
Some considerations regarding Colombia's tax regime

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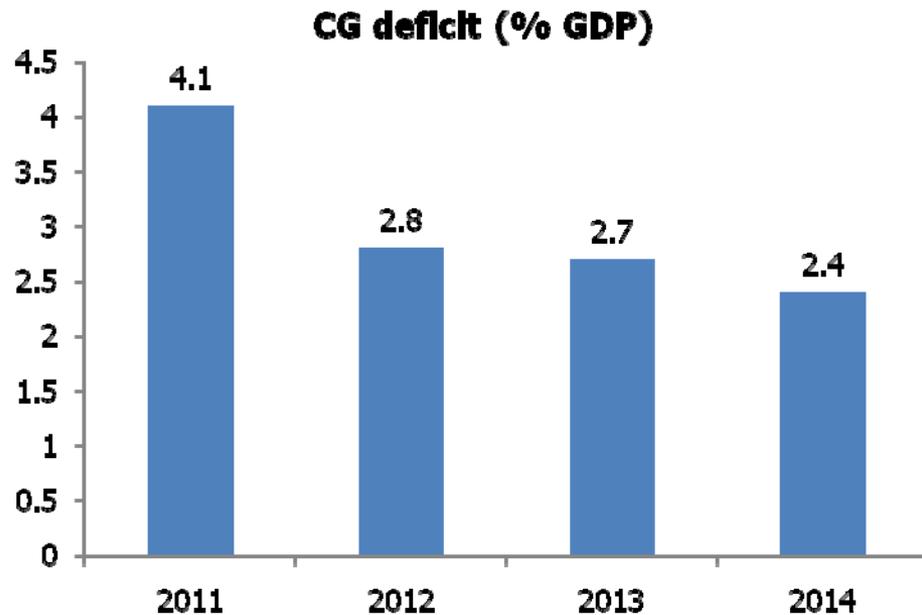
Agenda

- General features of the tax regime
- Specific characteristics of the main taxes
- The political dimension of tax policy
- Progressiveness of public expenditure
- A tax reform proposal

Efficiency, progressiveness and horizontal equity of Colombia's tax regime

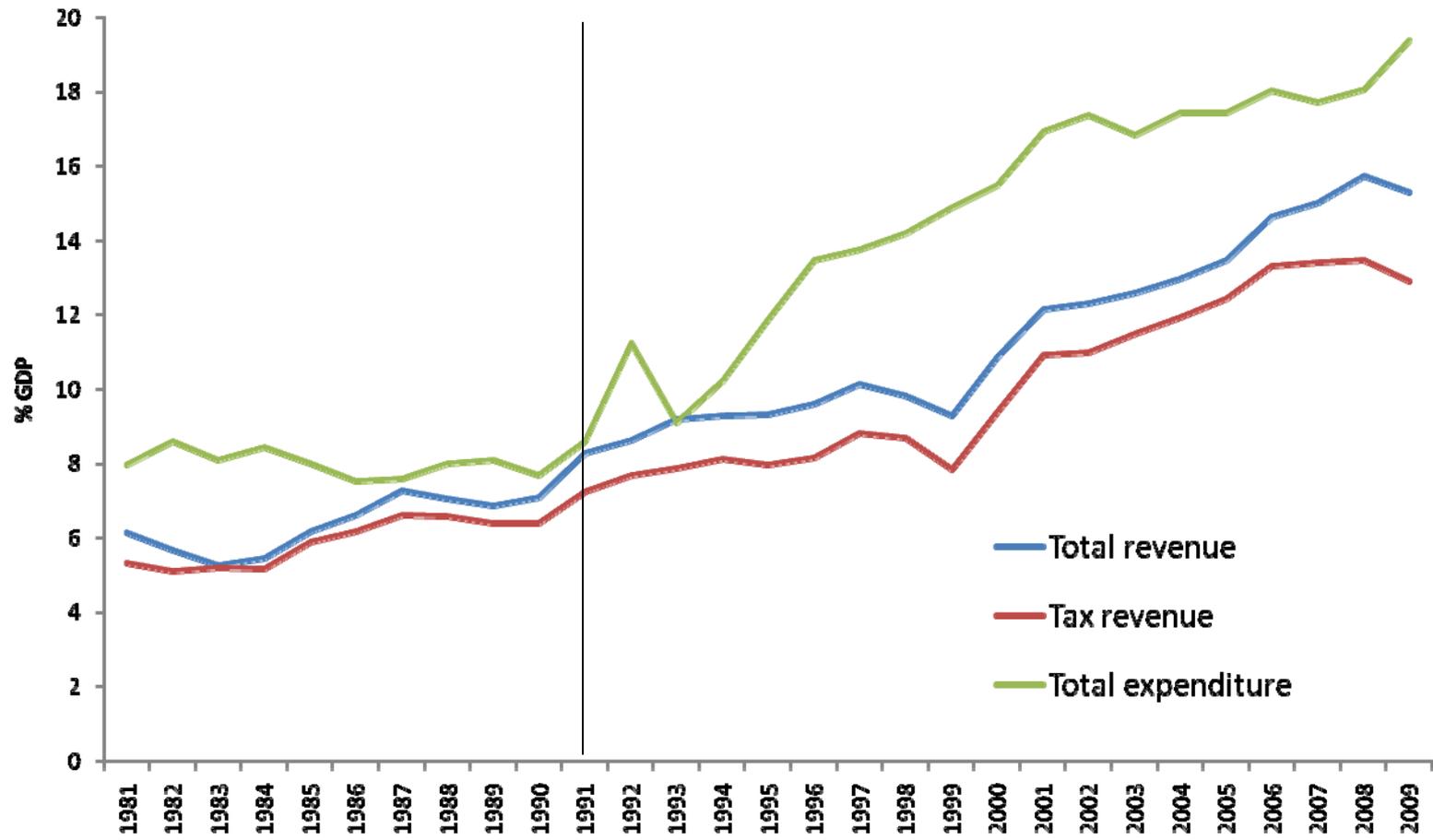
- These three guiding principles coming from the theory are explicitly mentioned in Colombia's Constitution
- None of the three is fulfilled: the regime is inefficient, not very progressive and horizontally unequal
- The political discussion has tried to act in favor of progressiveness (Congress and Constitutional Court)
- The power of lobbying of “economic groups” amid the political fragmentation of the Congress has led to benefits proliferation, reducing the productivity of taxes, promoting horizontal inequity, introducing complexity to the system and making its administration more difficult
- The high level of informality in the economy contributes to the insufficiency of tax revenue
- It has been necessary to turn to highly distorting taxes (Wealth tax, FTT, payroll taxes)

