



Ideas to finance the transit to a universal social protection system

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The Colombian Tax System: A Diagnostic Review and Proposals for Reform¹

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Abstract

Colombia's tax revenues are relatively low, and its tax code runs counter to desirable taxation principles. We document this point in detail in the text and use it as a starting point for proposing road maps to improve the current tax code. This process is not merely a matter of adjusting technical parameters. Instead, it entails addressing the principles that should govern public debate, including legitimacy and the importance of graduality when implementing changes. We propose comprehensive reforms to corporate, personal, environmental and health taxes, among others. The proposed changes would take about 10 years to take full effect, allow for a more progressive, more efficient and fairer tax code and raise more than 3 percent of GDP in additional income.

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1. Introduction

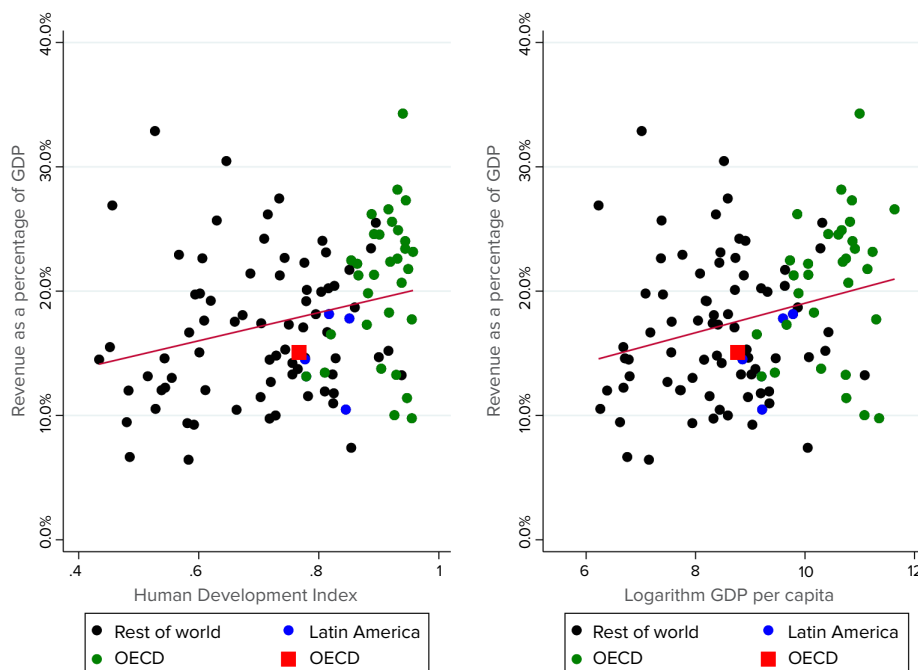
This paper conducts a diagnostic review of the national Government of Colombia's taxation system: the country collects relatively little in taxes and does so in violation of desirable taxation principles. Taking this premise as a starting point, we propose road maps for improving the code by suggesting changes to technical parameters while focusing on the principles that should govern public debate around taxation. These include legitimacy and the importance of graduality when implementing reforms that lead to substantial changes in corporate, personal, environmental and health taxes, among others. The proposed changes would take about 10 years to take full effect, allow for a more progressive, more efficient and fairer tax code and raise more than 3 percent of GDP in additional income.

2. Diagnostic review

2.1. Colombia collects too little in taxes

Various estimates reveal that the revenue collected by the Colombian Government through taxation is falling short. Relative to Colombia's income and human development levels, the national Government's tax revenue as a percentage of GDP is below average compared to the revenue levels of a broad sample of countries (see figure 1).

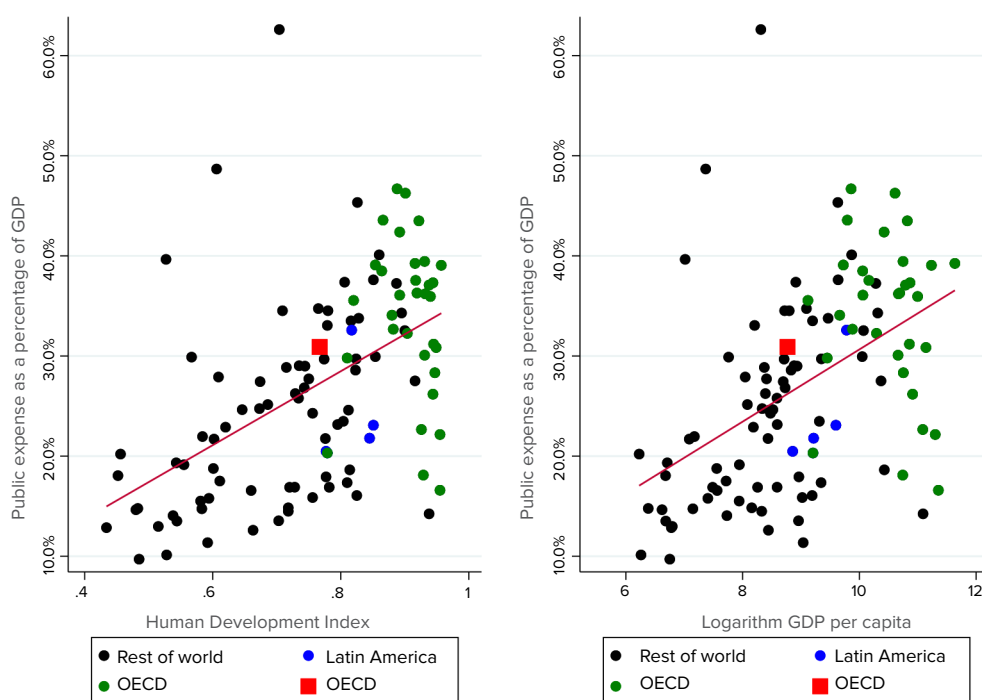
Figure 1. Revenue (as a percentage of GDP) in relation to the Human Development Index and per capita income in Colombia and countries around the world, 2019



Source: Compiled by the authors based on World Bank Open Data and data from the United Nations Development Programme (UNDP) Human Development Reports.
Note: In the World Bank's database, tax revenue refers to "compulsory transfers to the central government for public purposes. Certain compulsory transfers such as fines, penalties and most social security contributions are excluded. Refunds and corrections of erroneously collected tax revenue are treated as negative revenue."

While figure 1 shows that Colombia's revenue levels are lower than its income and development level might lead one to expect, figure 2 shows that the reverse is true for central Government expenditure.

Figure 2. Public expense (as a percentage of GDP) in relation to the Human Development Index and per capita income in Colombia and countries around the world, 2019

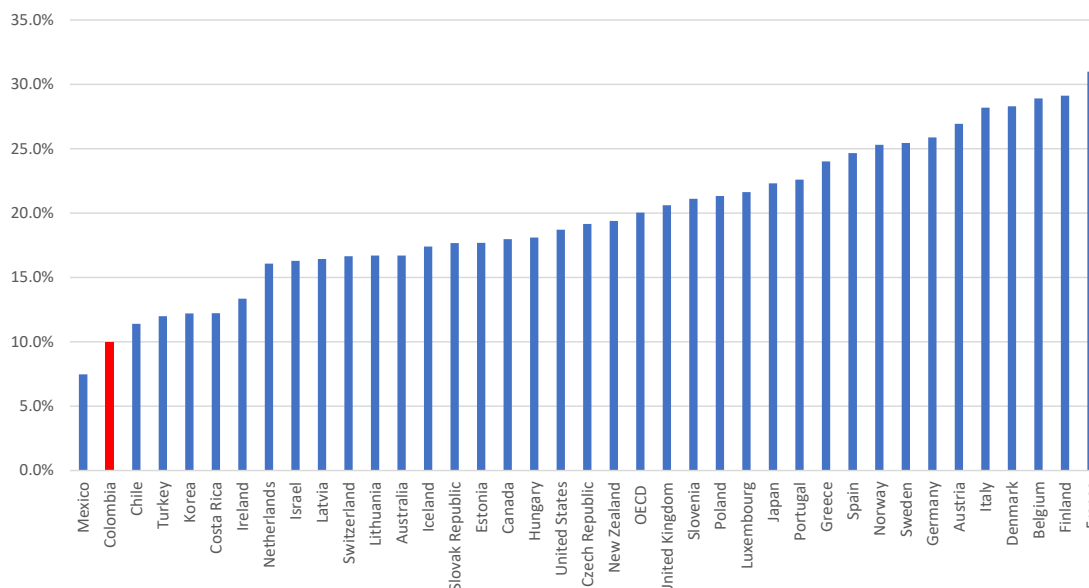


Source: Compiled by the authors based on World Bank Open Data and data from the UNDP Human Development Reports.
Note: In the World Bank's database, public expense is defined as "cash payments for operating activities of the government in providing goods and services. It includes compensation of employees (such as wages and salaries), interest and subsidies, grants, social benefits and other expenses such as rent and dividends."

The paradox of lower-than-expected revenue and high public spending explains the Colombian Government's hefty deficit and points to the challenges surrounding the sustainability of its debt. Although these issues are not discussed in this paper, the impossibility of reducing spending and current social demands make the need to seriously address tax code reform all the more necessary.

It should also be noted that although Colombia's public spending is higher than the average for countries with similar income levels, in many areas, it is very low compared to that of other countries. For example, the country's social spending as a percentage of GDP is the second lowest of all Organisation for Economic Co-operation and Development (OECD) countries (see figure 3).

Figure 3. Social spending (as a percentage of GDP) in Colombia and OECD countries, 2019



Source: OECD (2022).

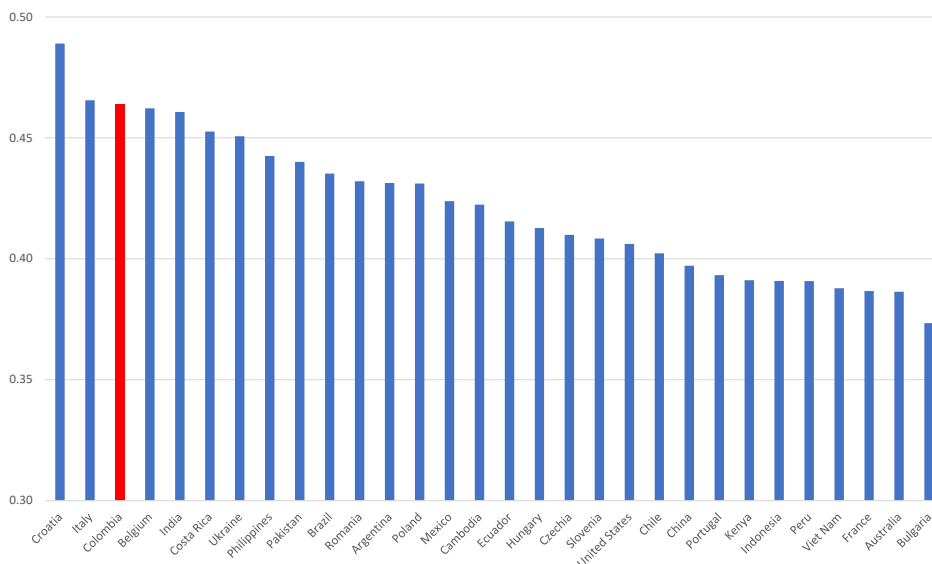
Note: Social spending comprises cash transfers, the provision of goods and services in kind and tax exemptions for social purposes.

