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TAX SYSTEMS AND TAX REFORMS IN LATIN AMERICA: COLOMBIA

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TAX SYSTEMS AND TAX REFORMS IN LATIN AMERICA: COLOMBIA

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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 large country in which the social and political environment does not favour the proper structuring and working of the tax system. In 2004, total fiscal pressure remained at around 20% %of GDP, which is close to the Latin American average. Direct and indirect taxes carried about the same weight: the most important individual direct tax was corporate tax (fueled by the taxation of the profits of multinationals and state enterprises), while the most important indirect tax was VAT. Income tax is very low in quantitative terms, because of political factors. From 1990 to 2004, total fiscal pressure almost doubled, mainly as a result of corporate tax, property tax, VAT and social security contributions, but also as a consequence of the many tax reforms implemented during the period in question. The structure of Colombian taxation is depicted from an institutional point of view, with a particular focus on corporate tax, income tax, VAT, wealth tax, tax on financial transactions, and local taxes. The main tax issues are then considered. The first of these is the personal distribution of the tax burden. We then look at a check of the overall Colombian taxation at the beginning of the third millennium. Finally, we analyze the relationships between central and lower Government levels. Colombia's short- and medium-term economic and budgetary prospects appear encouraging. In the short term, however, Colombia needs to compensate for the fall in revenue resulting from the temporary reforms introduced in previous years. In 2005 and 2006, in the wake of globalisation Colombia decided to modernize its tax system with regard to thin capitalization, tax havens and the rules governing transfer prices,. In July 2006, the Colombian Government submitted a broad package of tax reforms to Parliament, designed to make substantial changes to income tax (higher threshold, two rates, low burden), to corporate tax (fewer exemptions, deduction of investments, cutting of rate) and in particular to VAT (different regimes for small and large businesses, the replacement of many, but not all, goods excluded with zero-rating systems, the partial rebate of VAT to poor households, the reduction of rates to just four).We then conclude by discussing this tax-reform project both from an inside, technical perspective, and within the broader context of the social deprivation which currently plagues Colombia.

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'At a certain point I understood that I could not write this story without making any reference to the events of Colombia at that times'

GABRIEL GARCIA MARQUEZ, *Noticia de un secuestro,1996.*

1. Introduction, contents and conclusions*

Colombia is a large, historically important country covering more than one million km^2, extending from the Amazon to the Caribbean Sea, and inhabited by about 45 million people of various, mixed ethnic origins. It won independence in 1819 when the "*libertador*" Simón Bolivar defeated Spanish troops, and the country's present boundaries were established in 1886.[1]

From independence onwards, two political parties held power in Colombia, both of whom represented the interests of landlords and other wealthy citizens, while exploiting Colombia's *campesino,s* other poor workers and the unemployed. There was no true democracy, and the first truly free elections were only held in 1974. After a constitutional reform implemented at the beginning of the new millennium, a populist Government led by Alvaro Uribe has governed the country, and Ulribe was re-elected in the recent 2006 election. In the meantime, from the 1960s onwards the country has been plagued by the spread of *guerrilla* tactics involving several different political groups, and by the Colombian mafia's influence over the trade in agricultural goods, emeralds and, of course, cocaine. This environment is unfavourable to the proper working of the tax system and to its relationship with the tax payer. This highly sensitive governmental activity is performed within a context of civil war, crime, illegal activities, corruption[2] and social deprivation.[3] Furthermore, the enormous quantity of illegal economic activities, together with widespread tax evasion, call

* *The authors would like to thank A. Barreix, A. Rodriguez and J. Zapata for the considerable information and materials they kindly provided and which made the present study possible. V. Tromben, of ILPES-CEPAL helped us to interpret ILPES data properly.*

[1] The dream of a 'Great Colombia' incorporating Ecuador, Panama and Venezuela as well finally collapsed in 1830.

[2] The Corruption Perception Index (the values of which decrease as perceived corruption increases) has been estimated at 2.23 for Colombia in 1997. Values for European countries, the USA and Japan tend to be around the 7-8 mark. (Tanzi 1998).

[3] UN data for 2004 show that in Colombia, () about 100,000 people in different groups are in the army and are at war in the mountains together with Army forces and U.S. advisors. A large number of private police forces are at work. Kidnappings, attacks, assassinations and robberies - the so called '*violencia*' that characterizes Colombia - occur with exceptional frequency. For example, it is estimated that about 2,500 kidnappings take place each year. The assassination/kidnapping ratio is about 50%. The irregular troops, the *guerrilla*, the plethora of Government "informers", together with the striking rate of poverty, create an environment in which minor crimes also proliferate. The official view (IMF 2006) is that the security situation has improved over the past few years. A number of paramilitary forces have been demobilized, and the Government has started peace talks with other groups. This view, however, is not shared by everyone in Colombia.

for considerable caution when using economic data. Per capita income is (under) estimated at about 1,800 US$ (about 7,500 US$ after adjustment by PPP), but it is distributed very unevenly. The poverty index remains above the 60% mark. After the downturn of the late 1990s, growth subsequently recovered, the budget situation improved and inflation fell after a long period of two figure values.

In 2004, the General Government's total fiscal pressure reached about 20% of GDP (close to the Latin American average), and consisted mainly of taxes (17.5 %), rather than social security contributions (a mere 2.8%). Direct and indirect taxes carried approximately the same weight; the largest single item of direct taxation was corporate tax, while VAT was the largest item of indirect taxation. From 1990 to 2004, total fiscal pressure almost doubled, mainly driven by corporate tax, property tax, VAT and social security contributions, but also as a consequence of many smaller, 'incremental' tax reforms adopted during the period in question. More than one of the above-mentioned features is characteristic of Colombia, only to be found in a few other Latin American countries, but not in the continental average.

The main direct taxes are: personal income tax, which is applied, albeit according to slightly different rules, both to residents and to non-residents; corporate income tax; and the recently introduced tax on financial transactions. As far as regards indirect taxes, the most important of these are Value Added Tax, stamp duties and import duties. Finally, local taxes continue to play a limited role in the Colombian taxation system, despite an attempt to increase the fiscal independence of the lower layers.

A number of studies have been carried out in recent years in order to improve the efficiency and the equity of Colombian tax system. Of the various tax issues that come to light, one of the central ones is the redistributive impact of taxation. Although the Colombian fiscal system may initially seem to possess substantial redistributive powers, upon closer analysis we shall see that this is not really the case. Firstly, the considerably progressive nature of Colombia's personal income tax system is all but nullified by the low incidence of the tax and by the high degree of evasion, which are problems the government still needs to resolve. Secondly, the weight of direct and indirect taxes is basically the same, although the magnitude of the second source of revenue is constantly growing. As a consequence, any evaluation of the system as a whole needs to analyse the effect of this type of levy on the distribution of post-tax income.

Furthermore, another important concern is decentralization and fiscal federalism. In the 1990s, Colombia experienced a huge imbalance between local government revenue and expenditure. In fact, most tax revenue was collected by central government, while expenditure was administered by Departments and Municipalities. The result was the over-expansion of local public spending. In order to restore fiscal responsibility, the 2001 Constitutional Reform established a system of transfers whose main characteristic was the breaking of the link between actual central government revenue and local transfers.

Colombia's economic and budgetary outlook appears positive both in the short and medium term. Real GDP is forecast to grow at 4% a year until 2010, while inflation is to be reduced to 3% by that same year. The Non-Financial Public Sector Budget should more or less balance out. Public debt is forecast to decrease by about 10 percentage points of GDP. However, a set of conditions have to be met in order to achieve these targets, especially within the field of structural reforms, including those of a fiscal nature.

As far as concerns more recent developments in taxation, two temporary fiscal reforms were adopted in 2002 and 2003: the first introduced a surcharge of 10% on income and corporation taxes, while the second doubled the tax rate on financial transactions. Thus in 2006-7 Colombia is forecast to see a reduction of about 2 percentage points of GDP in tax revenue. The Government is confident of the buoyancy of import duties and VAT, whereas some observers maintain the need for structural reform.

The Government is reasonably satisfied with the fiscal trends and features of 2002-2005 regarding revenue, the number of tax payers and the streamlining of the tax system. In 2005 and 2006 certain changes were made to the tax code, the most important of which regards the treatment of transfer prices. On the back of internalization in 2007, new procedures will be adopted for thin capitalization and tax havens.