Nowadays, insufficiency and inefficiency of taxes are the main concerns



- Some estimations show that, by broadening bases and/or modifying tax rates with an improvement in tax management, the tax collection should increase in 1,5% -2% of GDP, to achieve the medium-term fiscal path implicit in the fiscal rule

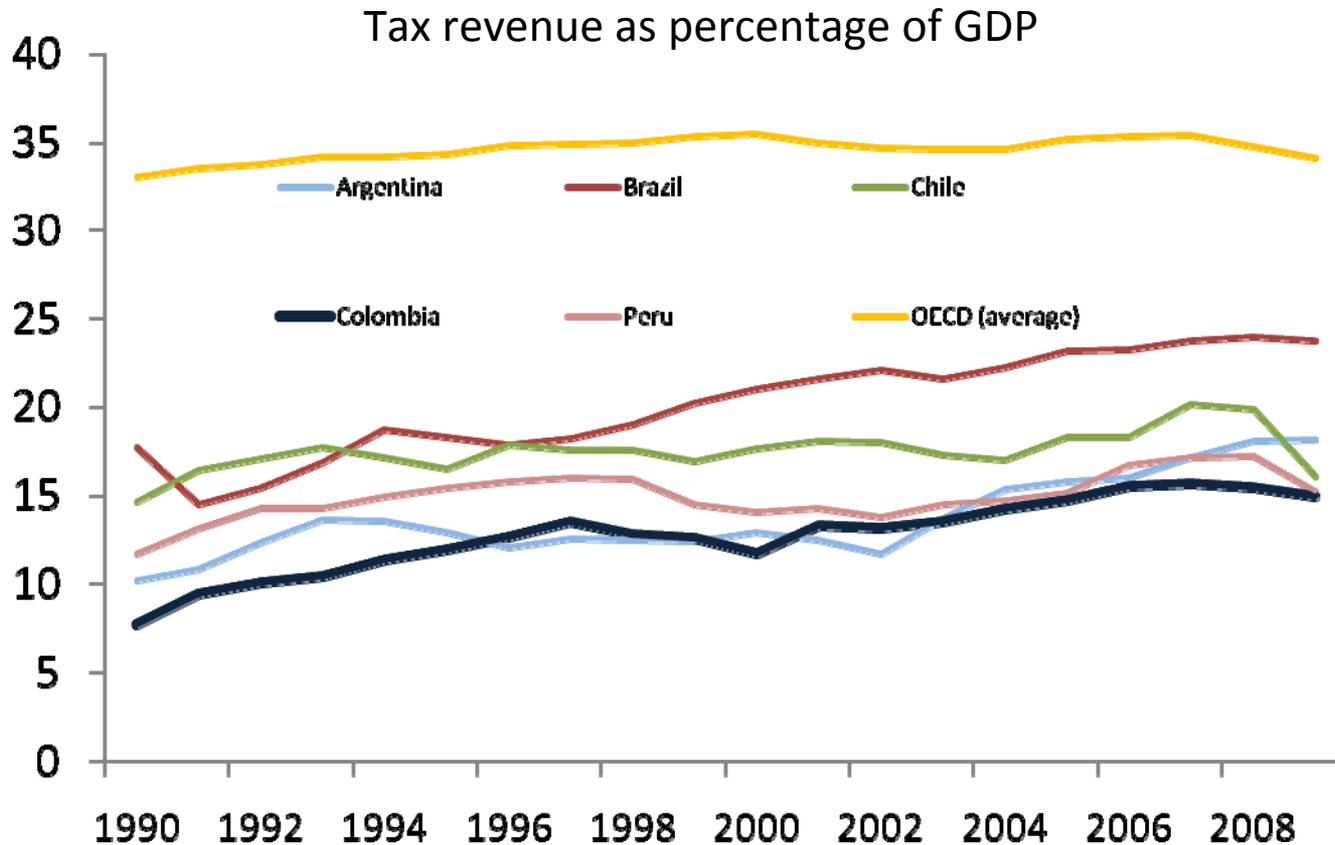
Tax revenue is insufficient to cover the central government expenditure



*Note: Does not include contributions to social security.

