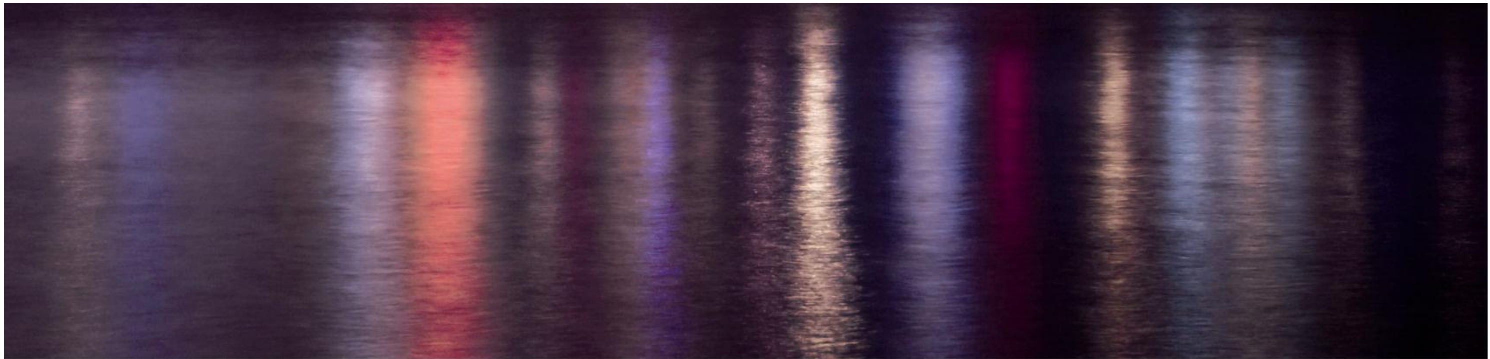
OECD Economic Surveys Colombia

January 2015

OVERVIEW



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BETTER POLICIES FOR BETTER LIVES

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Executive summary

- *Main findings*
- *Key recommendations*

Main findings

Promoting more inclusive growth

Colombia's economy has done remarkably well over the last decade. Strong growth was driven by an oil and mining boom, foreign direct investment in the commodity sector and broad-based investment. Bilateral free trade agreements and unilateral measures have continued to reduce barriers to trade and investment. A solid monetary, fiscal and financial framework reduced macroeconomic volatility, which characterised the previous decades. The improved security situation has also contributed to growth. All this has allowed fast catch-up growth in GDP per capita relative to OECD economies. However, productivity and investment outside oil and mining remains subdued, due to a high tax burden on corporations and labour, inadequate infrastructure, and limits to access to finance. Inequality and informality, and old-age poverty remain among the highest in Latin America, despite recent progress in overall poverty reduction. The minimum wage is high relative to earnings, pushing low skilled workers, youth, and those in less developed regions into the informal sector. Although declining to historical lows, structural unemployment remains high by international comparison, reducing the population's well-being.

Raising revenues and making the tax mix more efficient and fair

The fiscal framework and the fiscal position are both strong. The challenge ahead is to meet rising spending demands in the context of public debt containment and the expiration of some revenue sources. The tax system does not promote efficiency and fairness as much as it could, and tax evasion is pervasive. Formal sector companies face a high and complex tax burden, and only few individuals pay income or wealth taxes.

Expanding coverage and increasing equity of old-age income support programmes

Old-age poverty in Colombia is high, reflecting the very low coverage of the Colombian pension system and the high labour market informality. Only formal sector employees earning more than the relatively high minimum wage are covered, and eligibility is restrained by long contribution periods. Many pension benefits are linked to the minimum wage, which makes the system costly. To extend coverage, especially to the poor informal workers and those without full eligibility in the formal sector pension system, a separate scheme (*Beneficios Económicos Periódicos*) was created with government-subsidised contributions. Modest old-age income support to the poorest (*Colombia Mayor*) has also been extended in recent years.

Key recommendations

Main priorities

- Enhance inclusive growth with greater financial, education and skills development as well as better infrastructure.
- Undertake a comprehensive reform of the tax system to increase fairness, growth and revenues.
- Thoroughly reform the pension system to reduce old-age poverty and inequality.
- Further reform labour markets to reduce informality and create more quality jobs.

Promoting more inclusive growth

- Maintain the strong macroeconomic framework.
- Create incentives to improve co-ordination of infrastructure projects across subnational governments within the National Development Plan.
- Adapt legislation to improve the business environment, foster competition, and make the judiciary process more efficient to enhance the rule of law.
- Keep minimum wage growth close to inflation to increase the gap with average wage. In the medium term, differentiate the minimum wage by age.

Raising revenues and making the tax mix more efficient and fair

- Reduce tax evasion by strengthening the tax administration and by increasing penalties.
- Reduce the tax burden on investment by gradually lowering the corporate income tax rate, phasing out the net wealth tax on firms and eliminating VAT on investment.
- Make the personal income tax more progressive by taxing dividends and eliminating regressive exemptions.

Expanding coverage and increasing equity of old-age income support programmes

- Expand eligibility of the *Beneficios Económicos Periódicos* programme.
- Increase coverage and benefit levels of the public minimum income-support programme (*Colombia Mayor*).

Assessment and recommendations

- *Macroeconomic Outlook*
- *Macroeconomic policies*
- *Making the tax system more efficient, fair and green*
- *Promoting more inclusive growth*
- *Reforming the pension system and old age income support*

Colombia has been converging fast towards higher living standards since the early 2000's. Sound macroeconomic policy reforms – the adoption of an inflation targeting regime, a flexible exchange rate, a structural fiscal rule and solid financial regulation – have underpinned growth and reduced macroeconomic volatility (Figure 1). Colombia has gradually opened up to trade and investment and improved the security situation. Booming oil and mining investments and exports in turn trickled down to domestic demand. Growth has brought social improvements, as the population living below the national monetary poverty line declined from half to a third in the past decade. The recent peace talks between the government and armed groups could lead to an end of decades of violence.

However, the fading commodity boom requires policy action to sustain growth. Investment outside the natural-resource sector is needed to create formal jobs and reduce the high levels of income inequality (Figure 2, Panel A). The *2013 OECD Economic Assessment* pointed out that limited access to pre-primary and tertiary education for poor households reduces opportunities to upward mobility. Poverty has fallen, but old-age poverty is significantly higher than in most Latin American economies (Figure 2, Panel B). Productivity remains low, reflecting weak framework conditions, such as informality, low educational quality, inadequate skills, low investment in R&D, and a distortive tax system (see Annex). The *2013 OECD Economic Assessment* argued that the business climate would benefit from a better enforcement of bureaucratic procedures, such as licencing, improved monitoring of institutions vulnerable to corruption, and reducing barriers to trade and competition in some product markets. Several dimensions of well-being, including environmental quality, labour market vulnerabilities and weak public institutions also leave Colombia behind OECD countries. Despite progress in reducing violence – e.g. the homicide rate has declined from almost 69 homicides per 100 000 population in 2002 to below 31 in 2012 – it remains a key challenge to well-being (Figure 2, Panel C). This *Economic Survey* suggests that the following policies would complement the strong macroeconomic performance by putting more emphasis on inclusive growth:

- Enhance inclusive growth with greater financial, education and skills development and better infrastructure.
- Undertake a comprehensive reform of the tax system to increase fairness, growth and revenues.
- Thoroughly reform the pension system to reduce old-age poverty and inequality.
- Further reform labour markets to reduce informality and create more quality jobs.

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Figure 1. **Long-term macroeconomic performance**

A. GDP per capita is growing after two decades of stagnation

US dollars, 2011 PPPs

Average annual rate

3.7%

0.3%

3.2%

B. GDP per capita relative to the US has started to recover ground

%

C. A strong macroeconomic policy framework has tamed inflation

%

Source: Feenstra, Robert C., Robert Inklaar and Marcel P. Timmer (2013), "The Next Generation of the Penn World Table", available for download at *www.ggdc.net/pwt*; World Bank, *World Development Indicators database*, and Banco de la República.

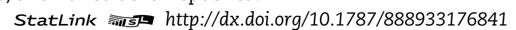
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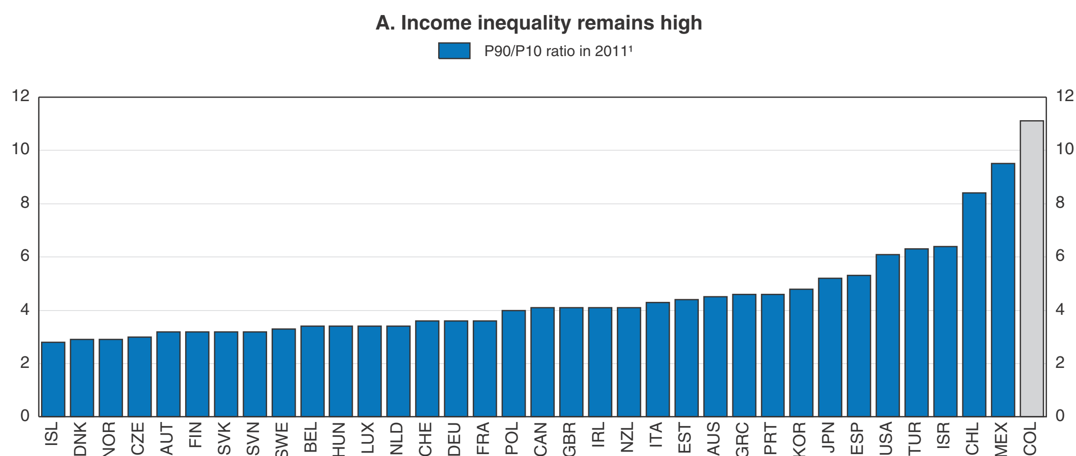
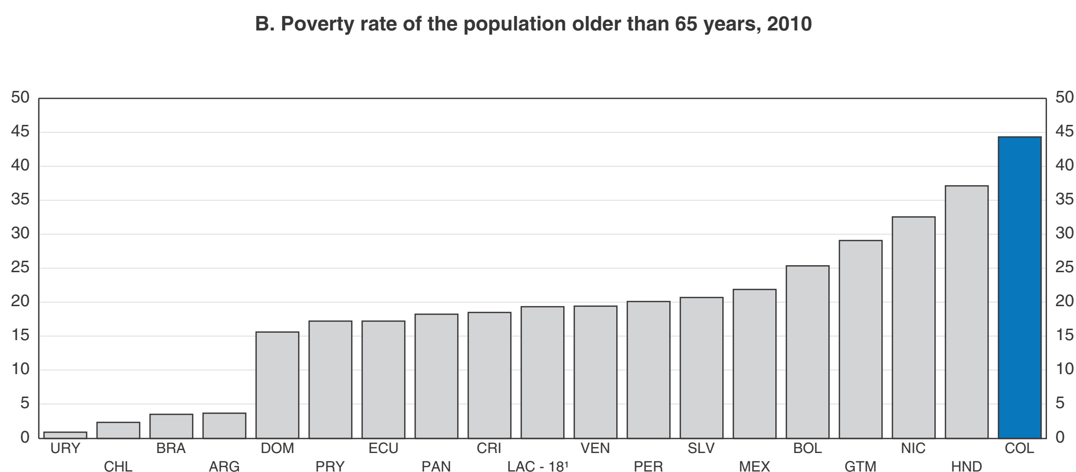
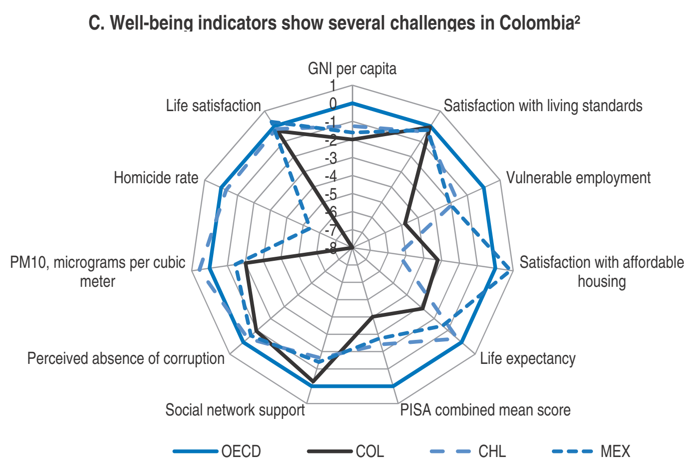
Figure 2. **Inequality, poverty and well-being indicators**







1. The P90/P10 ratio is the ratio of income of the 10% of people with highest income to that of the poorest 10%.
2. Panel C shows the difference between the values of the variable for the country with respect to the simple average of the OECD countries, normalise by the standard deviation. The OECD average does not include data for Korea regarding: satisfaction with living standards, affordable housing, social network support, corruption and life satisfaction.

Source: *OECD income distribution database*; SEDLAC, *Gallup database*, *World Development Indicators database*, *UNODC* (United Nations Office for Drugs and Crime) database, OECD PISA 2012 results (mean mathematics score) and *ILO database*; Cotlear (2011), Inter-American Development Bank, *HelpAge International Database*.