On July 21st 2006, the Government submitted to Parliament a wide tax reform. Income tax thresholds are to increase, with two rates (15% and 32%) above the level of exemption. These changes, together with the repealing of the previous allowances, will not increase the burden of income tax, which shall remain light and only burden a limited number of middle/high incomes at a moderate average rate. The increased basic deduction shall be equal for all taxpayers (and thus no longer linked to income). The corporate tax base has also been widened but all investments have been made tax deductible. The corporate tax rate will be further reduced by a certain percentage.

VAT shall be sub-divided into two categories - one for the smaller (substantially exempt) businesses and the other for larger-scale enterprise. Exclusions have been eliminated for many, but not all, goods and replaced by zero-rate regimes. In order to avoid overburdening the poor, they shall be entitled to a VAT rebate, although this will not cover the previous allowances granted by tax exclusions. As a result, the burden of VAT is going to increase for poor people as well. The reform goes only some way towards achieving the aims outlined in the study carried out by the MIP (2002). Various technical aspects of the reform could be improved, but the real problem is that it fails to resolve the social deprivation plaguing Colombia; in order to do so, a very different, more radical set of measures would have been needed, as we point out in the present study, but this would probably have been politically unfeasible as things stand.

2. A general overview of the Colombian tax system and its development since the ear1y 1990s

2.1 An initial view of its economic, budgetary and expenditure features

Colombia[4] is a large country covering more than one million km^2, and inhabited by about 45 million people belonging to various, mixed ethnic groups. GDP amounts to 75 billion US$[5], 14% of which is produced by agriculture, 30% by industry, and 56% by services. Per capita income is about 1,800 US$, but this figure rises to about 7,500 US$ (Wikimedia on IMF data) when corrected for PPP. Income distribution is very uneven: the Gini coefficient stands at the high figure of 0.52 (Zapata and Ariza 2005). The percentage of Colombians living below the poverty level has been calculated at 64%, (14th in the world ranking, an extremely high position given the level of per capita income). The unemployment rate is also very high, at around 20%.

GDP increased on average by about 2.1% per year during the 1990s, by sharing Latin America's 'lost half-decade 1997-2001' (Ocampo 2004) and by implementing the free-market policies suggested by the so-called "Washington Consensus" (Stiglitz 2003). The overall growth of the world economy and the increase in oil prices enabled Colombia to grow at about 3 -4 % in 2003 and 2004. While Colombia had a long history of double-figure inflation, this had fallen to less than 10% by the end of the 1990s, and to about 5% n 2004.

Turning our attention now to the public budget, we need to distinguish between the Non-Financial Public Sector (NFPS), General Government and Central Government which are presented in the ILPES-CEPAL figures that constitute the main quantitative source of this

[4] 2004 UN data, if not otherwise specified.
[5] The rate of change was 2,360 Colombian pesos for 1 US$ (Forex, July 2006).

present study.[6]We shall refer to the NFPS when evaluating the overall financial position of the public sector, whereas we shall consider the General Governmental sector when analysing fiscal revenue.

TABLE 1 ABOUT HERE

Both the total revenue and total expenditures of the NFPS almost doubled between the early 1990s and the first years of the new millennium.[7] At the beginning of this period, the budget balance was in a state of equilibrium; however, it subsequently deteriorated between 1996 and1999, at which point an adjustment plan was adopted and the financial position of the NFPS significantly improved. Taxes constitute only half of the NFPS' current revenue, the remaining portion coming mainly from the profits of the large non-financial public corporations[8]. This privileged situation allows Colombia to finance a high level of social expenditure with a relatively low level of fiscal pressure.

2.2 The tax system from the 1990s onwards compared with those of the other Latin American countries

During the 1960s and 1970s, Colombia's tax system was a relatively simple one. From the 1980s onwards, the system was subjected to repeated minor tax reforms (with the exception of the larger reform made in 1986); there were no long-term revolutionary reforms as was the case in Argentina and Bolivia (Shome 1995).[9] Seven major reforms were introduced between 1990 and 2003 (Gobierno de Colombia 2006).[10] These reforms were

[6] The *Non-Financial Public Sector* includes the State, decentralized Administrations (Departments and Municipalities), social security, *and* non-financial public enterprises, which are *usually not included* in the definition of 'General Government' adopted by the IMF's *General Government Statistics*, the OECD and EUROSTAT. *General Government and Central Government* correspond almost exactly to their counterparts in IMF, OECD and EUROSTAT public accounts. Unfortunately, the figures for all operations provided by ILPES only cover Central Government. The General Government table only shows fiscal revenue in a disaggregated form.

[7] The increase in size of the public sector in Colombia during the 1990s continued to run counter to what was happening in the majority of Latin American countries. It was largely the result of the new Constitution adopted in 1991, which gave rise to a process of government decentralization and an increase in public spending which was difficult to control.. Increased expenditure also resulted from pension reforms, public debt interest and the salaries of public employees, especially in the security sector. A further contribution to this process was made by the restriction imposed on the Central Bank, designed to finance the Government's budget deficit. The adjustment plan was agreed with the IMF (Lozano 2002; Jungito and Rincon 2004).

[8] Operating in the fields of electrical energy, telephones (until the recent process of privatization), transport and, in particular, oil (Ecopetrol).

[9] The main reforms were based on studies involving a series of highly-qualified tax professionals, such as Musgrave and Gillis in 1971, McLure in 1988, and Bird, Poterba and Slemrod in 2002.

[10] Together they increased fiscal pressure by about 7%, or by 1% each. (Government of Colombia 2006).

implemented in order to achieve just one aim, that of increasing revenue (Lozano 2002), and they tended to focus on VAT, just as had been the case in Argentina and Chile. The standard VAT rate was increased from 10% to 16%, and the tax base was also enlarged (to take in services). Trade liberalization led to a reduction in customs duties. As far as direct taxes were concerned, the then generous allowances were slightly reduced[11] in the case of both income tax and corporate taxation, whereas the rates were cut for the former and increased for the latter.[12] In the early 1990s, taxation on financial capital was eased in order to stimulate savings and investments; however, at the end of the decade a Central Government tax on wealth was introduced, and the tax rate on financial transactions was raised. The powers of the tax authorities were strengthened, while anti-smuggling measures were stepped up[13].

As a consequence of these reforms and of the buoyancy of the tax bases, from the early 1990s to the early 2000s, the total fiscal pressure of General Government almost doubled in Colombia, from 10.5% of GDP in 1990 to about 20% of GDP in 2004 (see table 2). This substantial increase was engendered by direct taxes, pushed by corporation tax and,

TABLE 2 ABOUT HERE

to a lesser degree, by property tax. Indirect taxation rose by about three percentage points; this was almost entirely accounted for by the increase in VAT. Social security contributions tripled, although their point of departure in 1990 was a mere 0.8%.

The total fiscal pressure of Colombia's General Government was thus about 20% of GDP in 2004 (see table 2). It is not easy to assess this figure in an adequate manner. Tax evasion is deemed to be particularly high (Shome 1995; Ministerio de Hacienda 2006; Clavio 2004), and is clearly underestimated since the potential tax bases are taken from national accounts, which allow for the large-scale exclusion of black and illicit, activities. On the other hand, para-fiscal[14] mandatory contributions remain high in Colombia (MIP 2002),[15]

[11] Among other things, State enterprises became subject to taxation.

[12] Compared with existing Latin American averages, Colombia's corporate tax rates are higher than the average values, whereas individual income tax rates are lower than the average rates (Martner and Tromben 2003).

[13] However, it has been pointed out that there have been too many small, short-term reforms linked to the concession of preferential treatment, and too many amnesties granted to offenders, which have the negative effect of reducing the tax base and increasing the rates of the main taxes (MIP 2002).

[14] In particular, payroll taxes and mandatory contributions for schooling.

[15] At the end of the 1980s, declared net VAT was estimated to be less than 40% of potential net VAT. During the early 1990s, evasion of corporate taxation was estimated to be 24% of potential revenue, while individual tax evasion accounted for 57.6% of potential revenue (Shome 1995). Subsequently, VAT evasion was estimated at

and “compulsory” contributions are made by certain *guerrilla* groups. In the first few years of the present decade, direct and indirect taxes have had approximately the same weight. In the case of direct taxes, those levied against large companies and multinationals in the mining, agricultural and oil sectors are the most important, whereas the burden of individual income tax has been almost inexistent (0.2% of GDP, that is, 1% of total taxes).[16] This astonishing figure can be explained in political and economic terms. The number of Colombians paying income tax is very small[17], the level of exemption is very high, and deductions are granted to all taxpayers. Marginal income rates are low (see below). Our belief is that the country’s landlords and other rich people chose to avoid directly taxing the middle class (and themselves) in order to obtain a political consensus.