2.2. Colombia’s approach to tax collection violates desirable principles of taxation

Colombia’s tax code violates desirable principles of taxation on many levels: it is long and complex, its emphasis falls heavily on companies rather than individuals, it entails enormous horizontal inequities, its role in income redistribution is almost non-existent and tax evasion rates are high. Some of these points are examined in more detail below.

Colombia’s tax code is long and complex and has become increasingly so over time (see, for example, Filippini and Zuleta, 2016). For example, recent data on corporate taxation shows that Colombia has the third-most-complex tax code in a sample of more than 30 countries (see figure 4).

Figure 4. Tax complexity index, 2020

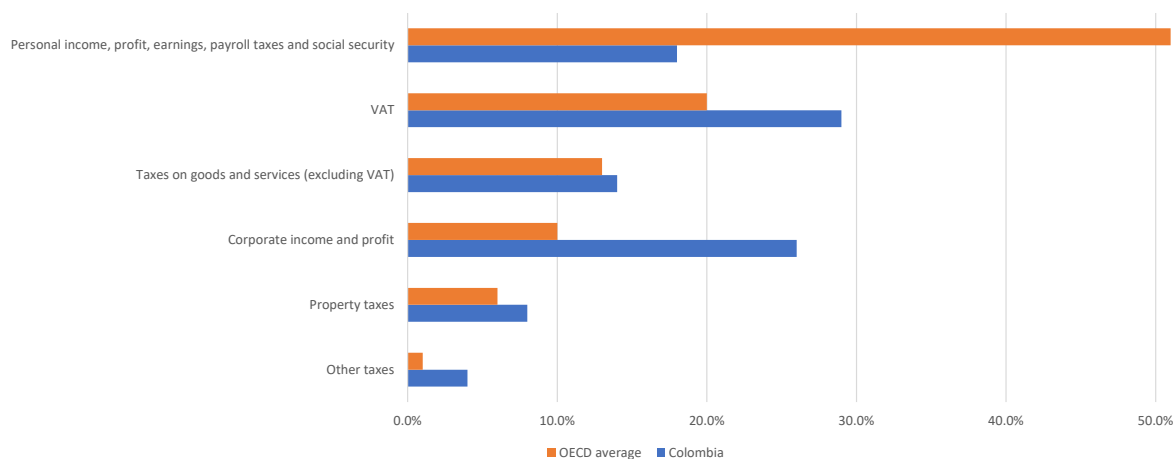


Source: Compiled by the authors based on data from the MNC Tax Complexity Project (2020).

Note: The tax complexity index measures the complexity of the corporate income tax for multinational corporations. The index ranges from 0 (non-complex) to 1 (extremely complex) and is constructed based on a two-yearly survey of tax consultants from leading tax services firms. The survey contains questions on the tax code (to measure the complexity of the various tax regulations) and questions on the tax framework (to measure the complexity resulting from the tax system’s characteristics and procedures).

In addition to its length and complexity, Colombia’s tax code places far more emphasis on corporate profits than the average OECD country but collects very little revenue from personal income. In OECD countries, taxes and contributions payable by individuals account for more than 50 percent of revenue, on average, but in Colombia, these represent less than 20 percent of the total. In contrast, a quarter of Colombia’s tax revenue is from firms, which is two and a half times higher than in the average OECD country (figure 5).

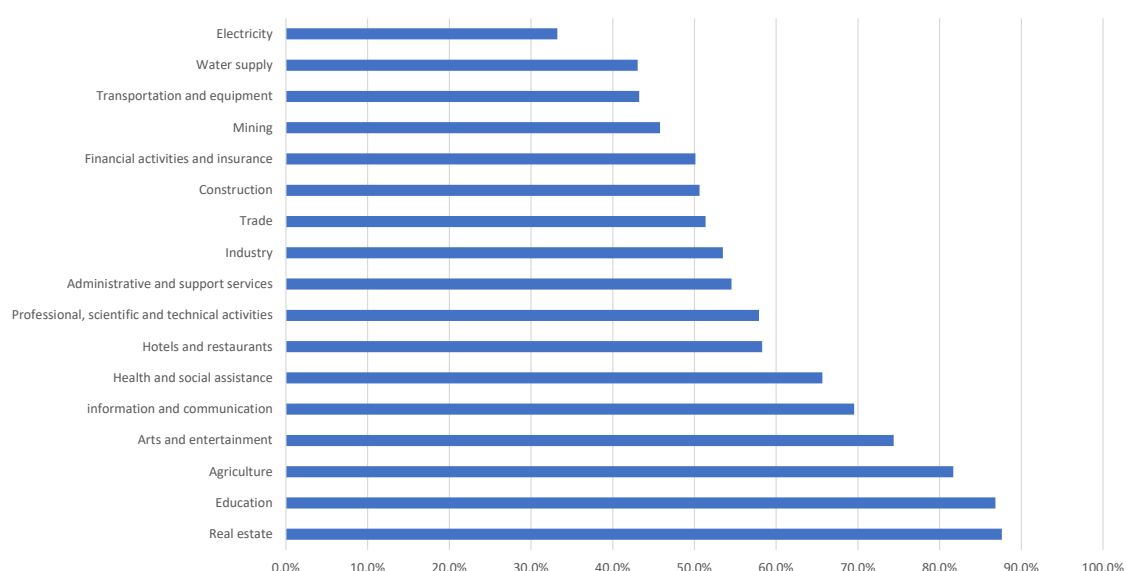
Figure 5. Revenue from the different taxes that make up total revenue (in percentages) in Colombia and OECD countries, 2018



Source: OECD (2022).

The Colombian tax code also entails significant horizontal inequities. Two individuals or companies with similar incomes may have very different tax rates. A study conducted by Fedesarrollo calculated the effective tax rates for legal entities from different sectors and found these to range from 33 percent to almost 90 percent in 2019 (see figure 6). These rates are calculated as the ratio of taxes that are paid over earnings before taxes and profits.³ The survey results corroborate those of a study by Carranza (2018), which also found huge disparities in the taxation of firms in the manufacturing sector. Moreover, tax rates do not appear to be linked to any firm characteristics other than profit levels—indeed, their relationship with these turned out to be negative. In other words, not only does there seem to be a specific tax regime for each firm, these regimes effectively punish firms that are experiencing difficulties.

Figure 6. Effective corporate tax rate in Colombia by sector (in percentages), 2019



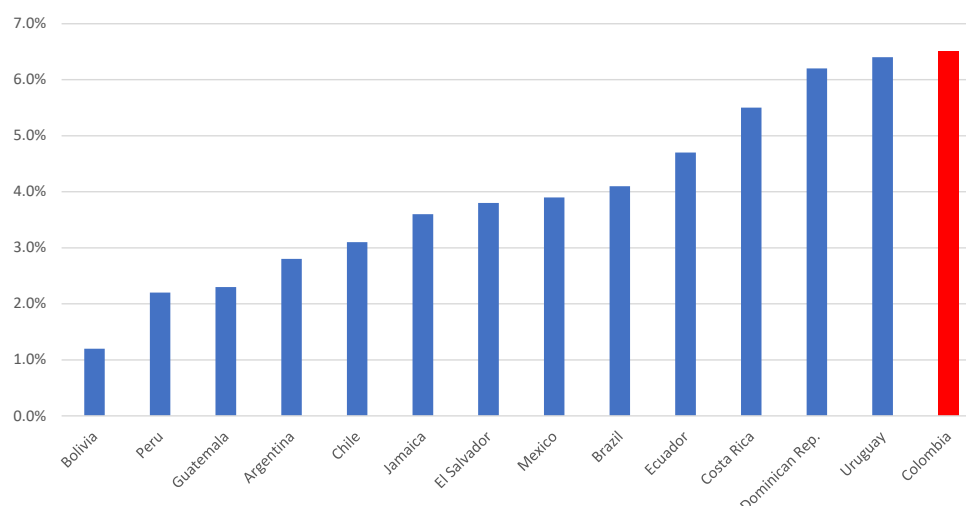
Source: Lora and Mejía (2021).

Note: The data consulted was calculated by Fedesarrollo based on information from Colombia's National Tax and Customs Authority (DIAN), the National Planning Department (DNP), the National Administrative Department of Statistics (DANE) and the Office of Corporate Compliance.

Over time, the tax code has come to include special treatment clauses for corporate income, value-added tax (VAT), and personal income. These exemptions go some way to explaining the complexity of the system, the variations in effective tax rates, the high average nominal rates for corporate income tax (which make up for the low rates that are applied to the large number of companies that do not have to comply with the general rules) and the low overall revenue levels. The prevalence of special treatment is a core feature of Colombia's tax code and an undesirable one. After passing a reform that introduced new exemptions, Congress ordered the creation of the Committee of Experts on Tax Benefits to study special treatment. The committee found that Colombia's levels of lost revenue are higher than those of 13 other peer economies it looked at (figure 7).

³ Taxes that are actually paid include local and national taxes, social security contributions, and parafiscal taxes. To calculate earnings before taxes and benefits, we added tax deductions, social security contributions, and parafiscal contributions to net operating income.

Figure 7. Tax revenue foregone (as a percentage of GDP) in Colombia and other countries in Latin America and the Caribbean, 2017



Source: Compiled by the authors based on data from the OECD, the Ministry of Finance of Colombia and the National Tax and Customs Authority (2021) and the Economic Commission for Latin America and the Caribbean (2019).

Note: The graph shows tax spending for different countries in Latin America and the Caribbean. Tax expenditures describe deviations from the benchmark or revenue losses attributable to benefits for certain taxpayers or the pursuit of specific policy objectives (Economic Commission for Latin America and the Caribbean, 2019).

Table 1 presents estimates of the fiscal costs of the special treatment discussed in the ECLAC (2019) report, based on data presented in the Medium-Term Fiscal Framework (OECD, Colombian Ministry of Finance, and National Tax and Customs Authority, 2021). The VAT revenue lost represents around 7 percent of GDP, while for corporate and personal income, this figure is about 1 percent of GDP in both cases. However, we need to clarify a few points regarding the validity of these estimates. The Medium-Term Fiscal Framework includes the following as tax expenditures: exempt income, deductions based on investment in tangible productive fixed assets and, for legal entities, tax discounts. In contrast, in the case of corporate income, non-taxable income and non-standard deductions are not included in the total revenues foregone. Revenues foregone due to the differential rates in force in certain corporate tax regimes are also excluded from tax expenditure calculations. These include the rates that apply to hotels, some municipalities in the areas most affected by the armed conflict (ZOMAC) and the Special Economic and Social Zone (ZESE). Similarly, tax expenditures other than non-income income and occasional income are not included in individuals' income calculations.

