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## **Tax Systems and tax reforms in Latin America, Part I : country studies, Colombia**

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# TAX SYSTEMS AND TAX REFORMS IN LATIN AMERICA: COLOMBIA UPDATED

by

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## **Abstract**

This paper is part of a wider research on “Tax Systems and Tax Reforms in Latin America”, carried out at the Department of Public Economics of the University of Pavia, under the direction of L. Bernardi, A. Barreix, A. Marenzi and P. Profeta, and the supervision of V. Tanzi. Colombia is a sizeable country in which the social and political environment has not favored, nor currently favors, the structuring and working of the tax system; hence the need for a far-reaching study rather than just a technical analysis. The structure of Colombian taxation is analyzed from the historical, economic and institutional points of view, with a particular focus (updated to take in the December 27<sup>th</sup> 2006 reform) on corporate tax, income tax, VAT, wealth tax, financial transactions taxation and local taxes. Two specific tax issues are then considered. The first of these is the personal distribution of the tax burden and the redistributive impact of the fiscal system, while the second is the relationships between central and lower Government layers. Finally, we briefly discuss the broad fiscal reforms that were submitted by the Colombian Government to Parliament on July 2006 but subsequently withdrawn. We conclude by discussing this legislative project together with December’s reform within the broader context of the social turmoil and poverty currently plaguing Colombia. We firmly believe that Colombia needs a completely different fiscal reform from the ones passed and/or proposed in 2006, and we outline our own radically alternative proposal for fiscal reform in Colombia.

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*At a certain point I realized it was impossible to separate this story from the events in Colombia at that time.*

GABRIEL GARCIA MARQUEZ, *News of a kidnapping*, 1996.

## 1. Colombia's environment, economy and public budget\*

Colombia is a historically important country, covering about one million km<sup>2</sup> and inhabited by about 43 million people. It won independence from Spain in 1810, and since then power has been in the hands of two parties, both of whom represent the interests of the country's large landowners and other wealthy citizens. At the outset of the 2000s, Colombia was governed by a conservative, demagogic Government led by A. Uribe and backed by the U.S. Government. Uribe was subsequently re-elected in 2006. Since the 1960s onwards, the country has been plagued by the spread of *guerrilla* warfare involving different groups, and by the Colombian mafia's influence on the trade in agricultural goods, emeralds and, of course, cocaine. This environment was, and remains, unfavorable to the building and working of the tax system and to the tax payer's relationships to this system. This sensitive activity is performed within a context of civil war, crimes, illegal activities, corruption and social deprivation.<sup>1</sup> Further, the substantial size of an informal or illegal economy, together with wide tax evasion, means that high caution should be taken when using economic data.

In 2005 GDP stood at US\$ 98 billion (Cia-Factbook), while per capita income was US\$ 2,240, US\$ 7,900 if adjusted for PPP. Income distribution is very uneven: the Gini coefficient for household income stood at 0.54 in 2005. The share of Colombians living in poverty is nearly 50 per cent. The unemployment rate is also quite high, standing nearly 15 per cent. Colombia's GDP grew at a yearly rate of about 5 per cent in 2005 and 2006. Inflation fell to 4.5 per cent in 2006. Both macro and public budget indicators are forecast to go well in both the short and medium run (IMF 2006; Confis 2006). In 2007, real GDP is forecast to grow by 4.0 per cent, while inflation should fall to 4.0 per cent, values that ought to be maintained in the medium run (to 2010).<sup>2</sup>

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<sup>1</sup> UN data show that about 100,000 people are at war in the mountains together with Army forces and U.S. 'advisors'. A large number of private police forces and Government 'informers' are at work. Kidnappings, assassinations and robberies -the so called '*violencia*'- occur with alarming frequency. The official view (also: IMF 2006), which is not shared by everyone in Colombia, is that the security situation has improved over the past few years, due the fact that some (right-wing) *guerrilla* groups have lain down their arms since 2005, benefiting from a full amnesty as a result thereof.

<sup>2</sup> The question of the reliability of these forecasts remains open, however. The said IMF report defines them as 'prudential', but subject to a series of structural reforms and to virtuous Governmental behavior. In the long run, the most critically important trend seems to be the one regarding pension expenditure, notwithstanding the 1993 reform (see below).

Focusing now on the public budget, we first need to distinguish between the Non-Financial Public Sector (NFPS), General Government and Central Government.<sup>3</sup> We shall refer to the NFPS when evaluating the overall financial position of the public sector, whereas we shall consider the General Government level when analyzing tax revenue. Both the total revenue and the total expen-

TABLE 1 ABOUT HERE

diture of the NFPS increased by 75 per cent between the early 1990s and the early 2000s.<sup>4</sup> Taxes constitute just half of the NFPS' current revenue, with the remaining share mainly accounted for by profits from public utilities and the State-owned oil company. This allows Colombia to finance a sizeable welfare expenditure (on education, health and old age pensions) without excessive fiscal pressure.<sup>5</sup> This clearly raises some question marks about the future sustainability of Colombia's public finances, since: *i*) the contribution made by non-renewable resources will inevitably decrease; and *ii*) more than one utility will be privatized. In both cases, non tax-revenue will have to be replaced by permanent structural taxes, and this will not be an easy task.<sup>6</sup> At the beginning of the 1990s, the budget was balanced, but this situation subsequently deteriorated during the years 1996-1999, at which point an adjustment plan was adopted and the financial position of the NFPS improved as a consequence. The overall NFPS balance stood at -1.9 per cent in 2006, and it is forecast to stabilize at -0.4 per cent by 2010. At that time the public debt/GDP ratio should decrease by about ten points (down to about 50 per cent). Half of the funding of Colombia's public debt is forecast to come from internal sources, while the other half is due to be provided by foreign capital.