The most important indirect tax is the general tax on goods and services (*i.e*. VAT); other forms of taxation (including custom duties) play a secondary role. Taxation by the various administrative levels of Government is highly centralized.[18] Central Government only grants Departments and Municipalities the power to collect a limited amount of tax revenue (no more than a few percentage points of GDP) from property tax and “other” direct taxes, specific taxes on goods and services, and “other” indirect taxes (see below for details of the specific items in question).

Total fiscal pressure and tax structure differs substantially from one Latin American country to another (see Marten and Tromben 2003). A comparison of taxation in Colombia and in other Latin American countries may be considered as being purely indicative for a number of reasons.

TABLE 3 ABOUT HERE

Nevertheless, the limited data reported in table 3 may provide an important insight into the respective fiscal situations in these countries. At the beginning of the third

32% by Clavijo (2004) and at 25% by the Government (Ministerio de Hacienda, 2006), which also estimated evasion of income tax and tax on business profits at 35%..

[16] We lack data for subsequent years.

[17] According to CONFIS (2006), 515,000 corporations and shareholders, who paid 85.9% of all tax on income and profits in 2005, and 830,000 natural persons, comprised of 317,000 employees (accounting for 7.7% of total tax paid, through withholdings) and 513,000 self-employed workers (6.4% of total tax paid, through tax returns). These figures cannot be compared at all with those for employed people, who amount to about 16.2 million, of whom 21.6% are employed in agriculture, 19.1% in industry, and 59.2% in services (UN figures for 2004).

[18] 82.9% of total tax revenue went to Central Government, 6.6% to Departments and 10.7% to Municipalities in 2002 (Lozano, Ramos and Rincon 2004).

millennium, total fiscal pressure in Colombia appears close to the Latin American average,[19] both with regard to the Central Governments and General Governments of the countries for which data are available.[20][21] The increase in Colombia's taxes during the 1990s, in terms of both Central Governments and selected General Governments, was a multiple of the Latin American average,.[22] However, the point of departure was lower in Colombia's case than in that of the Latin American average.[23] The figures shown in table 3 qualify Colombia as a country with a relatively high proportion of direct taxes and with a relatively low proportion of indirect taxes; however, it is clear that direct taxes are mainly those levied on the profits of multinationals and other big companies.

3. The institutional characteristics of Colombia's main taxes

3.1 National taxes

3.1.1 Personal income tax

General information

Colombia's PIT is a *global* income tax. In fact, it adds the various different sources of income, and then taxes them at the same rate, which depends on the income of the individual tax payer. In calculating the tax base, almost every form of income is subject to the same rules. Special taxation plays a very marginal role and is only levied on a few items of capital gains (for example, gains from lotteries).

There are two distinct tax regimes for different kinds of tax payer. The IIT (Individual Income Taxation) is paid by Colombian residents, while non-resident income tax (NIT) is levied on non-Colombian residents. Resident nationals are taxed on their worldwide income, whereas resident foreigners who have been living in the country for less than six years are only

[19] Those countries whose total fiscal pressure is close to the Latin American average are Peru, Argentina, Chile and Bolivia. Higher figures can be found in Brazil and Uruguay, for example, while lower figures characterise, among others, Mexico, Paraguay and Venezuela.
[20] We are aware that this comparison may be distorted by the peculiarities of the available sample.
[21] Furthermore, the Colombia's fiscal pressure stays very near the fitting line between the fiscal pressure and the per capita GDP of Latin American countries (Martner and Tromben 2003) so to confirm the Wagner's law hypothesis.
[22] A fiscal effort similar to that of Colombia may be not found in many countries, like Bolivia and Venezuela. An increase not far from the Latin American average was realized by Argentina, Brazil and Chile. Mexico and Uruguay remained at their 1990's level of fiscal pressure.
[23] Total fiscal pressure was 8.7 % of GDP in Colombia and 11.6 % in the average of Central Governments of Latin American countries. 10.5 % and 16.6 % respectively in General Government of Colombia and in the average of selected countries.

subject to taxation on their income earned in Colombia. As of their sixth year of residence, however, foreign nationals are also taxed on their worldwide income.

Taxation of residents' income (Individual Income Taxation)

Based on a broad concept of income, Colombian IIT puts considerable emphasis on the personality of taxation. As a consequence, many kinds of revenue are included in an individual's total income, including:

1. wages and salaries, and all forms of income derived from employment, including retirement, old-age, disability and company pensions received after 1998, or, regardless of when the latter has been received, that amount exceeding 50 times the minimum monthly salary;
2. inheritances from deceased Colombians or from deceased foreign residents;
3. business income;
4. investment income and most capital gains.

A large number of substantial exclusions and exemptions are granted.

People whose gross income does not exceed a certain threshold, which is periodically adjusted for inflation, are not asked to file an income tax return and are exempt from personal taxation.

The following categories of income are exempt from taxation (up to a certain maximum established by law);

1. 25% of employees' gross earnings, provided they do not exceed COP 7,033,000[24] per month (for tax year 2006);
2. accident or sickness benefits, or indemnities received as severance payment or for termination of employment;
3. maternity benefits;
4. retirement, disability or old age pensions received before 1998;
5. life insurance payments;
6. most awards and prizes;
7. certain kinds of stock dividends.

Tax rates.

[24] 2,360 Colombian pesos = 1 US$

The IIT is a progressive tax levied at rates ranging from 20% to 35%. People who earn less than COP 22,742,000 (in tax year 2006) are exempt from payment of IIT, while those incomes over and above COP 100,154,001 are subject to a fixed withdrawal plus 35% on the amount exceeding that limit. Table 4 gives the complete income tax brackets and rates for the year 2006.

TABLE 4 ABOUT HERE

Withholding tax

A share of income tax is deducted directly from workers' pay packets. This is true of all kinds of earned income (including compensation paid for unjustified dismissal and retirement payments). It is also true of bonuses, rewards and various types of expense like those for transport or entertaining customers. Married couples are taxed separately.

Taxation on the income of non-residents

NIT is levied on non-Colombian residents, and only on that income and those capital gains pertaining to activities located in Colombia. It is a withholding tax levied on dividends paid to foreign companies, on profits distributed to foreign investors, as well as on other types of payment such as fees, rents, pay for personal services and so on.

3.1.2 Corporate income tax (CIT)

CIT is levied on the following categories of tax payers:

1. every Colombian corporation or foreign corporation that makes profits in Colombia (limited companies, general partnerships, partnerships limited by shareholding, investment funds, and so on);
2. irregular or *de facto* partnerships;
3. cooperative societies, unions, mutual societies and so on;
4. state-owned enterprises and mixed public/private companies;
5. certain non-profit-making foundations or associations of public interest (for example, those dealing with education, culture, scientific research or environmental protection);[25]

[25] Non profit-making entities and associations approved by the Colombian Institute for the Promotion of Higher Education (ICFES) are exempt from taxation.

6. non-profit-making associations under the supervision of the Financial Commissioner;
7. mutual investment funds[26] that collect income from business activities;
8. family compensation funds set up for income derived from commercial, financial or industrial activities.

The tax base:

Colombian corporations are taxed on their worldwide income, while foreign corporations are only taxed on what they earn within Colombia. Capital gains are included in the tax base for corporate income tax. Once all sources of income, capital gains, rebates, returns and discounts have been added up, taxable income is then calculated by subtracting cost and expenses from this sum.

Furthermore, a wide range of deductions are available. In fact, the law allows taxpayers to take the depreciation and amortization of investments into account, while inventories are generally valued using the FIFO method. Finally, tax losses may be deducted the year that they are incurred, and can be carried forward for up to five years. No carry-back is authorized.

The CIT tax base is deemed to be the higher of the following two: taxable income and a "minimum presumptive income" equal to 6% of the corporation's net equity on the final day of the previous tax year. The income presumption does not apply to entities subject to special taxation regimes and to other special-category tax payers. The latter include: suppliers of domestic utilities such as electricity; investment and pensions funds; companies or financial institutions in the process of liquidation or reorganization; district and municipal land banks dealing in land to be urbanized, public limited companies.