Table 1. Fiscal cost of special treatment (as a percentage of GDP) by type of tax in Colombia, 2019

Tax	Percentage of GDP (2019)
VAT	7.1
Exclusions	5.8
Exemptions	1
Reduced rates	1.3
Corporate income tax	0.9
Exempt income	0.4
Tax discounts	0.4
Investment in fixed assets	0.1
Reduced rates for Free Zones and certain stability contracts	0.05
Personal income tax	0.7
Exempt income and tax deductions	0.6
Other	0.1
Special taxes on fuel	0
Carbon tax	0
Total	8.7

Source: Compiled by the authors based on data from the OECD, the Ministry of Finance of Colombia, and the National Tax and Customs Authority (2021), table 2.2 on revenue foregone as measured in the Medium-Term Fiscal Framework (MTFF).

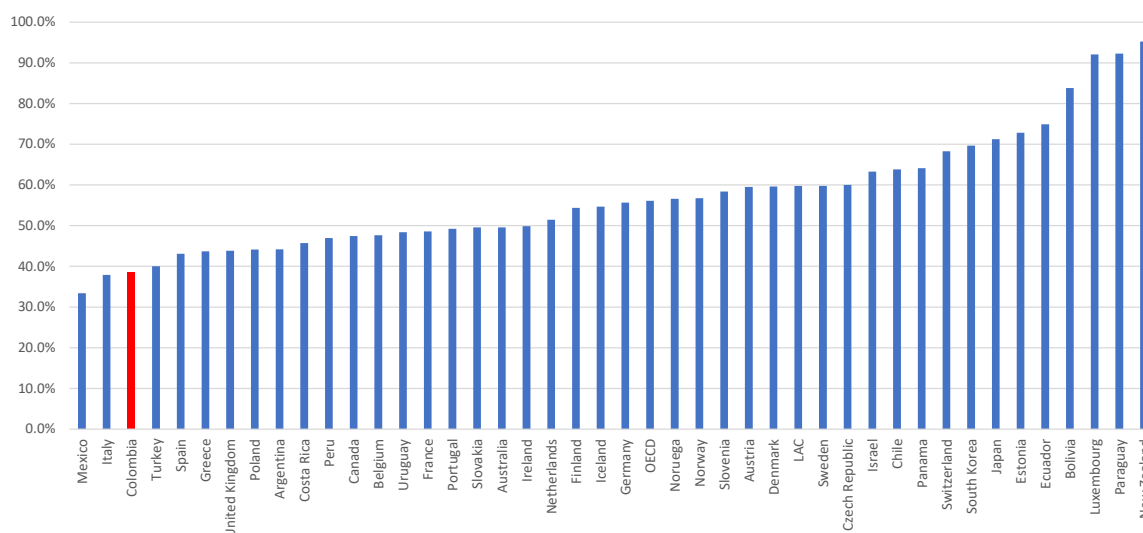
Note: Excluded goods are goods that do not generate VAT. In other words, their sale is not considered a taxable event. Consequently, there are no deductions for production-related costs. Exempt goods are goods that generate VAT but are taxed at a zero rate. Unlike the first group, production-related costs can be deducted from the total tax payment. They therefore result in negative tax revenue. Goods with a differential rate are VAT-taxable goods that are taxed at a rate other than 19 percent.

In conclusion, Colombia loses out on large amounts of revenue due to exemptions. Specifically, as far as corporate income tax calculations are concerned, the way taxable income is estimated is uncertain (as well as questionable), and the publicly available data is too imperfect for us to undertake such estimations ourselves. In other words, the revenue foregone is actually greater than suggested by the data in table 1.

OECD data allows us to compare some of these results with those of other countries. Specifically, figure 8 shows potential VAT revenue, which is estimated as the amount that would be obtained if all goods were taxed at 19 percent. As it shows, not only does Colombia collect less than 40 percent of the revenue it potentially could but it is also among the OECD countries with the lowest revenue levels.⁴

⁴ For these calculations, potential VAT revenue is considered to be equal to the total that would be obtained if all final consumption were taxed at a standard rate of 19%. Consequently, the estimates implicitly take current levels of tax evasion as a given and therefore do not consider that unifying rates might reduce evasion and thus also influence revenue.

Figure 8. VAT revenue (as a percentage of potential revenue) in Colombia and OECD countries



Source: Compiled by the author using data from OECD (n/d).

Note: For each country, the data used was for 2019 or the latest year for which data was available. The potential VAT revenue is the result of calculating the revenue that would be obtained if VAT were applied to all final consumption at the standard rate (19 percent).

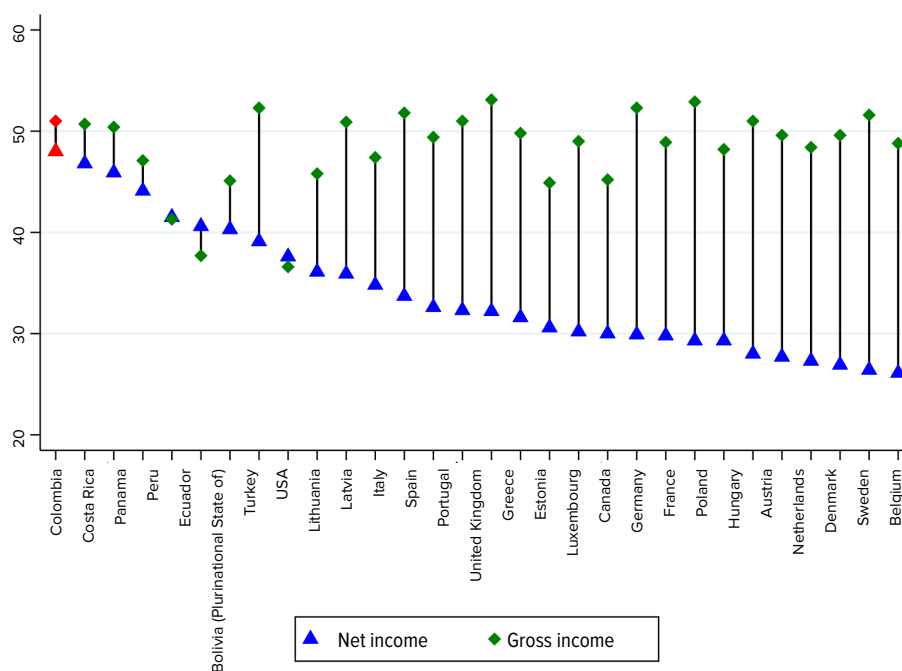
This begs the question of whether taxing all final goods in the economy at a single uniform rate such as 19 percent would indeed be desirable. Given the loss of efficiency in revenue collection that results from differing rates and the exclusion of some goods, reducing these disparities would have significant effects on revenue collection. Taking into account these positive effects on revenue and tax progressivity, if compensation schemes were implemented in parallel with the unification of VAT, it would affect the disposable income of broad sectors of the population who feel the Colombian tax system to be extremely unfair. This would also make it easier for interest groups to use widespread opposition to VAT to halt such changes and other reforms. In conclusion, there is extremely little policy space for moving towards a more uniform VAT. Instead, this debate should be broached once the Colombian tax system is perceived as being more legitimate, which in principle can only be achieved by increasing tax from the most privileged sectors of society, as discussed below. Even if it were possible to implement uniform VAT, studies are needed on how this would impact tax evasion. For these reasons, further details of this particular proposal are not included in this paper.

The State's endemically limited capacities mean that tax evasion is rife in Colombia. These capacities are undoubtedly related to the low revenue levels and problems with the tax code described above. Estimates on evasion levels are high: for example, the Fedesarrollo study mentioned above estimates that the fiscal cost of corporate tax evasion alone reached 5.7 percent of GDP in 2018 (Lora and Mejía, 2021).⁵

Effective tax progressivity is very low in Colombia. Given the low revenue it obtains from individuals and the limited amount of income that is taxable, the Colombian tax system plays only a marginal role in mitigating inequitable income distribution. Figure 9 shows the Gini coefficient for income concentration in 2019 for a broad sample of countries and distinguishes between the coefficient before taxes and transfers (gross) and after these (net). The outcome is clear: Colombia is not an outlier in terms of the concentration of its income distribution before state intervention, but it tops the income inequality list once the role of the State is included in the calculation.

⁵ A detailed examination of tax evasion is beyond the scope of this paper, but a more in-depth discussion of the issue can be found in chapter 8 of Lora and Mejía (2021).

Figure 9. Gross Gini coefficient (before taxes) and net Gini coefficient (after taxes and transfers) in Colombia and other countries, 2019

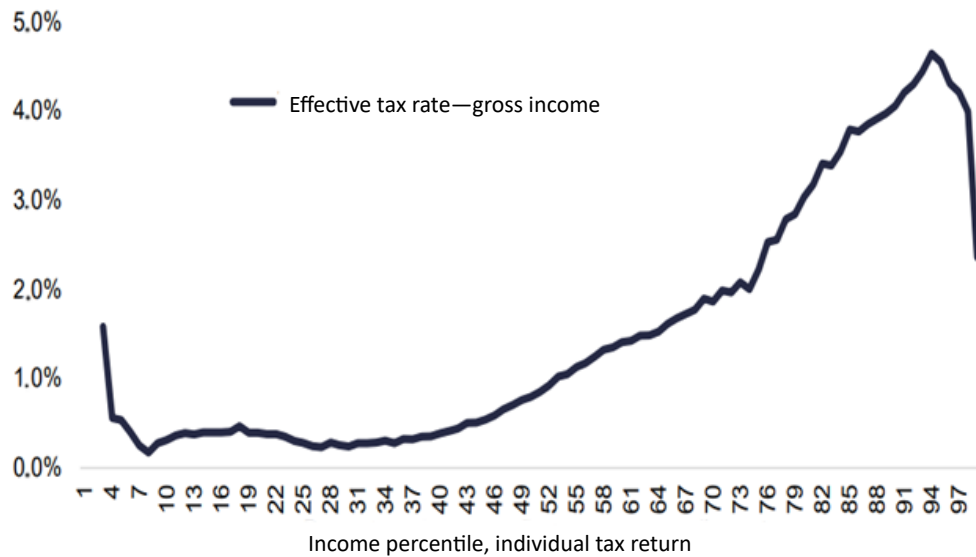


Source: Compiled by the author based on Solt (2022).

The Colombian State’s limited role in redistributing wealth owes partly to the fact that much personal income is not subject to income tax. While income such as wages and benefits, fees, interests or dividends are subject to income tax, others such as mandatory contributions to the pension and health system, the liquidation of assets, profits from the sale of shares, and income from pensions are not included as income.

