional providers by defining a list of supplies and components that could be imported.

The benefit of this program is the importation of assets with a preferential tariff included in the corresponding sector; nevertheless, there is always an opportunity to request the incorporation of new sectors as long as they prove they manufacture the corresponding assets.

Main requirements

- Identifying that the tariff fraction of the goods to be imported belongs to the authorized sector and that this tariff fraction is used to manufacture a product belonging to the authorized sector.
- Submitting a yearly report before the Secretariat of Economy of the operations carried out under this Program.

c) Drawback

Import tax return scheme for exporters, which allows the beneficiaries to request the return of tariffs paid for the importation of supplies, raw materials, parts and components, packing and containers, combustibles, lubricants, and other materials incorporated into the exported product, or that they are returned in the same state for situations related with defects, surpluses, or not corresponding to the required good.

Benefits

- Tariffs return (General Import Tax)

Requirements

- Applicable to goods and supplies included in exportation goods (Transformed Materials).
- Goods returned abroad in the same state or subject to reparation or alteration processes

d) VAT and Special Tax on Production and Services (IEPS) Certification.

This certification allows the immediate application of a 100% credit of VAT and IEPS in temporary importations of supplies and components for being used in the industrial process for the manufacture of final goods or for providing exportation services by IMMEX companies, fiscal automotive deposit, and strategic fiscal precinct, which does not involve the immediate payment of the VAT and IEPS in temporary importations.

Currently, there are three different certification modalities, "A," "AA," and "AAA," which are based on the validity period for such authorization (1, 2, and 3 years correspondingly.

Benefits

- 100% Fiscal credit for VAT and IEPS in temporary importations of raw materials and components required to manufacture final goods or provide exportation services.

Chapter 3

Appendix 3.1. Evolution of FDI into Mexico

Europe emerges as the second-largest contributor to Mexico's FDI, accounting for 32 percent of the total aggregated share of FDI. This suggests that European investors recognize Mexico's potential as a strategic nearshoring partner, leveraging its proximity, skilled workforce (particularly in the manufacturing sector), and relatively favorable business environment. In 2019, Mexico occupied the 60th position out of 190 countries in the Doing Business Report 2020.[88] Asia represents another noteworthy contributor, albeit to a lesser extent, contributing seven percent of the aggregated FDI share.

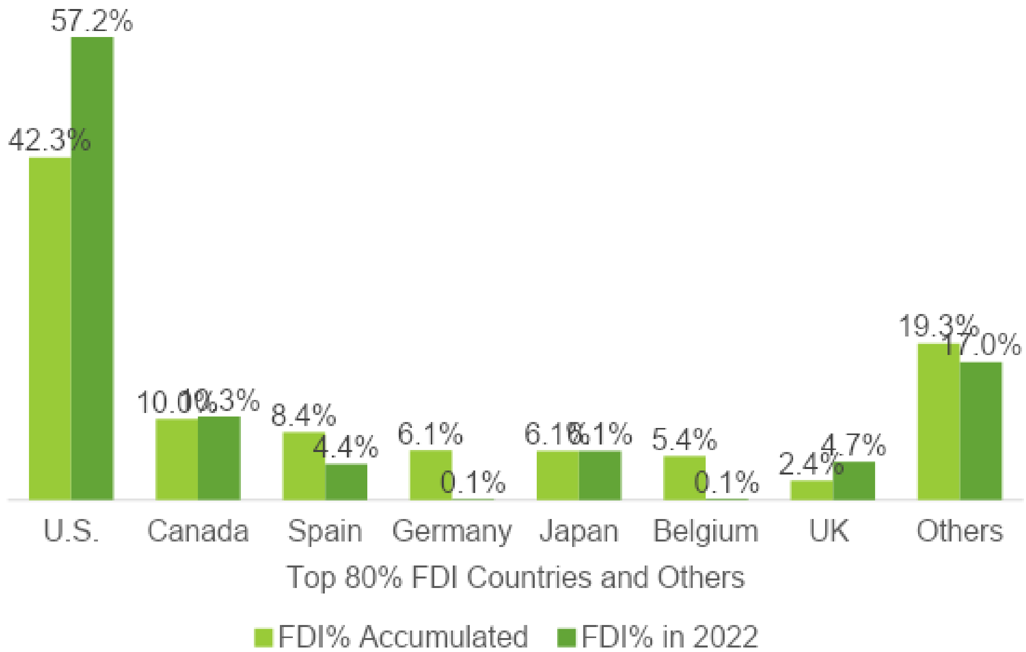
Interestingly, the United Kingdom's FDI has charted a contrasting trajectory, experiencing an upswing since 2018. These observations underscore the prominent role of the U.S. in Mexico's FDI landscape while highlighting the dynamic and evolving nature of FDI sources.