Source MHCP

In comparative terms, Colombia exhibits a low tax to GDP ratio

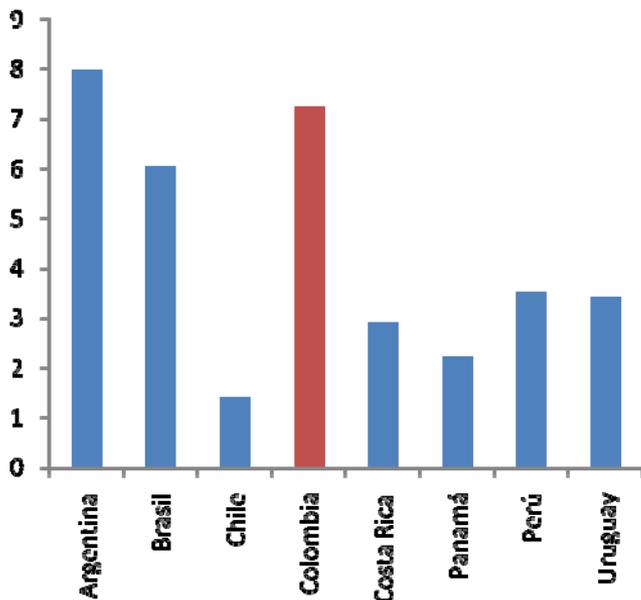


Note: includes direct and indirect taxes, contributions to social security and other.

Source: ECLAC and OECD

However, several reforms have increased tax collection

Change in tax collection/GDP between 1990 and 2009 (pp)



Source: ECLAC

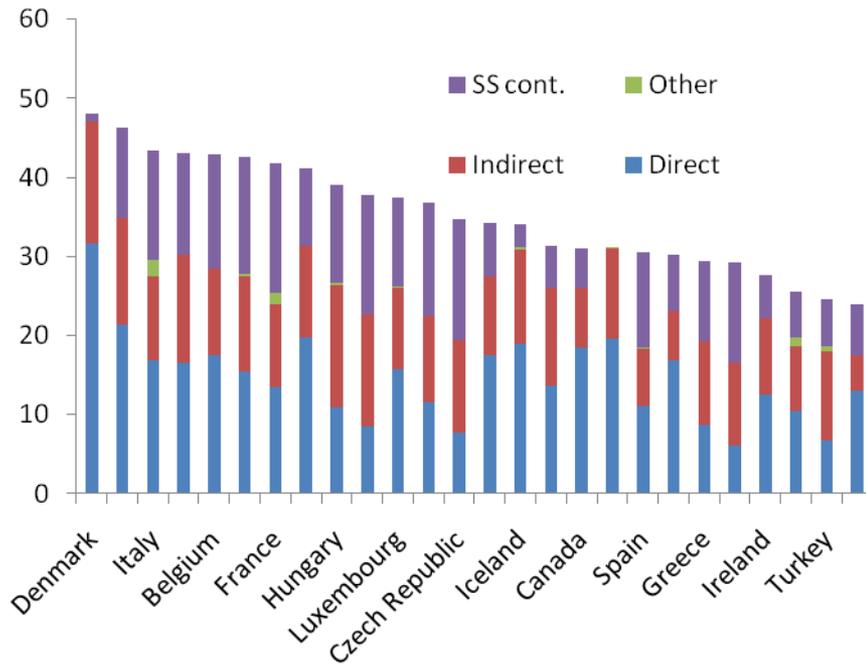
	Change 2009/1990
Total tax revenue	5.93
Direct tax revenue	3.73
Taxes on income, profits and capital gains	2.71
Property taxes	1.02
Indirect tax revenue	2.34
Other taxes	-0.15
Social security contributions	1.29
Total tax revenue (including social sec. contributions)	7.22

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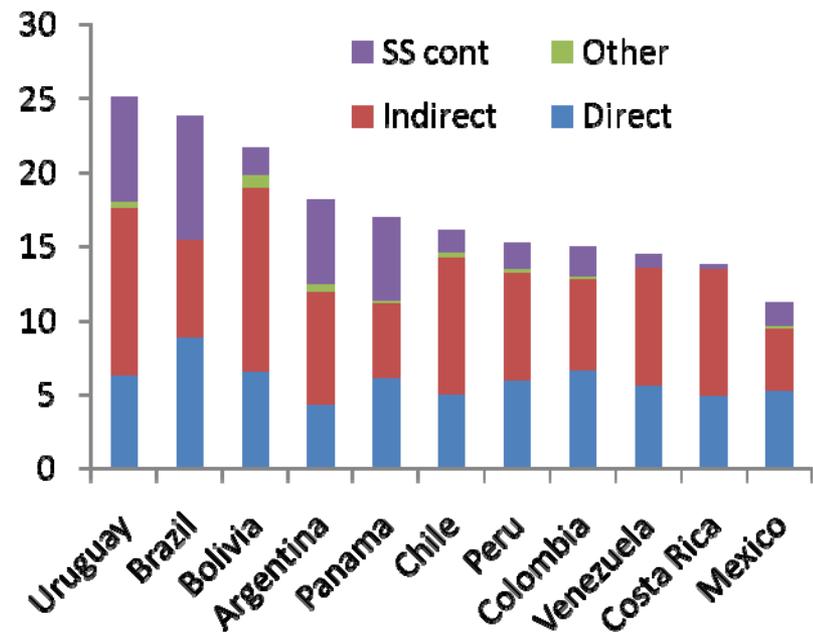
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As is usual in Latin America, indirect tax collection is more important than direct tax collection