The Committee of Experts on Tax Benefits estimated the effective tax rates for individual income tax returns for different income percentiles of the population. Figure 10, from the aforementioned report of the Committee of Experts on Tax Benefits, aggregates all income reported by those filing tax returns regardless of its source and estimates the effective tax rate paid by these individuals as a percentage of the total. The figure shows that progressivity works properly up to the 95th percentile, after which it declines: the effective rate paid by the 5 percent with the highest income is lower than that paid by other sectors with lower incomes.

Figure 10. Effective tax rate on income received by individuals (as a percentage of total income) in Colombia, 2018

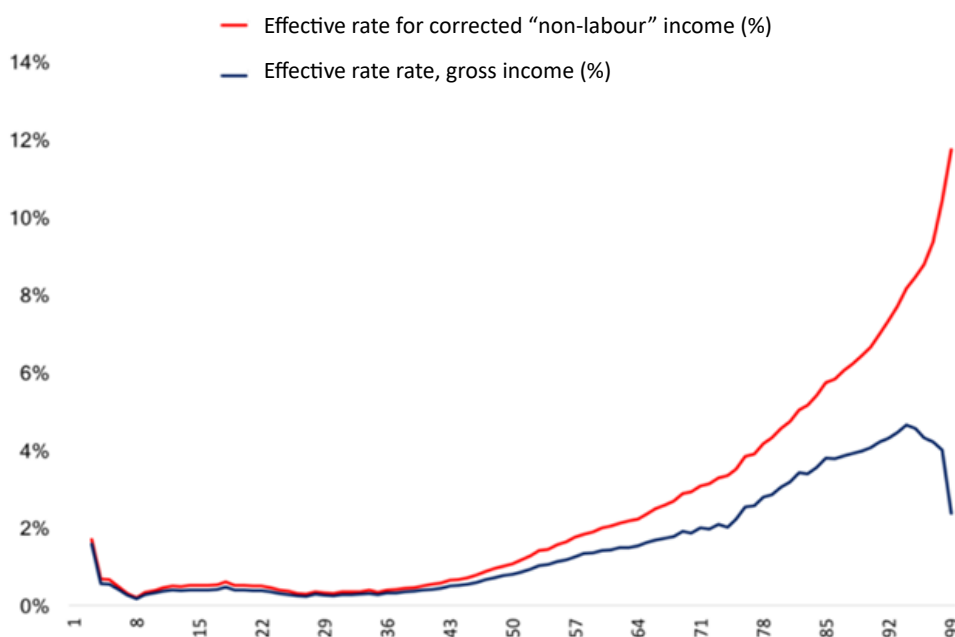


Source: OECD, Ministry of Finance of Colombia, and the National Tax and Customs Authority (2021: 171, figure 6.3).

Note: The effective rates are only calculated for taxpayers, not the total population.

After the committee published this result, a discussion arose around the calculations underlying it. Some argued that the revenue in question included costs that should be subtracted, which would change how the drop in the tax rate from the 95th percentile onward should be interpreted. For example, a self-employed professional who rents office space or pays for administrative staff should be able to subtract those expenses from their income before paying taxes. Figure 11 shows the calculation proposed by Angarita Tovar (2021), in which costs such as these are subtracted from reported income.

Figure 11. Effective tax liability on income received by individuals in Colombia (as a percentage of total income), 2018



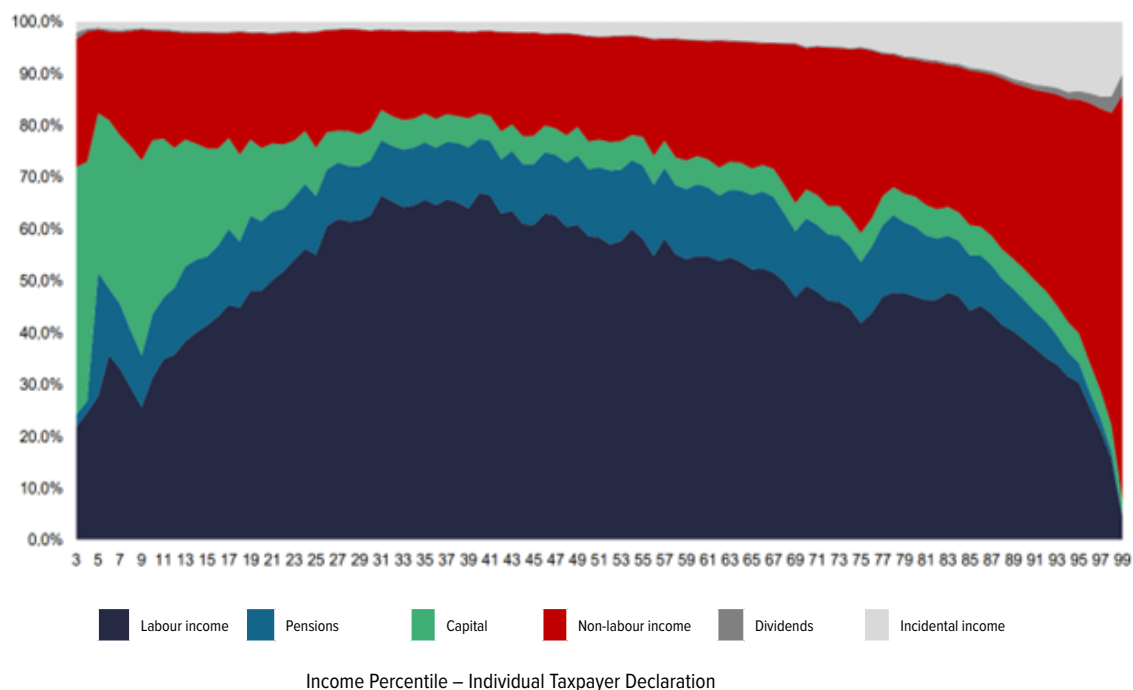
Source: Angarita Tovar (2021).

Others have responded to this interpretation by pointing out that many of the discounts that apply to higher-income individuals to reduce their tax liability are not necessarily justified. These discounts are thus problematic on two different counts: they often lack a sound economic justification and they tend to favour the wealthiest. Some of these discounts are part of the legislation that is currently in force. For example, exempt income and deductions are limited to 40 percent of taxable income after non-income income and incidental income have been subtracted, which allows higher-income individuals to access the highest discounts of all. The exemption of 25 percent of labour income has similar consequences. In other cases, the discounts may be tax evasion or avoidance mechanisms (to give a simple example, although more sophisticated ones exist, a self-employed professional may pass invoices for a family lunch off as a business expense). Naturally, it is difficult to assess whether such behaviour is actually taking place, given that these are potential abuses of the tax code.

Regardless of the discussion on the slope of the curves in figure 11, it is worth focusing on the average levels of these: the effective tax rates on personal income are very low at any income level. Indeed, the average for all taxpayers is below 5 percent, according to the committee's calculations. Even Angarita Tovar's (2021) more optimistic estimates of effective rates put them at just 12 percent for the wealthiest taxpayers in the country.

This discussion also highlights possible grey areas for corporate and personal income tax and reveals how both parties use the rules of the game to reduce their contributions. Figure 12, also from the Committee of Experts on Tax Benefits report, shows the different sources of income mentioned in income tax returns, by income percentile. It clearly shows that from the 95th percentile onward, the most significant sources of income are non-labour income, occasional income, and, to a lesser extent, dividends. This topic is taken up again later, in the section on reform proposals.

Figure 12. Distribution of gross income among individual income taxpayers (in percentages) in Colombia, 2018



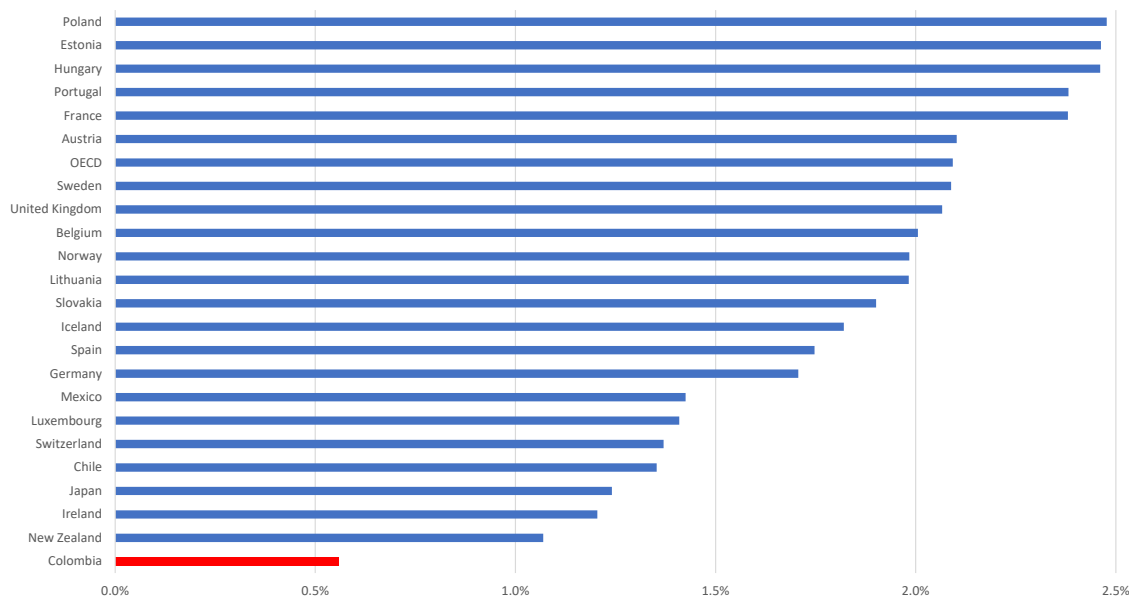
Source: OECD, Ministry of Finance of Colombia, and the National Tax and Customs Authority (2021), figure 6.1, p. 169.
Note: The figure shows the composition of gross income received by taxpayers who file individual income tax returns. Taxpayers must only file a tax return when their gross monthly income is greater than 1,400 tax value units (UVTs) (4.64 million 2018 COP). Below this threshold, filing income tax returns is voluntary.

2.2.1 Environmental and health taxes

Colombia has fine-tuned taxes on tobacco and alcohol to raise the cost of these products to better reflect their social externalities. However, the country has made little progress on green taxes and no progress at all on health taxes (which are levied on foods with high sugar or sodium content or ultra-processed foods).

Environmental tax revenue as a percentage of GDP is low in Colombia compared to the international context. While the average revenue in OECD countries is 2.3 percent of GDP, this figure is 1.0 percent in Latin America and the Caribbean, 0.9 percent among the LAC-6 countries, and 0.8 percent in Colombia (see figure 13).

Figure 13. Environmental tax revenue (as a percentage of GDP) in Colombia and OECD countries, 2020



Source: OECD (n.d.).