An additional method for assessing the trends and progression of Mexico's FDI is presented below in Graph 20. This illustration contrasts the proportion of FDI from the top countries of origin over ten years with the most recent year recorded (2022). In the most recent year under consideration, Mexico's FDI inflows from the U.S. experienced a substantial increase, in contrast to the FDI received from Canada and the United Kingdom.

Conversely, a contrasting pattern emerges in the case of two particular European countries—Spain and Germany, leading investors in energy and infrastructure-where the FDI share from these nations witnessed a decline. This trend aligns with the observations from Graph 8. This supplementary analysis confirms the pivotal role played by the U.S. in propelling FDI flows into Mexico, particularly within the most recent period.

[88] Mexico Projects Hub. Investment and Infrastructure. Competitive Business Environment.

Graph 20. FDI Share by Country of Origin, accumulated and 2022

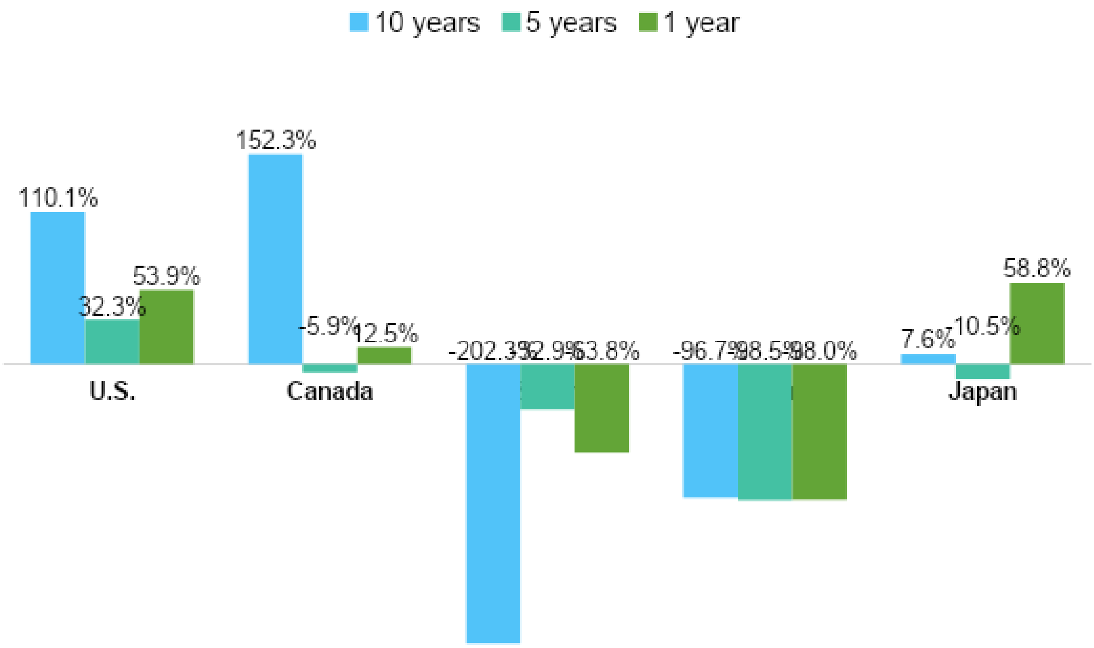


Source: Ministry of Economy, Mexico.

A similar analysis is shown in Graph 21, which illustrates the fluctuation in FDI from the top 5 source countries across three distinct time intervals. Notably, a consistent upward trajectory is evident for the U.S. and Japan, potentially attributed to their robust involvement in Mexico's automotive sector. Conversely, Germany's FDI in Mexico experienced a consistent decline throughout the three comparative time frames.

In addition, despite Canada's favorable upturn in FDI during the most recent year, it is essential to acknowledge that its growth rate remains notably subdued compared to the preceding decade. This analysis underscores the evolving patterns of FDI inflows from these key nations. It offers insights into the sectoral dynamics shaping Mexico's FDI landscape, informing strategic considerations for nearshoring initiatives.

Graph 21. Change of FDI from top 5 countries in 1, 5, and 10-year time frame



Source: Ministry of Economy, Mexico.