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Macroeconomic Outlook

Recent macroeconomic developments

Growth recovered quickly from the 2008 global financial crisis. Until 2012, terms of trade gains and large FDI flows supported growth, although they also pushed up the real exchange rate, favouring non-traded goods (Figure 3). After a brief drop in 2012, domestic demand growth picked up, driven by government consumption, strong investment and higher household income due to the steady decline in unemployment (Table 1; Figure 4). Since 2013, higher investment has been supported by infrastructure investment by subnational governments and strong residential investment, due to an expansion of public housing programmes and the so-called PIPE ("plan to promote productivity and employment"), which provides subsidies to mortgage interest rates.

Figure 3. **Strong terms of trade and FDI flow into oil and mining have led to a real appreciation**

A. Terms of Trade and Real effective exchange rate

B. FDI inflows by sector

Source: Banco de la República.

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Table 1. **Macroeconomic indicators and projections**

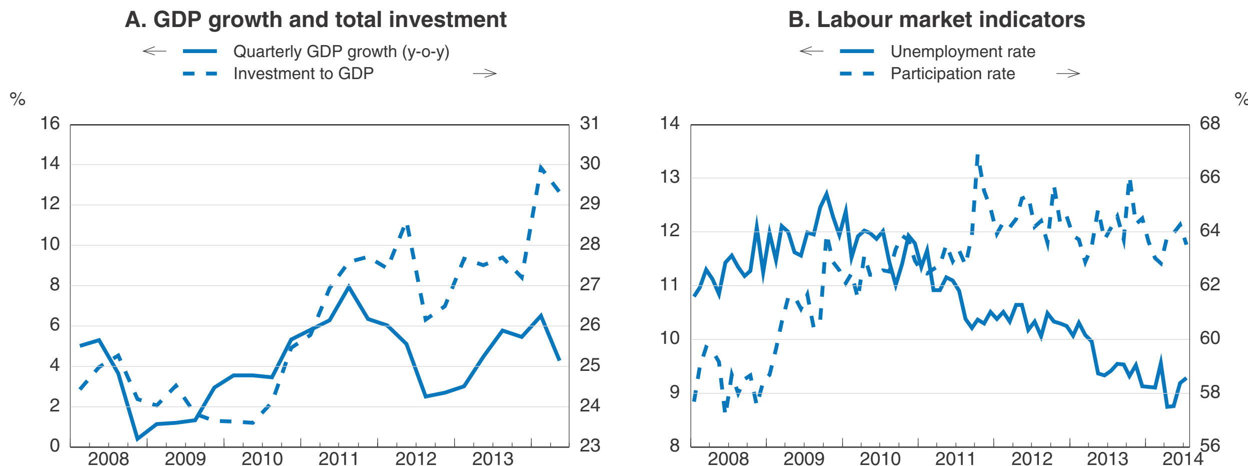
Annual percentage change, volume (2005 prices)

	2011	2012	2013	2014	2015	2016
	Current prices, trillions of COP	Percentage change, volume (2005 prices)				
GDP	619.9	4.0	4.7	4.9	4.4	4.7
Private consumption	379.5	4.4	4.2	4.6	4.0	4.3
Government consumption	99.8	5.7	5.8	5.2	2.6	3.4
Gross fixed capital formation	146.2	4.6	6.1	11.9	4.5	6.5
Final domestic demand	625.6	4.7	4.9	6.5	3.9	4.7
Stockbuilding[1]	1.7	0.0	-0.2	0.2	-0.2	0.0
Total domestic demand	627.3	4.9	4.5	6.6	3.6	4.8
Exports of goods and services	116.1	6.1	5.4	-1.6	5.8	6.3
Imports of goods and services	123.6	8.9	4.5	7.9	2.0	5.9
Net exports[1]	-7.4	-0.6	0.1	-1.9	0.5	-0.3
Other indicators						
Unemployment rate	-	10.4	9.6	9.2	9.4	9.5
Consumer price index[2]	-	3.2	2.0	2.7	3.0	3.0
Current account balance[3]	-	-3.2	-3.4	-4.2	-4.1	-3.9

1. Contribution to changes in real GDP, actual amount in the first column.
2. Annual average percentage change.
3. As percentage of GDP.

Source: OECD Economic Outlook 96 database.

Figure 4. **Strong investment has supported growth and labour market performance has been solid**



Source: OECD Economics Department database and Banco de la República.

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By contrast, the non-mining tradables sectors, manufacturing and agriculture, suffered from economic turmoil in neighbouring Venezuela, competition from Mexico, the strong real exchange rate, weak international demand, and smuggling (Table 2). This aggravated existing structural problems facing exporters. Transport bottlenecks impose serious barriers to competitiveness and reduce competition by fragmenting the domestic market. According to Mesquita Moreira (2013), Colombian agricultural and manufacturing exports would gain the most from lowering transport infrastructure costs, compared to

Table 2. **Contribution by sector to GDP growth**

In percentage points

	Agriculture	Oil and mining	Manufacturing	Construction	Services	Indirect taxes	GDP
2005	0.2	0.3	0.6	0.4	2.8	0.4	4.7
2006	0.2	0.2	1.0	0.7	3.8	0.9	6.7
2007	0.3	0.1	1.0	0.5	4.0	1.0	6.9
2008	0.0	0.5	0.1	0.5	2.0	0.4	3.5
2009	-0.1	0.8	-0.7	0.4	1.4	-0.2	1.7
2010	0.0	0.7	0.2	0.0	2.5	0.6	4.0
2011	0.1	1.0	0.6	0.5	3.3	1.0	6.6
2012	0.2	0.4	-0.1	0.4	2.7	0.5	4.0
2013	0.3	0.4	-0.1	0.8	2.8	0.5	4.7
Average (2005-13)	0.1	0.5	0.3	0.5	2.8	0.6	4.8
Share of GDP in 2005	7.9	6.3	14.2	5.4	57.7	8.5	100.0
Share of GDP in 2013	6.2	7.7	11.3	6.9	58.0	9.7	100.0

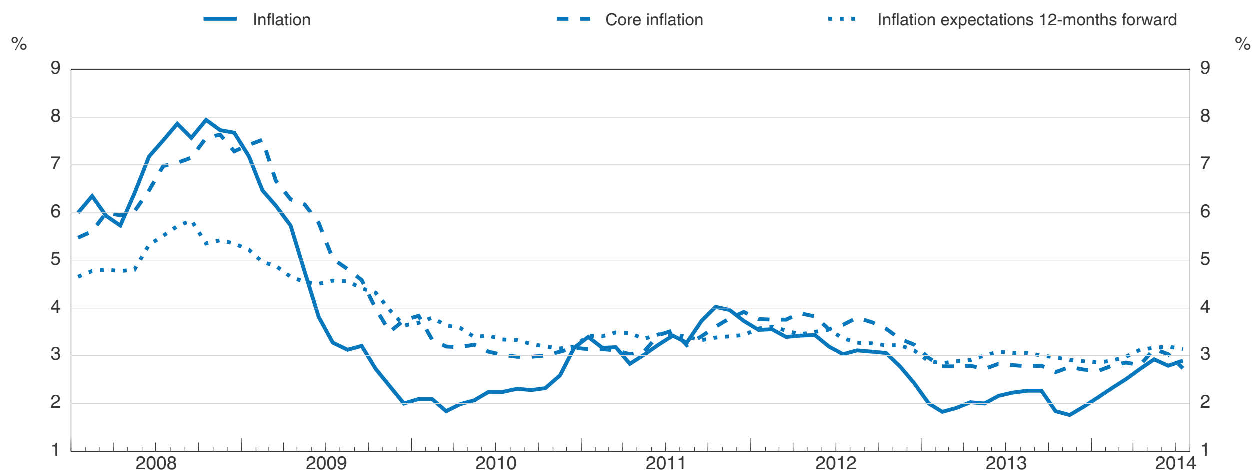
Source: DANE.

other Latin American economies. Agriculture is being held back by weak land tenure rights, high land concentration, an underdeveloped land market and barriers to trade (OECD, 2015) and competition (e.g. price stabilisation funds).

Skilful monetary management within the successful inflation targeting framework has contained inflation to the 2-4% target range since mid-2009, even as growth has been strong and unemployment has declined (Figure 5). After falling slightly below the target range in 2013 due to temporary shocks to food and regulated prices as well as economic slack, inflation has returned to near the 3% midpoint. Inflation expectations have been well-anchored around 3% since early 2013.

Lower oil and coal prices and weak non-commodity exports and imports (boosted by strong domestic demand) have widened the current account deficit (Figure 6). However, at 4.2% of GDP in 2014 it remains sustainable and has been largely financed by FDI; external debt is only 24% of GDP. Nevertheless, despite the positive medium-term effects of a more

Figure 5. **Inflation and inflation expectations have stabilised around the target mid-point**



Source: OECD Economic Department database and Banco de la República.

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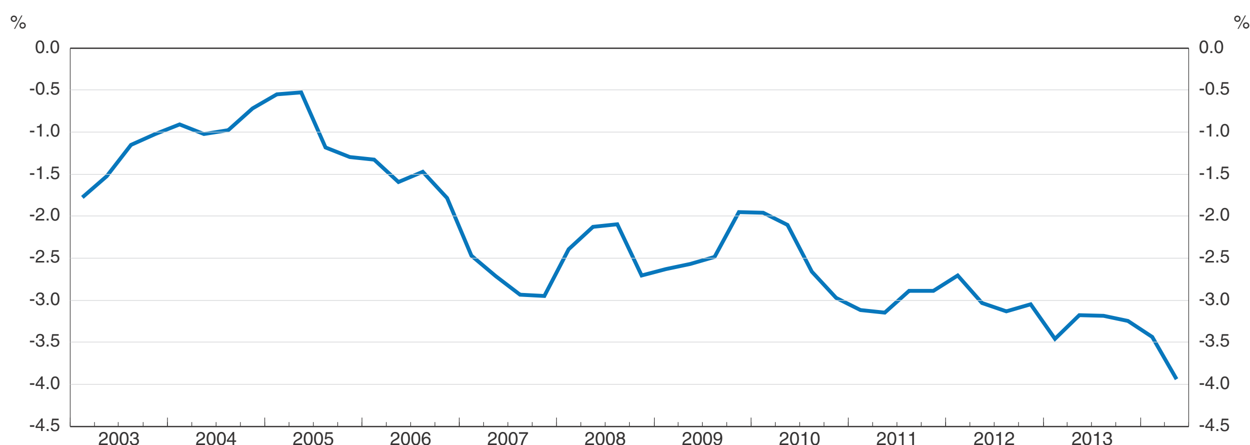
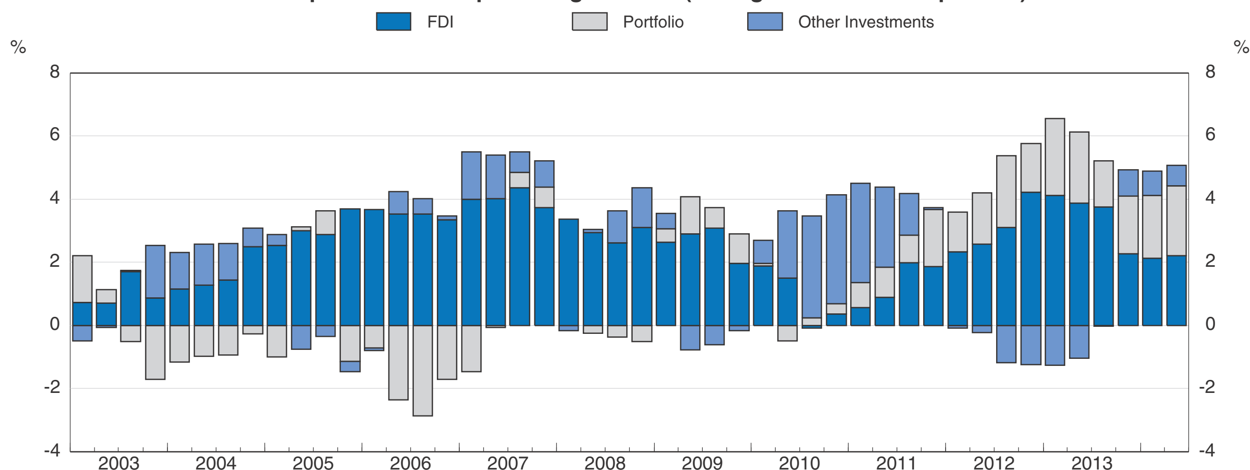
Figure 6. **The current account deficit is widening**

A. Current account as percentage of GDP (average over last four quarters)



B. Net capital inflows as percentage of GDP (average over last four quarters)



Source: OECD Economics Department database.

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diversified investor base, the increase in the current account deficit, combined with a rise in portfolio flows since early 2014, could make Colombia more vulnerable to short-term fluctuations in global risk appetite (Mehrotra, Miyajima and Villar, 2012).

