In a nutshell….

The Colombian tax system poses significant barriers for investment and does not share the tax burden fairly. Despite some recent improvements, the system does little to reduce high-income inequality. The tax mix is unbalanced, with a high tax burden on formal firms. The tax system does not promote investment, entrepreneurship and formalisation.

Meeting the fiscal rule without spending cuts requires more revenue. Tax revenues have increased but remain low in international comparison while, at the same time, social spending needs are increasing. In order to meet the fiscal rule, without large cuts in spending, government will need to start collecting more tax revenues. This requires a tax reform.

A VAT reform can raise more revenue, improve equity and foster investment and formalisation. More affluent individuals benefit most from VAT reduced rates and exemptions. Applying the standard rate to all consumption and compensating low-income households through cash transfers would raise more revenue in a more inclusive way. It will also create room to reduce tax burden on firms, boosting investment and promoting formalisation.
The tax system does not promote fairness and efficiency

Income inequality in Colombia is high and the tax system does little to reduce it. In contrast to most OECD economies, income inequality in Colombia remains broadly unaltered by taxes and transfers (Figure 1).

The tax mix is unbalanced, as it relies heavily on revenues from the corporate income tax while the personal income tax collects little revenue. (Figure 2).

Figure 1. The tax and transfer system contribute little in reducing inequality

A tax reform is needed to safeguard a solid fiscal framework

Tax revenues have been increasing gradually over time, but at 20% of GDP remain low compared to other Latin American countries and the OECD average (Figure 3). This puts strains on the budget at a time when additional spending pressures are rising, such as those related to the expansion of social policies, the peace process or the rapid increase in immigration.

The fiscal rule has provided macroeconomic stability and fiscal discipline. These features are even more important at a time of high market volatility for many emerging market economies. Still, the rule requires the central government deficit to decline from 3.1% this year to 2.2% in 2020. Achieving this fiscal reduction, without large cuts in spending, will require a reform of the tax system to raise more revenue. Raising more
revenue and strengthening the tax system’s efficiency and equity has been a long-standing recommendation in OECD Economic Surveys and analysis.

Figure 2. The tax burden is unbalanced

A. Personal income tax revenue as % of total tax revenues

B. Total of corporate tax as % of total tax revenues

Source: OECD Global Revenue Statistics database.
**Figure 3. Tax revenues are low**

*Total tax revenues in international comparison*

2016, % of GDP

*Note:* Data refer to countries’ total tax revenues. LAC refers to the unweighted average of Argentina, Brazil, Chile, Mexico and Peru.

*Source:* OECD Global Revenue Statistics database.

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**Significant scope for tax reform exists**

The functioning of the VAT in Colombia should be strengthened. More than half of the VAT revenue potential goes untaxed, as a result of reduced VAT rates and exemptions and weak tax enforcement and tax evasion. (Figure 4). The VAT standard rate stands at 19%. Many goods and services are exempt from the VAT, including construction, electricity, transport, financial and other services. Goods belonging to the “family shopping basket” are also largely exempt or taxed at a 0% rate. Because the richest households consumes over half of the exempted or reduced VAT rate goods, the rich end up capturing a large share of this implicit subsidy (Figure 5). This is thus an inefficient way to protect the purchasing power of poor households. It is also expensive as the revenue foregone is large. Such a complex VAT system further fosters tax evasion and informality, and compromises efficiency. Cash transfers to low-income households, depending solely on their socio-economic characteristics, would be better for both equity and efficiency purposes. Colombia has made good progress in rolling out conditional cash transfer schemes, showing that replacing reduced rates and exemptions with cash transfers is a feasible option.
Figure 4. A large share of potential VAT revenues goes untaxed

Note: The VAT revenue ratio (VRR) is defined as the ratio between the actual value-added tax (VAT) revenue collected and the revenue that would theoretically be raised if VAT was applied at the standard rate to all final consumption.


Figure 5. Higher incomes benefit disproportionally from VAT relief

Note: The implicit subsidy refers to products that are excluded and/or exempted from the VAT or enjoy 5% reduced rate.


Taxation on corporations is high by international standards. The statutory corporate income tax rate is high by international standards, which discourages investment (Figure 6). The corporate tax system is also complex, as it has multiple exemptions and special regimes. Businesses also pay the standard VAT rate on the purchase of fixed assets but, in contrast to other countries with a VAT, do not receive a refund for the VAT paid on investment. This greatly increases the cost of investment in Colombia.
Figure 6. The corporate tax rate remain high

There is room to broaden the personal tax base significantly. The income threshold where taxpayers start paying income tax is at 2.1 times the average wage, which is high compared to practice in OECD countries where single taxpayers start paying on earnings above 0.3 times the average wage (Figure 7). The PIT base has a wide range of other tax deductions, which often benefit higher incomes most. The top marginal rate is also low in comparison with OECD countries (Figure 8). Broadening the base and increasing the top marginal tax rate would provide more revenue and equity by increasing progressivity.

Figure 7. The income threshold where single taxpayers start paying income tax is high

Note: Data refer to 2016. For India, the average worker income is for the organised manufacturing sector as reported in the Annual Survey of Industries.
Source: OECD calculations and DIAN.
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Figure 8. The top marginal personal income tax rate is relatively low

Note: Data show the combined central government and sub-central government marginal personal income tax rate at the earnings threshold where the top statutory personal income tax rate first applies. It is calculated as the additional central and sub-central government personal income tax resulting from a unit increase in gross wage earnings. The combined rate takes account of the effects of tax credits, the deductibility of sub-central taxes in central government taxes, et cetera. Data refer to 2016 - 2017.
Source: OECD Tax database.

Key elements of the tax reform proposal

- Unification of VAT rates and elimination of exemptions, retaining those related to health, social security or education.
- Cash transfers to compensate households in the first three deciles of income for the elimination of VAT reduced rates and exemptions.
- Reduction of the corporate tax rate from 33% to 30%.
- Full refund of the VAT paid on investment and the financial transaction tax and 50% refund of the industry and commerce tax.
- New simplified tax scheme (SIMPLE) for small firms.
- Creation of an additional tax bracket in the personal tax income. Top-earners would be taxed at 37%. Deductions would be limited to 35% of taxable income.
- Simplify the personal tax system by unifying labour, pension and capital income.
- Enhancing electronic invoicing mechanisms and fostering tax administration.

The proposed 2019 tax reform contains important steps that would strengthen the design of the tax system. It would do so by both raising more revenue and making the tax mix more efficient and fair. The proposed VAT reform would be particularly important, as it would be a fundamental step to boost revenue and, at the same time, reduce inequality and poverty (Figure 9). It would also simplify tax administration and improve incentives for informal firms to register, as being registered would allow for the recovery of VAT on inputs. Reducing corporate taxes would help raising investment and entrepreneurship, boosting growth prospects and creating formal jobs. The proposed reform to the personal income tax would improve progressivity and raise additional revenue.
The key elements of the reform proposal are in line with previous OECD recommendations. Additional OECD recommendations include lowering the income threshold where taxpayers start paying personal income tax, broadening the tax corporate income tax base and continuing efforts to raise more revenue from environmentally related taxes and to reduce informality.

Figure 9. Relative poverty and inequality will decline after compensating households from the 3 poorest deciles

Note: 1. Relative poverty rates after taxes and transfers (threshold of 50% of the median income). The statistical definition is different from the one followed by DANE.
2. The P90/P10 ratio is a measure of income inequality computed as the ratio of income of the 10% of people or households with highest income to that of the poorest 10%.

References