Tax rates:

Corporate income is taxed at a flat rate of 35%. However, those taxpayers listed above under numbers 5, 6 and 7 (non-profit-making entities) are entitled to pay CIT at the lower rate of 20%. Moreover, a 7% withholding tax is levied on dividends paid to foreign investors. Nevertheless, when such profits are reinvested in the country, the payment may be deferred for the period that the reinvested sum remains in the country. Moreover, if the period of reinvestment exceeds five years, the dividends automatically become exempt from

[26] Mutual investment funds that do not carry out industrial or marketing activities are also exempt.

withholding tax. However, if those dividends are distributed before the fifth year, they are subject to taxation at the normal 7% rate.

Principal exemptions:

1. the income of “Public utilities companies”;
2. income from free trade operations;
3. income from state-owned industrial and commercial enterprises;
4. funds for the reconstruction of the coffee zone and livestock farming funds;
5. interest due on the Government’s foreign debt and on insurance reimbursements;
6. the income of publishing companies.

3.1.3 Taxation of capital and of financial transactions

Net wealth tax (Impuesto al patrimonio)

Law no. 863 of 2003 introduced a temporary net wealth tax for the years 2004, 2005 and 2006. This tax is levied on tax payers whose liquid net worth on the 1st January of each taxable year is over and above a certain amount (COP 3,344, 370 in 2006).
The temporary net wealth tax rate is 0.4 % , and it is levied on the net value of wealth excluding shareholdings in nationalised companies. The value of the house in which a tax payer usually resides is subject to taxation for that part over and above a certain threshold. Non–profit-making associations and other bodies subject to special rules are exempt from payment of this tax.

Financial transactions tax (Gravamen a los Movimientos Financieros)

This tax was a temporary measure introduced in 1998. Nevertheless, since the 2000 tax reform it has became a permanent feature of the tax system, and the revenue it produces now plays a fundamental role in Colombia’s fiscal system. This tax is levied on financial transactions regarding cashier’s checks as well as checking and savings account deposits. However, transactions involving accounts belonging to the same person or entity are exempt from taxation.

3.1.2 Indirect taxes

Value added tax (VAT)

The main indirect tax is Value Added Tax *(Impuesto sobre las ventas)*. It is levied on the supply and importation of all tangible goods and services, with the exception of those explicitly exempted by law (in which case the goods can be either subject to a 0% tax rate or exempt from VAT altogether). The latter category of goods includes a basket of essential goods consumed by, among others, poor households. VAT is levied in a non cumulative manner at each stage of production and distribution. The subtraction method is used to credit taxes paid on purchases. Moreover, whenever the tax credit on input is higher than the amount due on sales, the excess amount may be used as a credit against future VAT liabilities.

Tax rates

The standard VAT rate is 16%, but certain goods and services are subject to different rates. Vehicles, for example, are subject to higher rates ranging from 20% %to 45%%; similar rates are also levied on alcoholic beverages, while a lower rate of 10% %is levied on certain goods or services such as commercial air transportation, several kinds of food, machineries utilized in the production of food and beverages, cotton, matches and works of art. VAT is not levied on exports, and the tax payer is entitled to a refund for the tax paid on inputs.

Stamp duty (impuesto de timbre nacional)

Stamp duty is levied at a rate of 1.5% on several kind of documents. Any public or private document concerning the establishment, existence, modification or cancellation of obligations is subject to stamp duty if it is issued or undersigned by an individual or legal entity whose gross receipts or gross wealth exceeds a certain threshold, adjusted for inflation, which in the tax year 2006 was fixed at COP 63.101.000 .

Both the signatories and the beneficiaries are liable to payment of stamp duty. A person who signs a contract with a public body must pay the entire sum of the tax.

Other indirect taxes

Excises duties are imposed on petrol, tobacco and alcoholic beverages. Tax rates vary, depending both on the characteristics and type of product. Exports are exempt from this kind of taxation. Other indirect taxes are levied on agricultural products *(Cuotas de Fomento Arrocero, cacaotero y cerealista)*, entertainment, mineral and oil products *(impuestos a la gasolina, impuesto al transporte de oleoductos).*

Import and export duties.

As we have already said, imports may be subject to VAT and excise taxes. In addition, certain import 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 for those raw materials not produced, or scarce, in the member countries is set at 0%. Moreover, intermediate goods are taxed at 5 or 10% while a 20% rate is applied to final products. The duties on vehicles are the highest of all, some of which may even be as high as 40%. With the sole exception of coffee, which is subject to several duties, no taxes are levied on exports.

3.2 Local taxes

As of the 1991 Constitutional reform, which changed the network of relationships between Colombia's Central government, Departments and Municipalities, the debate on fiscal decentralization has become increasingly central to the analysis of the country's fiscal system. However, most of the changes that have been implemented over the last two decades have regarded the system of transfers to departmental and municipal governments, and have not strengthened sub-national taxation power.

Taxes may be imposed by Colombia's National Parliament, although certain kinds of levy may also be introduced by Departmental Assemblies and District or Municipal Councils. However, the revenues raised by local government constitute but a tiny part of the total tax burden and a very small portion of the resources needed to finance local public spending.

If authorized to do so by Parliament, the Departments may establish taxes on the consumption of alcoholic beverages, cigarettes or tobacco, on petrol, on 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 (ICA), represent Municipalities' main source of revenue. The base used to calculate the property tax is the national cadastral assessment system[27], while the tax rates are chosen by local authorities from a range specified by national legislation. Public establishments, government departments, state-run commercial and industrial enterprises, mixed public/private companies, and companies belonging to administrative Departments, are not subject to the property tax. Furthermore, Municipalities may levy road taxes, forestry taxes, gambling taxes and taxes on prize-winnings.

3.3 Social security contributions

Every Colombian worker sees part of his wage deducted by his/her employer in the form of a contribution to social security. Subsidies are provided for those citizens who are not able to contribute themselves to social welfare funds. Contributions are calculated as a percentage of an individual's salary. Only those tax payers earning more than 20 times the monthly minimum salary are asked to pay the said social security contributions. The health insurance charge is 4% for employees and 8% for employers.

4. Tax policy issues

3.1 The distribution of Colombia's fiscal burden

The Colombian Government's increase in public spending over the last 20 years has meant the implementation of a large number of tax reforms during the period from 1983 to 2006. Notwithstanding the increasing importance given to social expenditure (which in any case remains below European standards), those policies implemented by the Colombian Government have not been very effective; this has been due, among other things, to the lack of a valid system of evaluation and to the fragmentation of the system into a series of different agencies. (Perotti 2000). Although the Colombian government seems to have given great importance to welfare expenditure, if we take a closer look at the composition of the said expenditure, we can see that the measures in question simply consisted in generalised support to the areas of education and health, while no attempt has been made to improve the social insurance part of public spending.

[27] This does not apply to the municipalities of Bogotá, Cali and those in the department of Antiochia, each of which has its own local assessment system.

Over the last five years, given similar experiences in other Latin American countries[28], Colombia took greater interest in the question of social welfare, with the setting up of a programme (*familias en acción*) consisting in targeted transfers to the poor. Since the money spent on welfare programmes does not appear to have made any substantial impact on existing income distribution, it is worthwhile analyzing the redistributive effect of tax reforms.

In the last 25 years, the tax burden has risen from 9.2% in 1980) to about 20 %(in 2004). Within this context, while the amount of income tax has remained substantially the same over the last two decades, VAT has become increasingly important, and from 1995 onwards can be considered the Government's main source of tax revenues. This predominance of indirect taxes over direct ones is even clearer if we consider the whole amount of taxes of the two types.

GRAPH 1 ABOUT HERE

Graph shows the trend in tax revenue from 1995 to 2003. Although direct taxes increased slightly both in 1999 and in 2001, the change was only due to a rise in personal income tax in the second case, while in the first it resulted from the introduction of a new tax on financial movements, the GMF (*gravamen a los movimientos financieros*). It is difficult to evaluate the impact that the introduction of this new tax has had on the progressive character of the tax system, since this would require making certain assumptions about the number of financial transactions carried out by the various different percentiles of the population. Despite this difficulty, however, some attempts have been made to do so. For example, Sanchez and Espinosa (2005) perform a simulation, as a result of which they conclude that the GMF has a slightly positive effect on redistribution. On the other hand, Clavijo (2005) points out that the tax only affects users of financial markets, whereas the owners of financial capital remain unaffected by it.

