

TAX INCENTIVES COMMISSION: KEY FINDINGS

PUBLIC CONSULTATION

Presentation by the DIAN-OECD Technical Secretariat on
behalf of the Tax Incentives Commission





Tax Expenditures in the Colombian tax system



The TIC has identified and reviewed all **tax expenditures**

Definition: Tax expenditures are provisions in the tax legislation that modify the tax liability of specific groups of individuals or businesses.

Four reform categories:

- (i) Maintain
- (ii) Reform
- (iii) Conditional reform
- (iv) Unclear whether to reform



Colombia's complex tax system is out of step with international standards

- Successive policymakers and legislators have **introduced tax expenditures** in an attempt to **address Colombia's structural economic deficiencies**, and have largely failed
- Almost **yearly piecemeal reforms** have tried to **counteract the system's imbalances**
- To compensate for the **narrow tax base**, **high tax rates are imposed** upon those **who cannot avoid** paying tax in Colombia
- **Highly distortive taxes** (financial transaction tax, ICA, VAT on investment) have been implemented to **help balance the budget**
- And **more tax expenditures** have been introduced to **recompense taxpayers for high tax rates**, further narrowing the tax base and limiting the tax revenues
- The tax system has become **excessively complex**, calling for a fundamental **tax base broadening reform that restores efficiency, equity and raises more revenues**



The timing and extent of reforms to Colombia's tax system are crucial

- COVID-19 pandemic has **increased** the **fiscal deficit**. **Fundamental reform** will be **necessary** to raise the tax revenues to reduce it
- **Balancing act**: not **too quickly** or the tax reform may **harm** the **economic recovery**, but not **too slowly** or growth in **fiscal deficit** **could scare investors** and credit rating agencies
- **Abolishing individual TEs** within each tax will be **ineffective** because of the wide range of TEs. **Ambitious tax base broadening packages** **are necessary** to be effective
- **Some recommendations** will only be feasible if **broader systemic tax reforms** are made and may require **long transitional periods**



Changing the way tax policy is made is crucial if improvements are to be sustainable

1. Stronger mandate and greater resources for DIAN to produce **an annual, standalone, item-by-item, tax expenditure report**
2. Mandatory **framework chapter** in each new tax law that provides the **rationale** for the **reform** and a **detailed economic assessment**
3. Create an **independent body** of public finance experts to assist the Ministry of Finance in (i) developing a **strategy for implementing** the suggested reforms and (ii) the **economic assessments** of tax proposals