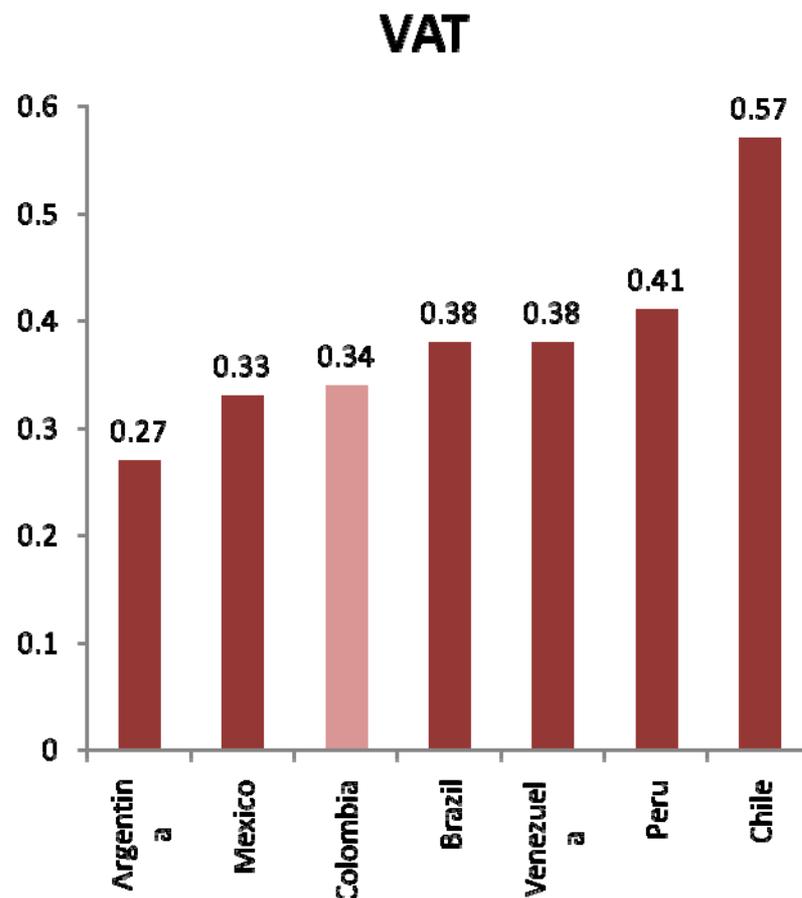
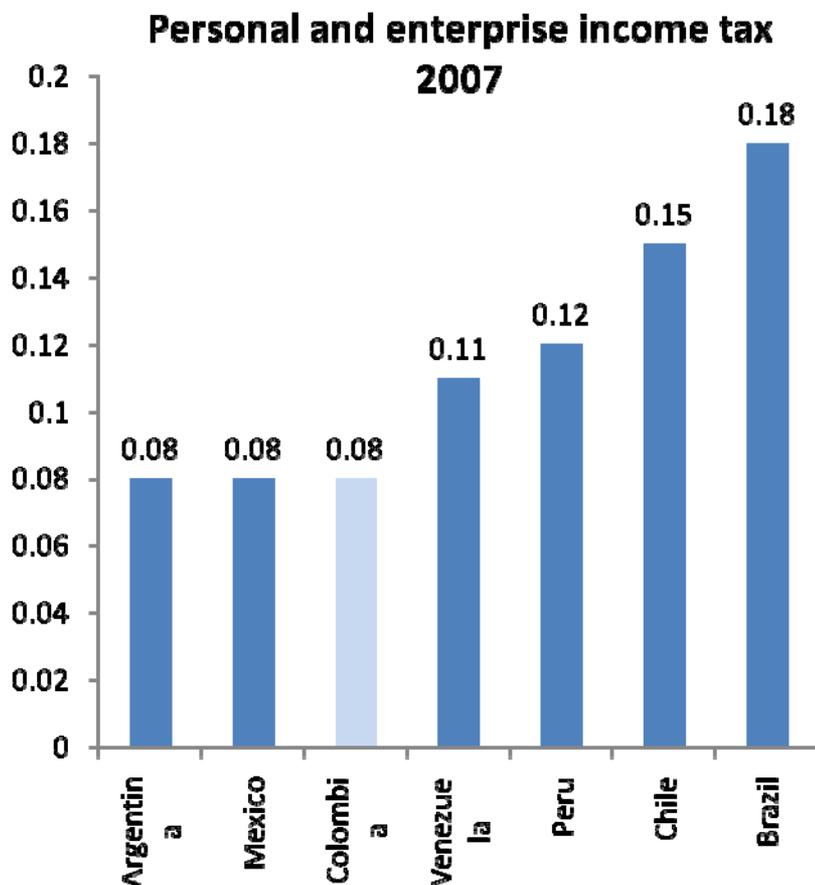
Tax revenue (% of GDP)



Source: ECLAC



Income tax and VAT productivity are low



The productivity is measured as the additional collection (% GDP) by an increase of one percentage point.

Source: ECLAC

Income tax

Low productivity reduces the progressiveness

➤ Enterprises

- Many exemptions, special deductions and discounts with high tax expenditure (1.5% of GDP, cost that reduced slightly with the elimination of IAFP deduction)
- Unequal incidence by sectors and enterprises

Horizontal inequity: similar taxpayers pay different effective tax rates

	Average Enterprises	Enterprises located in Free trade zones
Average	39.80%	26.10%
Minimum Sub sector	29.10%	22.70%
Maximum Sub sector	54.10%	38.10%
Difference	25 pp	15.4 pp
Maximum difference average Enterprises Minimum FTZ	31.4 pp	

Source: Declaraciones de renta, bodega de datos. Subdirección de Gestión de Análisis Operacional-DIAN.