At first glance it would seem that personal income tax contributes towards the redistribution of wealth within the Colombian economy, given its unquestionably progressive nature. In fact, the average value of the Gini coefficient for personal income tax, calculated for the period 1993-2000, is 0.64 (Sanchez and Espinosa 2005). This value points to a huge concentration in the distribution of the tax burden, whereby the richer quantiles of the

[28] Progresa in Mexico in 1997 , Bolsa-Escola in Brazil (1995).

population are responsible for payment of a large share of the said tax. Thus we could conclude that income tax improves income distribution. However, the highly progressive nature of Colombia's income tax (98% of which is paid %by the highest-earning 10% %of the population) does not necessarily imply that the tax system manages to significantly level out the inequalities plaguing Colombian society.

As partial proof of this fact, we only have to look at the Gini indexes (for 2003) as calculated by Zapata and Ariza (Zapata and Ariza 2005). The Quasi-Gini index for personal income tax is 0.89, which is much higher than the Gini index for pre-tax consumption(a mere 0.52). While there can be no doubt about the progressive nature of the *'impuesto a la renta'* , nevertheless we ought to look at the post-tax Gini index in order to better evaluate the redistributive power of the measure. If we compare the Gini index for per capita consumption before tax, with the same indicator for per capita consumption after tax, then we will realize that their difference is miniscule (only 0.005).

The weak redistributive power of income tax can be explained by various factors. First of all, personal income tax represents a small part of the total taxes levied by government, since it is not the principal instrument utilized by the nation's public administration to fund its expenditure (see sub-section 5.2 below). Two specific factors help explain the marginal role of personal income tax compared with other forms of taxation. Firstly, the large number of exemptions introduced throughout the 1990s has narrowed the tax base, thus weakening the scope of personal income taxation; secondly, we should not underestimate the vast effect of tax evasion upon Colombia's economy and tax system. Steiner and Soto (1998) estimated that during the period from 1988 to 1993, total evasion of personal income tax amounted to between 30% and 38%; this figure only decreased in 1994 and 1995, when it fell to figures of 26% and 20% respectively. While the effect on the progressiveness of the first phenomenon can not be clearly assessed since most of the exemptions regard low-income tax payers, the effect of evasion is a clear threat to both horizontal and vertical equity. In other words, even if Colombia's PIT is highly progressive, its equalizing power is quite weak since, for the above-mentioned reasons, the incidence of the tax is extremely low.

Since indirect taxes play a vital role in the Colombian economy, it is important to understand whether or not they counter the partial redistribution achieved by means of income tax. Most studies of public finance point out the negative effects on equity produced by indirect taxation, since it does not take into account the taxpayers' decreasing propensity towards consumption. However, the particular nature of Colombian VAT, whereby many basic goods are excluded and some luxury goods are taxed at higher rates[29], has led certain scholars to study the redistributive effect of the tax.

. 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 since saving is exempt from VAT. In fact, the effect of the tax on income distribution depends on the share of earnings an individual earmarks for saving, as this latter category is not taxed. Thus VAT's effectiveness in reducing inequality depends both on the tax rate and on saving propensity. 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 (in terms of income, consumption and GDP) towards the amount of VAT collected by the government. By using this method, they are able to show that the tax is a progressive one that it is mainly paid by the richer sectors of society, if we consider all three indicators (i.e. income, consumption and GDP).

It is worth noting here that not only does the percentage of the tax paid by individuals increase as their incomes increase, but also that this percentage increase is larger than the respective increase in income. In fact, as incomes rise, so the ratio rises. The negative aspect of this VAT system is the loss in revenue resulting from a variety of exclusions and exemptions. Although VAT revenue exceeds personal income tax revenue, the VAT burden as a share of GDP is still well below the figures for other Latin American countries, thus leaving little room for redistribution through public spending measures (Clavijo 2005).

4.2 Checking the system: proposals for reform

In keeping with a lengthy tradition, over the last five years the Colombian tax system has been the subject of numerous studies by different groups of researchers, each of which has tried to identify its institutional and economic weaknesses, and to make some suggestions for the future. Two of the most interesting such studies are the 'Alesina mission'(Alesina 2000) and the 'Misión del ingreso público'(MIP 2002).

The Alesina proposal tries to promote reform both in the political-institutional and economic fields. From the political point of view, Colombia is burdened by a highly fragmented parliament and an electoral system that allows local lobbies to easily gain power. Moreover, the nation's Constitutional Court has the power to challenge all Colombian laws.

[29] For example cars.

Another source of imbalance lies in the relationship between legislative and executive powers. Due to the political system's inefficiency, the Government often chooses to intervene, circumventing Parliament and taking on the latter's legislative function.
This difficult political situation is made worse by constant institutional instability: since independence was won in 1818, a whole series of constitutional modifications have been made, thus forcing the country to frequently change its political order.

The country's economic institutions are also characterised by a number of problems which need analysing. Despite the fact that for a long time, Colombia was considered a fine example of macroeconomic stability and relatively low inflation, in recent years it has suffered from increasing fiscal fragility and mounting public debts. On top of this delicate macroeconomic situation, Colombia also needs to make improvements in the field of poverty relief, and social welfare programs need to be implemented. Proposed changes focus on various different areas of interest, but not on the tax system: decentralization and fiscal federalism, budgetary institutions, the nation's bureaucracy, the provision of social services, and the Central Bank. We are now going to look at the first three of these issues.

1. *Fiscal federalism*: the main problem, according to the report consists in the fact that Colombia is a highly decentralized state with respect to public spending, while tax collection itself is still entrusted to central government. Due to the incapacity of local Municipalities to raise revenues, the international advisors recommended a few simple changes:
   i) municipalities and departments should not be allowed to borrow;
   ii) allocation rules should be simplified: transfers from the centre should be maintained, but they should be allocated using a rule of conduct that insures that local authorities benefit from a given share of the revenue produced in the area, thus allowing for redistribution from richer areas to the more depressed ones, and rewarding improvements in tax collection.
   iii) greater flexibility with regard to spending decisions;
   iv) greater clarity with regard to spending responsibilities;
   v) mayors should be allowed to head local authorities for 2 terms (of 4 years each).

2. *Budgetary institutions*:_they suffer from a worrying lack of transparency, but this could be resolved through:
3. i) a reduction in the number of budget documents;
   ii) the adoption of accounting standards aligned to international standards;
   iii) wider coverage of the nation's budgets;

iv) giving private external agencies the job of producing forecasts;

v) each year's budget should take account of public spending for many years to come.

4. *Bureaucracy, civil servants and teachers:* the government should reform both the educational system and the salaries and conditions of teachers. The following proposals are suggested:

i) decisions regarding the hiring of teachers and their salaries should be made by the government jurisdictions ;

ii) nominal pay differences accounting for differing costs of living should be allowed;

iii) the government should reduce the overly generous pensions teachers currently enjoy;

iv) the government needs to support experiments like *'Escuela nueva'*;

v) Colombia needs to focus more on the process of teacher evaluation, and salaries should be linked to performance.

The "Misión del ingreso público" identifies the basic principles that the Government needs to follow when developing its fiscal system. The main points of this study are as follows:

1. both vertical and horizontal equity have to be improved;
2. the tax system needs to be made more efficient;
3. the Government has to create new taxes that are easy to handle;
4. public spending has to be carefully monitored;
5. long-term improvements have to be pursued;

Within this framework, fiscal reform needs to: improve the efficiency of both direct and indirect taxes; reduce tax evasion ; improve the fiscal balance in the long run; reform the structure of the tax system and build a good relationship between central government and local departments.

The practical recommendations are as follows:

1. to widen the income tax base and eliminate certain deductions granted to rich citizens (in other words, to increase the progressive nature of the tax and bring down the income threshold below which citizens do not have to pay taxes);
2. to simplify para-fiscal contributions, and divide tax payers into two groups according to their incomes;
3. to strengthen corporate income tax (impuesto a la renta empresarial);
4. to widen the range of goods on which VAT is payable, and to reduce the number of VAT tariffs. If the tax base were expanded so as to represent one half of GDP, the

Government could apply a lower 10.4% ate on all eligible goods while guaranteeing the same revenue as before. The negative effects on redistribution could be compensated for by keeping essential goods tax-free, or alternatively by giving poorer households a VAT rebate;

5. to reduce the tax on financial transactions;
6. to strengthen local taxes.

