TAX INCENTIVES COMMISSION: **KEY FINDINGS**

PUBLIC CONSULTATION

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

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BETTER POLICIES FOR BETTER LIVES

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

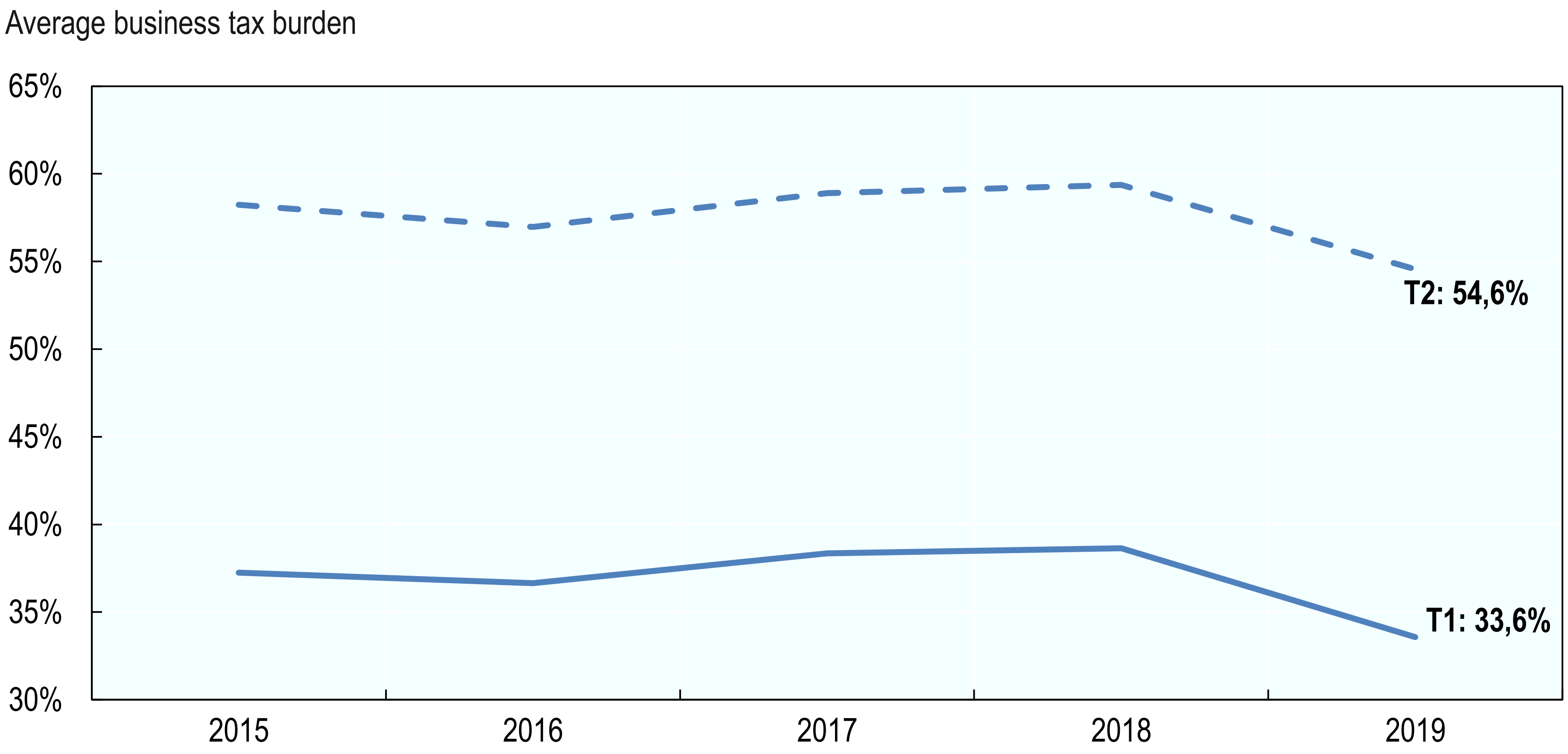
1. Stronger mandate and greater resources for DIAN to produce **an annual, standalone, item-by-item, tax expenditure report**