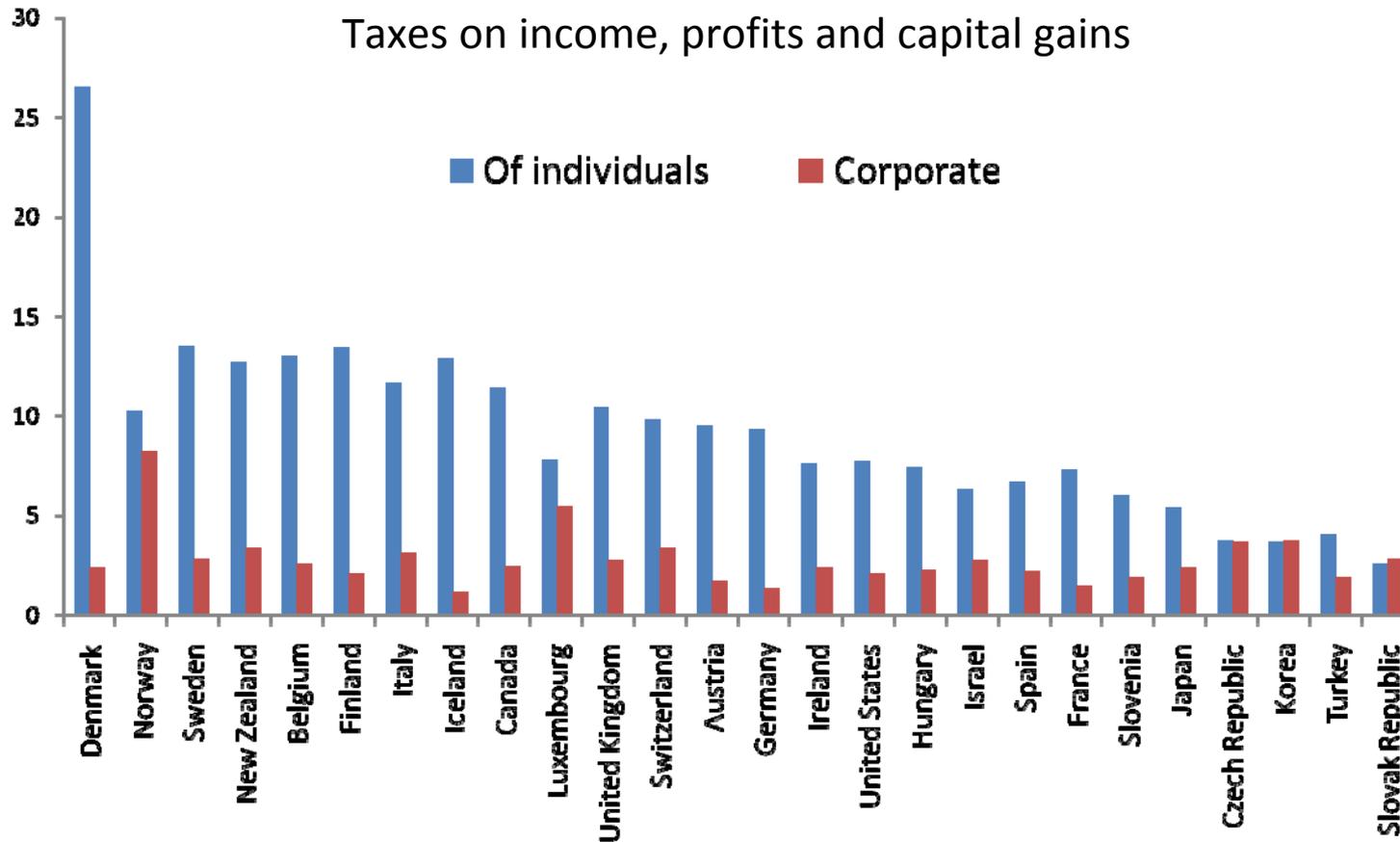
Income tax

Low productivity reduces the progressiveness

➤ Personal

- High level of minimum exemption
- Exempted Income (labor related)
- Special deductions (education, health and house acquisition) that benefit high income individuals

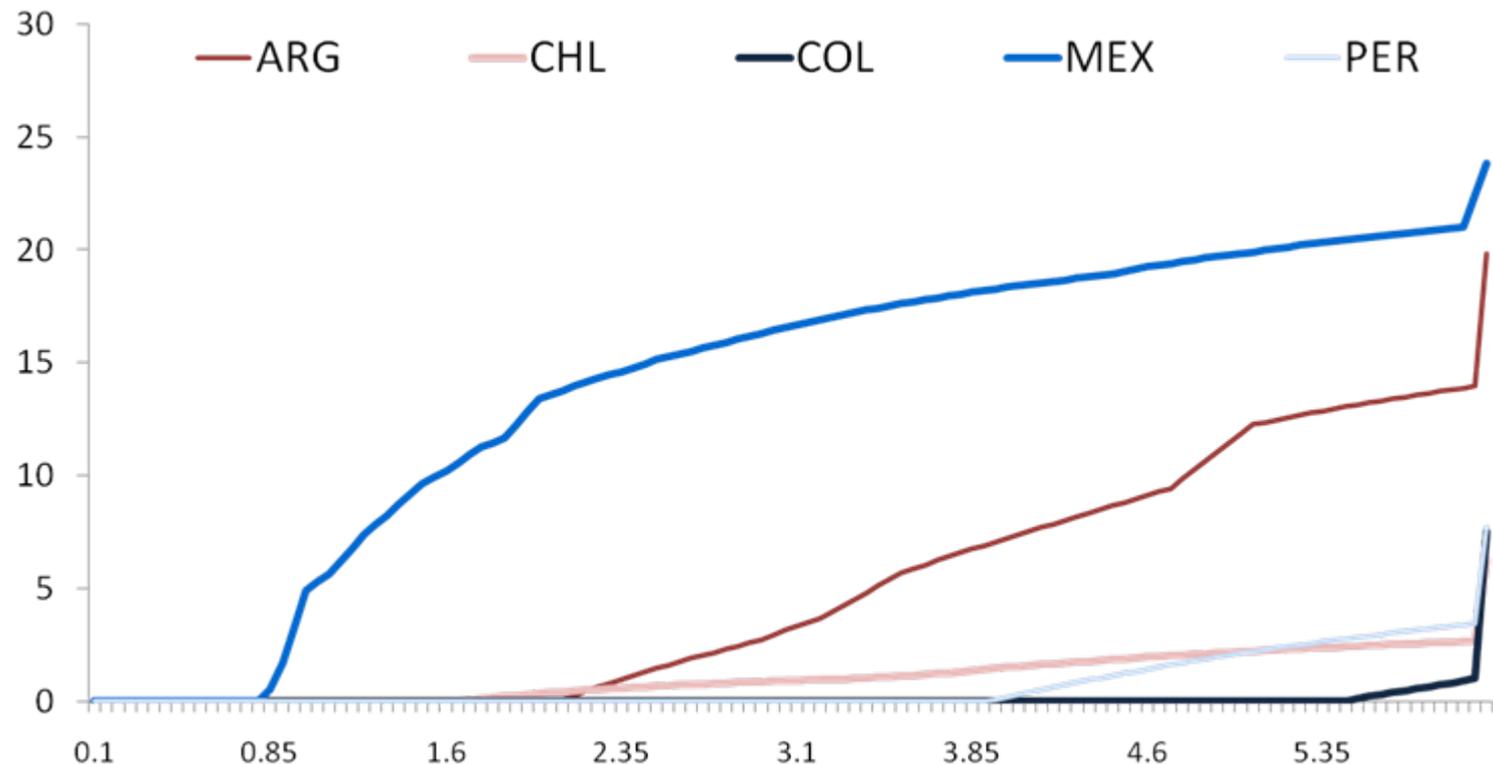
In the OECD countries, the direct taxes are concentrated on individuals