Sustained growth in the near-term, but subject to downside risks

Growth has picked up somewhat in 2014, on the back of strong investment and private consumption. The current monetary policy stance is likely to keep inflation within the 2-4% target range. In 2015, residential construction and private consumption are projected to moderate due to tighter credit conditions, the likely withdrawal of mortgage rate subsidies and a less buoyant labour market. Weaker terms of trade are projected to postpone stronger export growth to the second half of 2015, as the US recovery consolidates and commodity exports recover somewhat from recent supply constraints. Government consumption will also slow down to reach the fiscal balance target for 2015. However, overall investment is projected to remain strong due to subnational investment

and private road infrastructure investment under the fourth generation (so-called 4G) public-private partnership (PPP) concession plan during 2015 and 2016 (Table 1).

The balance of risks is tilted to the downside. Global growth, especially China, and geopolitical risks can affect Colombia's oil, coal and mining exports. A further and sustained decline in oil prices would affect investment, the balance of payments and reduce government revenues by squeezing the profits of *Ecopetrol* (the oil company majority-owned by the state), income tax revenue and royalties. Monetary policy normalisation in the US could imply tighter international financing conditions, and spikes in uncertainty and risk aversion could increase asset price volatility in emerging markets. For instance, in May 2013, upon announcement of potential tapering of Quantitative Easing (Olaberría, 2014), the Colombian peso depreciated significantly and other asset prices also fell. Currency risks may also rise slightly because of increased bond issuance by Colombian non-financial firms abroad, although currency mismatches remain largely contained. In October 2014, the government presented a series of tax changes to meet its fiscal targets in 2015, which will increase corporate income taxation. Although the effect is uncertain, this could impact investment decisions, either by firms postponing decisions due to uncertainty on the final tax burden or by essentially raising the cost of investment. At the same time, stronger than anticipated external demand from the United States and a successful completion of the peace talks are the main upside risks. In addition, the robustness of the macroeconomic policy framework as well as the soundness of the financial system allows Colombia to face these risks and other economic shocks well.

The banking system remains solid, although housing-market vulnerabilities persist

Solvency and liquidity indicators of Colombian banks remain solid and nonperforming loans and delinquency rate indicators are historically low. The legal and institutional framework for financial regulation and supervision by the *Superintendencia Financiera* is strong. However, the recent expansion of Colombian banks to other countries in Latin America poses some financial vulnerability through financial spill-overs via Colombian subsidiaries and branches abroad, as they represent around 20% of the Colombian banking system's assets. The regulator's proactive approach in monitoring these developments is welcome. It should continue with current on-site visits of foreign subsidiaries of Colombian conglomerates and foreseen agreements with supervisors in the relevant jurisdictions to exchange information on a regular basis. Reserve accumulation and continued access to the Flexible Credit Line by the IMF also mitigate currency volatility risks.

The booming housing sector and consumer debt are a potential source of domestic vulnerabilities that should continue to be monitored closely. Housing prices have nearly doubled in real terms since 2005 and increased by 30% compared to disposable income (Figure 7, Panel A). This has been accompanied by strong growth in household debt. The mortgage rate subsidy reduced rates from 12.5% to 7% per annum, spurring demand (Figure 7, Panel C). Although moderate compared with the recent experience of several OECD economies, household indebtedness with financial institutions at around 28% of disposable income in 2014 is historically high (Figure 7, Panel B).

Strong mortgage loan indicators and the good regulatory framework imply that risks are currently contained. Mortgage loan quality remain strong (Figure 7, Panel D), the share of mortgages in total loans is relatively small (9%) and the loan-to-value ratio remains below the 70% stipulated by the regulator. Furthermore, a series of macro-prudential policies that strengthen buffers and provisions have been implemented in recent years.

Figure 7. **Housing market indicators suggest some overheating risks**

A. Housing prices relative to disposable income[1]

Index 2000 = 100

B. Household debt with financial institutions[2]

per cent of disposable income[1]

Mortgage debt
Consumption debt

C. Share of construction sector and mortgages in GDP

Construction
Mortgage loans

D. Quality of mortgage loans and provisions

Loan-quality adjusted provisions ratio
Non-perfoming loans, % of total
Provisions/NPL

1. For Panels A and B, disposable income for 2013 and 2014 was estimated using a growth rate of 4.3% and 5%, respectively.
2. Household debt includes all consumption and mortgage operations with credit establishments (including leasing operations), the National Savings Fund (FNA), Credit Unions and mortgage-backed securities.

Source: Calculations provided by Banco de la República based on data from the SFC, Fondo Nacional de Ahorro, Superintendencia de Economía Solidaria, and DANE.

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Counter-cyclical provisioning for commercial and consumption loans were introduced in 2007 and 2008, respectively. In June 2012, additional provisions on consumer loans to limit the potential deterioration in loan portfolios were created, applying a 0.5% additional provision on the outstanding capital of the loan if the growth rate of nonperforming loans accelerates. Liquidity buffers to limit risks have also been in place since 2009. Furthermore, in 2012 new norms to increase the quality of capital were issued. Finally, liquidity requirements for broker-dealers were introduced in 2014. Despite the limited risks and strong regulation, it would be prudent to remove housing subsidies, such as the PIPE and personal income tax exemptions for real estate savings, and to continue monitoring developments in the housing market closely.

Macroeconomic policies

The macroeconomic policy framework is robust

The 1991 Constitutional Reform and the Law 31 of 1992 re-established the central bank's autonomy and gave it a clear mandate to preserve price stability. Its board of directors is composed by seven members: five members, appointed for four years and renewable for up to two additional terms; the Minister of Finance; and the General Manager of the Central Bank, who is appointed by the board. The overlapping terms for board members limit the possibilities of the government to significantly change the composition of the board, as it can appoint only two board members during its tenure. The Central Bank has operated a successful inflation targeting regime since 1999, with an inflation target range of 2-4%. This greater independence and commitment to price stability has led to a low and stable inflation rate.

The fiscal policy framework is also strong. In 2011, fiscal sustainability was included in the Constitution as a key guideline for public policy. Furthermore, a fiscal rule that targets the central government's budget balance, adjusted for cyclical factors and oil and mining prices, was created by law in 2011. The law establishes annual targets, such that the adjusted budget deficit will gradually decrease from around 2.3% of GDP in 2014 to 1% by 2022. Furthermore, the law also created a savings and stabilisation fund. The key parameters are set by two external committees of independent experts that determine potential GDP and the long-term reference prices for commodities. In addition, a solid framework to ensure subnational fiscal sustainability was put in place, after problems of over-borrowing and excessive expenditure growth during the 1990s. In particular, the Law 358 of 1997 (known as the "traffic light law") introduced a set of liquidity and solvency indicators for subnational governments to borrow freely or require authorisation and an adjustment programme agreed with the Ministry of Finance (MHCP). In addition, the Law 617 of 2000 introduced a cap on current expenditures and a set of sanctions if limits are not respected.

The short-term macroeconomic policy mix is broadly appropriate

While monetary policy was supportive in the slowdown in 2012, it has appropriately become less stimulative as growth picked up. OECD estimates of an open-economy Taylor rule imply that the monetary policy stance is appropriate. As inflation rose in early 2014, the Central Bank raised the policy rate by 25 BPS each month between April and September (Figure 8, Panel A). Inflation expectations remain well anchored around the midpoint of the target range, and inflation has been low and broadly stable for several years.

Inflation targeting has been accompanied by a flexible exchange rate. The real exchange rate has been relatively stable since 2010 (Figure 8, Panel B) and is judged by the IMF to be in line with fundamentals (IMF, 2014). Exchange rate intervention has been used to increase the stock of reserves and smooth volatility. Adequacy indicators show that reserves are at prudent levels, although some additional reserves would help to deal with extreme events (IMF, 2014). The flexible credit line with the IMF would also help in this regard. The volatility of capital flows remains a concern, especially with the recent increase in portfolio inflows. Exchange market interventions should continue to be consistent with the inflation target and a market-determined exchange rate. In any case, existing prudential rules on currency mismatches and anchored price expectations will help to deal with volatility.

Figure 8. **Macroeconomic policy indicators**

A. Monetary policy stance

Monetary policy rate | Estimated Taylor-rule

B. Real Exchange Rate

Index 2001 = 100

C. Budget balance (% of GDP)

Central Government | Non-financial Public Sector

D. Net debt end-of-year (% of GDP)

Central Government | Non-financial Public Sector

Source: Banco de la República and MHCP.

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Fiscal policy has been largely countercyclical. After a fiscal impulse of two percentage points of GDP in 2009 to support aggregate demand during the global economic crisis, as growth resumed the central government gradually started to reduce its fiscal deficit from 4.1% of GDP in 2009 to 2.4% in 2013 (Table 3). The fiscal situation of subnational governments is solid. In 2013, subnational governments presented a budget balance of 1.2% of GDP, while higher investment expenditures will reduce it to 0.5% of GDP in 2014 (MHCP, 2014a). As economic growth started to slow again in 2013 the central government implemented a small fiscal stimulus package (PIPE, see above) to stimulate mainly residential housing construction. As growth is picking up, fiscal policy should again move back towards a more neutral stance.

The public sector net debt of around 25% of GDP (gross debt is 43% of GDP) is low, and has been falling since 2002 (Figure 8, Panel D). It is sustainable in view of Colombia's capacity to pay and raise revenue (IMF, 2014). The debt of subnational governments at 1.4% of GDP is low. Over the medium term the government targets an even lower public

Table 3. **Central government budget balance targets and projections**

As percentage of GDP

	2007-12	2013	Official projections				
			2014	2015	2016	2020	2025
Total revenues	15.2	16.9	17.0	17.0	16.9	16.4	16.0
Tax revenues	13.3	14.3	14.8	15.1	15.2	14.8	14.5
VAT and consumption taxes	5.4	5.1	-	-	-	-	-
Income taxes (incl. CREE)	5.5	6.8	-	-	-	-	-
Wealth tax	0.5	0.6	-	-	-	-	-
Financial transaction tax	0.7	0.8	-	-	-	-	-
Other taxes	1.2	1.0	-	-	-	-	-
Other revenues	1.9	2.6	2.2	1.9	1.7	1.6	1.5
of which: Ecopetrol dividends	1.0	1.9	1.4	1.0	-	-	-
Total expenditures	18.3	19.3	19.5	19.3	19.2	17.8	17.0
Interest payments	2.7	2.3	2.3	2.3	2.4	2.1	1.7
Current expenditures	13.3	13.7	14.3	14.6	14.5	13.6	12.6
Investment	2.3	3.3	2.9	2.4	2.3	2.0	2.7
Budget balance[1]	-3.1	-2.4	-2.4	-2.4	-2.2	-1.4	-1.0

1. From 2014 onwards it refers to the legal target set by the fiscal rule.
Source: MHCP (2014a).

debt. As a result of the fiscal rule, the net central government debt is projected to fall from 36% of GDP currently to 26% by 2025. Such a low debt level is justified by Colombia's strong dependence on potentially volatile resource revenues and its exposure as an emerging-market economy to global financial shocks. Indeed, emerging-market economies have been excluded from international capital markets in the past during periods of international capital market turmoil. Moreover, Colombia still has higher debt levels than similar emerging market economies, such as Chile or Peru, which enjoy betters ratings and lower financing costs.

The expected decline in a number of revenue sources in the near future poses a challenge for the consolidation plans. A wealth tax is set to expire at the end of 2014, and the financial transaction tax will be gradually phased out between 2015 and 2016. These taxes together represent around 1.4% of GDP (Table 3). Dividend payments by *Ecopetrol* to the Central Government are also expected to decline by half a percentage point of GDP in both 2014 and 2015. While lower oil-related revenues are in part cyclical, in the absence of efficiency gains by *Ecopetrol* most of the projected decline will be permanent (MHCP, 2014a), and over time oil production is also expected to decline.

At the same time, Colombia has important spending needs. Public infrastructure investment will be critical to economic development and is expected to rise after 2020. Indeed, currently planned infrastructure investment may prove insufficient to address bottlenecks in transportation and energy (Clavijo, Vera and Vera, 2013a). Spending pressures also arise from already planned expansions of social policies and a potential peace deal with armed groups. For example, expanding non-contributory pensions, increasing the quality of education and the coverage of early childcare programmes, and planned additional health care expenditures would cost around 1.7% of GDP. Furthermore, despite the positive effect on economic growth of a peace agreement, its implementation would require additional expenditures, especially in the agricultural sector, of around 1% of GDP per annum for 2015-18 (Villar and Forero, 2014).

Raising revenues in an efficient and fair way is therefore critical. At about 20% of GDP, general government revenues are low compared to OECD countries or some of its Latin American peers (Figure 9). Tax revenues are between 2 and 4 percentage points of GDP below the value that might be expected given Colombia's level of economic development and structural characteristics (IADB, 2013). This reflects such factors as pervasive tax evasion, high exemptions and the need to strengthen the tax administration.