4.3 The decentralization of government layers

During the last two decades, Colombia has been making great efforts to establish its own approach to fiscal decentralization and federalism. The first important step taken towards this goal was the 1991 Constitutional Reform, the declared aim of which was to assign greater control over welfare expenditure to lower governmental levels. The decentralization process, however, failed to alter the way in which tax revenues are collected. While taxation remained centralized, a complex system of vertical transfers was set up in order to help local governments maintain a high standard of public spending (mainly on health and education).

The transfers were granted according to the amount of revenue collected by Central Government, and they were calculated using special revenue-sharing parameters. This method of financing lower layers produced a sharp rise in the flow of resources from Central Government towards the lower administrative levels. During the second half of the 1990s, the quantity of transfers grew in a disproportionate manner, and this tended to discourage tax efforts at the local level, thus making fiscal planning and management increasingly complicated.

The debate that ensued subsequent to the 1991 Constitutional Reform pointed out that one of the main weaknesses of Colombia's fiscal system was the imbalance between the revenue raised by local governments and their spending decisions. While most of the tax revenue was collected by Central Government, public spending was administered by Departments and Municipalities, and these lower-level administrative authorities continued to overspend. The first issue that arises here is the problem of incentives. The 1991 Constitution does not provide Departments and Municipalities with any real fiscal autonomy or flexibility. Moreover, since the said local administrations were still able to borrow in order to finance their expenditure, and could rely on generous transfers from Central Government, the problem arose of the moral risk involved.

In fact, when local governments do not need to finance their spending decisions with their own tax revenue, this tends to encourage them to overspend. This happens because in this situation local governments do not need to "select" the best possible projects since they know that Central Government will eventually bail them out. However, the amount of available resources was not the only factor creating potentially inefficient incentives. Transfers to Municipalities were established as a weighted average of various indicators, where the percentage of the population with "unsatisfied basic needs" accounted for more than 60%; consequently, PM transfers were basically need-driven. Although this scheme helped establish a degree of horizontal equity, it also creates the so-called "soft budget constraint problem" which led to the dramatic growth in transfers we have just mentioned.

In order to try and reverse the expansive trend in local government spending, while at the same time preserving decentralization, Colombia witnessed a further reform of the tax system in 2001. In order to restore fiscal responsibility, this constitutional reform set up a new system for the transition period 2002-2008; the main feature of this system was the limit imposed on local governments' discretionary spending. In fact, it removed the link between the real revenue of Central Government and local transfers, and converted the latter into a block of grants. For the initial period 2002-2005, the upper limit on yearly increases in transfers was fixed at 2% in real terms; for the period 2006–0808, this upper limit is due to rise to 2.5%. Finally, as of 2009, transfers will be allowed to rise at the same pace as Central Government's current revenue.

These changes are designed to limit the massive growth in public spending that took place in the 1990s, although any serious discussion of the success thereof will have to wait until the end of the transitional period. After 2009, funding to local administrative levels will once again be linked to Central Government's current revenue; the consequences of such a decision will depend on the degree to which the transitional scheme manages to re-establish fiscal responsibility.

Furthermore, the setting of excessively binding constraints could hamper the pursuit of equality. A state pursuing decentralization needs to grant a certain degree of fiscal freedom, as local governments are deemed to possess more information about the needs of the local population, and because decentralization can help to lower bargaining costs and to asses equalization.

5. Current and future tax reforms

5.1 An initial glance at economic and budgetary prospects

Both macro indicators and public budget indicators are forecast to perform well in Colombia, both in the short and medium term (IMF 2006; Confis 2006; Ministerio de Hacienda 2006). Real GDP grew by 5.1 % in 2005, 4.8 % in 2006 and is forecast to grow by 4.0% in 2007, sustained by investments and exports. The rate of inflation should decrease from 4.9 % in 2005 to 4.0 % in 2007 (4.5 % in 2006). Similar values should be maintained in the medium term, that is up until 2010, with a further reduction in the inflation rate to 3 % during that period. Urban unemployment fell to about 12 % in 2005, while the poverty rate decreased to 49 % in 2005. Income distribution also improved: 50 % of the poorest sectors of the population saw their share of income increase, while the wealthiest 20 % saw their share of overall income fall. However, the Gini coefficient remained high (55 %) in 2005.

The oil windfall, together with a recent reform which has strengthened the position of all levels of Government and public enterprises, have improved Colombia's public budget prospects, and as a consequence have stabilised revenue and expenditure levels (in terms of GDP). The overall NFPS balance balanced out in 2005[30], fell to -1.9 % in 2006, and is forecast to stabilise at -0.4 % by 2010. Given these rosy prospects, the sustainability of public debt, which until some years ago was a matter of concern (Lozano 2002; MIP 2002), would now seem to be following a positive trend. The public debt/GDP ratio should decrease by about ten points with regard to the NFPS (down to about 50 %). 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.

[30] This was also due to a change in the accounting procedure for interest.

The question of the reliability of these forecasts and targets remains open, however. The above-mentioned IMF report defines them as "prudential"[31], albeit subject to the implementation of a series of structural reforms (also in the fields of the tax code and of inter - governmental transfers, earmarked taxes and public enterprises) and to virtuous behaviour with regard to pensions (a reform of which would only seem necessary in the medium, rather than the short, term), to transfers to local authorities entities, and to the tax system in general. However, planning documents, even when agreed with international economic organizations, tend to be somewhat optimistic.

5.2 Recent tax reforms

Subsequent to the 1998-2002 adjustment plan, which is credited with accounting for about 2.5 percentage points of GDP, two small tax reforms were made in 2002 and 2003, specifically designed to finance the battle against drug trafficking and *guerrilla* warfare, which was a central issue in the political program of Uribe's government. The principal measure introduced in 2002 (Law 788) consisted of a surcharge of 10 % on both individual and corporate income tax. The 2003 reform (Law 863) increased the rate of the Financial Transaction Tax (introduced in 1998 as a part of the above-mentioned adjustment plan) from 0.2 % to 0.4 %. Taken together, these two measures yielded approximately 0.7 % of GDP.

These reforms have been criticized (Clavijo 2005) because, together with the wealth tax (0.25% of GDP), they could have negative effects on company investments and on the efficiency of the country's financial markets. This conclusion is somewhat exaggerated given the limited amounts of money at issue. However, a more important problem does emerge here: the said two reforms, together with the wealth tax, were introduced as temporary, short-term measures, but have been subsequently extended (in general to 2006 – 2007), with about 1.2 – 2.0 GDP percentage points of revenue due to evaporate, and this lost revenue must be replaced in some way[32].

However, the Government appears quite satisfied with the fiscal trends and features of the 2002-2005 period (Ministerio de Hacienda 2006), when it points out that during this period the number of individual and corporate income tax payers leapt from 395,000 up to

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[31] Oil price are forecast to remain almost constant in nominal terms, ranging marginally from US$ 68.0 (spot price per barrel) in 2006 to US$ 66.0 in 2010.

[32] The Government optimistically believes that the end of the wealth tax in 2007 will be compensated for by the buoyancy of import taxes and of VAT. Other observers disagree, maintaining that the tax gap can only be adjusted by structural reform (Clavijo 2005).

992,000, while evasion measures have been strengthened and compliance procedures have been simplified and partially computerized.

In 2005 - 2006 (CTF various issues)a number of specific measures were introduced regarding VAT on technical services, OECD-type regulation of transfer prices, a new act to avoid double taxation among Andean countries, the new regimes for free-trade zones, and the credit due for VAT paid on machinery and equipment, which has a long, tortuous history in Colombia (Shome 1995). As in the case of transfer prices,, the increased openness of the economy encouraged tax reforms designed to improve international fiscal relations and to make the tax system more similar to those of Colombia's trading partners and of the more advanced countries. As a consequence, at least three important innovations, due to come into force in 2007, have been introduced recently (International Law Office 2006).

i) Thin Capitalization Rules - This feature is a novelty within the Colombian context, and covers both domestic and foreign investors. The introduction of a maximum allowable debt-equity ratio is forecast, with the excess debt to be considered as equity for tax purposes.[33]

ii) Low-Tax Jurisdictions - At present an increased withholding tax rate is due to be applied to cross border payments to beneficiaries located in a list of foreign tax havens. However, the Colombian Government has yet to issue the list of countries acting as tax havens. This will replace the concept of 'low-tax jurisdiction', and will probably be based on the income tax rate (as in Brazil).

iii) International Income Taxation – In 2005, Colombia entered into its first OECD-type tax treaty, on that occasion with Spain. The Government is currently negotiating similar treaties with Chile and Switzerland.