Source: OECD

Average personal income tax rates by income

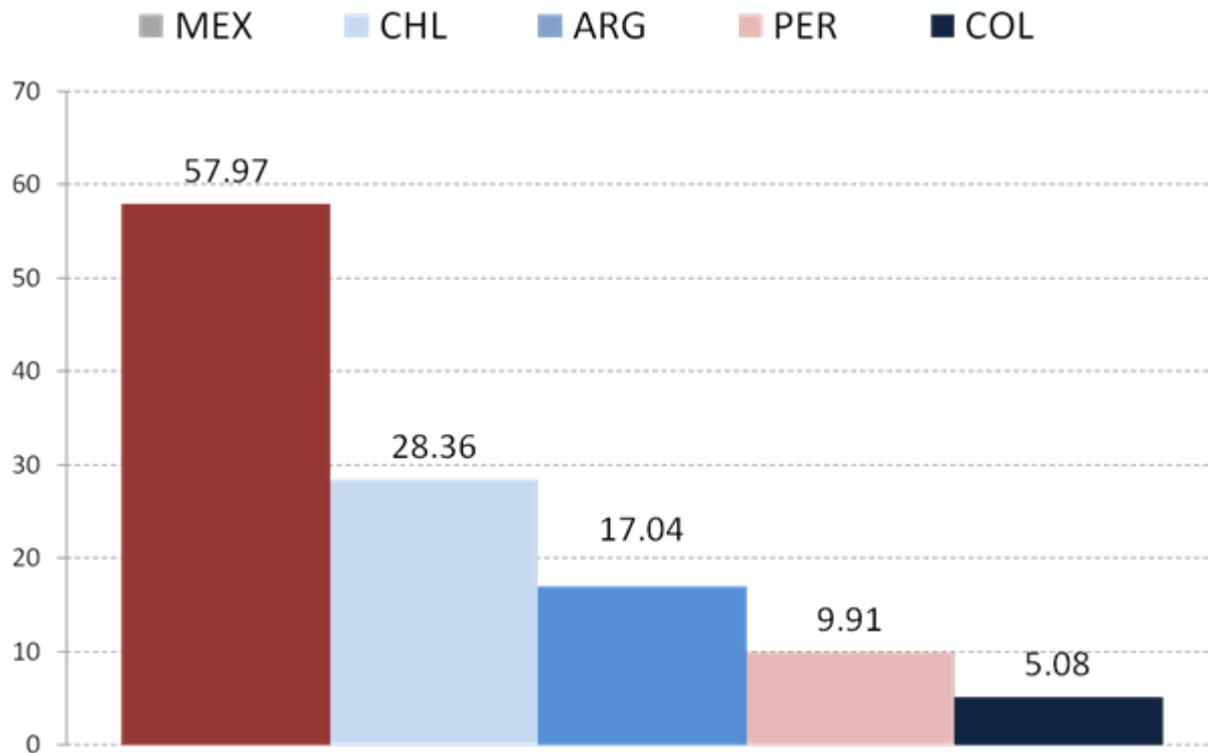
(Relative to national median labor income, percentage)



Note: On the horizontal axis, 1 represents the national household labour median income.

Source: OECD based on national household surveys and corresponding national tax codes.