The rest of the chapter is organized as follows. Section 2 discusses a general overview of the Colombian tax system from the early 1990s onwards. Section 3 describes the main features of the major national and local taxes, updated to include the tax reform introduced in December 2006. Section 4 discusses a couple of significant tax policy issues: the personal distribution of the tax burden, and the financing of lower government tiers. Section 5 provides a brief overview of the broad reform submitted by the Government in July 2006 but subsequently withdrawn in November

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<sup>3</sup> These aggregates are given in the ILPES-CEPAL data that constitute the main for this study. The *Non-Financial Public Sector* includes State, Departments, Municipalities, social security, and public enterprises. *General Government* and *Central Government* correspond to their counterparts in OECD and EUROSTAT public accounts. Unfortunately, the ILPES data fully cover the NFPS and the Central Government, but just partially the General Government.

<sup>4</sup> The expansion in public spending was largely due to the new 1991 Constitution, which led to a process of expenditure decentralization. This rise in expenditure was also the result of pension reforms, interest payments on public debt, and the salaries paid to public employees. A further contribution to this process was made by the restriction imposed on the Central Bank's power to finance the Government's budget deficit. (Lozano 2002; Jungito and Rincon 2004).

<sup>5</sup> At a first guess (data are not given in IMF 2005) the three said sectors accounted for about GDP 15 per cent by 2005 (education 5per cent, pensions 4per cent, health 6 per cent ). Military spending probably accounted for GDP 4 per cent.

<sup>6</sup> For example, the increase in oil prices pushed up the NFPS' current non-tax revenue from GDP 10.3 per cent in 1998 to 18.8 per cent in 2004 (ILPES-CEPAL).

2006, and also outlines our suggestion for a more radical reform of taxation designed to reduce social deprivation in Colombia, but which would probably be met by strong political opposition.

## **2. A general outline of the Colombian tax system and its development since the early 1990s**

### **2.1 The Colombian tax system from the early 1990s onwards**

In the 1960s and 1970s, Colombia's tax system was a relatively simple one. However, from the 1980s onwards the system was subject to repeated reforms of a non-radical nature (Shome 1995).<sup>7</sup> Seven major reforms were introduced between 1990 and 2003 (Gobierno de Colombia 2006)<sup>8</sup>, mainly designed to increase revenue (Lozano 2002)<sup>9</sup>. These reforms focused principally on VAT: the standard rate was increased from 10 to 16 per cent, while its tax base was also enlarged. On the other hand, trade liberalization led to a reduction in revenue from customs duties. As far as direct taxes were concerned, the generous allowances of the early 1990s were only slightly reduced, while tax rates as such were not substantially modified either for individuals and for corporations. During the early 1990s, taxation on financial capital was eased to stimulate savings and investment; however, at the end of the decade the Colombian government introduced a wealth tax.<sup>10</sup>

Subsequent to the adjustment plan introduced towards the end of the 1990s, two small tax reforms were made in 2002 and 2003; these were partly designed to finance the battle against *guerrilla* warfare, which was a central issue in the Uribe Government's program. The main tax measure introduced in 2002 consisted of a 10 per cent surcharge on both income and corporate tax, while the 2003 reform increased the rate of the financial transaction tax (introduced in 1998 as a part of the adjustment plan) from 0.2 to 0.4 per cent<sup>11</sup>. Taken together, these two measures yielded approximately 0.7 per cent GDP. However, there was a real problem with the said reforms, they were all introduced as temporary measures, but were subsequently extended (in general to 2006-07), as about 1.2 - 2.0 GDP percentage points of revenue (wealth tax included) was due to evaporate, and this lost revenue had to be replaced in some way.<sup>12</sup> In 2005-06 the increased openness of the econ-

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<sup>7</sup> The main reforms were based on studies by highly-qualified tax professionals, such as Musgrave and Gillis, Mc Lure, Bird, and Poterba. However, politicians repeatedly failed to follow the experts' recommendations.

<sup>8</sup> Taken together these reforms increased fiscal pressure by about 7 per cent (Government of Colombia 2006).

<sup>9</sup> The more theoretically consistent substantial recommendations, illustrated in Shome (1995), were largely ignored.

<sup>10</sup> However, it has been pointed out that there were too many small, short-term reforms granting preferential treatments, and too many tax amnesties, which had the effect of reducing the tax base (MIP 2002).

<sup>11</sup> It also introduced OECD-like transfer price rules.

<sup>12</sup> The Government believes that the removal of the wealth tax in 2007 will be compensated for by the increase of import taxes and VAT, while other observers maintain that the tax gap must be closed by tax reforms (Clavijo 2005).

omy encouraged to introduce a number of specific tax measures (International Law Office 2006), including new legislation designed to avoid double taxation among Andean countries (thus replacing the one in place dating back to 1971<sup>13</sup>), and new tax regimes for Free-Trade Zones and for Low-Tax Jurisdictions. With reference to the latter, a higher withholding tax rate is currently due to be applied to cross-border payments made to beneficiaries located in a list of foreign tax havens. However, the Government has yet to publish the list of those countries acting as such tax havens.

## **2.2 An overview of the current fiscal structure, and a comparison with that of other Latin American countries**

As a consequence of the above-mentioned reforms and of the buoyancy of the tax bases, General Government's total fiscal pressure almost doubled between the early 1990s and the early 2000s, increasing from 10.5 per cent of GDP in 1990 to 20.4 in 2004 (Table 2).<sup>14</sup>

TABLE 2 ABOUT HERE

This substantial increase was generated by direct taxation, and in particular by corporation, property and wealth taxes. Indirect taxation rose by more than three points, and this was entirely accounted for by the increase in VAT. Social security contributions more than tripled, partly as a consequence of the 1993 pension reform (Clavijo 1998), although their point of departure in 1990 was only GDP 0.8 per cent. Thus total fiscal revenue in 2004 consisted mainly of taxes (17.5 per cent of GDP), rather than of social security contributions (2.8 per cent of GDP). The respective weights of direct and indirect taxes were evenly balanced. More than one of the above-mentioned features is characteristic of Colombia, to be found in very few other Latin American countries, and is not to be found in the continental average (see the chapter by Martner and Sabaini).