Note: Environmental taxes include all taxes that introduce price signals that help polluters take the costs of environmental pollution into account when making decisions around production and consumption. They include carbon taxes and taxes on greenhouse gas emissions or the production of plastic packaging, among others.

A carbon tax has been in place in Colombia since 2016 that uses higher taxes to penalize the consumption of polluting fuels. The rates are updated annually by the National Tax and Customs Authority (DIAN). The most recent data is shown in table 2.

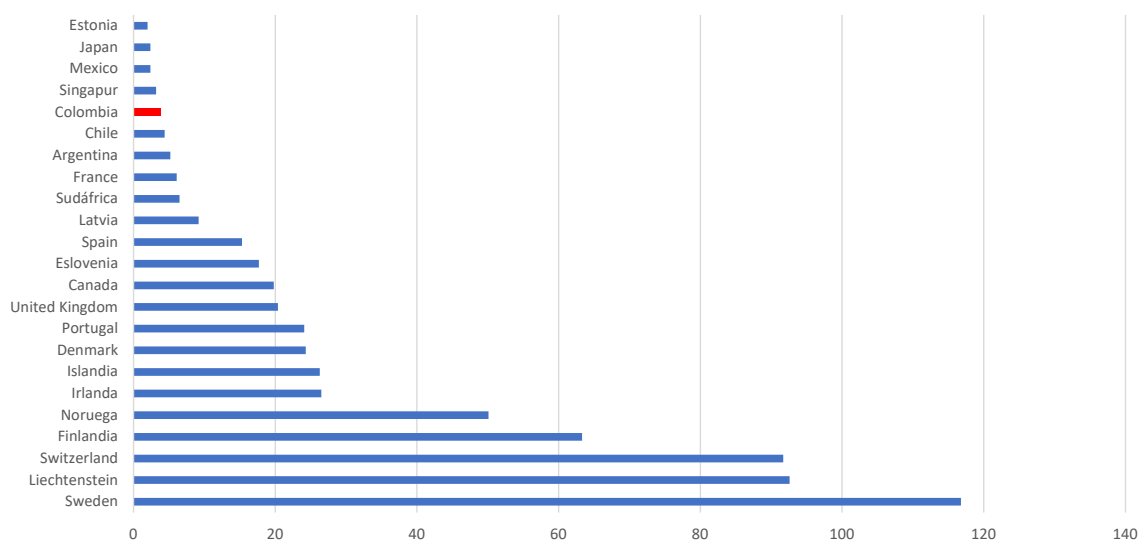
Table 2. Taxable income and rate of carbon tax in Colombia, 2022

Fossil fuel	Unit	Rate/unit
Natural gas	Cubic metre	\$36
Liquefied petroleum gas	Gallon	\$119
Gasoline	Gallon	\$169
Kerosene and jet fuel	Gallon	\$186
Diesel	Gallon	\$191
Fuel oil	Gallon	\$222

Source: Compiled by the author based on data from the National Tax and Customs Authority (DIAN).

These rates are low in comparison with those of other countries, as can be seen in figure 14 (rates per ton of CO₂), leading to relatively little revenue: in 2021, this amounted to approximately COP330 billion (0.028 percent of GDP).

Figure 14. Carbon tax (in euros per ton of CO₂), 2020



Source: Compiled by the author using data from the World Bank (n/d).

In Colombia, not only is the taxation rate on fossil fuel pollution low, but the effect of this tax is overshadowed by two undesirable aspects of public policy. First, the consumption of coal, the most environmentally problematic fuel, is not included in the carbon tax. And second, in practice, there are huge government subsidies to the consumer price of gasoline and diesel. The origins of these subsidies lie in a fuel price stabilization fund that was designed to protect consumer fuel prices from fluctuations in international prices but has in practice become a fund that subsidizes fuel. Between 2020 and 2021, these subsidies were higher than 1 percent of GDP per year (Corficolombiana, 2022). However, current international fuel prices mean that this percentage looks set to climb even higher. Using these more recent figures and assuming an average Brent oil price of US\$100 for the remainder of 2022, this subsidy will represent more than 2 percent of GDP, a massive amount for a central government whose revenues are below 15 percent of GDP. There is little point to having a carbon tax to make fuel more expensive, reduce its use, and promote more environmentally friendly alternatives if the State itself simultaneously reverses this effect by lowering prices through massive subsidies.

As for health taxes, although there has been some public debate on the matter, which has also reached legislative bodies, there has been little progress on it, unlike in other Latin American countries like Chile, Ecuador, Mexico, Panama and Peru and many others outside the region. Introducing taxes of this sort, such as taxes on sodium or sugar content, are expected to bring about a twofold benefit. First, there is a fiscal gain in terms of revenue. Second, and more importantly given that these taxes have a social purpose, they are expected to spark a reaction from the food industry, prompting it to reinvent its products and move towards producing healthier foods to avoid having to pay these new taxes. Although this second point implies that in the long term, revenue from these taxes will likely decrease, this is not a significant problem since the objective of levying them is to have a positive impact on public health.

There are, however, concerns about the harmful effect that health taxes might have in the short term in terms of regressivity. Specifically, there is concern that they may jeopardize poorer households, which tend to consume foods with higher calorie content and lower nutritional quality. However, there is evidence to suggest that this may not be

the case. For example, a study by the Pan American Health Organization (2015) points out that the introduction of a tax on sugar-sweetened beverages in Mexico did not produce considerable regressive effects, as the demand for them is elastic (this elasticity was estimated at 1.3). Similarly, the process of reinventing the food industry could lead to positive changes in the supply of healthy foods that would quickly counteract these regressive effects.

3. Obstacles and the feasibility of reforms

Recent attempts to implement major tax reforms in Colombia have revealed just how difficult this is. The more ambitious government initiatives have often failed to garner democratic support in Congress. Indeed, the scope of many proposals has been limited even before they reach Congress, at least in comparison with the recommendations of experts (including those of committees established by the Government itself to guide its policies, such as the Committee of Experts for Tax Equity and Competitiveness during the Santos Administration and the Committee of Experts on Tax Benefits during the Duque Administration). This suggests that governments do not anticipate that proposals will pass smoothly through Congress and moderate their scope even before they are debated. This is the flip side of the frequent, fragmented, incomplete and sometimes incoherent reforms that have been carried out in Colombia.

The difficulty in implementing more ambitious, definitive reforms owes to many factors, most notably the following three points. First, any change to taxation creates winners and losers, and when the latter have political power, they can block or redirect reforms or limit their scope. Second, in a context like Colombia—where political parties are fragmented within Congress, interest groups exert powerful influences, and clientelist operations abound (Fergusson, Molina and Robinson, 2022)—it is particularly difficult to reach agreements and take measures that benefit society as a whole, even though there will also be losers. Third, the absence of tax culture in the country and the lack of legitimacy of the rules of the game mean that the general public often resist more ambitious reforms. This leads to a paradox: changes that increase this legitimacy are sorely needed, but the lack of legitimacy limits the possibility of implementing such changes (even if they are desirable and fair).

Realist proposals for implementing tax reform need to take these political difficulties into account. The following section explores some circumstances and strategies that may increase the likelihood of reaching an agreement to implement a more permanent structural tax reform.

3.1. Crisis

Colombia is currently in the throes of a real social and economic crisis due to several factors, and this crisis has been aggravated by the aftermath of the COVID-19 pandemic and the ensuing economic crisis. However, crises can be opportunities to implement complex fiscal adjustments (Alesina and Drazen, 1991). The costs of inaction increase during crises, and those who would have been reluctant to shoulder a particular cost as part of a tax reform process may be willing to contribute to avoid an even higher one further down the line. Of course, this will not happen automatically, as has been shown by the last administration's inability to implement a structural tax reform during the COVID-19 crisis. There is a clear opportunity, but certain mistakes must be avoided. Some of these are examined below. In fact, a quick look at Colombia's fiscal history confirms that some of its most difficult fiscal measures were taken during or shortly after major economic crises (Junguito and Rincón, 2004). Consequently, the critical historical juncture at which the country currently finds itself may be the right time to adopt reforms that have failed or have been avoided in the past.

3.2. Gradual implementation

Some tax changes may become more feasible when they are implemented gradually. This approach sidesteps the costs of abrupt adjustments for economic agents, which makes them more willing to accept changes and reduces possible social costs. For example, if taxes on higher pensions are introduced, but the rate is increased gradually over several years rather than being introduced immediately, pensioners will have time to adjust their spending patterns to accommodate this reduction in disposable income. Another example is the gradual elimination of income tax exemptions for some economic sectors: if these tax benefits are reduced over time, the sectors in question can adapt without affecting their investments and the employment they generate in the short term.

Another advantage of including transition periods in the move to a new tax scheme is that agents suffer from a present bias when making many economic decisions (O'Donoghue and Rabin, 2015), whereby future sacrifices are perceived as being less costly than sacrifices in the present. This bias makes social stakeholders more willing to accept the idea that “everyone should chip in”.

One possible downside to gradual implementation is that it may give groups that are affected by the new regulations time to react by proposing and implementing changes that restore their benefits. This is why it is vital for there to be widespread political acceptance of the path to change. Crucial to this is the principle of legitimacy, which is discussed below.

3.3. Legitimacy

The best way to tackle the paradox of the lack of legitimacy of the current Colombian tax system, which needs to be changed but at the same time hinders such change, is by prioritizing asking the most privileged echelons of the most privileged sectors of society to contribute more. On the one hand, this is consistent with extremely disparate theories of justice, such as the utilitarian perspective (which acknowledges that greater income for the wealthiest sectors of society constitutes less of a social benefit than greater income for the poorest sectors) or the Rawlsian perspective (one of whose principles of justice is not to introduce iniquities against the least fortunate members of society). Furthermore, in the context of very weak tax culture, this approach reduces the power of the following argument: “Why should I pay more tax when people who are better off than me are not paying more?” This argument is open to criticism from a regulatory perspective since the fact that some people do not comply with their part in a social contract does not exempt others from their obligation to do so. However, in practice, this situation fuels feelings of unfairness and makes people less willing to make sacrifices.

When attempting to design a legitimate tax reform, the fact that taxes send a message must not be overlooked, in addition to their strictly economic effect. In the words of Michael Sandel (2020), taxation is not only a way to raise money, it is also a way to express social values. For example, a nominal green tax may be levied on the polluting firm or on the consumption of the goods that the firm produces. From a tax incidence perspective (i.e., who ends up paying the cost of this tax in practice via a change in equilibrium prices and demand), this decision is irrelevant. However, deciding to apply the tax to the company may be more widely accepted since it conveys the idea that companies have a social obligation and must pay for any damage they cause. Other examples of fiscal measures with an expressive role are taxes and spending cuts that have only a marginal impact on the balance of public accounts but convey a message that endows the government behind them with legitimacy. For example, a tax on mega-pensions (which few people in the country receive) or measures to reduce the expenditures associated with civil service benefits (gas allowances, vehicles, unnecessary bodyguards) would not make a substantial difference to the fiscal deficit but could improve perceptions of the fairness of the system.