Congress approved a bill in December 2014 to extend the wealth and financial transaction taxes by four years, impose a surtax on corporate income, and improve collection by reducing evasion with tougher sanctions. These measures will help to reach the fiscal targets, but such a piecemeal reform might raise uncertainty regarding future tax

Figure 9. **Tax revenues in Colombia are low**

A. Evolution of tax revenues as per cent of GDP

Colombia — Lac-18 average[1] — OECD average[2]

B. Comparison of tax revenues as per cent of GDP in 2012

1. LAC-18 is the average of the 18 LAC countries (Guatemala, Paraguay, Venezuela, Salvador, Dominican Republic, Honduras, Peru, Panama, Nicaragua, Costa Rica, Uruguay, Bolivia, Brazil, Argentina, Colombia, Chile and Mexico).
2. For 2012, the OECD average is for 29 countries, data are missing for Australia, Japan, Mexico, the Netherlands and Portugal.

Source: OECD Revenue Statistics and OECD/ECLAC/CIAT (2013), *Revenue Statistics in Latin America: 1990-2012.*

policy and is unlikely to lead to a tax system that is especially efficient, fair or revenue-enhancing. By contrast, a comprehensive reform would hold the promise of encouraging investment, growth and fairness (see below).

Recommendations on macroeconomic and financial policies

Key recommendations

- Maintain the strong macroeconomic framework.

Further recommendations

- Monitor closely developments in the housing market and withdrawal the PIPE subsidy to mortgage loans as well as tax exemptions for real estate savings.
- Implement the gradual fiscal consolidation path in line with the central government's fiscal rule by raising more tax revenues.

Making the tax system more efficient, fair and green

The Colombian tax system does not promote efficiency and fairness and is very complex. High levels of informality in the economy constrain tax administration and enforcement, and explain to some extent why personal income and wealth taxation is such a limited source of tax revenue, while the tax burden on firms is very high. In the past, the internal armed conflict has also made it difficult to tax land and activities in the agricultural sector. To compensate firms and individuals for the distortive and regressive tax structure, successive governments have introduced special regimes and tax exemptions that often do little to effectively reduce inequalities and increase the complexity of the tax system. As all these elements interact, a comprehensive approach to tax reform will be the most effective way to change the tax system so as to raise revenues in a way that stimulates investment and growth, reduces distortions and increases fairness.

A correct sequencing of such a reform is important. In this sense, a first priority is to strengthen the tax administration to reduce tax evasion and improve its revenue-raising capacity. At the same time, reforms such as broadening the corporate income tax base, reducing rates and simplifying the tax system should be implemented gradually, given the need to raise the tax intake over time to finance higher social expenditures and to continue with fiscal consolidation.

Tax evasion is pervasive

Widespread tax evasion significantly reduces revenues. According to official estimates, VAT evasion is around 2% of GDP (Cruz, 2011), while the IMF and some analysts put it at twice that level (Steiner and Medellin, 2014). The tax administration has little effective control on customs administration due to lack of personnel and other constraints, which has led to very high levels of VAT evasion on imports. Also, the tax administration inspects just around 0.1% of taxpayers compared to around 3% in other Latin American countries (IADB, 2013). Estimates of tax evasion in the corporate income tax amount to 2.3% of GDP. According to estimates of the tax administration, many firms misreport or evade completely corporate income taxes and VAT. Although there are no reliable estimates for the personal income tax, the international evidence shows that in general it is more pervasive than in VAT and corporate income tax (IADB, 2013). In any case, actual collection of the personal income tax at around 0.7% of GDP is low.

Strengthening tax administration would curb evasion. This requires more technical capacity and personnel to take advantage of information technologies for detecting areas of potential tax fraud. Tax fraud penalties could also be increased, by following general practice in OECD countries and by making domestic and offshore tax evasion a criminal offence. Criminal sanctions could then possibly be lifted or reduced if taxpayers disclose domestic and offshore non-compliance on a voluntary basis. Recent advancements in bilateral and multilateral agreements for automatic exchange of information could also make sanctions more credible. Such a reform should be accompanied by measures that strengthen the tax administration's capacity to perform audits and strengthen tax compliance.

A reform of the tax system could also increase tax compliance. For example, the net wealth tax discourages taxpayers from disclosing domestic and offshore income and assets. The government's proposal to introduce a special voluntary disclosure programme for a limited period of time is a step in the right direction. In order to maximise the impact of such a programme, it should be part of a comprehensive tax reform that lowers distortions, as otherwise the same patterns of evasion may reappear.

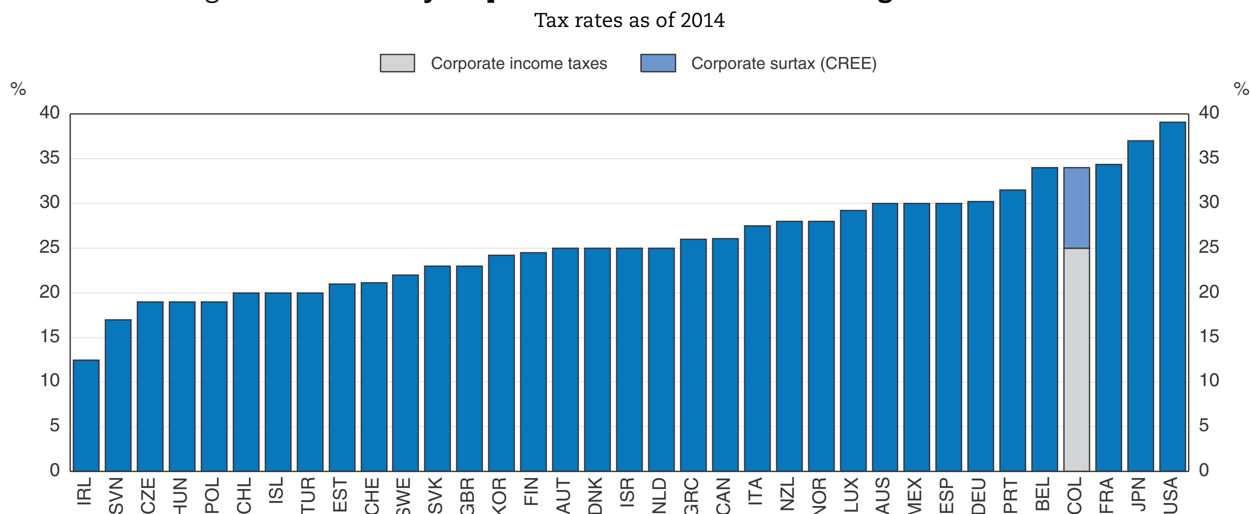
Taxation on corporations is high by international standards

The effective corporate tax burden in Colombia is high because of the combined effect of the statutory corporate income tax rates, the net wealth tax levied on business assets and the VAT levied on investment.

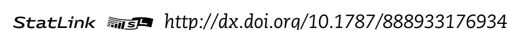
The statutory corporate income tax rate at 34% is high by international standards and discourages investment, especially outside the oil and mining sector (Figure 10). The corporate income tax base is eroded by many exemptions stemming from industry and company-specific tax contracts and special regimes such as free trade zones. To finance a reduction in payroll taxes and close tax loopholes, the government introduced a surtax of 9% in 2012 (CREE) levied on a broader base. The government is planning to increase this surtax to 18% for 2015 until 2018 to substitute a net wealth tax on firms. As the corporate

Figure 10. **Statutory corporate income tax rates are high in Colombia**

Tax rates as of 2014



Source: OECD Tax database.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income tax and the CREE have different tax bases, withholding and reporting systems, the reform introduced additional complexity. To enhance efficiency and growth, the corporate income tax and the CREE should be unified, the tax base broadened, and the combined rate reduced. Such a reform would attract foreign and domestic investment beyond oil and mining. Higher investment and growth would compensate in the long-term for most transitory revenue losses (Steiner and Medellin, 2014).

Individuals and businesses are liable for a wealth tax levied on net assets. It was introduced as a one-off tax on declared net wealth in 2011 at a top rate of 6%, with the amount payable over four years. The bulk of the tax falls on companies, only a few individuals (50 000 or 0.01% of the population) pay the tax, as exemptions are high and identifying wealth is difficult. The law passed in December 2014, extends this tax until 2018 for individuals, while it will gradually phase it out for firms by 2017. The wealth tax raises the required breakeven return on investment and the effective corporate income tax rates, thereby distorting capital allocation (Clavijo, Vera and Vera, 2013b). Most OECD countries do not have a wealth tax and among the five countries that do, the highest marginal rate is 1.5%. Firms should not be liable to the wealth tax. Instead, personal ownership of shares of businesses should be in the tax base, as they are one form of wealth.

Moving towards a consumption-based VAT would reduce the tax burden on investment. Businesses pay the standard VAT rate of 16% 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. As part of a comprehensive tax reform, Colombia should levy VAT only on consumption and not on investment.

Tax exemptions and special regimes make the tax system more complex and regressive

Colombia has a very narrow VAT base. Many activities are excluded from the VAT system – including construction, electricity, transport, financial services and other services. The estimated revenue loss amounts to about 2.4% of GDP (Yori Parra et al., 2013). Many of these items are subject to VAT in other Latin American and OECD countries. Therefore, there is significant room to broaden the base by eliminating exemptions. Broadening the base could be achieved by removing exemptions for non-essential goods and services. If more revenues are needed, the basic VAT rate of 16% could be increased, as it is low compared to OECD countries (19.1% on average) or Chile (19%).

The personal income tax would be made more progressive if exemptions were narrowed, because they tend to increase with income (Alvaredo and Londoño, 2013). For example, all pensions are currently exempt from income tax. Exemptions, for example on voluntary savings for retirement and real estate, and deductions on income for employees should be phased out as they are regressive.

The 2012 reform implemented an alternative minimum personal income tax (IMAN) that acts as a cap on some exemptions, increasing slightly the effective tax rate paid by high-income households (OECD, 2013a). The top marginal rate is currently at 33% for annual earnings under the ordinary income tax and 27% for the IMAN (for annual earnings above USD 190 000). The minimum exemption level of 3 times the average per capita income – compared to 0.5 times in OECD economies – is high. Lowering this threshold and increasing the marginal tax rate (e.g. moving the IMAN rate from 27% to 33%) would provide more revenue and could also increase progressivity.

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Taxing dividends, which are currently not taxed at the personal level, would raise revenues and increase progressivity. In the medium term, shift some of the tax burden on capital income from the corporate towards the personal shareholder level. Colombia could consider moving towards a dual income tax system under which dividends and capital gains are taxed at the personal level at a proportional tax rate. Taxing dividends at the shareholder level may require increasing the capital gains tax rate beyond the current 10%.

Subnational governments could raise more revenue

In terms of subnational fiscal sustainability, the current framework is solid. For example, the fiscal responsibility law of 2003 set targets and rules for subnational budget balances, lending and debt that have improved subnational fiscal sustainability significantly (MHCP, 2014b). Until 2016, by law, transfers to subnational governments will grow 3% per annum in real terms. Additional one-off resources are transferred when real GDP grows above 4%. After 2016, transfers will grow at the same rate as revenues in the four previous years. This smoothes out most short-run fluctuations, but linking transfers to the central government's structural revenues, in line with the fiscal rule, would be better.

Subnational governments have significant expenditure responsibilities, but local revenues are limited. Most expenditures are financed through earmarked transfers from the central government, leaving little incentive to improve the allocation of these resources at the local level (OECD, 2014b). Property and excise taxes are the main sources of revenues for departments and municipalities. However, few municipalities have up-to-date cadastral and land registries, as they currently have to compensate the national technical office (IGAC) to compute property values and they are often pressured by local lobbies not to do so. Therefore, the national government should provide cadastral services free of charge – or at a lower cost – and reward greater subnational tax effort by, for example, linking increases in transfers from the central government to subnational revenue growth. This would also help develop land markets needed to increase efficiency in the use of land.