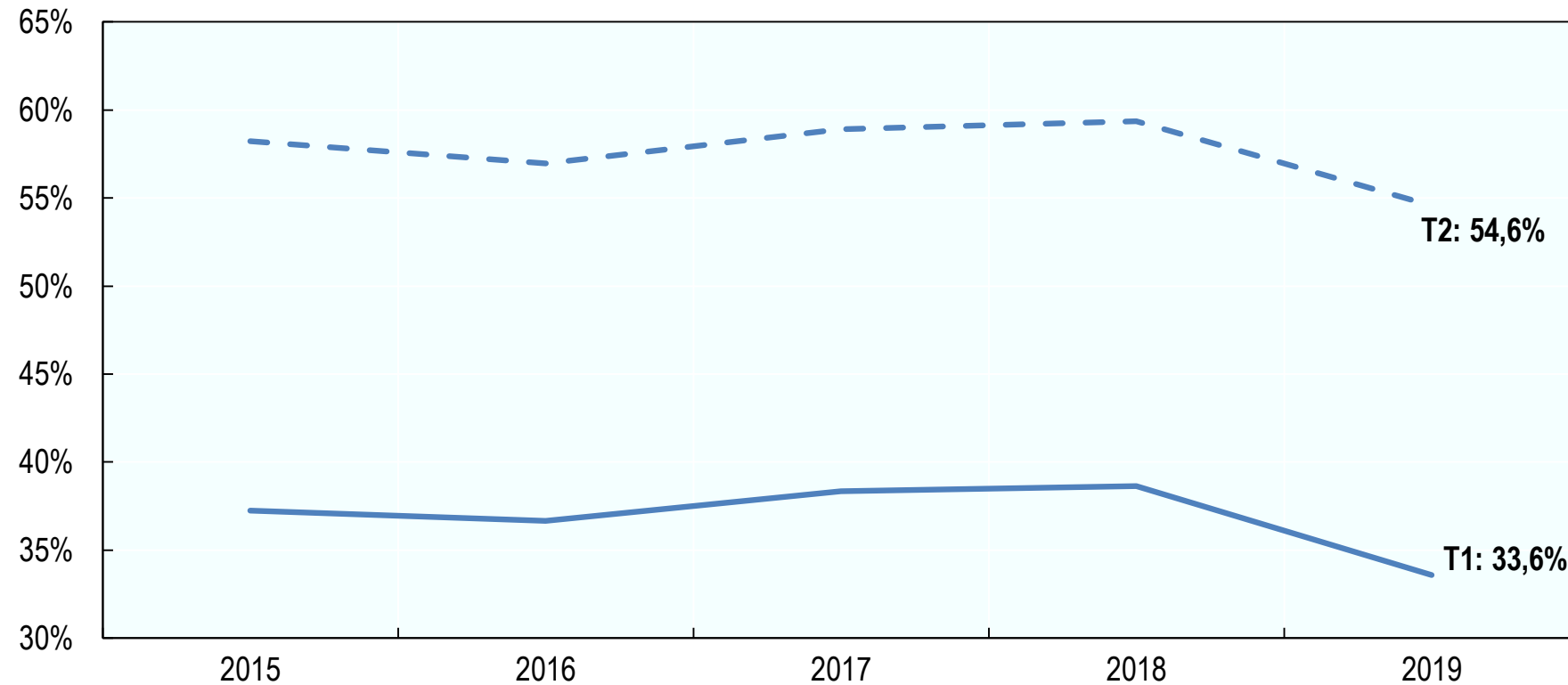


SYMPTOMS OF A DYSFUNCTIONAL TAX SYSTEM



The overall tax burden on businesses would be very high without tax expenditures

Average business tax burden



T1 = Income tax, CREE and surcharges / Accounting profits

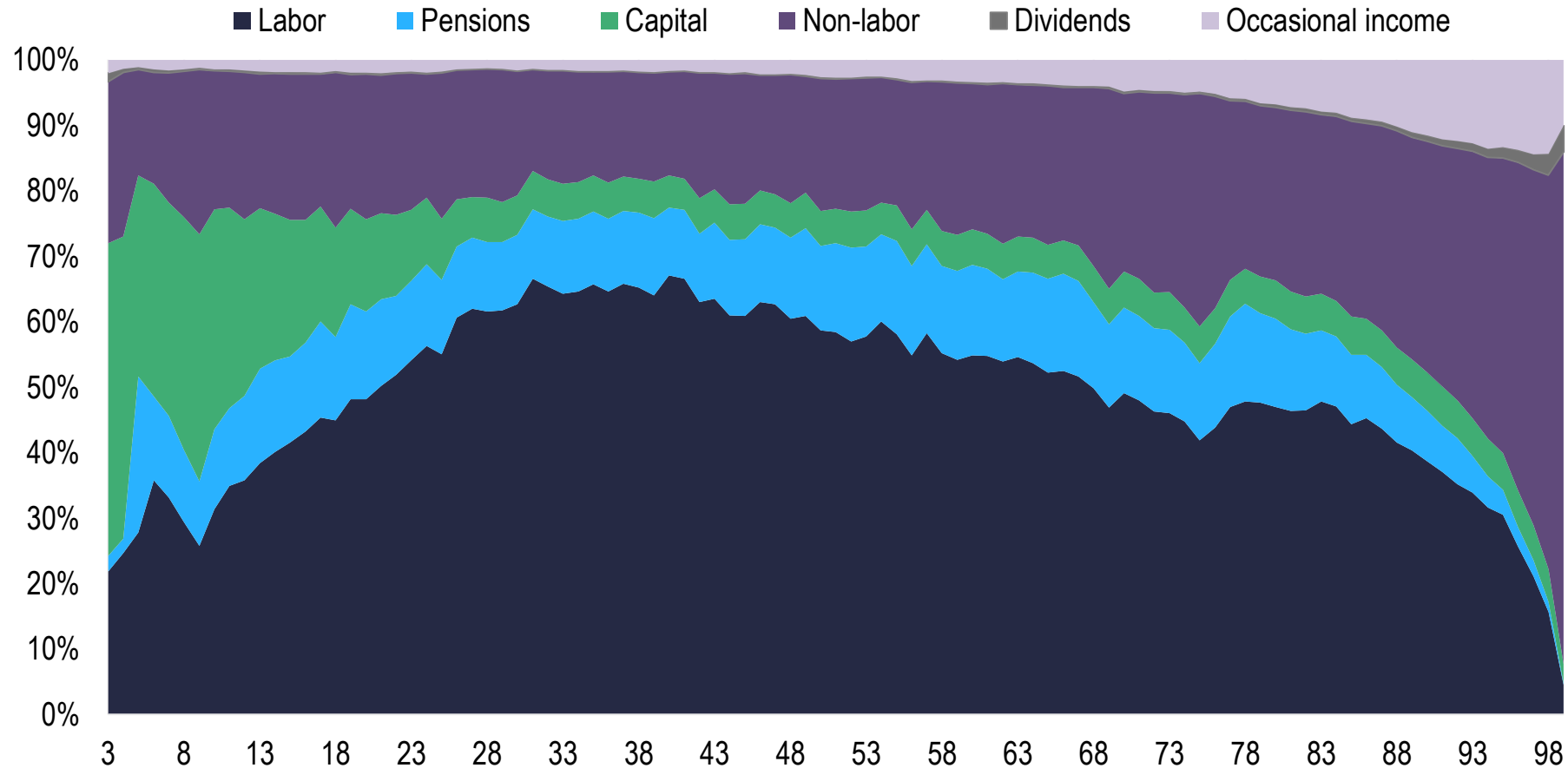
T2 = Income tax, CREE and surcharges + Non-deductible VAT + Turnover tax (ICA) + Debit tax + Customs tariffs + VAT on fixed assets + Property tax + Stamps + Public lighting + Wealth tax + Stamp duty tax) / Profits before all taxes

Source: DIAN (2020)



Business taxes distort how corporations choose to distribute dividends

Distribution of gross income by individuals that file a PIT return across the personal income distribution, 2018