In the case of direct taxes, up until the late 1990s the most important ones were those levied on large companies and multinationals, whereas the personal income tax burden has been virtually non-existent (0.2 per cent of GDP up until 1999).<sup>15</sup> This remarkable figure may be explained in political-economy terms (see also the chapter by Martner and Sabaini). Very few Colombians actually pay income tax<sup>16</sup>, as tax exemptions and deductions are substantial. We believe that the country's

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<sup>13</sup> Bolivia, Colombia, Ecuador, Peru and Venezuela.

<sup>14</sup> It is not easy to properly evaluate Colombian fiscal pressure. Tax evasion is deemed to be high (Shome 1995; Ministerio de Hacienda 2006; Clavijo 2005), and yet remains underestimated since the potential tax bases are calculated from national accounts, which in turn allow for the large-scale exclusion of illegal business activities.

<sup>15</sup> We lack figures for subsequent years.

<sup>16</sup> According to CONFIS (2006), these included 515,000 corporations and shareholders who paid 85.9 per cent of taxes on income and profits in 2005, and 830,000 individuals, comprised of 317,000 employees (accounting for 7.7

landlords and its other wealthier citizens deliberately chose to avoid directly taxing the middle classes (and themselves) to obtain political consensus. The most important indirect tax is VAT, while other forms of indirect taxation play a secondary role. Taxation by the various levels of Government is highly centralized.<sup>17</sup> Central Government only grants Departments and Municipalities the power to raise a limited amount of money from property and from specific goods and services.

Total fiscal pressure and tax structure differs substantially from one Latin American country to another (see the chapter by Martner and Sabaini). A quick comparison of taxation in Colombia with that of other Latin American countries must necessarily be deemed to be purely indicative.

TABLE 3 ABOUT HERE

Nevertheless, the few figures shown in Table 3 may provide some insight into the comparative position of Colombia. In the first few years of the 2000s, fiscal pressure in Colombia has been close to the Latin American average; the increase in Colombia's taxes during the 1990s, on the other hand, was a multiple of the Latin American average. Moreover, the data show that Colombia has a relatively high share of direct taxes. If we compare these figures with those in Table 2, the picture becomes more complex. It is immediately clear that up until 2000, the structure of Colombian taxation was not that far removed from the one revealed by the averaged figures for Latin America as a whole. The reforms implemented in the late 1990s and during the first few years of the 2000s were mostly temporary measures, and their impact should not be overestimated. Hence the rise in the share of direct (corporate) taxation can only be seen as a temporary phenomenon.

### **3. The institutional features of Colombia's principal taxes**

The following section illustrates the Colombian fiscal system (IBFD 2006) and includes the changes recently made by the tax reform passed by Parliament on the 27<sup>th</sup> of December 2006, and which came into force on the 1<sup>st</sup> of January, 2007 (Congreso de Colombia 2006; Colombian Tax Flash 2007; Parra, Escobar & Cia 2006). At the end of the chapter we shall see that a broader, more ambitious reform had been submitted by the Government to Parliament in July, 2006; but after a heated debate outside of Parliament, the Government withdrew the reform proposal .

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per cent of total tax paid by withholdings) and 513,000 self-employed (6.4 per cent of total tax paid by tax returns). These data pale when compared with the number of the employed, to about 16.2 million, (according to UN data).

<sup>17</sup> 82.9 per cent of total revenue went to Central Government, 6.6 per cent to Departments and 10.7 per cent to Municipalities in 2002 (Lozano, Ramos and Rincon 2004).

## **3.1 National taxes**

### ***3.1.1 Direct Taxes***

The income tax system consists of a general tax levied on both individuals and business enterprises. For practical purposes, we distinguish between the tax applicable to individuals (Personal Income tax - PIT) and that applicable to businesses (Corporate Tax - CT).

#### **3.1.1.1 Personal income tax - PIT**

Colombian PIT is a global income tax. It is levied at the same rate on the total income of an individual. Special taxation plays a very marginal role and is levied on a few items. The deemed minimum annual net income of individual taxpayers is 3 per cent of their net wealth. Married couples are taxed separately: each spouse is taxed on his/her income, but spouses cannot divide their joint income for taxation purposes. There are separate tax regimes for two specific groups of tax payers: Colombian national and foreign residents pay Individual Income Taxation-IIT, while Non Resident Income Tax-NIT is levied on non residents in the form of a withholding tax.<sup>18</sup> Resident Colombian citizens are taxed on their worldwide income, while resident foreigners who have been living in the country for less than five years are subject to tax on their income earned in Colombia. As of their fifth year of residence, foreigners resident are also taxed on their worldwide income.

#### ***Individual Income Taxation - IIT***

IIT is based on a broad concept of income that places considerable emphasis on the personality of taxation. The main kinds of income comprised within the tax basis are as follows:

1. wages, and all other incomes from employment, together with retirement, old age, disability and company pensions received after 1998 or, regardless of when received, that amount over and above a certain threshold;
2. capital gains, gifts and inheritances, including any such sums from deceased foreign residents;
3. business and investment income.

On the basis of certain personalized targets, a considerable amount of tax exclusions and exemptions are granted: for example, the following are exempt from income tax:

1. those incomes which do not exceed some thresholds (not automatically adjusted for inflation);
2. the following incomes (up to a certain threshold established by law):

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<sup>18</sup> Income originated in countries of the Andean Community is in general taxable only in the source country.