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



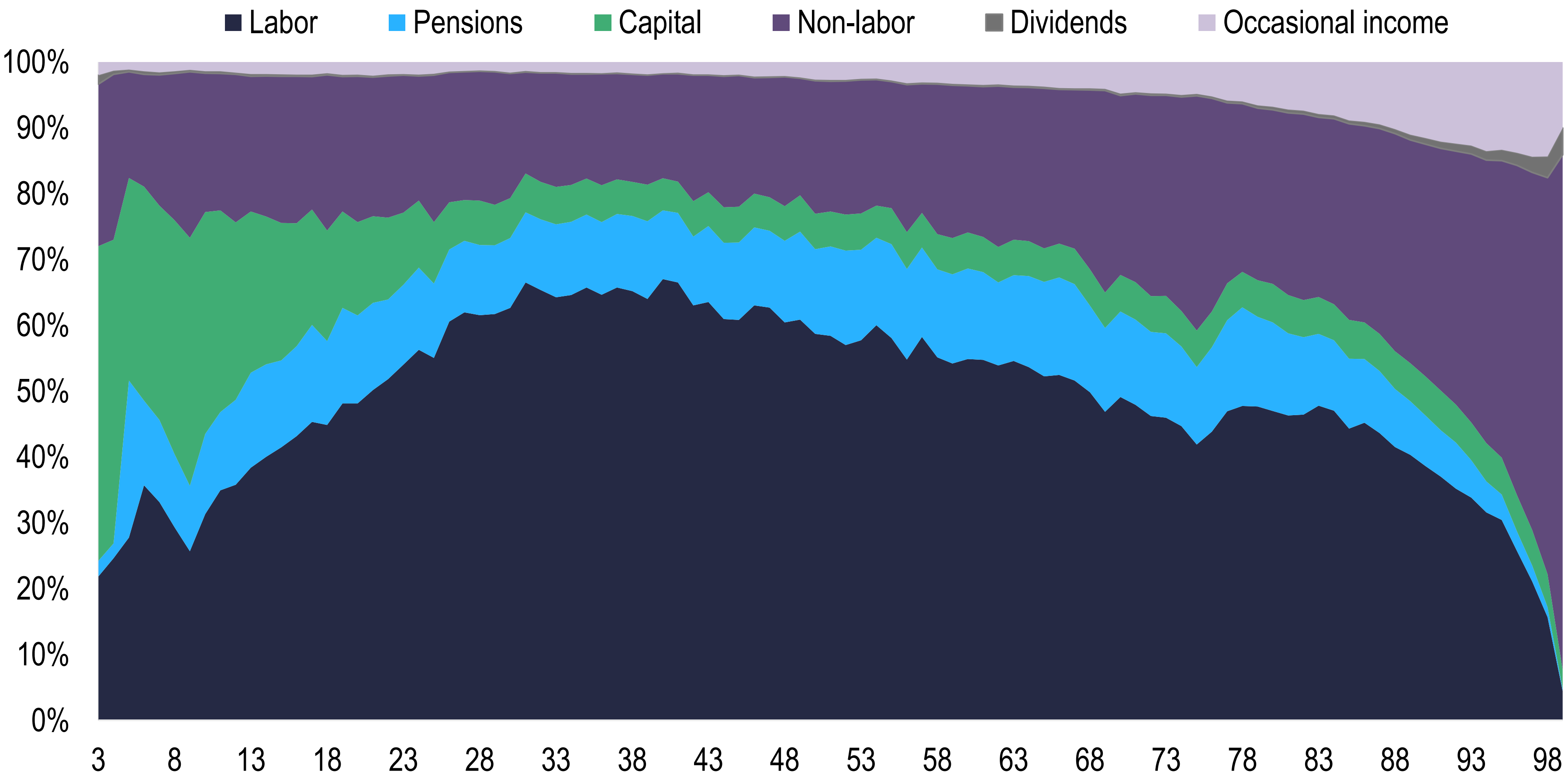
T1 = Income tax, CREE and surcharges / Accounting profits