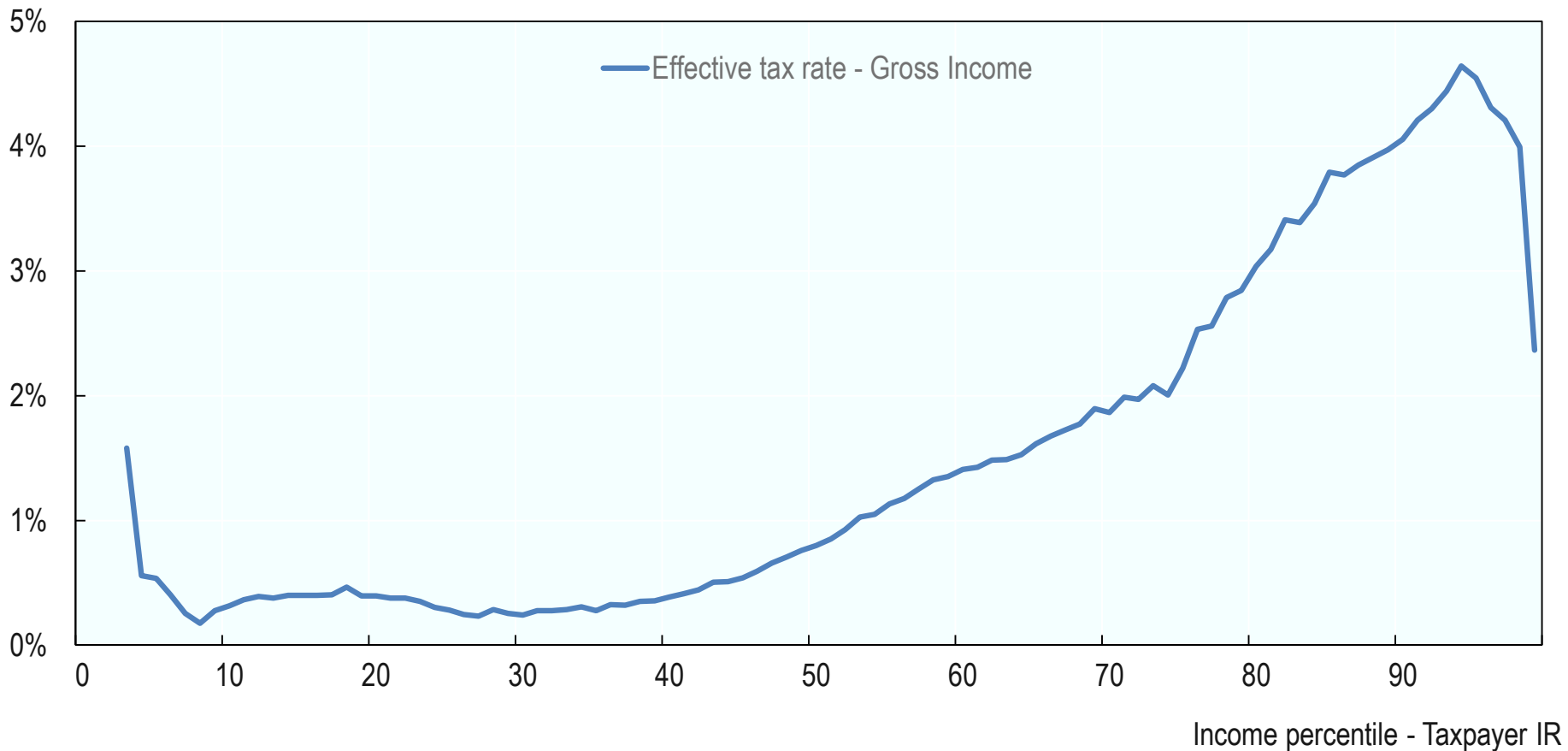


Source: DIAN



The proliferation of tax expenditures and insufficient monitoring result in extremely low effective tax rates

Effective tax liability on income earned at the individual level as a % of total income, 2018