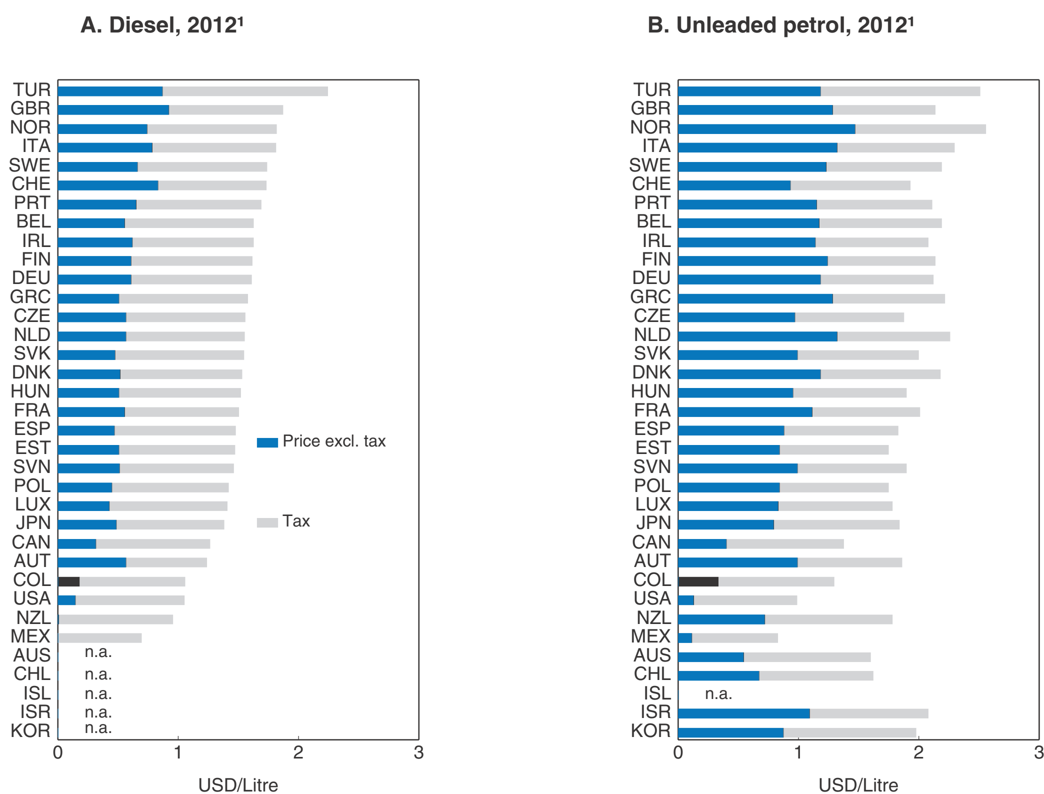
Reforming the system for sharing national tax revenues with subnational governments would improve stable and sustainable financing for the latter. The central government shares around 30% of its total revenues with subnational governments. Transfers are earmarked for current expenditures for education, health and sanitation, and capital expenditures are financed with own resources and the oil and mining royalty transfers. Co-ordinating better both systems would improve efficiency in subnational expenditures (OECD, 2014a).

Greening the tax system

One of the largest environmental issues is the stress on biodiversity imposed by the expansion of extractive industries, urbanisation, road traffic and livestock grazing (OECD/ECLAC, 2014). Greenhouse gas emission intensity is slightly higher than the OECD average, due to emissions from agriculture (OECD/ECLAC, 2014). The surface area used for oil extraction and mining has also increased significantly, and some activities, particularly illegal mining, pollute water and soil. Energy-linked CO_2 emissions are low thanks to heavy reliance on hydropower. However, Colombia has not many instruments to discourage environmentally damaging activities and to encourage improved environmental performance. In this sense, introducing a carbon tax as proposed by President Santos in 2012 and recently implemented by Chile and Mexico would be a step in the right direction.

Revenues from environmentally-related taxes are low and mainly come from taxes on transport fuels. Environmentally related taxes represent just 3.6% of total tax revenues, compared to 5.7% in OECD countries. Tax levels on fuels do not fully reflect their environmental impact (Figure 11), which has resulted in implicit fuel subsidies. Nevertheless, compared to other oil-producing countries, especially in Latin America, Colombia's fuel prices are much closer to international standards. In particular, the 2012 reform reduced the difference between diesel and petrol, but the surtax on top of the combined VAT and excise tax is still lower for diesel. The resulting increase in diesel consumption has probably increased the negative environmental impact of transport. While the reform took steps in the right direction, differentiating fuel taxes according to their energy content or their impact on GHG emissions and local air pollution would be more effective (OECD/ECLAC, 2014).

Figure 11. **Road fuel prices**



1. Diesel fuel: automotive diesel for commercial use, in current USD. Unleaded petrol: Unleaded premium (RON95) except NZL (RON96), COL and JPN (regular unleaded); USD at current prices and PPP (COL: 2011 PPP).

Source: OECD (2013), *Environmental Statistics database*.

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Recommendations on raising revenues and making the tax mix more efficient and fair

Key recommendations

- Undertake a comprehensive reform of the tax system to raise fairness, growth and revenues.
- Reduce tax evasion by strengthening the tax administration and by increasing penalties.
- Reduce the tax burden on investment by gradually lowering the corporate income tax rate, phasing out the net wealth tax on firms and eliminating VAT on investment.
- Make the personal income tax more progressive by taxing dividends and eliminating regressive exemptions.
- Introduce a carbon tax to deal with emissions in a cost-efficient way.

Further recommendations

- Broaden the corporate income tax base by eliminating exemptions and special regimes. Unify the corporate income tax with the CREE surtax in the medium term.
- Include shares of businesses in the wealth tax base for individuals and reduce the tax rate.
- Increase the standard VAT rate, if more revenue is needed. In the medium-term, broaden the base and eliminate exemptions on non-essential items.
- Assist subnational governments in updating cadastral property values. Link increases in transfers from the central government to subnational revenue growth.
- Co-ordinate the revenue sharing system better with the oil and mining royalty sharing system. Link transfer growth to the central government's structural revenues.
- Adjust tax rates on transport fuels to reflect their environmental impact.

Promoting more inclusive growth

Structural policy settings across product, labour and financial markets support growth, but despite good short-term prospects, sustaining growth and making it more inclusive will be a challenge, especially if the oil and mining wealth starts to run out. It is crucial to raise productivity and competitiveness outside the commodity sector to create more jobs in the formal sector. Productivity would be enhanced by reducing informality through upgrading skills training and changes in labour market policies. Some dimensions of the business climate clearly show positive developments. In particular, regulations have been simplified in a series of areas, which is reflected by the continuous improved of Colombia's ranking in the World Bank's Doing Business Indicators. Despite these positive outcomes, more reforms are needed to reduce barriers to trade and competition, strengthen public governance, close transport infrastructure gaps, increase access to finance and make labour markets more efficient and inclusive.

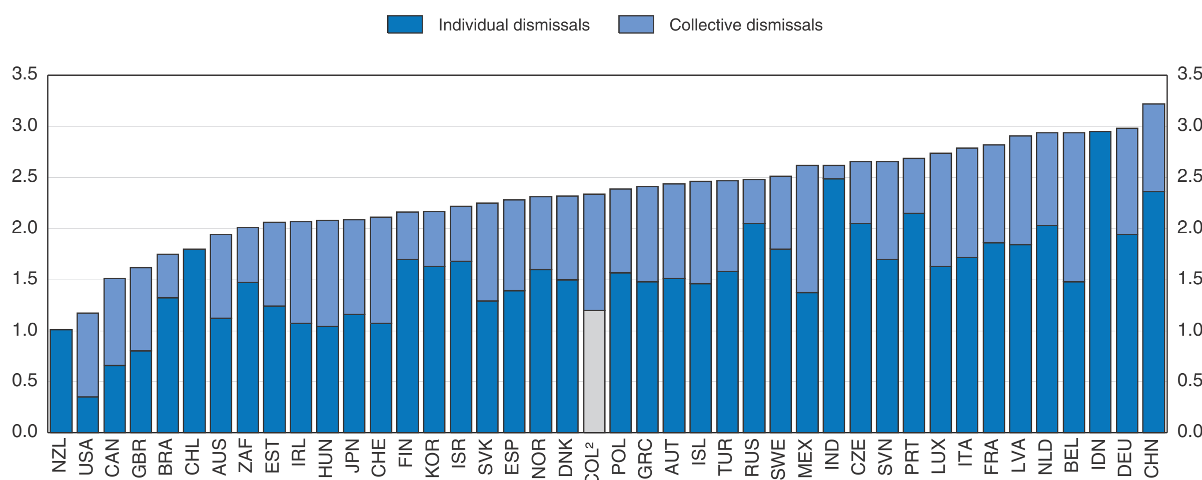
The increased budgetary allocations for education and early childhood development in the 2015 budget are a step in the right direction. This will help to enhance enrolment at the pre-primary and tertiary level. At 50%, pre-primary enrolment remains well below the OECD average (close to 90%) and should be further increased. Access to tertiary education has increased, tripling during the last 20 years. Nonetheless, at around 45%, the Colombian gross tertiary enrolment rate is well below the OECD average (70%) or other Latin American

countries (e.g. Argentina 78% or Chile 74%). As recommended in the *2013 OECD Economic Assessment*, the quality of education should be improved, while more training should be provided to teachers to increase and modernise their qualifications.

Labour and product market regulations are close to the OECD average

Colombia ranks around average with respect to employment protection legislation compared to OECD countries (Figure 12). For example, fixed-term contracts can be renewed indefinitely (after three fixed-term contracts the duration of a fixed-term contract must be at least one year). Despite this flexibility in the labour law, companies and the public sector use subcontracting services extensively to reduce costs. Protection against unemployment was recently enhanced (*Mecanismo de protección al cesante*) by extended social protection for some unemployed, a network of public employment services, active labour market policies and a voluntary system of individual unemployment savings accounts. While it is too early to evaluate this system, it is a step in the right direction. However, challenges in the enforcement of labour rights persist. Despite recent progress, there are still too few labour inspectors, they lack training, job security and authority, and the collection of fines continues to be problematic (US Department of Labor, 2014).

Figure 12. **Protection of permanent workers against individual and collective dismissals, 2013**[1]



1. Data refer to 2013 for OECD countries and Latvia, 2012 for other countries. The figure presents the contribution of employment protection for regular workers against individual dismissal (EPR) and additional provisions for collective dismissal (EPRC) to the indicator of employment protection for regular workers against individual and collective dismissal (EPRC). The height of the bar represents the value of the EPRC indicator.
2. For Colombia, data are preliminary and have been estimated in collaboration with the Inter-American Development Bank.

Source: *OECD Employment Protection Database*, 2013 update.

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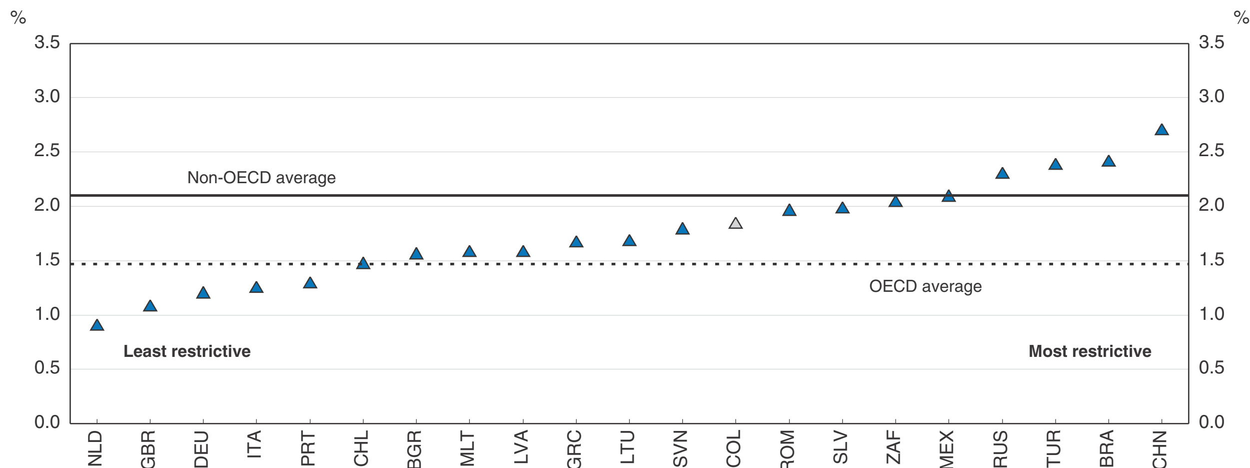
Colombia's product market regulations are less restrictive than in most non-OECD countries but somewhat above the OECD average (Figure 13). In particular, barriers to trade remain high. Lowering these barriers could increase productivity and growth. Productivity is hindered by the lack of competition in product markets such as telecommunications, food and the retail sectors. For instance, while Colombia has improved its telecommunication regulatory framework and promoted the internet economy, concentration in the mobile and fixed-line markets is still one of the highest in the world. Despite the successful auction

Figure 13. **Product market regulation**

Index scale 0 to 6 from least to most restrictive



Note: Diamonds represent scores and lines represent the 90% confidence intervals derived from the random weights analysis.
Source: *OECD Going for Growth database.*

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in 2013 of 4G mobile licenses that allowed the entry of two new companies to the mobile market (see Annex), stronger competition is still needed to increase adoption rates and extend the benefits of telecommunication services to all Colombians (OECD, 2014b).

The competition law of 2009 has improved competition policy settings, but it could be strengthened in various aspects. More political independence of the Superintendency of Industry and Commerce (SIC) would allow it to function more effectively. The SIC's law enforcement policies should be more transparent. Furthermore, reducing the high turnover of SIC employees, modifying the competition advocacy system to ensure effective competition assessment, and improving communication to raise the public's understanding of competition and the role it serves in promoting economic prosperity would be helpful. In addition, further efforts are needed to address the strong resistance to competition policy principles exhibited by the agricultural sector.

Strengthening public sector governance

Colombia has made progress towards a public policy framework that facilitates effective policy-making to improve economic performance. Colombia has adopted a good-governance framework, with a performance assessment system that is advanced by OECD standards, a modernised budget process and significant improvements to institutionalise its public service. Regulatory simplifications have reduced red tape, but contract enforcement is still cumbersome and costly. Regulatory policy would benefit from a more systematic approach to *ex ante* and *ex post* regulatory impact assessments and evaluation (OECD, 2013b). The National Council for Economic and Social Policy recently approved a policy document (CONPES 3816 of 2014) that will gradually move towards the mandatory use of regulatory impact assessments and other tools, as well as building the necessary institutions and capacity. In this sense, the implementation of this document would be a step in the right direction.