3. 25 per cent of employees' earnings when they are not over (2006) COP 7,033,000<sup>19</sup> per month;
4. pension-fund related payments and life insurance payments and proceeds;
5. accident, sickness, maternity benefits, and sums received as severance or job's end payments.

The IIT is progressive with four brackets and marginal rates, shown in Table 4. Note the high thresholds in a country where the PCI of those not living in poverty and/or the employed is estimated to be about US\$ 4,500. Income tax is directly *withheld* monthly by employers from their employees' wages. The 10 per cent surcharge, in force up until 2006, has recently been abolished.

TABLE 4 ABOUT HERE

### ***Non-Residents Income Tax - NIT***

NIT is levied on non-residents on the part of their income pertaining to activities located in Colombia, which in principle is subject to taxation at 33 per cent. However, the income paid abroad is *de facto* subject to a final *withholding tax*, which may be levied at a rate of well below the said rate, either at 10 or even at 0 per cent, according to the various incomes in question. The previous surcharge of 7 per cent was abolished by the 2006 reform. Of particular interest is that dividends are exempt from NIT when they are taxed at the corporate level, or are taxed at 33 per cent when untaxed at that level. Interest may be taxed at either 0 or 33 per cent, depending on its source. All payments to a party of a jurisdiction defined as a tax haven are subject to the 33 per cent rate.

#### ***3.1.1.2 Corporate tax - CIT***

CT is levied on the following broad categories of tax payer:

1. Colombian corporations or foreign corporations making profits in Colombia;
2. state-owned enterprises and mixed public/private companies;
3. investment funds, mutual investment funds, family compensation funds and so on;
4. cooperative and mutual societies, unions, non-profit-making foundations or associations.

Colombian citizens are taxed on their worldwide income, whereas foreigners on their Colombian earnings<sup>20</sup>. A broad income concept is applied in principle. Total income includes all receipts, unless specifically exempt. Once all proceeds and capital gains have been added up, net income is then given by subtracting cost and expenses from total revenue. Tax losses may be carried

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<sup>19</sup> 1 US\$ = 2,360 COP; 1 € = 3,013 COP (Forex, average 2006).

<sup>20</sup> Foreign income tax paid by Colombian enterprises may be creditable under certain specific rules. Income from business activities located in the Andean Group countries is in general only taxable within the source country.

forward without any limitations, but no carry-back is allowed. A large number of exemptions are provided for, and their entity was further enlarged by the December 2007 reform. They include:

1. 40 per cent of the value of tangible fixed assets in the tax year the said assets were purchased;
2. all taxes paid as a consequence of the economic activity performed are fully deductible;
3. up to 25 per cent of the Tax levied on financial transaction;
4. placement or transfer to capital reserve of certain items;
5. those incentives granted to business enterprises operating in the Free Zones (Fzs).

The CT tax base is deemed to be the higher of the taxable income, and a 'minimum presumptive income' equal to 3 per cent of a corporation's net worth.<sup>21</sup> Corporate income will be taxed at a flat rate of 33 per cent from 2008 onwards (taxed at 34 per cent in 2007).<sup>22,23</sup>

### **3.1.1.3 Other direct taxes**

#### ***Financial income paid to residents***

Interest and capital gains received are included in taxable income *i.e.* they are taxed under the ordinary rules, with the exception of a few items which are exempted/subject to special rules. Dividends paid to Colombian residents by Colombian corporations or Colombian branches of foreign companies are no longer taxable (they were taxed at 7 per cent before the December 2006 reform).

#### ***Net wealth tax and other taxes on capital and property***

Up until the year 2010, net wealth tax will be levied on those tax payers (individuals or enterprises) whose liquid net worth at the 1<sup>st</sup> January of each year exceeds a given amount (COP 3,000,000 in 2007). The tax rate is 1.2 per cent (compared with 0.3 per cent before the December 2006 reform), and the tax is levied on the net value of wealth excluding shareholdings in nationalized companies.<sup>24</sup> Real estate benefiting from works of local public interest may be subject to the payment of a battlement contribution. Inheritances, bequests and gifts are not taxed as such, but are considered and taxed as capital gains within the income tax framework.

#### ***Financial transactions tax***

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<sup>21</sup> This presumption does not apply to enterprises subject to special regimes or to tax payers operating mainly in financial markets and the public services.

<sup>22</sup> Colombia's is the highest such rate among Latin American countries, and is on a par with that of Paraguay. The Latin American average is 28.3 per cent, while the lowest rate - 15 per cent - is that of Brazil (ILPES-CEPAL).

<sup>23</sup> However, the taxpayers listed under 4 are entitled to pay at a lower rate of 20 per cent. Enterprises operating in FZS are subject to a rate of 15 per cent provided they qualify for it.

<sup>24</sup> The value of the house in which a tax payer usually resides is subject to taxation just for a part. Some non-profitable organizations are exempt from payment of this tax.

This tax was originally conceived as a temporary measure when introduced in 1998: nevertheless, since the 2000 tax reform it has become a permanent feature of the tax system, and the revenue it produces now plays a sizeable role in Colombia's fiscal revenue. The tax is levied at the rate of 0.4 per cent on those financial transactions regarding cashier's checks and savings account deposits. However, transactions between accounts belonging to the same person or company are exempt from financial transaction tax, and a 25 per cent deduction from income tax is granted.