Proportion of households which are net payers of personal income taxes



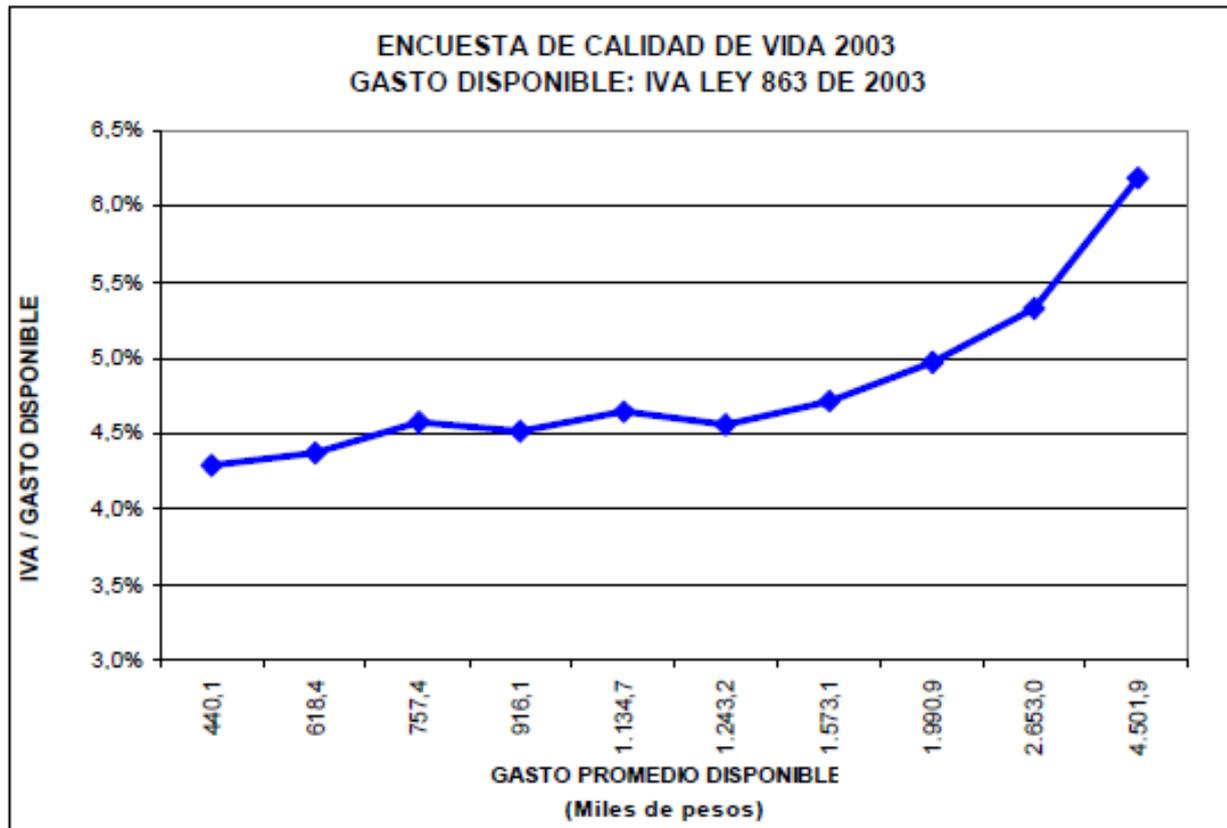
Source: OECD based on national household surveys and corresponding tax codes.

VAT: low productivity and efficiency

- Low productivity due to:
 - Considerable amount of excluded or exempted goods and services that reduce taxable base
 - Multiple rates (8 different to 1 in Chile and Peru, 2 in Ecuador, Mexico, Venezuela and Panama)

- Economic efficiency
 - It is not possible to fully discount the VAT paid in the acquisition of capital goods
 - Excluded products affect sectors which cannot discount the VAT paid on inputs, e.g. agricultural

VAT is slightly progressive



FUENTE: DANE. Encuesta de Calidad de Vida 2003
CÁLCULOS: DIAN. Oficina de Estudios Económicos

VAT progressiveness (demasiado detalle)

- Actual VAT structure in Colombia is not regressive, and does not have incidence on income redistribution
- Exemptions and exclusions of the VAT support this conclusion: effective incidence on the households expenditure is relatively low (5,4% - ECV 2003)
- Impact differs notably by deciles, however the differences have progressive features (4.2% in first decile and 6.2% for the last decile)
- Even this feature, the Gini Index before and after taxes remains constant practically (43,6%)

Source: Avila and Cruz (2006).

Fiscal expenditure of goods exempted, excluded and taxed with rates under 16%

	Fiscal expenditure (% of GDP)
Excluded	0.95
Exempted	0.52
Taxed at 5%	0.04
Taxed at 10%	0.09
Total	1.6

*This exercise maintains exempted education services, land transport, financial intermediation, health, construction, domestic and house rental

Source: Subdirección de Gestión de Análisis Operacional - Dian

Wealth tax, payroll taxes and FTT: try to compensate low productivity of Income and VAT

➤ **Wealth tax**

- Applies to big enterprises, taxing business capitalization and investment

➤ **FTT**

- Generates financial “disintermediation” with certain effects on growth and income distribution
- The productivity was declining (tax reform of December 2010 corrected evasion)

➤ **Payroll taxes**

- In Colombia these are clearly an obstacle to formal employment
- Unemployment rate and labor informality are high, 56% and 10.8%, respectively

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The political dimension of tax policy: the Legislative power

- The Constitution: political parties fragmentation, corrected partially with the threshold and “Ley de Bancadas”
- The way to form coalitions in Congress requires broad exception and protection of particular interests, of which depend their campaigns (much important than parties discipline)
- Colombian Congress, invoking reasons of progressiveness, has disapproved modifications on VAT and reductions in the minimum exemption of the personal income tax; it has also favored approval of distorting taxes such as wealth tax and FTT (which is now permanent)

Source: Perry, Pachón and Olivera, 2009 and Perry, 2010

The political dimension of tax policy : Constitutional Court and Private Sector

- **Constitutional Court**

- The Sentencia C-776 de 2003 stated as unconstitutional the law that taxed some exempted or excepted goods with a low rate, based on the fact that it affected the minimum vital income of the low income families and the CC argues that it did not find adequate compensations
- Some posterior initiatives about the VAT have contemplated some compensation devices