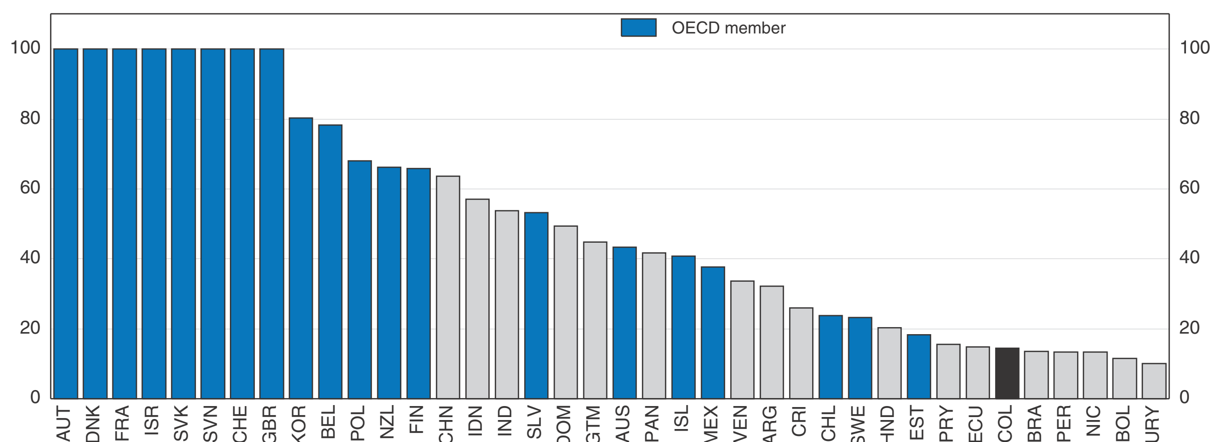
Despite positive developments in enhancing the transparency and accountability of government, corruption remains a problem in Colombia. It still ranks first among the constraints to doing business in Colombia (WEF, 2014). Colombia has joined the Open Government Partnership, and is starting to implement some of its commitments, mainly regarding service delivery. The adoption in March 2014 of Law 1712 of 2014 – on Transparency and Right to Access Public National Information – represents an important milestone in this regard. Colombia joined the OECD Anti-bribery Convention in 2013. Some additional positive steps have been taken, such as the creation of the National Public Procurement Agency in 2011, which centralises public procurement and improve efficiency and transparency. However, it needs greater capacity and resources to fulfil its goals. Furthermore, the Anti-corruption Statute of 2011 redefined the legal framework to fight corruption and strengthened the mechanisms to prevent, investigate and punish acts of corruption, and the effectiveness of public control (OECD, 2013c).

Closing transport infrastructure gaps

Transport infrastructure (Figure 14) is a constraint on growth, as almost half of Colombia's exports are logistics-intensive or time-sensitive (OECD/ECLAC/CAF, 2013). Despite improvements in easing regulations, exporting a container still costs more than twice as much in Colombia as in OECD economies, mainly because of domestic transport costs (World Bank, 2013). Enhancing access to international markets is needed if Colombian firms are to take full advantage of the recently signed free trade agreements with the EU and the US.

Figure 14. **Paved roads (per cent of total roads)**

2011 or latest date



Source: World Bank World Development Indicators and CAF (2013), "La Infraestructura en el Desarrollo Integral de América Latina", CAF, Latin American Development Bank, IDeAL, Caracas.

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Transport infrastructure investment increased from around 1% of GDP in 2000 to almost 2.5% in 2011, mostly through more private participation. Nevertheless, this level of investment may be insufficient to close Colombia's infrastructure gap (Clavijo, Vera and Vera, 2013a). The new public-private partnership (PPP) legislation provides a coherent framework to attract more private investment and reduce past problems of costly renegotiations of contracts (Bitran, Nieto-Parra and Robledo, 2013). It also puts emphasis

on value-for-money analysis in choosing the contractual form for executing projects. Furthermore, the recent creation of a vice-ministry of infrastructure and a National Infrastructure Agency will increase administrative and technical capacities to strengthen the overall investment project cycle. However, the government should continue monitoring the potential fiscal risks closely, and ensure that the financing (including future liabilities) are transparently accounted for.

These changes should attract more private investment needed to finance the road concessions projects planned for 2015-20 of around 6.5% of 2013 GDP. Official estimates show that this would increase potential GDP growth by 0.7 percentage points over the next decade. Infrastructure gaps are also being reduced by local and regional infrastructure projects financed by oil and mining royalties under the recently reformed royalty sharing system, which are coming on stream in the next few years.

Infrastructure investment is hindered by institutional bottlenecks that create uncertainties and delays. New legislation has recently been approved to streamline the land acquisition process and to enhance environmental licensing. However, the cumbersome consultation process with citizens and minorities could be streamlined to raise efficiency and strengthened to better guarantee the rights of local communities (ANIF, 2014). This can be achieved by a clear definition of procedures, especially regarding compensation payments and a definition and registry of the minorities entitled to participate (Infrastructure Commission, 2012). Performing consultations and environmental assessments jointly before granting contracts would reduce costly risks and delays.

The new oil and mining revenue sharing system decentralises planning and execution of projects, which improves the framework for subnational infrastructure investment. However, more capacity building and technical assistance would strengthen local planning and execution. Despite better co-ordination of investment across levels of government in the new framework, the system remains complex. Furthermore, most resources are allocated to municipalities, which tend to favour small local projects. This fragmentation means that large scale infrastructure projects with higher social returns might not be prioritised sufficiently (OECD, 2014a). Using incentives such as matching grants and building institutions to co-ordinate broader regional infrastructure projects across departments could be a solution. In this sense, a recent proposal of extending performance contracts ("*Contratos Plan*"), which include financial incentives to prioritise these investments and penalties for non-compliance through the National Development Plan 2014-18, should be implemented.

More competition in the banking system would boost financial development

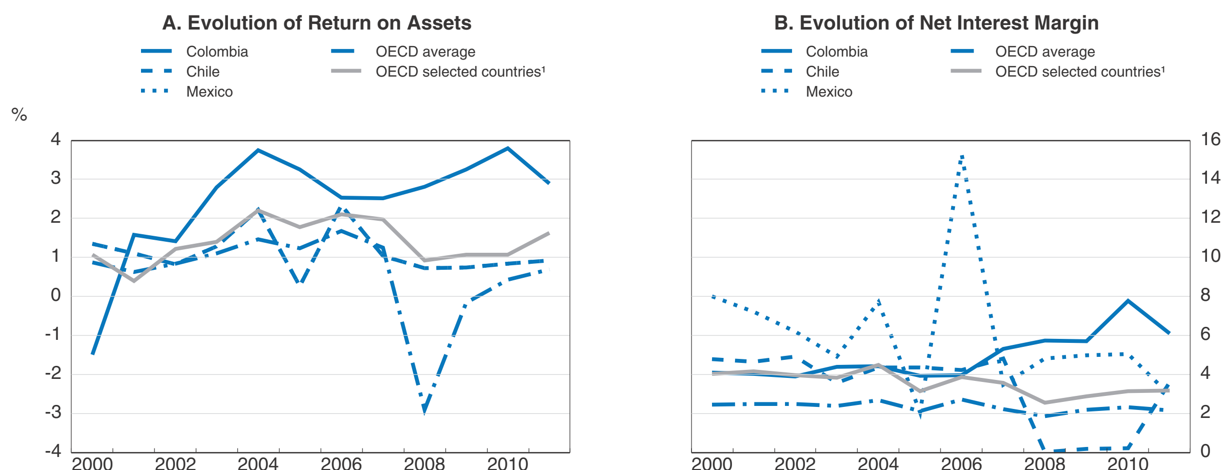
Domestic credit to the private sector has increased significantly, but financial deepening remains limited and firms face important barriers to accessing finance. In the wake of the 1998-2000 banking crisis, credit to the private sector contracted from its peak of 33% of GDP in 1997 to 20% of GDP in 2003. Since then, it has increased to almost 41% of GDP in 2013, which is still low compared to the OECD average (above 150% of GDP) or e.g. Chile (100% of GDP). This pattern also holds for equity and debt financing (Medellin and Pedroza, 2014). In particular, SMEs face difficulties in accessing credit. For example, the share of SME loans in total business loans has declined and is below most OECD economies. The share of short-term loans has increased, and interest rate spreads for SMEs compared to large firms are also high despite the decline in the funding rate.

There is room for deepening financial markets by increasing efficiency and competition in the banking system. Since 2008, new banks have entered the market as several existing financial service providers decided to become banks, and several foreign banks entered Colombia. Nevertheless, profitability indicators and net interest margins remain high compared to OECD economies (Figure 15). Higher margins reflect in part an increase in more risky consumer loans, but the co-ordinated reduction in 200 BPS in mortgage rates (as part of the PIPE), indicates significant intermediation margins. Estimates of cost efficiency and market contestability show that efficiency and competition in Colombia's banking system is relatively low (Figure 16). Inducing more competition in the banking system by avoiding excess concentration and enforcing anti-trust regulations could lower the cost of finance and improve access.

Enhancing the supervisory power of the Superintendence of Finance (SFC) would also have positive effects on the banking system. In particular, while the SFC is financially independent, the superintendent is directly appointed by the President and does not have a fixed-term appointment, which reduces its independence. The Colombian authorities are currently exploring the legal alternatives to enhance the *de jure* independence.

The cost and access to finance is also influenced by regulatory requirements. Banks are required to hold securities that finance the second-tier agricultural guarantee fund (*Finagro*) create distortions in portfolio allocations (OECD, 2013a). The financial transaction tax, despite exemptions for small transactions, harms access to formal credit markets. Furthermore, it creates barriers to competition by exempting transactions within the same institution of the same holder. Colombia still faces problems with creditor rights, uncertainties regarding collateral recovery and weak contract enforcement. Forced investments and the financial transactions tax should be phased out. Legal reforms that increase creditor rights and make the judiciary process more efficient would enhance competition and banking efficiency.

Figure 15. **Profitability and intermediation margins in the Colombian banking system remain high**



1. OECD selected countries is the average of 9 OECD Countries: Chile, Czech Republic, Hungary, Israel, Poland, Slovak Republic, Slovenia, South Korea and Turkey.

Source: Daude and Pascal (2015), based on *Global Financial Development Database*, World Bank, Bloomberg and SNL Financial.

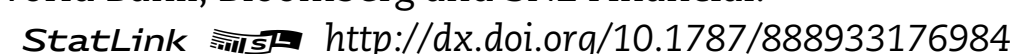

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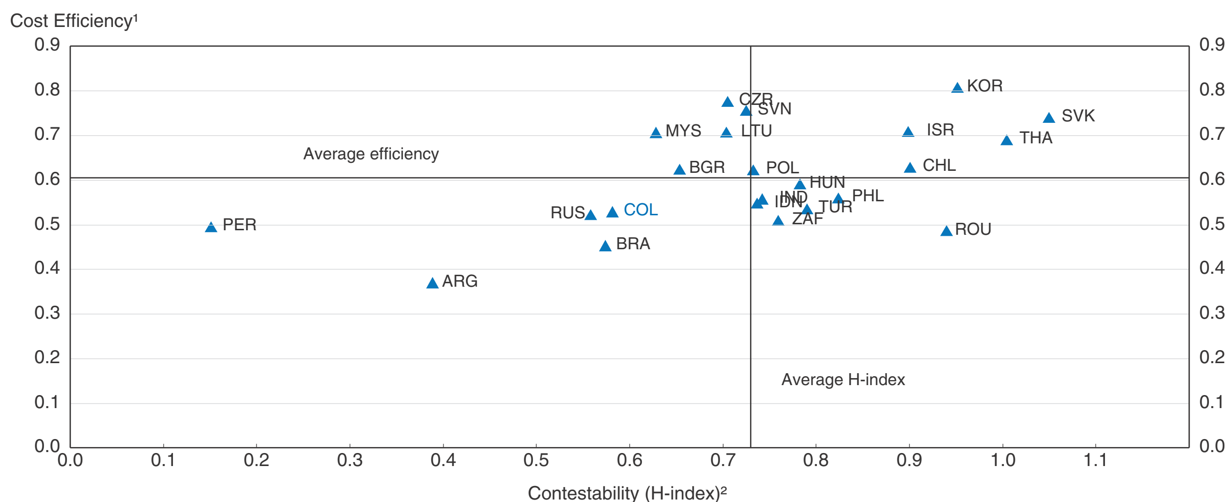
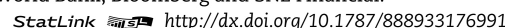
Figure 16. **Efficiency and competition in the banking system are comparatively low**



1. Cost efficiency (CE) is a measure of the relative distance from the efficient frontier. It ranges between 1 and 0 for a fully efficient and a fully inefficient firm, respectively.
2. The Contestability H-index captures the elasticity of bank interest revenues to input prices. The H-index is equal to one in case of perfect competition and it ranges between 0 and 1 in monopolistic competition. Below 0, the index implies a monopoly.