Appendix 3.2. Trade between the U.S.-Mexico Border

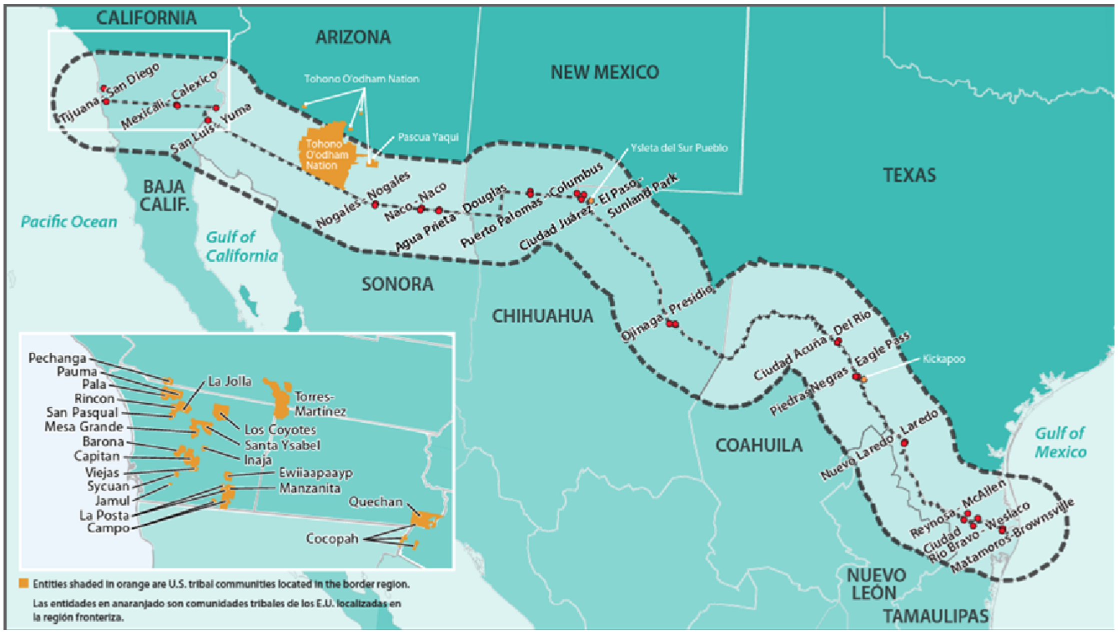
The U.S.-Mexico border region is economically, socially, and geographically integrated, home to 15.2 million people from both countries who are predominantly concentrated in 15 pairs of sister cities, marked by red circles in Figure 3. By sharing a 2,000-mile border with 55 active land ports of entry, these two countries have a solid and robust trade dynamic:

- Over 1.2 million dollars in products move across the border every minute, making it the busiest in the world. [89]
- Trade between these two countries amounted to $779.3 billion in 2022, establishing Mexico as the U.S.' second-largest trade partner and first as in June 2023, displacing China.[90]

[89] Mexico's Ministry of Foreign Affairs. Mexico – U.S. Trade Relation.
[90] Ibid.

- In 2022, Mexico was the largest source of goods for the U.S. and the second-largest market for U.S. exports.[91]

Figure 3. U.S. – Mexico Border's Paired Cities



Source: US-Mexico Border Region, EPA.

Appendix 3.3. Corporate decision-making in nearshoring to Lithuania

Firm 1 presents a case of a company that previously conducted sourcing operations offshore in the U.S. and China, leading to significant transportation and operational costs. To address these challenges, the decision to nearshore activities to Lithuania was driven by several factors, including the ease of engagement with local vendor companies, cost of competitiveness, and the availability of high-quality, competent companies, ensuring access to skilled labor and advanced technologies.

Firm 2 exemplifies a company that initially offshored highly IPR-sensitive activities to China. Despite the competitive costs in China, the decision to move nearshore to Lithuania was driven by the country's robust institutional capacity for IPR protection. With innovation as its most valuable asset, the firm recognized the importance of safeguarding its

[91] Ibid.

intellectual property. It saw Lithuania as a strategic choice due to its efficient distribution network and client proximity.

Firm 3 is an example of a company that opted to outsource its manufacturing processes from Denmark to Lithuania, choosing to nearshore over complete offshore production in Asia to maintain proximity to its headquarters. Following a successful experience, the company ultimately relocated all manufacturing processes to Lithuania while continuing to source from Asian suppliers. The physical proximity played a crucial role in attracting Danish FDI to Lithuania.