Linking this principle with that of gradual implementation, the best approach to introducing new tax measures is to begin by targeting the more privileged sectors of society before gradually expanding downward. For example, if the goal is to increase the tax base for personal income tax returns, it would be advisable to start with relatively wealthier individuals and work down the income distribution.

Of all the recent tax reform proposals in Colombia, none failed as miserably as the one presented at the beginning of 2021. At first glance, this is somewhat paradoxical. Unlike previous proposals (such as the two that preceded it), this one included many of the more ambitious recommendations put forward by various committees of experts and would have substantially increased the progressivity of the tax system. However, the reform was so lacking in legitimacy and support that it triggered public demonstrations and displays of political discontent, which led to it being withdrawn by the Government and the resignation of the minister behind it.

In light of some of the above considerations, this outcome is less paradoxical than it might first appear. First, the proposal indeed included measures that would help make the tax system more progressive. Some examples of these are VAT compensation (along with a reduction in exemptions to this), an increase in the share of the population that is obliged to declare their personal income, and an increase in marginal income tax rates. However, the impetus on this front contrasted with only a timid call for solidarity from the most privileged of the privileged (e.g., it did not effectively target the personal income of the wealthiest percentiles of the population or corporate profits for some highly advantaged sectors, which held onto their tax incentives). There were thus no legitimacy-building guarantees around the idea that “everyone chips in, starting at the top”. This is especially important in Colombia, where the concentration of income means that many sectors are not comfortable in financial terms, even if they are relatively well-off (a situation that has been exacerbated by the post-COVID recession).

Second, the legitimacy of the messenger is as important as the message itself. The legitimacy of the minister who proposed the reform was called into question on two counts. He had pushed for previous reforms that had maintained the benefits granted to some productive sectors, contrary to what most experts recommended. Moreover, his name appeared in the Panama Paper in association with schemes that are frequently used to evade taxes.

Third, the discussion around this reform did not take into account the expressive role of political messages, in this instance, rather than of taxes. The initiative was discussed with trade unions, which are associated more with powerful lobbies than with society itself and its political representatives. Indeed, suffice it to say that neither the president nor his party lent the proposal their support. It could be argued that it would be political suicide for a president to defend a tax reform at any price, such that it would make strategic sense to get the Minister of Finance to handle the matter. However, there are at least two arguments against this. First, the Colombian political system revolves heavily around the president, and a president’s strong support for legislative initiatives is important for their success. Second, some local experiences, such as that of Antanas Mockus during his time as Mayor of Bogotá, suggest that openly and transparently announcing the intention to raise taxes does not necessarily preclude obtaining public support, especially when such initiatives go hand-in-hand with a coherent message, which should contemplate the factors that have been discussed in this paper so far. At the national level, Gustavo Petro won the recent presidential elections with a clear announcement on the tax reform he would implement if elected, which set him apart from his opponent in the second round.

These factors may contribute to the success of a structural tax reform, but they are far from guaranteeing it. In fact, despite the advantages of implementing such a reform, there are at least three clear obstacles to doing so, even if there is a strategy in place that prioritizes (in terms of time and amounts) the contributions of the most privileged of the privileged. First, their privilege itself means that these sectors may have sufficient political clout to oppose reforms that potentially jeopardize them. Second, given their income levels and connections with certain economic sectors, one of

these privileged groups is made up of legislators themselves. Third, in Colombia, the wealthier echelons of society do not access some components of public spending as much as in other societies. For example, they tend to turn to private solutions for education, security, recreation, and sports instead of using public services (see Cárdenas, Fergusson and García Villegas, 2021, for the case of education). This reduces the benefits they receive in return for their contributions to the public treasury and, consequently, makes them less willing to pay taxes (Giacobasso et al., 2022).

3.4. Paths of least resistance or low-hanging fruit

There is one advantage to the fact that the Colombian tax system faces serious problems such as those described above: the dilemmas that might be sparked by proposing changes to a more refined system are not an issue.

For example, tax measures (and economic policy measures in general) often have to make a trade-off between efficiency and equity or fairness: if the aim is to create a fairer system, the redistribution of taxes to benefit less-favoured sectors of society may increase the fairness of the system, but this may come at the cost of economic efficiency (due, for example, to the fact that particularly dynamic sectors of society might be more heavily taxed). However, the flaws in the Colombian tax code are so huge that it is possible to take measures that are fair and efficient at the same time. One such example would be the (gradual) elimination of business exemptions: they level the playing field for entrepreneurs who take risks and invest their capital, restoring equity and horizontal fairness while implementing appropriate incentives for economic activities to flourish. A measure of this sort could be accompanied by a decrease in the overall rate of business taxes.

Although some individuals or firms inevitably lose out from changes of this sort, and may potentially oppose them, there are many more potential winners and thus relatively less resistance (thus making them low-hanging fruit). In conclusion, a successful tax reform strategy should focus heavily on these kinds of opportunities in terms of both the content of the reform and the messaging around it.

4. Priority areas for tax reform

This section discusses changes that would help to address some of the problems that were identified in section two of this study, without forgetting the strategies and circumstances that might improve the likelihood of the changes analysed in section 3 succeeding.

4.1. Corporate taxes

The most pressing issue in this area is reducing corporate tax benefits, which may take the form of differential tax rates, non-income income and tax deductions or discounts. There are several reasons for this, some of which have already been discussed in this paper: i) these benefits unlevel the playing field, discourage enterprises among disadvantaged sectors and protect the profits of more privileged sectors; ii) they erode revenue, forcing replacement sources to be found for it (including a very high rate of taxation for companies that do pay full rates); iii) they create a tax system that is complex and difficult to run and that favours evasion and avoidance; iv) the complexity of the system and the fact that these revenues never even enter the public coffers make them difficult to monitor, making them an opaque (and therefore very persistent) mechanism that benefits some sectors at the expense of others; and v) the revenue shortfalls generated by these benefits end up being compensated by higher tax rates for most sectors.

From a strategic point of view, in addition to the above arguments, there is a growing consensus on the importance of this change that is shared by experts, some political sectors and the committee established by the Government itself. As indicated in the previous section, moreover, reducing differential treatment while simultaneously lowering the overall corporate tax rate is one of the paths to reform that should pose the least social resistance: it reduces unfairness while improving the functioning of the economy and producing many winners. Finally, this proposal is in line with the principle that changes to the tax code should begin by targeting the most privileged sectors—in this case, business sectors that receive generous discounts paid by other taxpayers.

As the Committee of Experts noted, there are so many tax benefits in Colombia that determining which should be eliminated first is no easy undertaking. Eliminating these exemptions one by one would be extremely complex. However, if only some of the benefits were removed, taxpayers could resort to using others that are still in force. In other words, the tax code might change, but inefficiencies and inequities would persist. Both the 2016 Committee of Experts and the Committee of Experts on Tax Benefits advised against taking this path.

With these considerations in mind, and applying the principle of gradual implementation, we propose the following approach. First, gradually eliminate all exemptions, discounts or differential rates. As a result of this measure, companies' benefits would decrease yearly. Based on an overall horizon of application of six years, taxpayers would continue to receive 100 percent of the benefits brought by the current regulations in the year the reform is passed. That percentage would fall to 80 percent in year two, 60 percent in year three, and so on until year six, by which time the benefits will have been fully eliminated. The revenue that would derive from this proposal would depend heavily on how households and firms respond, as they may alter their consumption and investment decisions in response to the removal of the multiple distortions caused by the differential treatments currently being applied to some types of income. Consequently, the ultimate gains that removing these benefits would yield are highly uncertain, but they could range between 0.55 percent and 1 percent of GDP. These figures are conservative, as many of the available estimates are optimistic about the benefits that these exemptions bring, as was discussed in the diagnostic review.

Second, while these benefits are being eliminated, a new, more demanding procedure for establishing any new benefits could be put in place. In any case, these benefits should only be valid for a limited time (unless they are renewed, after going through the procedure again). There are two reasons for implementing this complementary measure: first, we acknowledge that some tax benefits may play an important part in improving the functioning of the economy (such as by internalizing externalities); second, we wish to emphasize that these benefits should be the exception rather than the rule, because exemptions imply enormous costs. Some of the existing proposals are along these lines. For example, the Committee of Experts mentioned the creation of another independent committee to evaluate the proposed benefits and calculate their cost. The World Bank (2021) report on Colombia's public finances proposed that a council of ministers be established to report on expenditures, which could include exemptions. This council would receive technical support from the Higher Fiscal Policy Council (CONFIS) and a technical committee. Although these factors are desirable, calculating the fiscal cost of benefits is already a requirement but it has not been effective or fully transparent because governments may underestimate the cost of benefits they themselves grant. Arboleda and Fergusson (2020) show that this was the case for the Duque Administration's exemptions, which were deemed to come at "no cost" in government calculations, based on questionable assumptions. The decision on benefits will ultimately rest with Congress. In support of these general ideas, it is worth noting that it will be crucial to ensure that those analysing the merits and costs of benefits are truly independent and objective, and that there is sufficient publicity and awareness-raising around the results to inform the public and legislative debate.

The opaque nature of the exemptions is compounded by the scarce (public) information available from DIAN. This makes it hard to accurately calculate the revenue benefits that eliminating business exemptions would bring, as has been observed by the Committee of Experts on Tax Benefits (OECD, Colombian Ministry of Finance, and National

Tax and Customs Authority, 2021) and Fedesarrollo (Lora and Mejía, 2021). With these caveats, Fedesarrollo's calculations suggest that eliminating business exemptions would increase revenue by about 0.3 percent of GDP. In addition, including 20 percent of non-income income to be taxed at the statutory rate would generate additional revenue of 0.25 percent of GDP. Consequently, bearing in mind that opacity may lead to lost revenue being underestimated and that the exercise only contemplates 20 percent of non-income income, a conservative estimate of the additional revenue that could result from this proposal would be 0.55 percent of GDP (0.3 percent + 0.25 percent). In any case, although there is a high probability that the actual figure would be substantially higher, it makes sense to be cautious.

Finally, a gradual reduction of the overall corporate income tax would be applied in parallel with reducing exemptions, over the same period. The reduction in the income tax rate would be gradual, going from the current rate of 35 percent in the first year to 34 percent in the second year, 33 percent in the third year and so on, until the target rate of 30 percent is reached in the sixth year. The explanatory memorandum to the Growth Act, which reduced the rate from 32 percent to 30 percent, estimated that this would entail a fiscal cost of approximately 0.3 percent of GDP (based on an average of 0.15 percent per percentage point of the corporate income tax rate). However, the subsequent Social Investment Law calculated that increasing the rate from 32 percent to 35 percent, where it currently stands, would bring gains of 0.6 percent of GDP (based on an average of 0.2 percent per percentage point). Reducing the rate from 35 percent to 30 percent could thus be estimated to cost between 0.75 percent and 1 percent of GDP. If we base our calculations on the midpoint between these two estimates and combine it with the gains from eliminating exemptions, the overall outcome is slightly negative in terms of revenue (-0.325 percent of GDP, as a result of a 0.55 percent gain and a 0.875 percent loss). However, given the uncertainty surrounding the calculations and the decision to use conservative estimates of the benefits, in practice, the measure could be neutral or even positive in revenue terms.