### **3.1.2 Indirect Taxes**

#### ***3.1.2.1 Value added tax- VAT***

Since 1983, VAT has gradually emerged as a vital source of tax yield, taking the place of the then general sales tax. Certain of its present, important features have only emerged over the course of time, including the gradual increase in VAT rates, its extension to services, the deductibility of machinery, and its being credited against incoming VAT rather than against PIT or CT due (Shome 1995). VAT is levied on the supply and importation of all goods and services, unless those explicitly excluded by law. In the latter case, the goods may be either excluded (*i.e.* not subject to VAT) or exempted (zero-rated, *i.e.* subject to VAT at 0 per cent ). The former category of goods includes a basket of essential goods consumed by, among others, poor households. The latter category consists mainly of exports, financial and insurance services and some social services (health, public transport, education). Special rules apply to small taxpayers. A share of the yield is transferred to lower tiers. The standard VAT rate is 16 per cent <sup>25</sup>, although certain goods and services are taxed at four different rates: 1.6 per cent (in the case, for example, of cleaning and private security services); 10 per cent (certain foods, health insurance, entertainments, cotton, tobacco, works of art, air freight); 20 per cent (e.g. mobile telephone services, some vehicles and some alcoholic beverages); while other vehicles and alcoholic beverages may be subject to 25 and 35 per cent VAT.

#### ***3.1.2.2 Other indirect taxes***

##### ***Stamp duty***

Stamp duty is payable on any public or private document concerning the creation, existence, changes or cancellation of obligations over and above a certain threshold. Pursuant to the 2006 re-

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<sup>25</sup> This rate is slightly higher than the LA average (14.7 in February 2006 (ILPES-CEPAL))

form, the tax is due to be gradually phased out. The current rate of 1.5 per cent will be reduced to 1.0 per cent as of 2008, then to 0.5 per cent in 2009, before the tax is abolished altogether in 2010.

### ***Excise duties and agricultural products' taxes***

Excises duties are due on petrol, tobacco and alcoholic beverages. Tax rates vary, depending both on the characteristics and type of product in question, but most are relatively high, as they indeed are in other developing tax systems.<sup>26</sup> Exports are exempt from such duties. Other lesser taxes are levied on agricultural products (such as rice, cacao, wheat, barely, maize, sorghum and oats).

### ***Import and export duties***

Certain custom duties are levied on foreign products. As a member of the Andean Group, Colombia must abide by a mutual plan regarding external tariffs. According to this plan, the rate levied on those raw materials either not produced in the member countries or scarce therein, is set at zero per cent. Intermediate goods are taxed at 5, 10, or 15 per cent while a 20 per cent rate is applied to final products. The duties on vehicles are the highest of all, and may even be as high as 35 per cent. With the sole exception of coffee, which is subject to several duties, no taxes are levied on exports.

## **3.2 Local taxes**

Taxes may be imposed by Colombia's Parliament, although certain levies may also be introduced by Departmental Assemblies and Municipal Councils. However, the revenue from these taxes constitute but a very small part of the total tax burden and a very small share of the resources needed to finance local spending. If authorized to do so by Parliament, the Departments may establish taxes on alcoholic beverages, cigarettes or tobacco, gasoline, lottery tickets and horse race betting, together with registration duties and social security contributions. The *Unified real estate tax*, together with the *Industry and commerce tax*, represent the Municipalities' main source of revenue. The basis used to assess the property tax is the national cadastre, while the rates are chosen locally from a range set by national law. Public establishments, government departments, state-run enterprises, mixed public/private companies, and companies belonging to Departments, are not subject to the tax. Furthermore, Municipalities may levy road, forestry, gambling and prize-winnings taxes, and benefit from contributions when real estate properties appreciate as a result of public works.

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<sup>26</sup> For instance 20 to 40 per cent on alcoholic beverages, 48 per cent on beer; 55 per cent on tobacco.

### 3.3 Social security contributions

Subsequent to the 1993 pension reform<sup>27</sup> (Clavijo 1998; Rudolph *et al.* 2006), and its following amendments, any public or private sector employee<sup>28</sup> has to contribute to the pension system at a rate of 15.5 per cent of wages, approximately two-thirds of which was charged to the employer, while the rest to the employee. Subsidies are provided to those citizens who are not able themselves to contribute to social welfare funds. Only those taxpayers earning over and above a certain threshold income are asked to pay their social security contributions in full. The health care insurance charge is about 5 per cent for employees and 7 per cent for employers. Payroll taxes are due from employers to cover unemployment insurance, subsidies for families and poor children, occupational accident insurance and technical training, at rates varying from 2 to about 8 per cent for any single item. Hence the total burden of payroll taxes amounts to all of 47 per cent, about 37 per cent of which is charged to employers and about 10 per cent to employees. One may ask why such high rates do not give rise, as is the case in Brazil, to higher revenue from social security contributions than the present figure of 2.8 per cent of GDP (see Table 2 above). One answer may lie in the fact that the present pension system is estimated to cover only about 25-30 per cent of the entire labor force, and in the lengthy term of transition to the new pension system (completion is due in 2013).

## 4. The principal tax policy issues

### 4.1. The distribution of Colombia's fiscal burden

The increasing Colombian social expenditure over the last 20 years has not been very effective from the redistributive viewpoint. This has been due to the lack of a valid evaluation system, to the fragmentation of the welfare programs (Perotti 2000), and to the fact that these measures have mainly consisted in funding education and healthcare -expenditures which however appear to be progressive (Ariza and Zapata 2005)-, while no attempt was made to implement a social security safety net. Colombia has merely adopted a targeted program of transfers to the poor (*Familias en acción*) like to those introduced in recent years in other Latin American countries (Clavijo 2005).<sup>29</sup>

It is thus worthwhile analyzing the redistributive effects of taxation. Over the last few years, Colombia's government has made efforts to expand progressive taxation. In particular, from 1998

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<sup>27</sup> The main change introduced by the reform was the establishment of a fully funded, privately administered defined contribution pension system running parallel to the existing defined benefit PAYG State scheme. Workers may choose *between* the two systems, but may *not combine* the two. Hence the system ought to be defined as a single pillar system, the main consequence of which being that the contribution rates are the same for both the systems.