The time was ripe at that point for the introduction of a broader structural reform comparable to that of 1986.[34] On the 21st of July 2006, the Government submitted a general tax reform plan to Parliament[35], which was designed to substantially modify existing taxes without significantly changing the basic tax system as such. According to previous analyses,

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[33] Clearly the restrictive nature of the measure depends very much on the value of the ratio, which has still to be set, and which in Europe varies from 1.1:1 in Belgium to 5:1 in Italy, and which stands at 3.5:1 for German holdings.

[34] This was the viewpoint of the MIP, and was outlined by tax experts during subsequent years right up to 2006 (*e.g*. Montano 2006; Cardernas and Mercer Blackman 2006).

[35] 'Projecto de Ley "Por medio del cual se sustituye el Estatudo Tributario de los impuestas admistrados por la Direction de Impuestos y Aduanas Nacionales"'. In fact, the plan replaces the present tax code regarding national taxes, together with general principles of taxation and procedures for assessment and punishment. The plan consists of 283 articles, whereas the present code comprises all of 1,111 articles.

debates, proposals and political pledges, the main objectives (Government of Colombia 2006) consist of simplicity, equity (the poor do not have to pay tax, and the middle classes do not have to pay more than they do at present), the promotion of growth, competitiveness and stability (of the tax/GDP ratio). The taxes due for change are as follows:

i) Corporation and business tax –As regards the tax base, there is a provision for an exemption similar to that for individuals, while the number of exempt incomes will be reduced but not cancelled out altogether, and all fixed investments shall be tax-deductible. The rate has been set at 34 % for the first year of the reform, 33 % for the second, 32 % for the third and later years.

ii) Natural persons - The tax base includes wages and other forms of income other than that deriving from business activities. The basic level of exemption is to be raised *on a monthly basis* from about 850 US$ to about 1,210 US$, which corresponds to seven months "minimum wages".[36] Between the said exemption threshold and about 4,350 US$, income shall be taxed at the marginal rate of 15 %. Above 4,350 US$, the rate will be similar to that levied on businesses and corporations. All allowances, barring the basic exemption, are to be repealed. Note the importance of the basic exemption: it excludes a very large number of low and middle income earners from taxation, and is granted to all taxpayers, so that effective rates fall well below the statutory rates.

iii) VAT - Two regimes are to be introduced: an ordinary one, and a simplified one for certain taxpayers whose sales do not exceed approximately 35,000 US$. On principle, all commercial concerns shall be subject to the tax. The system of rates has not been unified, but it has been greatly simplified. The general rate shall be maintained at 16 %, with a discounted rate of 10 % and an upper rate of 25 % (on luxury goods)[37]. Exclusions are not going to be completely abolished, but in the main replaced by exemptions (a 0.0% tax rate and the deduction of VAT paid on inputs). Rebates of about US$ 100 will be introduced to (partially) compensate poor households for the reduced exclusions on essential goods.

iv) Financial Transaction Tax - This shall be kept in force at the current rate of 0.4% , although an allowance shall be granted to those borrowers who borrow money to finance the construction of their homes.

v) Stamp duty and wealth tax - Both are to be abolished.

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[36] The value of the monthly "minimum wage" is set at about 408,000 Colombian pesos, which is the equivalent of about 170 US$. Seven months' minimum pay amounts to about 2,856 million Colombian pesos, that is about 1,210 US$.

[37] Curiously enough, a special 20% rate is to be applied to mobile phone calls only.

The Colombian Government estimates that the overall effect of the reform, in terms of revenue, shall be substantially neutral, at least until 2010 (Government of Colombia 2006). The total tax on incomes and profits shall be almost completely neutral. VAT should assure an increase of 0.4 % of GDP (resulting from the reduction in tax-free goods, which is only partially compensated for by the rebates granted to households), to at least partially compensate for the abolished taxes.

The main features of the distribution of the tax burden among individuals can be seen if we turn to the figures given in Table 5 below.

TAB 6 ABOUT HERE

The income tax threshold exempts all tax payers within the first 7 deciles, and is also very light when income reaches substantial levels, especially when expressed in annual terms.[38] The case of VAT is quite different[39].In brief, only those tax payers with an annual income of at least 44,000 US$ pay a combined (income tax + VAT) rate of just over 20 %. This is a favourable situation for the middle classes, and more so even for Colombia's richer citizens[40]. As far as businesses are concerned, the Government claims that the smaller concerns, representing 80 % of all businesses, will not be taxed, while the remaining 20 % (the larger businesses) shall pay a statutory rate in keeping with international standards, which however falls to about 15 - 20 % in terms of its effective rate when taking the remaining exemptions and the deduction of investments into account.

The plan may be assessed in terms of its technical features, and then in terms of its more general structure. Colombia's reform of its corporate tax fails to adopt two innovations that have been introduced on a worldwide scale in order to facilitate cross-border operations in a global economy: the so-called 'participation exemption' (the exemption of intra - corporation dividends and corporate capital gains on share sales); and the consolidation of the budgets of parent corporations for fiscal purposes, so as to immediately compensate the loss of holdings' brands. The deductibility of investments can give rise to a loss of tax revenue, as the allowance is also granted for investments that firms would have made anyway. A less

[38] The average annual income of the 9th decile amounts to about 18,000 US$, while the average income tax rate is only about 2 %. In the case of the final decile, average annual income is about 44,000 US$, while the average tax rate is less than 12 %.
[39] An approximately flat rate of around 5 % is levied on taxpayers within the first 5 deciles, up to an annual income of about 7,000 US$, after which there is an increase in the tax rate which burdens more heavily on the 10th decile.
[40] In the average EU situation, with annual income at about 38,000 € (approx. 44,000 US$), the combined (income tax + VAT) rate is not much lower than 30 %.

costly, more incentive-inducing measure, would be to credit only those investments over and above a certain average parameter, or those made in certain strategic fields such as R &D.

The structure of individual income tax will mainly be considered in the following section. For now we only wish to point out that a huge loss of tax revenue is due to the fact that the basic exemption is granted to all taxpayers, regardless of their incomes. This loss could be avoided, and the progressive nature of the tax increased, if the exemption were gradually reduced to zero over and above the threshold income level.

The VAT reform hits Colombia's poorer citizens more than anyone else, and this would not have happened if the MIP proposals had been fully adopted. This result is in clear contrast with the very idea of equity promoted by the country's tax reform. Further, the double system of rebates and the exclusion of certain goods appears to be unnecessarily complicated.

5.3 Conclusions

President Uribe's new tax reform package is only apparently in line with the MIP recommendations we previously presented. The exemption of individual incomes from the tax base has been extended rather than reduced. In fact, it is not clear which business incomes remain exempt, and in any case such exemptions have not been made on a temporary basis VAT continues to be levied at several different rates, and a dual system of untaxed goods and rebates to poor households established.

A number of important issues have not been addressed by the reform. The first is the question of decentralized government's revenue and the related problem of the need to stabilise Central Government's transfers, which we have already dealt with. Moreover, 'para-fiscality' should be reorganized, and tax payers should, at the very least, be sub-divided according to income levels .

Indeed, from a radical perspective one could say that Uribe's tax reforms seem to favour the middle and upper classes, who are lightly taxed on their incomes, and not at all on their wealth. Colombia's poorer citizens, on the other hand, are punished when it comes to consumption. In order to counter social deprivation, the Government has increased welfare spending in the fields of education, health and housing. However, an effective reform of taxation would need to be completely different from the one currently underway.

The cornerstones of tax reform should consist in the enforcement of income tax, together with a permanent increase in wealth tax rates, as well as serious measures to combat tax-evasion and smuggling which, as we have said, has changed very little over the past decade.