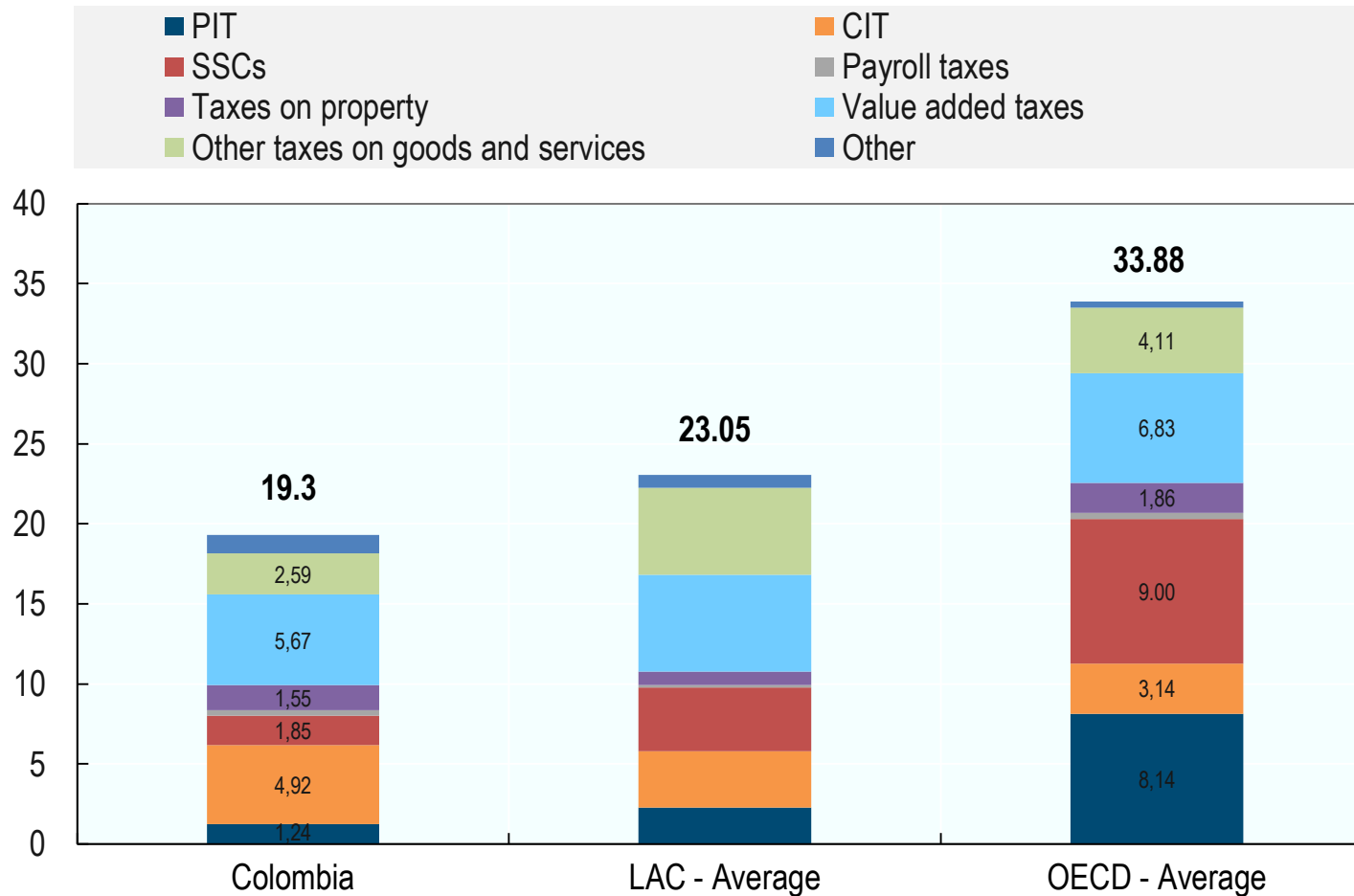


Source: DIAN and MoF

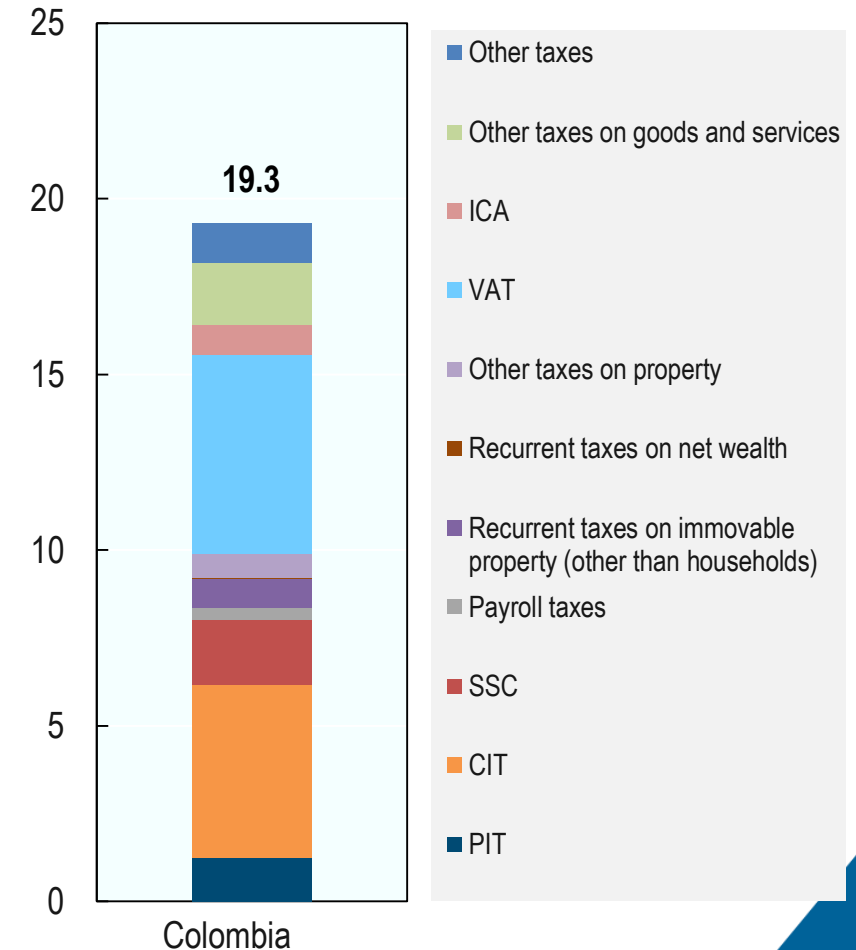


The narrow tax base limits revenue raising