<sup>28</sup> Self-employed workers may join either system voluntarily, provided their contributions reach a minimum level.

<sup>29</sup> '*Progresas*' in Mexico in 1997, '*Bolsa-Escuela*' in Brazil in 1995.

onwards increasing importance was given to the Financial transaction tax; however, it is difficult to assess the impact of this tax on the progressivity of the tax system.<sup>30</sup> At first sight it would seem that income tax has contributed towards the redistribution of income, given its system of progressive rates. In fact, the average value of the PIT quasi Gini coefficient<sup>31</sup> for 1993-2000 (Sanchez and Espinosa 2005) is quite high (0.64).<sup>32</sup> These values point to a huge concentration in the distribution of the tax burden, whereby the richer quantiles of the population pay the majority of the tax. However, this does not necessarily imply that the tax system significantly levels out the inequalities plaguing Colombian society. To check this effect we ought to look at the post-tax Gini index. A good example is provided by Ariza and Zapata (2005), who calculate the Reynolds-Smolensky index<sup>33</sup> for 2003 and obtain a miniscule value (0.005). The weak redistributive power of the tax can be accounted for by two simple facts. The first is that the above-mentioned series of exemptions substantially narrows the tax base; secondly, we ought not to forget the massive effect of tax evasion in Colombia. To conclude then, even though the legal structure of Colombia's PIT is a progressive one, its equalizing power is quite weak since the incidence of the tax is extremely low.

Standard literature of public finance point out the negative equity effects of indirect taxation, due to taxpayers' decreasing consumption propensity. However, one must take into account the structure of Colombian VAT, whereby many basic goods are VAT-exempt, while certain luxury goods are taxed at higher rates. According to Avila *et al.* (2001), the tax allows for income redistribution for the first 18 ventiles, whereas the situation differs in the case of the last two ventiles where the rates of saving are quite high. Other scholars, on the contrary, believe that the tax is fully capable of improving equity at any stage. Sanchez and Espinosa (2005), for example, consider the contribution of each decile towards the amount of VAT collected by the Government. They show that the tax is a progressive one that it is mainly paid by the rich people.

## 4.2 The decentralization of government layers

Over the last two decades, Colombia has made substantial efforts to define its fiscal decentralization model. The first step taken towards this goal was the 1991 Constitutional Reform, one aim of which was to assign greater control over welfare expenditure to the lower tiers of government. The process, however, failed to modify the allocation of tax revenue. While taxation remained centralized, a complex system of vertical transfers was set up to allow local governments to maintain high

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<sup>30</sup> This would require certain assumptions regarding the transactions carried out by the various strata of the population. Some attempts were made in this direction. Sanchez and Espinosa (2005) conclude that the FTT has a small redistributive effect, whereas Clavijo (2005) holds that it only affects users of bank markets, not the owners of financial capital.

<sup>31</sup> This is the Gini Index calculated considering the distribution of tax on households' incomes or consumption.

<sup>32</sup> The same index computed by Zapata and Ariza (Zapata and Ariza 2005) for 2003 is even higher at 0.89.

<sup>33</sup> This index gives the reduction in inequality (Gini index) after tax, which combines the quasi-Gini with the mean rate.

levels of spending (mainly on health and education: Lozano 2000). The transfers were granted as a share of Central Government revenues, and were calculated using revenue-sharing parameters. This way of financing the lower tiers produced a sharp rise in the flow of resources from Central to the lower governments. During the second half of the 1990s, the quantity of transfers grew enormously, and this discouraged tax efforts at the local level (Jungito and Rincon 2004). The ensuing debate pointed out that the main weakness of the existing transfers' system was the imbalance between the revenue raised by local layers and their actual spending. Since local administrations were also able to borrow to finance their expenditure, and could rely on transfers from Central Government, the problem of the moral risk arose (Iregui *et al.* 2001). Local layers did not need to promote efficient spending, since they knew that Central Government could bail them out (Alesina *et al.* 2000). However, the entity of resources was not the only factor creating bad incentives. Transfers to Municipalities were established as an average of various indicators, where the percentage of those people with 'unsatisfied basic needs' accounted for more than 60 per cent. While this scheme improved horizontal equity, it also contributed towards the 'soft budget constraint' problem.

The inadequacy of Colombian fiscal decentralization was one of the main concerns analyzed by the 'Alesina mission' (Alesina 2000), a study group whose aim was to suggest institutional reforms. The group's advisors recommended that a few simple changes be made as follows:

- i)* Municipalities and Departments should not be allowed to borrow;
- ii)* allocation rules should be changed, not by eliminating transfers but allocating them using a rule ensuring that local tiers benefit from a share of the taxes collected in the local area;
- iii)* greater flexibility and clarity with regard to spending decisions and responsibilities.

In line with these recommendations, and in an attempt to reverse the trend in public expenditure while at the same time preserving a decentralized system, Colombia witnessed a new reform in 2001 (Sanchez *et al.* 2002). This reform set up a new system for the period 2002-2008. A limit was imposed on local tiers' spending. The link between the revenue of Central Government and transfers was removed, and transfers were converted into lump-sum grants. From 2002 to 2005, the upper limit yearly increases in transfers was set at 2 per cent in real terms; from 2006 to 2008, it was due to rise to 2.5 per cent. Finally, as of 2009, transfers will be allowed to rise at the same pace as Central Government's tax revenue. Hence, after 2009, funding to local layers will once again be linked to Central Government's revenue; the consequences of this will depend largely on the degree to which the transition scheme manages to recover fiscal responsibility (IMF 2006).