Table 17. Comparative analysis of nearshoring decision-making for three firms

FIRM 1 Large Swedish Automotive Company with Labor-Intensive Operations	FIRM 2 Small and Medium-Sized Enterprise (SME) with Intellectual Property Rights (IPR)	FIRM 3 Danish Textile Company in High-Quality Furniture Fabric and Textile Products
The goal of nearshoring: Utilize sources in nearshore regions. **Factors involved in the firm's decision:** • Access to a distribution network in target markets • Overall cost reduction in labor-intensive operations • Availability of specific and unique technologies **Benefits derived from nearshoring**: • Improved market penetration, which resulted in opportunities for innovation and product differentiation • Enhanced supply chain efficiency.	**The goal of nearshoring**: Safeguard IPR. **Factors involved in the firm's decision**: • Mutual interest in cooperation • Available manufacturing capacities • Experience in the relevant industry • Competitive production costs due to market pressures. **Benefits derived from nearshoring**: • Savings in transportation costs. • Advantages in product development • Efficient distribution and manufacturing • IPR protection	**The goal of nearshoring**: Optimize the supply chain. **Factors involved in the firm's decision**: • Focus on network coordination, marketing, and development • Interest in retaining the manufacturing side of the business nearshore **Benefits derived from nearshoring**: • Capitalize on the advantages of cost-effective sourcing from distant regions (inputs) • Ensuring better quality control and efficient communication (time zone) • Enhanced collaboration with partners in the geographical vicinity

FIRM 1 Large Swedish Automotive Company with Labor-Intensive Operations	FIRM 2 Small and Medium-Sized Enterprise (SME) with Intellectual Property Rights (IPR)	FIRM 3 Danish Textile Company in High-Quality Furniture Fabric and Textile Products
Challenges (hidden costs) of distant sourcing: • Additional resources needed for quality assurance and logistics management. • High fuel consumption and widening carbon footprint undermining environmental sustainability strategies. • Delays in the development of trial prototypes, impacting competitiveness.	**Challenges (hidden costs) of distant sourcing**: • The Scandinavian company assumed complete responsibility for establishing distribution networks. • Despite enjoying a relatively high profit margin, the company still faced significant pressure to reduce costs.	**Challenges (hidden costs) of distant sourcing**: • As the nearshoring initiatives grew, the company procured finished fabrics from external Asian suppliers.
Nearshoring decisions were primarily based on two key factors: • The ease of engagement with vendor companies; and, • Competent manufacturing operations are present with competitive costs. **To ensure effective nearshoring, the company made several decisions:** • Implemented a robust and pre-defined partner search and selection process; • Established service centers and invested in training centers in target markets to support its operations effectively.	**Nearshoring decisions were primarily based on two key factors:** • Transportation costs were the most significant factor impacting the overall cost of delivering products from the Far East. • The ease of controlling intellectual property in the Baltic countries, compared to the Far East.	**To ensure effective nearshoring, the company made several decisions:** • Adopted an incremental approach by outsourcing fewer complex processes • Identified critical processes for nearshoring (mainly those focused on distribution) • Strategically established partnerships with external suppliers located in Asia to purchase finished fabrics

Source: Based on Dmitrij Slepniov et al. 2013.

Appendix 3.4. Similarities between Balkan Countries and Mexico

The Balkan countries can serve as comparative cases to address Mexico's opportunities for nearshoring for several reasons:

- **Geographical Proximity to High-Income Regions**: Like Mexico, the Balkan countries are geographically close to major European consumer markets (EU). This proximity can reduce transportation costs and lead to shorter lead times, making them attractive locations for nearshoring. The EU market size is similar to the U.S.'
- **Competitive and Skilled Labor in Manufacturing**: Mexico and the Balkan countries offer competitive labor costs compared to other regions. In addition, Mexico and the Balkan countries have a relatively high-skilled and educated labor force in manufacturing.[92] However, more efforts will be required to reach developed market needs to compete, for example, with U.S. States.[93]
- **FDI-Oriented Policy:** Mexico and some Balkan countries, like Serbia and North Macedonia, have entered into trade agreements with the EU[94] and other major economies and have implemented various incentives to attract FDI, including tax breaks, grants, and other investment incentives.[95]

The greater the similarity between countries, the more they become potential alternatives for investment locations. Tax incentives play a crucial role in promoting competitiveness and economic activity in such scenarios[96]. As mentioned in Chapter 1, theoretical tax incentives can be classified into three categories: reduced tax rates, tax holidays, and other investment incentives. However, diverse incentives exist in practice, encompassing various characteristics of these incentives.

[92] OECD. 2017. Country Note. "How does Mexico compare?". Skills Outlook 2017. Skills and Global Value Chain.
[93] OECD. 2017. OECD Skills Strategy Diagnostic Report Executive Summary, Mexico.
[94] European Parliament. Factsheets on the European Union. The Western Balkans.
[95] PwC. Worldwide Tax Summaries. Mexico.
[96] Buckley, Peter. (2018). Towards a theoretically based global foreign direct investment policy regime. Journal of International Business Policy. 1. 10.1057/s42214-018-0011-2.

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