Colombia’s salaried employees number several millions, and yet incredibly, only just over 300,000 of them pay income tax. Is it really possible that the country’s multitude of public employees, military personnel, white-collar workers in private industry and services, all earn less than the taxable minimum (1,204 US$ per month, 14,400 US$ per year) ? Are such exemptions (granted to all potential tax payers) realistic in a country where average annual per capita income is less than 2,000 US$? Wealth tax is frequently criticized on the grounds that it might discourage investment. However, the well-established theory of tax - incidence (see Musgrave 1959) emphasizes the fact that wealth taxes are investment-inducing since they encourage the most productive forms of employment of wealth.

It is our opinion that political forces, rather than economic factors, are preventing Colombia from substantially increasing the room available for both income and wealth taxes. This potential revenue could be added to that recovered through the reduction in the massive, underestimated levels of tax evasion, by adopting instruments such as presumptive assessments and minimum-tax systems. A surcharge should be introduced on the rents of the big corporations operating under a regime of natural monopoly and/or exploiting natural resources, land included. The revenue gathered in this manner could be used to subsidize the poor of this beautiful, culturally rich, historical country, who inhabit those shantytowns one sees when landing at Bogotá’s Eldorado Airport, or Cartagena Airport, or who live in the impoverished villages of Colombia’s interior.

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

http://www.eclac.cl/Ilpes/ - United Nations Economic Commission for Latin America – Latin American and Caribbean Institute of Economic and Social Planning

TABLES AND FIGURES

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*
Total Revenue, of which:	*20.0*	*27.8*	*31.0*	*31.3*	*30.5*	*33.9*	*33.7*	*35.1*	*34.5*	*35.2*	*37.3*
Total Taxes	12.6	16.5	17.3	17.8	18.0	16.2	16.0	17.4	17.3	17.6	18.6
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
Total Expenditure, of which:	*20.6*	*28.1*	*32.7*	*34.1*	*34.2*	*38.0*	*37.5*	*39.1*	*37.9*	*37.7*	*38.3*
Current primary expenditure	10.9	15.7	17.6	18.9	20.2	25.8	25.0	25.8	25.3	25.1	26.2
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
Capital expenditure	6.5	9.2	11.2	11.5	9.4	8.3	8.2	8.5	8.1	7.9	7.7
Primary Surplus	*2.6*	*3.0*	*2.2*	*0.9*	*0.9*	*-0.3*	*0.4*	*0.7*	*1.0*	*2.1*	*3.5*
Budget Balance	*-0.6*	*-0.3*	*-1.7*	*-2.8*	*-3.7*	*-4.1*	*-4.0*	*-4.1*	*-3.5*	*-2.6*	*-0.9*
Total public debt of NFPS			*29.7*	*34.6*	*39.1*	*50.1*	*57.2*	*58.7*	*71.1*	*67.5*	*62.5*
Total public debt of Central Government	*14.8*	*13.9*	*14.4*	*17.8*	*22.1*	*29.5*	*36.9*	*44.2*	*50.1*	*50.4*	*46,8*

Source: ILPES-CEPAL.

Notes: The figures for 2004 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*
Total tax revenue	*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*	*17.5*
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	7.5	7.6	
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	
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	
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	
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	9.0	
general taxes on g & s	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	
specific taxes on g & s	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	
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	
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	
Social security contributions	*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*
Total fiscal revenue	*10.5*	*12.4*	*13.1*	*13.6*	*14.9*	*15.5*	*16.6*	*17.6*	*16.9*	*16.9*	*16.8*	*18.6*	*18.7*	*19.1*	*20.3*

Source: ILPES - CEPAL

Notes: The figures for 2004 are provisional.

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

	Central Government -2004		*General Government -2002**	
	Colombia	*LA average*	*Colombia*	*LA average*
Total fiscal pressure	17.2	15.5	18.7	21.1
% increase from 1990	97.7	33.9	78.1	27.1
% share direct taxes	41.8	27.1	41.7	28.9
% share indirect taxes	41.2	55.4	45.4	48.0
% share social security contributions	16.3	16.8	14.4	24.1

Source: ILPES – CEPAL

Notes: * Only Argentina, Bolivia, Brazil, Chile, Colombia, Costarica, Ecuador, Uruguay.

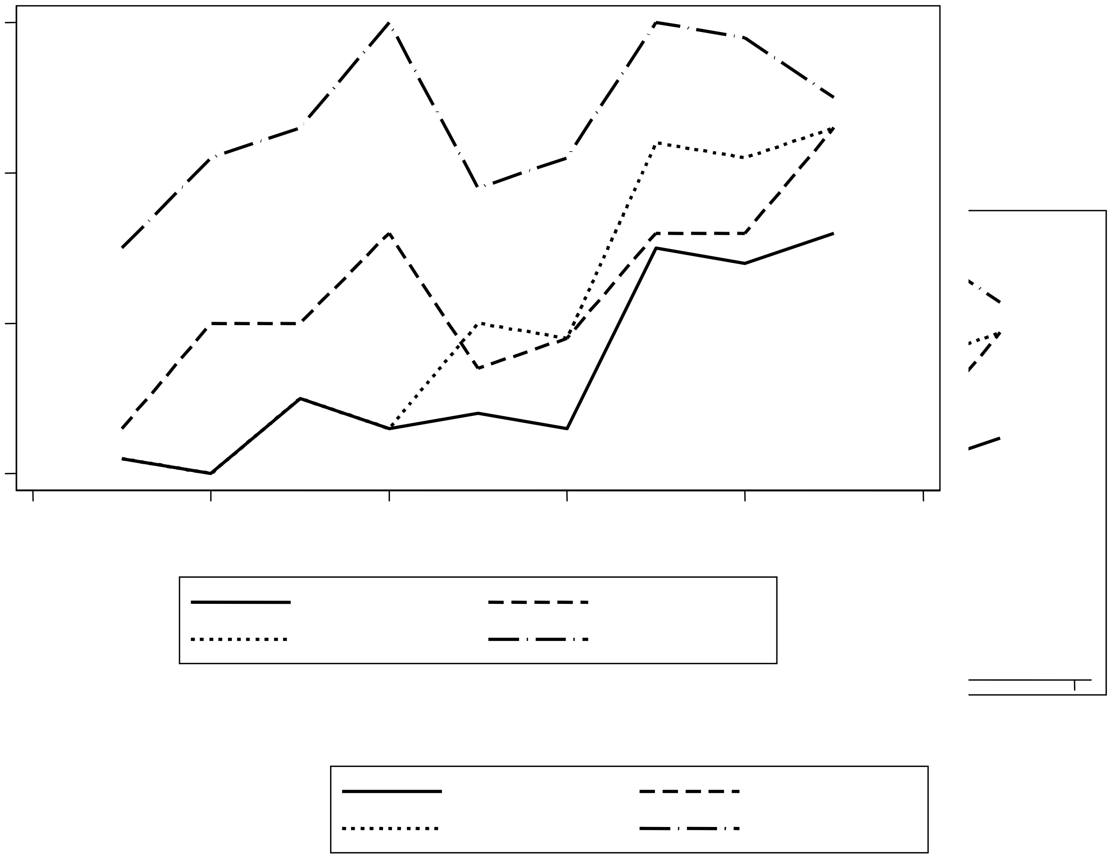
Table 4 Tax brackets and rates of personal income tax

Net taxable income	*Tax rate*
1-22,742,000	0%
22,742,000-86,954,000	20%
86,954,001-100,154,000	35%
Over 100,154,000	Lump-sum payment (COP 21,953,565) plus 35% of the excess over and above COP 100,154,000.

Tab. 5 - Distribution of fiscal burden by deciles according to the 2006 tax reform project - % and US$ for absolute values

Deciles	*Monthly income*	*Monthly income tax*	*Monthly VAT*	*Monthly Taxes*	*Combined rates*
1	180,595	0,0	8,635	8,635	4.8
2	297,635	0,0	15,691	15,691	5.3
3	378,256	0,0	20,626	20,626	5.5
4	463,454	0,0	25,979	25,979	5.6
5	557,887	0,0	32,273	32,273	5.8
6	671,227	0,0	59,720	59,720	8.9
7	822,065	0,0	73,382	73,382	8.9
8	1055,598	9,1150	93,918	103,032	9.8
9	1506,507	33,4282	130,572	164,000	10.9
10	3665,868	438,1855	304,354	742,540	20.3

Source: Gobierno de Colombia 2006.



Source: Informes estadistico tributario DIAN, Estadisticas generales de recaudo