## **5. The latest changes in the Colombian tax system: a lot of work resulting in a limited, unfair reform and an alternative proposal**

### **5.1. Step one: the need for a broad, theoretically coherent tax reform**

After the 1998-2001 adjustment plan, clear evidence emerged of the need for a broad reform of the Colombian tax system. A politically accountable, academically authoritative committee was appointed to identify the weaknesses of the existing system, to establish a coherent framework and to set directions for change: the *Mision de Ingreso Publico* (2002), and it drew up these guidelines:

1. both vertical and horizontal equity, as well as efficiency, need to be improved;
2. the Government has to create new taxes that are easy to handle;
3. a good working relationship between central and local governments needs to be built.

Consequently, the implementation of the following measures was suggested:

1. the widening of the PIT basis, by limiting some deductions and abating exemption thresholds;
2. the simplification of para-fiscal contributions, to be also divided according to payers incomes;
3. the strengthening of CIT by enlarging its basis and reducing the existing generous allowances;
4. the widening of the range of goods on which VAT is due, and the reduction of the number of VAT rates. The final proposal was to expand the base so as to cover one half of GDP, and to apply a single 10.4 per cent rate<sup>34</sup> on all goods while preserving the same revenue as before. The negative effects on redistribution could be compensated for by keeping some essential goods tax-free, or by giving poorer households a VAT rebate. In this case the VAT rate should remain at 16 per cent;
5. the reduction of the financial transactions tax;
6. the strengthening of local taxation.

### **5.2 Step two: the wide-ranging, ambitious program of reforms proposed in July 2006**

In July 2006, the Colombian Government submitted a program for a tax reform to broadly modify the existing system. The taxes due for change were as follows (Government of Colombia, 2006).

- i) CIT* - Exempt incomes to be cut but not fully cancelled out; all fixed investments to become deductible. A rate of 34-32 per cent to be applied from the first to the third and later years.
- ii) PIT* - The level of exemption to be raised and marginal rates reduced. All allowances, barring the basic exemption, to be repealed.

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<sup>34</sup> Apart from some presumed theoretical merits, the efficiency advantage of single-rate VAT is its greater administrative simplicity, ease and lower costs of compliance, especially given the resulting reduction in tax refunds; it may also help limit tax avoidance. Chile is the main example of a Latin American country with single-rate VAT.



iii) *VAT* - Rates to be greatly simplified (10, 16, 25 per cent). Exemptions not to be completely abolished, but in the main replaced by zero rates. Rebates of COP 236,000 (= US\$ 100) to be introduced to in part compensate the poor for the lesser number of essential goods exempt.

iv) *Financial Transaction Tax* to be kept in force at the rate of 0.4 per cent, while *Stamp duty* and *Wealth tax* to be abolished.<sup>35</sup>

The tax reform package was not at all in keeping with the *MIP*'s recommendations. The exemption thresholds not had to be reduced but raised to the point where total allowances were extended rather than reduced. VAT should continue to be levied at more than one rate, and a dual system of untaxed goods and rebates to poor households established. A number of important issues were not addressed: e.g. the question of decentralized government's revenue, and the reform of para - fiscality. In terms of equity, the reform proposal greatly favored the middle and upper classes, whose incomes were lightly taxed while their wealth was now largely to escape taxation. Colombia's poor citizens, on the other hand, were penalized when it came to taxation on consumption.

### **5.3 Step three: the minor, unfair 'reform' introduced in December 2006**

We have mentioned the changes introduced by the December 27<sup>th</sup> 2006 reform in the previous description of the Colombian taxes, since these changes will come into force from the 1<sup>st</sup> January 2007. However, the overall picture shows that once again the few real changes made are to the advantage of the country's wealthier citizens and its large corporations. Income tax has remained almost unchanged. While on the one hand, the lower limit of the top bracket has been brought down, on the other hand no adjustments for inflation have been made as yet. The rate of wealth used to calculate 'presumptive' personal and corporate income has been halved. The wealth-tax rate has been increased, but the tax will be abolished in 2010. A few goods have been exempted from VAT, but in the case of a larger number of goods, the previous rates have been replaced by a higher rate.

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<sup>35</sup> According to the Government's estimates, the PIT threshold exempted all tax payers within the first 7 deciles, and the tax would also have been very light when it came to higher incomes. The situation regarding VAT was quite different however. A roughly flat rate of around 5.5 per cent was to be levied on taxpayers within the first 5 deciles (those earning up to approximately COP 16.5 million yearly - about US\$ 7,000), above which the tax rate rose and burdened the 10<sup>th</sup> decile to the greatest degree. To sum up then, only those tax payers with an annual income of at least COP 104 million (about US\$ 44,000) were to pay a combined (PIT + VAT) rate of just over 20 per cent.

## 5.4 An alternative strategy for tax reform designed to benefit the poor rather than the rich

To counter social deprivation, any tax reform would need to be different from the latest proposals & bills submitted. The cornerstones of such a reform should be the extension of PIT to middle incomes at a reasonable mean rates, together with a reduction in VAT charges. Wealth tax should be made permanent, and serious measures should be adopted to combat tax-evasion and smuggling. In our opinion, political forces rather than economic factors are preventing Colombia from substantially increasing both income and wealth taxes. This potential revenue could be added to that recovered by extending instruments such as presumptive assessments and minimum taxes. A surcharge should be introduced on the rents of those large corporations operating within the framework of a natural monopoly or exploiting natural resources, land included. The revenue gathered in this manner could then be used to subsidize the poor of this beautiful, culturally and historically wealthy country; those same citizens who inhabit the shantytowns one sees when landing at Cartagena Airport, or who inhabit the impoverished villages of Colombia's interior.