Source: Daude and Pascal (2014), based on *Global Financial Development Database*, World Bank, Bloomberg and SNL Financial.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Making labour markets more efficient and inclusive

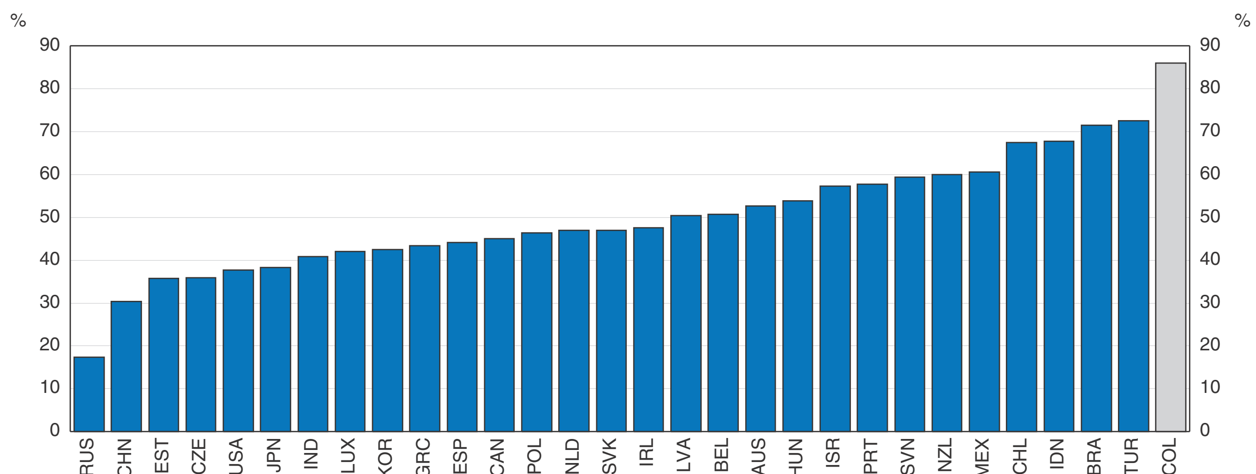
Despite improvements, labour-market inefficiencies are still a source of inequality. The labour force participation rate has fluctuated around 62% since the early 2000s and is around 64% since 2011. The unemployment rate has decreased significantly since 2001 from almost 15% to just above 9%. However, the employment rate of women is only 48% compared to more than 73% for men. Moreover, the most educated enjoy a very large, albeit declining, wage premium (Joumard and Londono Velez, 2013), exacerbating income inequality. This reflects the limited access to pre-primary and tertiary education for poor households. Furthermore, tertiary qualifications often do not match the skill requirement of the labour market. Around 45% of firms identify an inadequately educated workforce as a major constraint, up from 30% in 2006 and compared with 20% in OECD economies (OECD, 2013a).

High informality reduces productivity and compounds inequalities

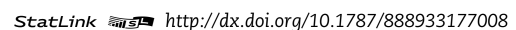
Colombia has one of the highest labour informality rates in Latin America, and it is above what would be expected given the country's level of economic development (Pallares-Miralles, Romer and Whitehouse, 2012). High informality exacerbates inequalities, because the informal sector has limited access to finance and public benefits, and intensifies the difficulties faced by the pension and the tax systems by narrowing contribution and tax bases. Depending on the definition, informal employment accounts for 50% to 70% of total employment. Youth, female, low-skilled workers and those displaced by political violence are the most likely to work informally (Bernal, 2009, Ibáñez and Moya, 2009a and 2009b). However, many workers tend to experience periods of informality followed by periods of formality.

The high minimum wage contributes to informality. The national minimum wage is 86% of the median wage, which is well above the OECD average (Figure 17). However, almost half of the total workforce (formal and informal) earns less than the minimum wage. As shown in the *2013 OECD Economic Assessment*, in many less developed regions the minimum wage is well above the average wage and informality is well above the national average. The high minimum wage reduces employment prospects for low skilled workers, youth and people located in less developed regions, and minorities. The high minimum wage reflects a history of large annual increases above inflation. To gradually return the minimum wage to a more job-friendly level, its increase should be limited, for some time, just to inflation. Differentiating the minimum wage by age would promote the employment of low-skilled youth. Noteworthy, the apprenticeship programme already allows trainees with no university degree to be paid 75% of the minimum wage.

Figure 17. **Minimum wage as per cent of median wage in 2012**



Note: For Russia, China, Indonesia and India it's a ratio as % of average wage in 2012.
Source: OECD (2014), *Going for Growth database*.

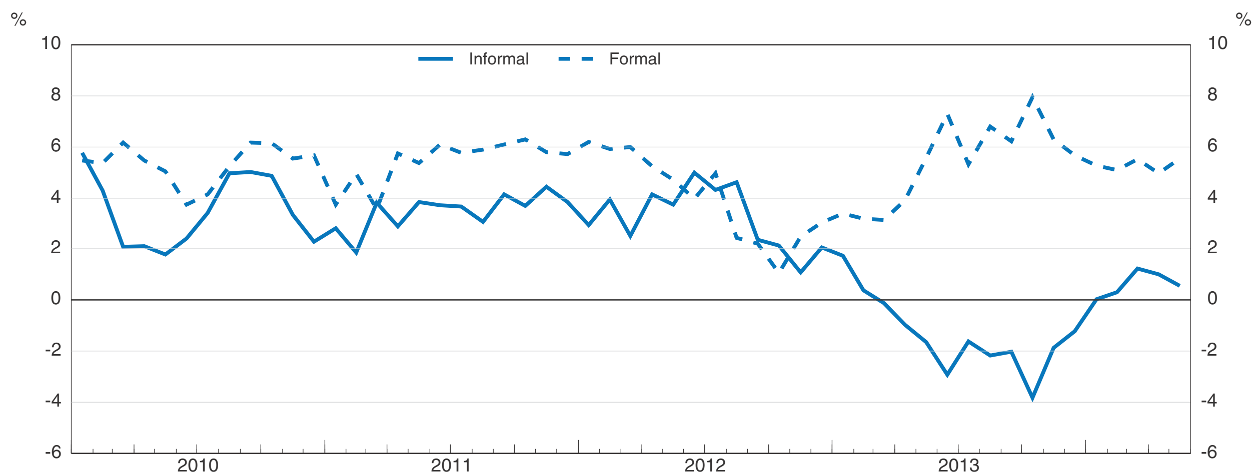


High non-wage labour costs also encourage informality. Formal job creation increased following the 2012 tax reform, which lowered social security contributions (Figure 18). Nonetheless, the 1.2 million formal jobs created since the beginning of 2010 is only 5% of the labour force. More should be done to reduce non-wage labour costs further. One option is to reduce or remove the 4% contribution on wages that finance the *Cajas de Compensación* system, which are non-profit private entities that provide family allowances, unemployment insurance and commercial and recreational activities. Recreational and commercial activities should become voluntary.

The Congress is currently discussing a law on overtime hours. The purpose of the law is to go from a night shift of 8 hours to one of 10 hours, with extra pay of 35%. If the law is passed it will move working conditions closer to OECD standards. However, it is important to provide employers enough flexibility to adjust working hours to their production needs by, for example, allowing employers to average working time – and extra-time compensation – over a longer period than a week, as is done in most OECD countries.

Figure 18. **Formal and informal job creation**

Growth rates (y-on-y)[1]



1. Data are calculated with a 3 months moving average (January 2010 is calculated with average from December 2009 to February 2010).
Source: DANE.

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Despite a steady decline, unemployment, at more than 9%, is still high compared to OECD and Latin American countries. Women, youth and those living in urban areas are the most exposed to the risk of unemployment. This high rate exacerbates income inequality (OECD, 2013a). Strengthening active and passive labour market policies would improve labour market outcomes.

Recommendations on promoting inclusive growth

Key recommendations

- Adapt legislation to improve the business environment, foster competition, and make the judiciary process more efficient to enhance the rule of law.
- Create incentives to improve co-ordination of infrastructure projects across subnational governments within the National Development Plan.
- Keep minimum wage growth close to inflation to increase the gap with average wage. In the medium term, differentiate the minimum wage by age.

Further recommendations

- Improve consultation with local minorities and environmental licensing processes by clearly defining how compensation payments are determined and which minorities are entitled to participate.
- Phase out forced investments in agricultural development securities and the financial transaction tax.
- Build more capacity at the sub-national government level to improve infrastructure planning and execution.
- Review the financing of the *Cajas de Compensación* system.

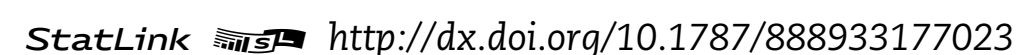
Reforming the pension system and old age income support

Income insecurity among Colombia's elderly is high compared to OECD countries, resulting in very low levels of well-being (Figure 19). Less than 40% of Colombians have a pension and half of the elderly live below the poverty line. This reflects low coverage of the pension system, especially for women and lower-skilled workers, and the lack of other income support for the elderly. Only formal sector workers have been able to contribute to the pension system. Recent reforms have aimed at raising coverage with old-age savings schemes for low-income informal workers, and extending income support for the poorest. So far, the uptake and the level of income support have been low. Reforming the pension system and old-age income support is becoming urgent to enhance equity, reduce income inequality and improve elderly well-being.

Figure 19. **Well-being of people aged 65 years and more**[1]

1. Each country's indicator is expressed as the difference with the OECD average and divided by the OECD standard deviation.

Source: HelpAge International (2013).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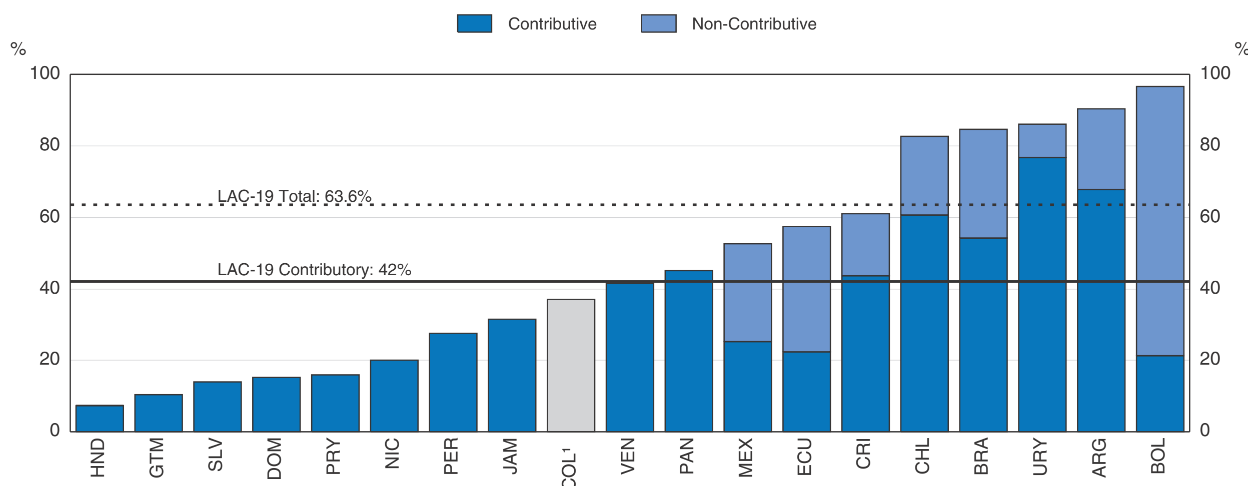
The low coverage of the pension system reflects high informality and stringent eligibility requirements. The public defined-benefit plan and a private defined-contribution plan compete with each other as workers can switch from one to the other several times during their working lives. Only formal sector workers earning at least the minimum wage can contribute to these two plans. The Constitution also requires pensions to be at least equal to the minimum wage, which is costly. The minimum pension represents around 60% of the average wage while, on average in OECD countries, it represent less than 20%. Currently, around 36% of formal employees are in the public scheme and 64% are in the private one. Pension eligibility is also reduced by the

requirements (around 25 years of contributions), given the relatively low stability of low-skilled workers in the labour market. Currently, only 22% of the retirement-age population receives a pension from these two plans, which is low by international standards (Figure 20). An additional 15% is covered by a number of special regimes (judiciary, military and police, teachers, among others). As a result of narrow overall coverage, the overall poverty rate increases from around 31% for working-age population to 42% for people at age 60 and above in contrast to many other Latin American countries (Bosch, Melguizo and Pagés, 2013).

Figure 20. **Pension coverage in LAC countries**

Percentage of people aged 65+ with a pension



1. The population covered by *Colombia Mayor* is not included. LAC-19 is the average of the 19 Latin American countries displayed in the chart.

Source: Bosch, Melguizo and Pagés (2013).