capacity, despite Colombia's multitude of taxes

Tax revenue (as % of GDP)



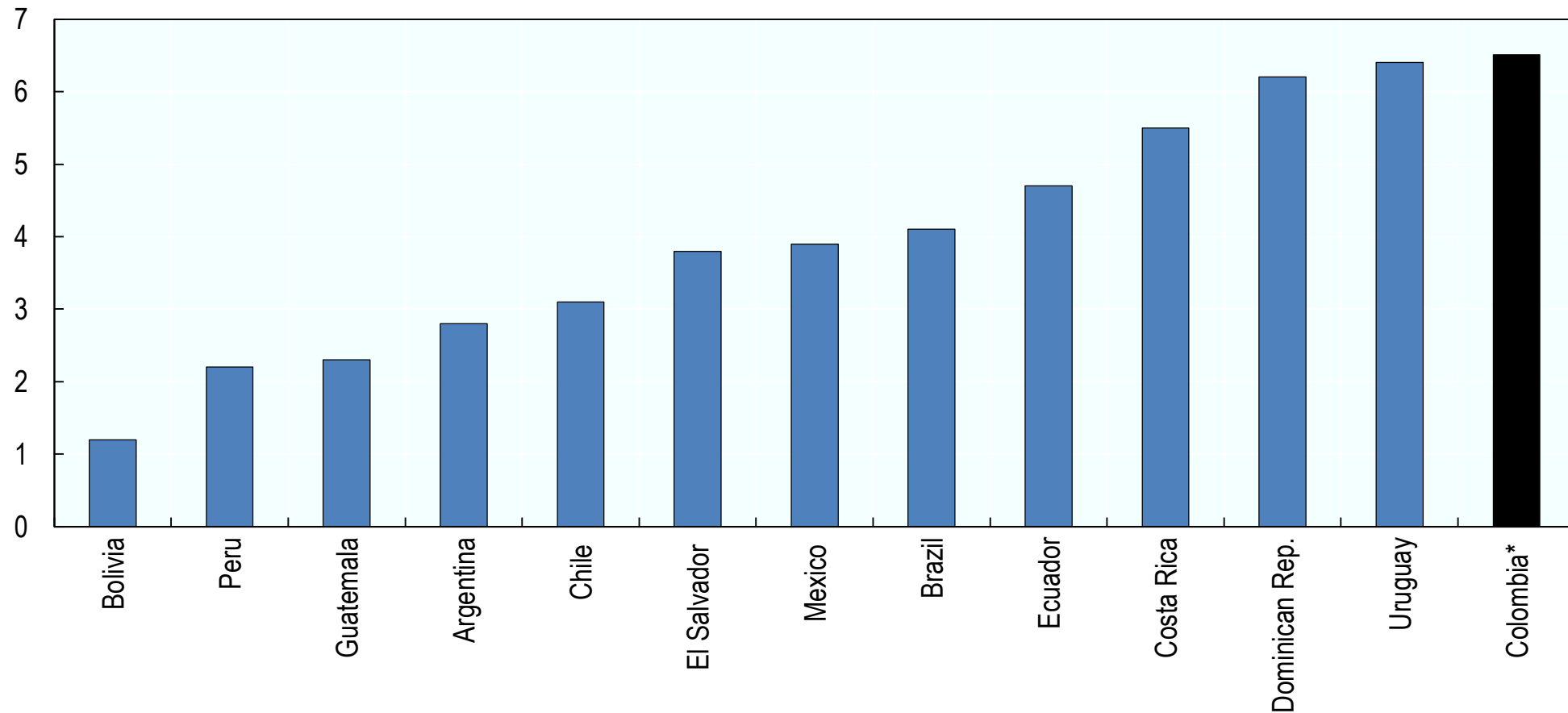
Tax revenue (as % of GDP)