Local corporate taxes are analysed in an article published by the Universidad de los Andes (Zuleta et al., 2022). The authors argue that local taxes are a major source of revenue for municipalities and departments that bring numerous positive effects when properly implemented. These include the increased provision of public goods, institutional development and the increased legitimacy of the tax system. Although this paper focuses on national taxes, the above argument suggests that there are significant points of contact between national and subnational taxation that are worth exploring. Specifically, in line with Zuleta et al. (2022), we propose converting the industry and commerce tax (ICA) into a local business income tax. The high cost of the ICA for some companies is compensated by a discount of 50 percent of its value when firms pay their corporate income tax, but this solution is both palliative and imperfect because it creates a clash between local and national revenue. The ICA discount should thus be eliminated in parallel with this reform, which would imply an increase in revenue of approximately 0.5 percent of GDP, according to Fedesarrollo's analysis (Lora and Mejía, 2021).

Finally, to make progress on taxing digital platforms, we propose that a tax on their gross income be created, a measure that has been implemented in other countries. In Colombia, 19 percent VAT has been levied on both domestic and international digital platforms since 2018. Introducing a 3 percent tax on the gross income of digital platforms would help correct horizontal inequity, as these are currently not subject to income tax. Furthermore, it could raise around 0.1 percent of GDP in revenue, according to Fedesarrollo (Lora and Mejía, 2021), largely from the 16 largest digital companies in the country.

4.2. Personal taxes

Effective personal income tax rates in Colombia are very low, as we noted in the diagnostic review. To keep up with international practices and improve the composition of tax revenue, the key measure would be to reduce the deductions and non-income income that widen the gap between the statutory rate and the effective rate. These practices are also regressive in two ways: first, it is often the wealthiest households that can access these discounts (for example, via savings in AFC accounts) and second, certain exclusions and deductions are defined by the taxpayer's income or limited to a percentage of this, which directly benefits wealthier sectors more.

The problem of low overall effective rates is compounded by the fact that wealthier taxpayers pay particularly low effective rates (relative to their income). As was discussed in the diagnostic review, this could be partly due to the fact that these individuals gain access to greater deductions and benefits (which are not always necessarily justified or even always legal) and that some of their income sources are treated more generously by the current tax system. Two examples of special treatment that should move towards being taxed in the same way as labour income are pensions and dividends.

Pensions in Colombia are not subject to personal income tax. This needs to be changed: pension income should be included in income tax returns like any other labour income, such that progressivity and minimum taxation thresholds are also applied to pension income.⁶

Although this measure would affect a privileged minority (in that it would apply to those who not only receive a pension but receive one high enough to pay income tax), this tax faces enormous opposition in the public debate. This argument is justified in one sense: pensioners have standards of living and future plans that are consistent with the income they receive. A tax that would change this pattern overnight would imply changes that might be hard to make.

The specifics of how such a tax is implemented and the time frame for doing so are therefore key not only to the legislative outcome of this proposal but also play a defining role in its fairness to new taxpayers. This paper proposes the following: the ultimate goal is for all pensions to become taxable personal income. However, the transition to reaching this objective must be gradual, such that the income that will be taxed is incorporated over 10 years. In the first year, 10 percent of the value of the pension would be included in taxable income, 20 percent would be included in the following year, and so on until the total has been included.

This form of implementation means that in the first year, only those who receive truly high pensions will start to pay tax on them since they will be the only ones over the threshold for the tax. This will only apply to a fraction of all pensions. The population at the lower end of the pension distribution would only start paying income tax on their pensions several years later, when the percentage of taxable pension income pushes them above the threshold. If income tax was applied to pensions in the same way as to labour income, it would bring additional revenue of around 0.5 percent of GDP, according to Fedesarrollo calculations (Lora and Mejía, 2021). This figure is a lower bound, since the taxable base would grow due to the increase in the number of pensioners.

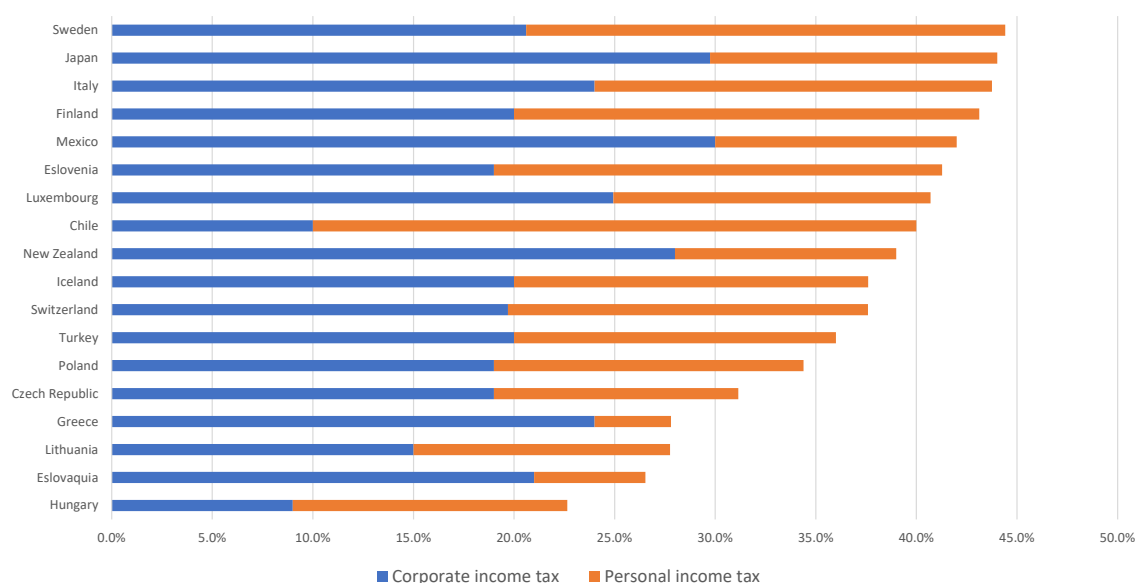
Dividends received by individuals should also be taxed like any other income. In Colombia, dividends pay a flat rate of 10 percent if they are above a certain threshold, so there is no progressivity in the tax obligations associated with this income.

This proposal is often countered in the public debate with the argument that taxing dividends to individuals is "double taxation" because the company has already paid income tax. However, taxing both companies and dividend

⁶ Pension reform in Colombia is discussed in Becerra et al. (2022).

recipients is a common practice in many countries. Moreover, in Colombia, the distribution of these taxes is poorly balanced: the tax on corporate income is high while personal income tax is low, and these taxes are not progressive. The proposal is for dividends to be fully included in taxable personal income under the same conditions as labour income.

Figure 15. Statutory income tax rates for individuals (via dividends) and corporations (in percentages), 2021



Source: Compiled by the author using data from OECD (n/d).

Note: The figure shows statutory tax rates when personal income tax (via dividends) and corporate income tax payments are combined.

Estimates of the revenue that this initiative would bring are uncertain, because tax payments would depend on the other income of households receiving dividends. The Fedesarrollo calculations estimate this revenue to represent 0.11 percent of GDP (Lora and Mejía, 2021). Thus, it is unclear what rate would be applied to the dividends each person receives, as that rate would depend on their overall income tax rate. Moreover, as is clear from the previous subsection, the dividend tax proposed in this paper and the progressivity it would entail would go hand-in-hand with a lower overall corporate income tax rate.

To be effective, a measure of this sort would require limiting the channels for processing these dividends. For example, being paid dividends through a paper company that then incurs expenses for the owner that are not included in their income tax return might be prohibited or subject to investigation.

Another undesirable aspect of the personal income tax code is the fact that the threshold for taxation is extremely high in relation to the average income in Colombia. Moreover, the maximum deductible income is proportional to total income, rather than being a fixed amount, as is the case in most countries. Increasing the tax base by including new taxpayers who are not currently required to file and pay personal income tax returns is desirable for several reasons. First, it promotes tax culture. Second, even though households will have to pay modest additional amounts in income tax⁷, they will be included in the DIAN system, whose records will show when their income increases and thus when their tax obligations do. Third, although the households in question do not have ample economic resources, they are relatively privileged in the Colombian context.

⁷ Those who pay taxes but do not file income tax returns may even benefit from tax refunds.

The proposal put forward in this paper is based on the recent suggestion from the World Bank (2021). The goal of broadening the tax base should include the wealthiest 20 percent in the short term. The World Bank estimates that this can be achieved by limiting all deductions to a single maximum fixed amount of 900 UVTs per year (about COP35 million). This way, only individuals with an income of over COP3 million per month would begin to be taxed, and they would be taxed only on income above that amount. If the marginal rate for that first band were 5 percent, people with incomes of up to COP5 million per month would pay effective rates close to 2 percent of their income. For people with incomes above that level, the effective rate would be higher, closer to the marginal rate, another desirable change.

These changes would increase revenue by 1.2 percent of GDP. Removing generous personal income tax deductions would have positive effects on the progressivity of income tax and would narrow the gap between corporate and personal income taxes (World Bank, 2021). There would thus be greater incentives for many self-employed workers to formalize their business operations by incorporating as companies.

One formula for incorporating the principle of graduality into this proposal entails calculating net taxable income after broadening the tax base, as described above (income B), and without doing so (income A). In the first year, the relevant net income would consist of 100 percent of income A; in the second year, it would consist of the weighted average of 80 percent of income A and 20 percent of income B; in the third year, 60 percent of income A and 40 percent of income B, and so on until the sixth year, when 100 percent of income B is used.

Another tax that may generate significant revenue and increase the progressivity of the system is a wealth tax on individuals (Londoño-Vélez and Ávila-Mahecha, 2021). Colombia has implemented several such initiatives in the 21st century: a net wealth tax was established in 2002 to finance the war against the FARC, which then mutated into a tax on liquid assets in 2018. This tax raised as much as 0.7 percent of GDP in 2015, but this revenue fell to about 0.1 percent of GDP in 2019.

The first tax reform bill of 2021 proposed taxing personal assets over COP5 billion at a rate of 1 percent, while assets over COP15 billion would be taxed at 2 percent. At the time, it was estimated that the revenue from this scheme would be around 0.5 percent of GDP, provided that deductions such as shares held by individuals were limited (World Bank, 2021).