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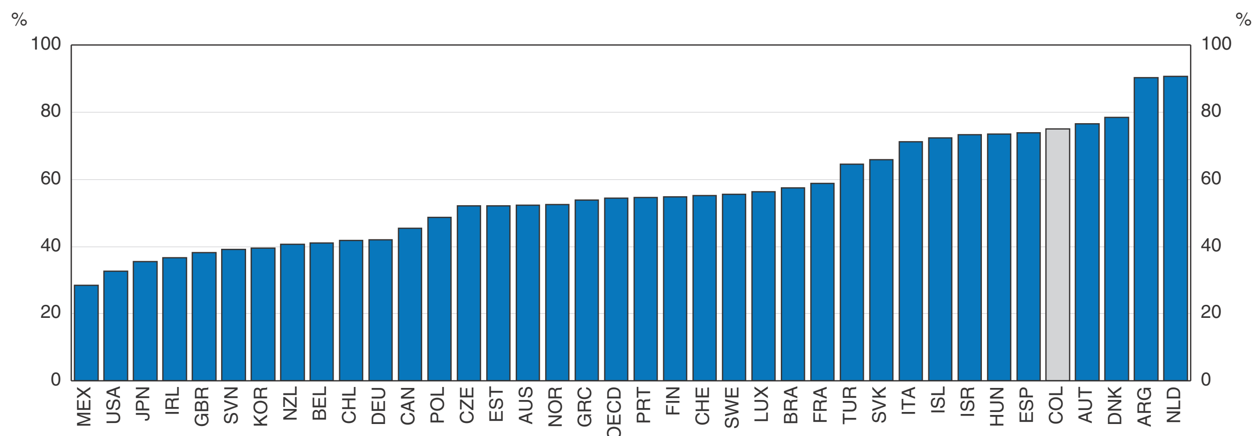
The public defined-benefit plan is very generous for the few that benefit from it contributing to inequality among the elderly. The reference salary to calculate the level of the pension uses the last 10 years of earnings which is much shorter than in most OECD countries and benefits those with steep earnings profiles, frequently the most educated and high-income individuals (OECD, 2013a). The replacement rate between 65-80% of the average contribution wage is high in comparison with OECD countries (Figure 21). It is even higher for people earning the minimum wage as it then reaches 100%. Reforming the system seems high priority to extend coverage and rationalise the benefits.

The long-run sustainability of the generous public defined-benefit plan – high replacement rate for a pension based on a reference salary calculated on few years of earnings – may also be at risk without reform, given current demographic trends. The dependency ratio is projected to rise substantially, as the currently young population is ageing (Figure 22). The situation is worse when considering the economic dependency ratio, which compares the number of people aged 65 and above with the employed (those potentially contributing to the pension system, including informal employment). As a consequence of population ageing, the need for old-age income support for the poor (*Colombia Mayor*, see below) will also increase significantly and put pressure on public finances.

Figure 21. **Gross pension replacement rates in 2013**[1]



1. Expected gross replacement rate of a man earning one average wage. For Colombia, it represents the upper bound of the middle incomes' replacement rate in the public pension scheme.

Source: National Authorities and OECD (2013b).

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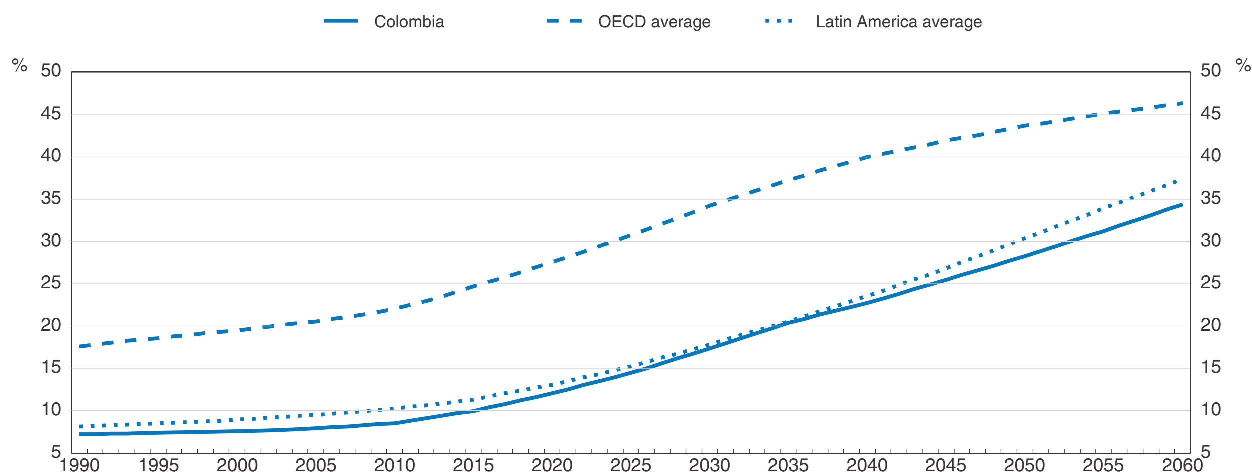
Figure 22. **Dependency ratio**

Population aged 65+ as percentage of the population aged 15-64



Source: UN population projections database.

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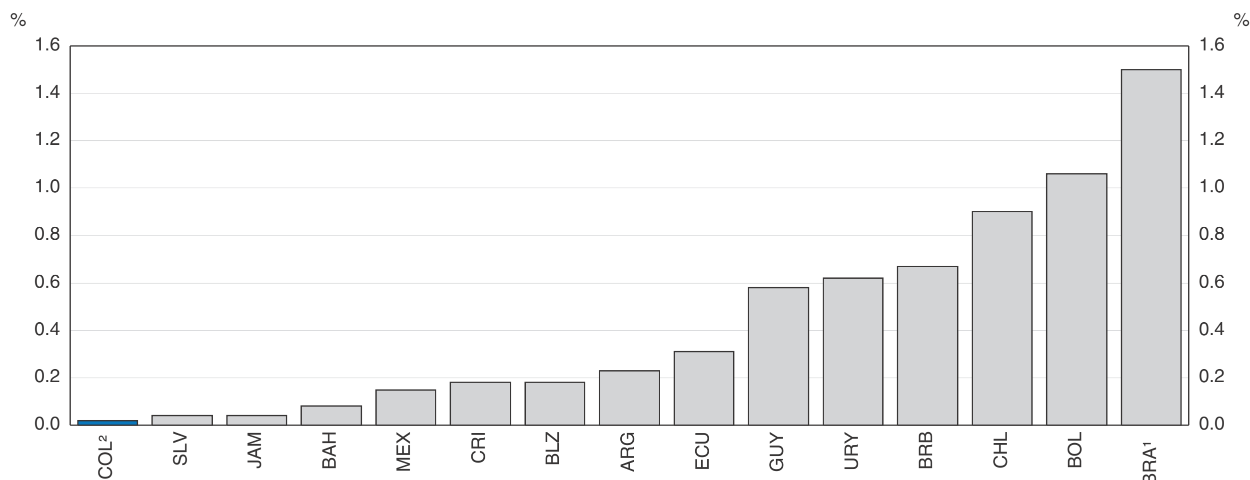
As noted, the two plans described above cover only formal sector workers. To deal with the lack of pensions for workers in the informal sector, the government has recently launched the *Beneficios Económicos Periódicos* (BEPS) programme to extend coverage. However, because pensions are required to be at least equal to the minimum wage, the lower BEPS benefits cannot be called "pensions". The BEPS programme sets up individual retirement accounts, for which the government subsidises 20% of individual contributions for low-income households. People can contribute to the scheme even if they earn less than the minimum wage. Thus, in principle, it allows for a contributory old-age scheme

without the minimum wage constraint. The reform is welcome, although so far only a few thousand people have joined the system. This may reflect the difficulty lower-income people face in saving for old-age.

The government also provides old-age income support for the poor through *Colombia Mayor*. To be eligible, a person should be at least 65 years old and belong to the lowest socio-economic groups. The average benefit is about a tenth of the minimum wage, which is in relative terms below that of most OECD countries, and is well below the Colombian poverty line. It is also reflected in the low share of public spending on old-age income support (*Colombia Mayor*), at 0.02% of GDP compared to Latin American peers (Figure 23). While the number of recipients of *Colombia Mayor* has increased significantly from almost 900 000 recipients in 2010 to more than 1.2 million currently, this expansion was in part financed by a 50% reduction in the average benefit. The Government plans to increase its coverage further to a total of 2.4 million potential legitimate recipients. It is a welcome initiative that should be accompanied by an increase of the benefit.

Figure 23. **Public spending on old-age income support**

% of GDP, 2013



1. For Brazil, spending refers only to rural sector old-age income support.
2. For Colombia, data refer to *Colombia Mayor*.

Source: Coltlear (2011), Inter-American Development Bank, and *HelpAge International Database*.

StatLink http://dx.doi.org/10.1787/888933177065

Options for pension reform in the near term

Pension coverage for all workers can be raised by reforming the two current public and private plans and extending the BEPS. The coverage could be extended, while fiscal costs could be contained, by relaxing the constraint that the minimum pension must be at least equal to the minimum wage, but this would require a difficult constitutional reform. Another option is to give people, who reach retirement age with less than the required number of years, a partial pension. This pension would be equal to the minimum pension adjusted for the difference between the effective contribution period of the retiree and the mandatory 25 years. Coverage can also be increased by expanding the potential beneficiaries of the BEPS, allowing those earning less than the minimum wage and having no access to the BEPS now due to income limits to contribute.

Coverage can also be increased by reforming some characteristics of the public defined-benefit plan. Lowering the replacement rate towards that of the private system (halving it) would eliminate the arbitrage between schemes and reduce the subsidies to the rich OECD/IDB/WB (2014). Considering more years of reference earnings to calculate the level of the pension would raise equity. Equalising the retirement age between men and women – currently at 62 and 57, respectively – would raise female pension coverage through longer contribution periods and higher chances to fulfil the requirements. Gradually moving towards a scheme that increases the retirement age in line with life expectancy would increase long-term sustainability. However, ultimately the solution to expanding pension coverage lies in shifting more of the workforce to the formal sector, where they will be able to pay contributions.

Towards a comprehensive reform

The complexity of the system and the many adjustments required to make it more equitable and sustainable suggest that a comprehensive pension reform is needed. Such a reform should extend the old-age income support (*Colombia Mayor*). The competition between the public defined-benefit and the private defined-contribution plans should be removed as it is costly and inefficient. There are several options regarding the contributory part of the system. The current private defined-contribution plan could be complemented by a basic public defined-benefit plan. In this case, the generosity of the public plan should be reduced significantly. Alternatively, the public defined-benefit plan could be gradually phased out. In this case, attention should be paid to transitional costs to the budget, which can be financed, for example, by a "pension bond", which as one-off payment could fall outside the fiscal rule. Relaxing the constraint of the minimum pension to be at least equal to the minimum wage would also be key to increase coverage. Through the BEPS, the Government would subsidise the contributions of low-income workers.

Recommendations on pensions and old-age income support

Key recommendations

- Thoroughly reform the pension system to reduce old-age poverty and inequality.
- Expand eligibility of the *Beneficios Económicos Periódicos* programme.
- Increase coverage and benefit levels of the minimum public income-support programme (*Colombia Mayor*).

Further recommendations

- Lower the replacement rate and base the reference wage on more years of earnings.
- Equalise the retirement age between men and women. In the medium term, increase the retirement age and link it to life expectancy evolution.

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Thematic Chapters

Chapter 1

Making tax policy more efficient, fair and green

Tax revenues at 20% of GDP remain low compared to other Latin American countries and the OECD average and tax evasion is pervasive. Lower oil revenues and the expiration of a number of taxes are putting strains on the budget at a time when social and development spending needs are rising. Heavy reliance on corporate income taxes reduces investment. At the same time, the redistributive impact of taxation is reduced because most of income and wealth taxes are paid by firms rather than households. Therefore, Colombia needs a comprehensive tax reform that boosts revenues and shifts the tax burden to support more inclusive and green growth. Tax loopholes and exemptions that reduce the tax base and favour mainly the rich should be reduced significantly. Strengthening the tax administration will help reduce evasion.

Chapter 2

Reforming the pension system to increase coverage and equity

Colombia is one of the most unequal countries in Latin America. The high level of informality in the labour market and many characteristics of the pension system leave many elderly in poverty. Only formal-sector employees earning more than the relatively high minimum wage are covered. Linking benefits to at least the minimum wage makes the system costly and reduces the provision of annuities by insurance companies as it is difficult to insure against changes in the minimum wage. The Government has recently introduced a matching-contribution scheme (BEPS) for informal workers and vulnerable retiring aged people who have not contributed enough to be entitled to a pension. Moreover, the coverage of the old-age minimum income support has been extended but at the cost of lowering the already modest benefits. More reforms in the pension system are needed to extend coverage while eligibility to the BEPS and the minimum income support should be expanded to guarantee old-age income for more Colombians. In the medium term an in-depth pension reform is required.

This Survey is published on the responsibility of the Economic and Development Review Committee (EDRC) of the OECD, which is charged with the examination of the economic situation of member countries.

The economic situation and policies of Colombia were reviewed by the Committee on 12 November 2014. The draft report was then revised in the light of the discussions and given final approval as the agreed report of the whole Committee on 3 December 2014.

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