Colombia forgoes more tax revenue than any other Latin American country

Tax revenue forgone as % of GDP



Source: DIAN; CEPAL (2019)



REFORMS BY TAX AREA



Enhance the role of the Personal Income Tax

- Significantly reduce the number of **exempt** and **non-taxable income items**
- Avoid tax **allowances** that **increase with income**
- Lower the **basic tax allowance** and reduce the number of **PIT brackets**; avoid increasing statutory PIT rates
- Tax **pensions** at a **fair effective rate**
- Improve the design of taxes levied on **personal capital income**
- Use **market values** (not historical) to **determine taxable income**
- Strengthen **tax enforcement**, particularly on the self-employed



Broaden the VAT base and improve its design

- Reduce the number of **excluded** and **exempted goods** and **services**
- Ensure that the **VAT compensation mechanism** reaches all the poor and increase the value of compensation when the VAT base is broadened
- If the compensation system cannot reach all the poor in the short run, **continue the 0% tax rate on the basic needs goods basket in the short term**
- Goods and services that cannot immediately be taxed at the standard VAT rate because the compensation system cannot be fully implemented, or that would result in a too high tax increase, could be **taxed at the reduced VAT rate**
- Increase the **reduced VAT rate** from 5% to a rate in the range of 10-12%
- Have **VAT on investment in fixed assets** credited within the VAT
- Bring (Special Permanent) **Free Trade Zones** within the standard VAT regime to prevent abuse



Improve the design of the business tax regime

- Replace **municipal turnover tax (ICA)** with recurrent taxes on immovable property (or grants/transfers or tax revenue sharing)
- Abolish **financial transaction tax**
- Significantly broaden **CIT base, work towards aligning the tax treatment across sectors**, and over time abolish **CIT recapture tax**
- **Avoid non-profit based business taxes**, and lower **standard CIT rate** to an **internationally competitive level**, then merge the FTZs within the standard CIT regime
- Do not reform the **SIMPLE regime** in the short run; encourage businesses to join from sectors with low take-up
- Strengthen the agricultural sector's formalization strategy and **tackle the problems faced by the sector at source** (e.g. infrastructure investment)
- **Redesign profit-based TEs into cost-based TEs** (ZESE and ZOMAC)



THANK YOU!

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