- **Private Sector**

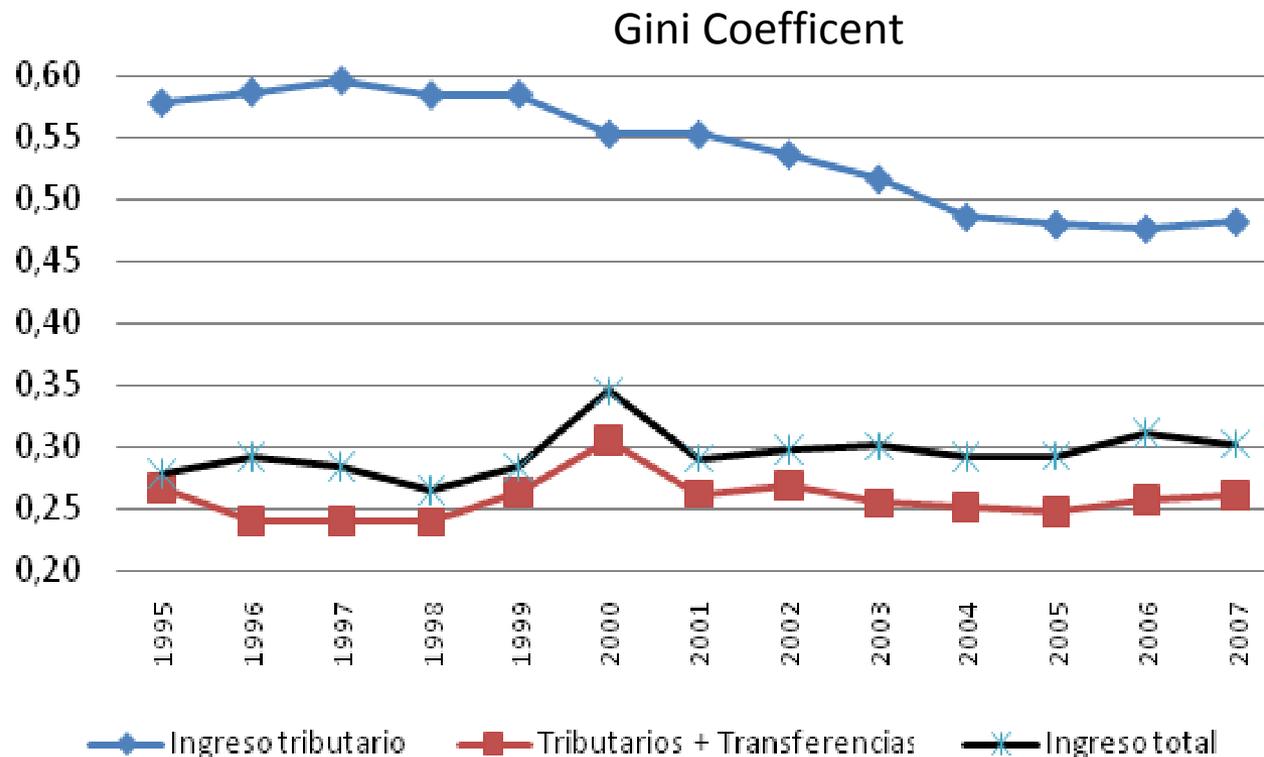
- Due to the political fragmentation in Congress and the resources dependence of it's members to finance their campaigns, the private sector complemented it's lobby in the Executive with the lobby in the Legislative to protect particular interests

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Public expenditure distribution in Colombia: some components are regressive

The case of royalties: a Constitutional reform, to achieve a more equitable distribution of public expenditures and better efficiency is currently under discussion in Congress



The royalties deteriorate the better distribution achieved by regional transfers

Source: Nuñez (2010)

Distribution of monetary transfers

Monetary transfers participation by income quintiles

	Quintile 1	Quintile 2	Quintile 3	Quintile 4	Quintile 5
Familias en acción	44.90%	29.50%	16.10%	8.20%	1.30%
PPSAM	37.20%	24.60%	20.20%	12.30%	5.60%
Pensiones	0.10%	0.20%	2.30%	11.10%	86.30%
Familias Guardabosques	42.30%	30.80%	11.40%	10.20%	5.20%
Subsidio Familiar CCF	1.90%	12.80%	21.70%	31.70%	31.90%
Total Monetarios	3.10%	2.60%	3.80%	11.50%	79.00%

Source: Núñez (2009)

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How's the Government's Proposal

- The 2010 tax reform eliminated the tax deduction that applied to investment in fixed assets
- It also eliminated the FTT starting in 2014
- Not much is known about the tax reform that is planned to be presented this year, however:
 - It has been announced that rates will not rise
 - There will be a broadening of the taxable base

Some final considerations

- Personal income tax:
 - Broaden the taxable base, reducing the minimum level of exemption
 - Eliminate special tax deductions that favour high income individuals (health, housing, education)
- Enterprise income tax:
 - Even the deduction that applied to fixed assets investment was eliminated, there are still exempted incomes and deductions that should be limited if it's not possible to eliminate them
 - Depending on the total fiscal effect, it could be possible to think about reducing the rate from 33%
- VAT
 - Reduce the number of rates
 - Broaden taxable base and compensate (There are several mechanisms to compensate the low-income population: social protection network- Familias en Acción and subsidies to public services)
 - The FTT phased-out has to be compensated and is probably that it will require a higher rate of VAT
- More efforts to reduce evasion
- It is essential to redistribute through public expenditure
 - Royalties
 - Pensions (5% of GDP favors one million people of high income levels)