The proposal put forward in this paper is to start taxing personal (but not corporate) assets in excess of COP1 billion at market prices, without the right to additional discounts. The rate should be marginal—that is, tax is levied on the amount above this limit. The proposed rate is progressive and starts at 0.5 percent, increases to 1 percent for assets over COP3 billion, and to 2 percent for assets over COP5 billion. Based on this data, it is estimated that total revenue will be close to 1 percent of GDP. The rates would be similar to those applied in other countries that also levy wealth taxes. These range from 0.5 percent to 1.5 percent in France; from 0.2 percent to 3.5 percent in Spain and from 0.05 percent to 4.5 percent in Switzerland.

The application of marginal rates is important and obeys a principle that should be applied more broadly: small changes in the tax base (in this case, the value of wealth) should not produce sudden leaps in tax liabilities. When this happens, economic agents may conceal information or make inefficient decisions to avoid passing thresholds that substantially increase their tax obligations. Avoiding abrupt leaps is thus a general suggestion that should be applied to all taxes, including personal and corporate income taxes.

4.3. VAT

The diagnostic exercise made it clear that the potential revenue that would result from unifying Colombia's scattered VAT rates is significant, so much so that it eclipses the potential outcome of actions that could be implemented in other areas. In spite of this, this paper suggests that VAT reform be addressed at a later stage, after the adjustments proposed above have been made. Evidence from recent attempts to reform VAT reveals that it is an extremely unpopular tax and that interest groups take advantage of this reaction to hinder the passing of other reforms.

There is only one aspect of VAT that this paper proposes including in the initial phase: the three VAT-free days created by the Duque Administration. There are several reasons for proposing a rapid reform of this: i) a huge amount of government effort goes into compiling the lists of goods to which this rebate applies, which could be better directed to other purposes; ii) the measure erodes tax legitimacy since it establishes days on which the public does not have to meet its commitment to contribute to financing public goods; iii) once again, those who benefit most from these discounts are higher-income sectors, which strengthens the regressive nature of the tax code; iv) the measure reduces revenue; (v) it promotes strategies for businesses to invoice goods on VAT-free days, which reduces revenue still further and (vi) the dates on which the measure applies are decided at the discretion of the Government, which opens up another front for the political manipulation of tax policy: in 2022, two of the three days coincided with the weekends when general elections were held.

Studies are being undertaken to calculate the toll these VAT-free days take on fiscal revenues but are not yet complete. For now, an estimate of excess sales on those days in relation to the previous average gives a figure close to COP500 million (0.04 percent of GDP).

4.4. Green taxes

The diagnostic review made it clear that Colombia charges little in the way of green taxes and that there is ample room for improvement for prices to better express the environmental costs of fossil fuel consumption. There are at least four ways forward on this front.

First, and unusually, coal—the fuel that has the greatest impact on climate change—is included in the list of fuels that pay a carbon tax. It needs to be added to this at the same rate per ton of carbon equivalent as other fossil fuels. While green taxes are not designed to provide the bulk of a country's revenues, adding coal to the carbon tax list would double the revenue that this tax raises (based on the current breakdown of fuel usage), producing additional revenue of 0.03 percent of GDP.

However, adding coal to the carbon tax list has raised concerns around Colombia's backup electricity options during droughts, when a considerable portion of its energy capacity comes from coal-fired power plants. Despite this, the country has made remarkable progress on transitioning towards the use of alternative energy sources. Although this process needs to be stepped up, it is plausible that Colombia's long-term dependence on dirty energy during drought will be reduced. In any case, the increased costs that the country would face if it needs to use coal to generate energy and therefore has to pay carbon tax on this use is nothing more than an internalization of the costly environmental externality resulting from this decision.

Second, as was also made clear in the diagnostic review, Colombia's tax rates on carbon emissions are very low in comparison with the rates observed at the international level. A gradual transition to significantly higher rates would be consistent with the country's climate change mitigation commitments. To reach rates per ton of emissions on par with those of Canada or the United Kingdom, for example, Colombia would have to quadruple its rates (see figure 14).

Naturally, increasing these prices would reduce demand. Based on Galindo et al.'s (2017) calculations on the effects of these increases on total activity as a proxy for the effect on the consumption of these fuels, the above two measures—including coal on the list and increasing the general rate to \$20 per ton of CO₂—could generate additional revenue of at least 0.115 percent of GDP.

Third, the State's approach needs to be coherent if green taxes are to fulfil their purpose. In a world that is deeply concerned about the consequences of the emissions generated by fossil fuel consumption, spending more than 10 percent of national revenues subsidizing this consumption is an outrage.

Of course, the underlying problem is the fact that the Government can define the prices of these fuels at its discretion, not to mention the electoral and political motivations that are the driving forces determining these prices. Simply drawing attention to this incoherence is not enough. Like Ulysses, Governments need a mast to tie themselves to if they are to avoid caving in to temptations.

We propose the following solution. First, the price stabilization formula for each fuel should be agreed upon and published. A version of this formula already exists, but the Government decides whether or not to apply it to fuel prices each month on a discretionary basis. Maintaining the formula is vital if Colombia is to keep the fund true to its purpose, namely protecting consumers from the short-term ups and downs of international markets.

Once the formula has been put in place, if the Government deems that the price of any of these fuels should be lower than the formula suggests, a complementary carbon tax would come into effect. The amount of this tax would be adjusted to offset the shortfall in the price per gallon. This would neutralize the temptation to use fuel price subsidies as a political tool, because the complementary carbon tax would cancel out the impact of the decision on consumer prices. As with many of the proposals described above, a prudent transition period would be required to implement this proposal fully. Indeed, this is even more true in this case due to the huge gap that currently exists between local and international fuel prices. This supplementary tax is expected to generate revenue (or a lower subsidy) equivalent to at least 2 percent of GDP, if oil prices and the subsidy remain at current levels. This amount is added separately to the final calculations in this paper: the size of the number is clearly a consequence of the current state of affairs, wherein international oil prices and local fuel subsidies are both high. This may not continue to be the case in the long term.

Finally, it would be helpful for the country to resume the unresolved debate around taxes on single-use plastic products by basing taxation of these on packaging weight. In addition, although current regulations require that stores and supermarkets charge a nominal amount for plastic bags, in practice this measure is only applied in big-box stores but is a dead letter everywhere else. Changing who is liable to pay might help: if, in addition to establishing a minimum price to be paid by consumers who receive bags, a cost for bag producers were also introduced, this price increase might promote a shift towards more environmentally balanced consumption patterns. In revenue terms, the Ministry of Finance estimates that a tax of COP2 per gram of plastic would lead to annual revenue of around COP14 billion.

4.5. Health taxes

Nearly 50 countries already have health taxes that aim to make the consumption of high-sugar, high-sodium or ultra-processed foods more expensive. It is imperative for Colombia to address this debate again, which the Duque Administration did not tackle but which was discussed during the Santos Administration.

The study by Arbeláez et al. (2021) presents estimates of the potential revenue that could be garnered by introducing health taxes in Colombia. These authors favour an approach that entails levying an ad valorem tax on products over the unhealthy threshold rather than taxing products based on the specific amount of sugar or sodium they contain. The calculations presented in Arbeláez et al. (2021) indicate that a tax of this sort could bring in revenue of about COP800 billion annually and that there would be a drop in demand for these products, which was also estimated in the analysis. This last point is significant, as the specific aim of these initiatives is to reduce the consumption of these products.

Following the practice of many countries and based on the experience accumulated to date, this paper proposes that tax should increase according to the amount of sugar or sodium a product contains, but that this tax should be paid by the firm or industry producing these goods, rather than by the points of sale. First, this may increase the incentives for these industries to produce healthier alternatives, since many low-priced mass-market products have considerably higher sugar or sodium content than similar, more expensive offerings. Second, placing the tax burden on producers rather than points of sale eases the logistical challenges of charging based on unhealthy contents rather than on product prices. It is also more effective in the public debate as it places the burden on the industry rather than on stores and consumers. Although the effect on prices is ultimately similar no matter which approach is used, public perception is not.

5. Conclusions

Colombia's tax system is unfair and inefficient. After comparing the size of its government with that of other countries and analysing its shortfalls in financing its spending, it is also clear that the country must find a way to increase revenue collection.

This paper has presented a diagnostic review of the main flaws in Colombia's national tax system and proposed various approaches to reform, taking into account whether they would be feasible to implement. In so doing, it seeks to address a problematic paradox: the system lacks legitimacy and thus must be reformed, but the lack of legitimacy is a stumbling block to reaching a consensus on the changes that need to be made.

Table 3 summarizes the main reforms discussed in this paper and includes estimates of their impact on revenue, where the available data allowed this calculation to be carried out. A tax code along the lines proposed here would be much fairer and more efficient, as it would correct several of the undesirable features of the existing code. It would also bring in more than 3 additional percentage points of GDP, once the horizon of application has been reached. If Colombia implements these reforms gradually, taking advantage of the post-COVID economic crisis to do so, and emphasizes the legitimacy of the measures, a new tax code may indeed be possible.

Table 3. Summary of proposals, horizon of application and approximate expected revenues

Proposed reform	Horizon of application	Estimated total annual fiscal revenue or cost (as a percentage of GDP)
Gradually eliminate all exemptions, discounts or differential rates for taxes on legal entities	6 years	0.55%
Implement a new, more demanding procedure for establishing benefits	Immediate	n.d. ^a
Gradually reduce the overall corporate income tax rate to 30%	6 years	-0.875%
Convert the current tax on industry and commerce (ICA) into a local corporate income tax	Immediate	n.d. ^b
Remove the current tax on industry and commerce	Immediate	0.50%
Include pensions in the personal income that is taxable for individuals	10 years	0.50%
Establish that dividends received by individuals are taxed in the same way as any other income	Immediate	0.11%
Eliminate all personal income deductions to a single maximum fixed amount of 900 tax value units (UVTs) per year	6 years	1.20%
Establish a progressive marginal rate on assets worth over COP1 billion without the right to additional discounts	Immediate	1%
Eliminate VAT-free days	Immediate	0.05%
Tax coal at the same rate per ton of carbon equivalent that applies to other fossil fuels and quadruple the rate per ton of CO ₂ emissions	Gradual	0.12%
Conclude the unresolved debate on taxes on single-use plastic products by basing taxation of these on packaging weight	Immediate	0.001%
Establish a tax on ultra-processed food industries that is higher for products that contain more sugar, sodium, etc.	Immediate	0.08%
Total	3.23%	
Create a complementary carbon tax that eliminates fuel subsidies	Gradual	2% ^c

Source: Compiled by the authors.

a No estimates are available, but the policy is expected to reduce revenues or constitute an expense.

b No estimates are available, but the policy is expected to increase revenues.

c In 2022, based on observed oil and fuel prices, these subsidies represent around 2% of GDP. This value is not included in the total because it fluctuates depending on these two variables. If the international price of oil falls, so will the amount subsidized under the current rules.

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