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<http://www.contaduria.gov.co> – Colombian Government Budgetary Department

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## TABLES

Tab. 1 - Structure and development of operations in the Non-Financial Public Sector - Selected figures and years - Percentage of GDP

	1990	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
<i>Total Revenue, of which:</i>	20.0	27.8	31.0	31.3	30.5	33.9	33.7	35.1	34.7	35.4	37.5	34.9
Total Taxes	12.6	16.5	17.3	17.8	18.0	16.2	16.0	17.4	17.3	17.6	18.6	18.0
Non-tax current revenue	7.3	9.4	11.4	10.9	10.3	16.7	17.2	17.6	17.2	17.6	18.7	16.9
<i>Total Expenditure, of which:</i>	20.6	28.1	32.7	34.1	34.2	38.0	37.5	39.1	38.1	38.0	38.6	35.5
Current primary expenditure	10.9	15.7	17.6	18.9	20.2	25.8	25.0	25.8	25.5	25.3	26.3	25.3
Interest on Public Debt	3.2	3.3	3.9	3.7	4.6	3.7	4.3	4.8	4.5	4.7	4.5	4.0
Capital expenditure	6.5	9.2	11.2	11.5	9.4	8.3	8.2	8.5	8.1	8.0	7.7	5.9
<i>Primary Surplus</i>	2.6	3.0	2.2	0.9	0.9	-0.3	0.4	0.7	1.0	2.1	3.6	3.7
<i>Budget Balance</i>	-0.6	-0.3	-1.7	-2.8	-3.7	-4.1	-4.0	-4.1	-3.5	-2.6	-0.9	-0.3
<i>Total public debt of NFPS</i>			29.7	34.6	39.1	50.1	57.8	62.9	71.5	67.7	62.6	60.2
<i>Total public debt of Central Government</i>	14.8	13.9	14.4	17.8	24.5	34.6	42.7	48.4	55.9	54.9	52.0	51.0

Source: ILPES-CEPAL on Colombian data of Ministerio de Hacienda and CONFIS.

Notes: The figures for 2005 are provisional.

Tab 2 - Structure and development of consolidated General Government revenue - 1990 - 2004 - Percentage of GDP

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004
<i>Total tax revenue</i>	9.6	10.7	11.2	11.5	12.1	11.8	12.5	13.2	13.1	13.4	13.9	15.8	16.0	16.6	17.6
Direct taxes, of which	3.6	4.6	4.9	5.0	4.8	4.7	4.6	5.2	5.2	5.7	5.9	7.0	7.6	7.7	8.4
income and profits	3.2	4.2	4.4	4.5	4.2	4.0	3.8	4.4	4.3	4.2	4.3	5.3	5.2	5.1	6.0
households					0.2	0.2	0.2	0.2	0.2	0.2					
corporations & businesses					3.9	3.8	3.6	4.2	4.1	4.0					
property	0.4	0.4	0.4	0.4	0.5	0.6	0.7	1.4	1.2	1.4	1.2	1.4	2.0	2.1	2.0
other direct taxes	0.1	0.1	0.1	0.1	0.1	0.2	0.1	0.1	0.1	0.4	0.4	0.4	0.4	0.4	0.4
Indirect taxes, of which:	6.0	6.1	6.4	6.5	7.3	7.1	7.8	8.1	7.9	7.7	8.0	8.8	8.6	9.1	9.2
general taxes on goods and services	2.4	2.8	3.2	3.3	4.1	4.1	4.7	4.8	4.6	4.4	4.8	5.3	5.2	5.7	5.9
specific taxes on goods and services	1.8	1.8	1.8	1.7	1.9	1.8	1.8	1.8	1.8	1.8	1.9	1.9	1.9	2.0	2.0
international trade	1.3	1.0	0.9	1.0	1.1	1.0	0.9	1.0	1.2	0.9	1.0	1.1	1.0	0.9	0.9
other indirect taxes	0.5	0.5	0.4	0.5	0.3	0.3	0.3	0.4	0.3	0.5	0.3	0.4	0.4	0.4	0.4
<i>Social security contributions</i>	0.8	1.8	1.9	2.1	2.8	3.7	4.1	4.4	3.8	3.6	2.9	2.9	2.6	2.4	2.8
<i>Total fiscal revenue</i>	10.5	12.4	13.1	13.6	14.9	15.5	16.6	17.6	16.9	16.9	16.8	18.6	18.8	19.21	20.4

Source: ILPES - CEPAL on Colombian data of Ministerio de Hacienda and CONFIS.

Table 3 - Central and General Government revenue compared with the Latin America average

	<i>Central Government -2005</i>		<i>General Government -2004*</i>	
	<i>Colombia</i>	<i>LA average</i>	<i>Colombia</i>	<i>LA average</i>
Total fiscal pressure	17.6	15.2	20.4	21.1
% increase from 1990	98.0	31.0	94.2	27.1
% share direct taxes	42.2	27.6	41.1	28.9
% share indirect taxes	43.2	59.9	45.1	48.0
% share social contributions	15.6	12.5	13.8	23.1

Source: ILPES – CEPAL.

\*Only Argentina, Bolivia, Brazil, Chile, Colombia, Costa Rica, Ecuador, Uruguay. The 2005 figures are provisional.

Table 4 - Tax brackets and rates of personal income tax

<i>Net taxable income</i>	<i>Marginal tax rate</i>	<i>Average tax rates at mid- brackets</i>
COP > 0-21,800,000 (US\$ 9,2506)	0	0
COP 21,800,000-34,000,000 (US\$ 14,400)	19	5.0
COP 34,000,000-82,000,000 (US\$ 34,750)	28	15.5
Over COP 82,000,000 (US\$ 34,750)	Lump-sum payment (COP 15,760,000) plus 33% of the excess over and above COP 82,000,000	27.7% as example for an income of COP 200,000,000 (US\$ 84,750)