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

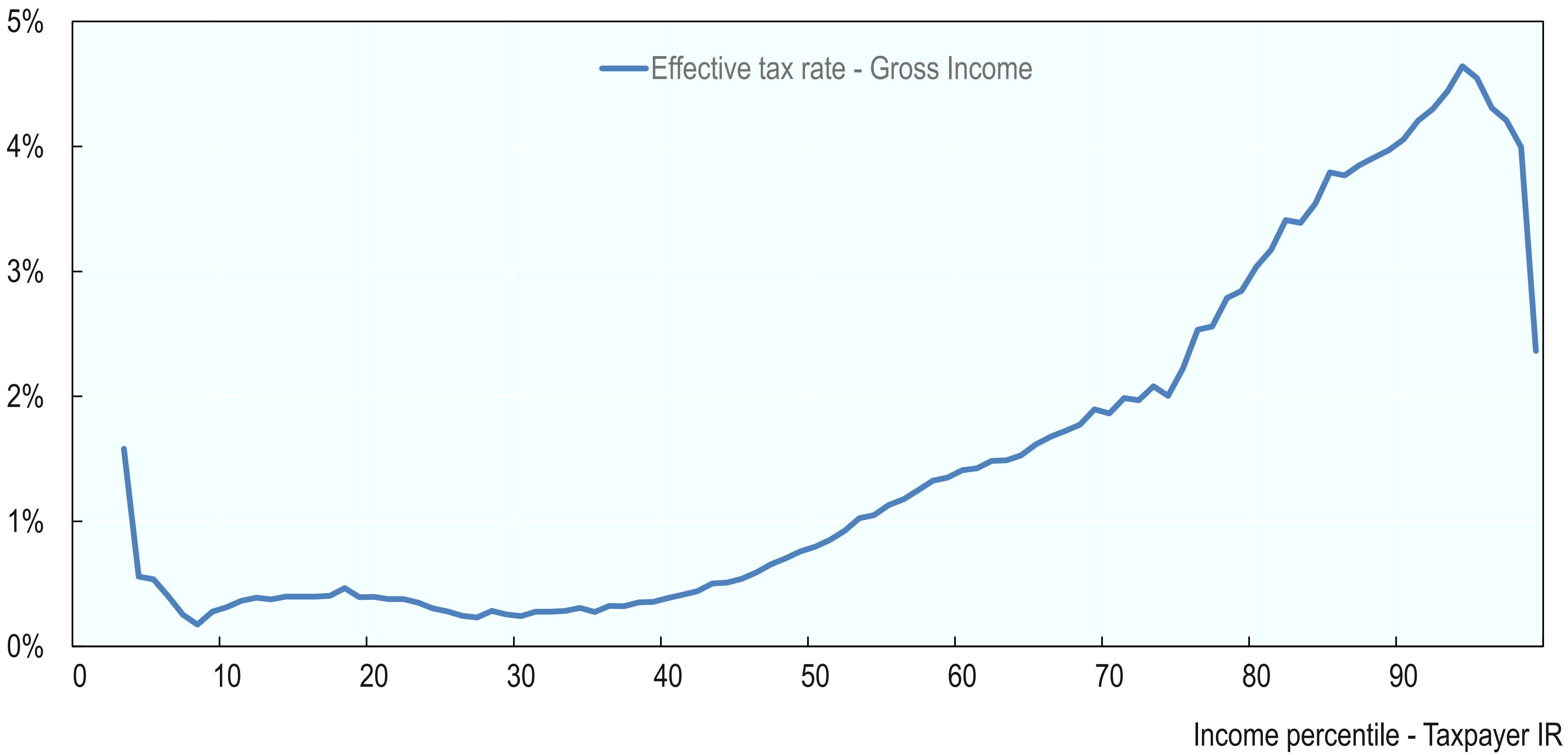
Distribution of gross income by individuals that file a PIT return across the personal income distribution, 2018



Source: DIAN

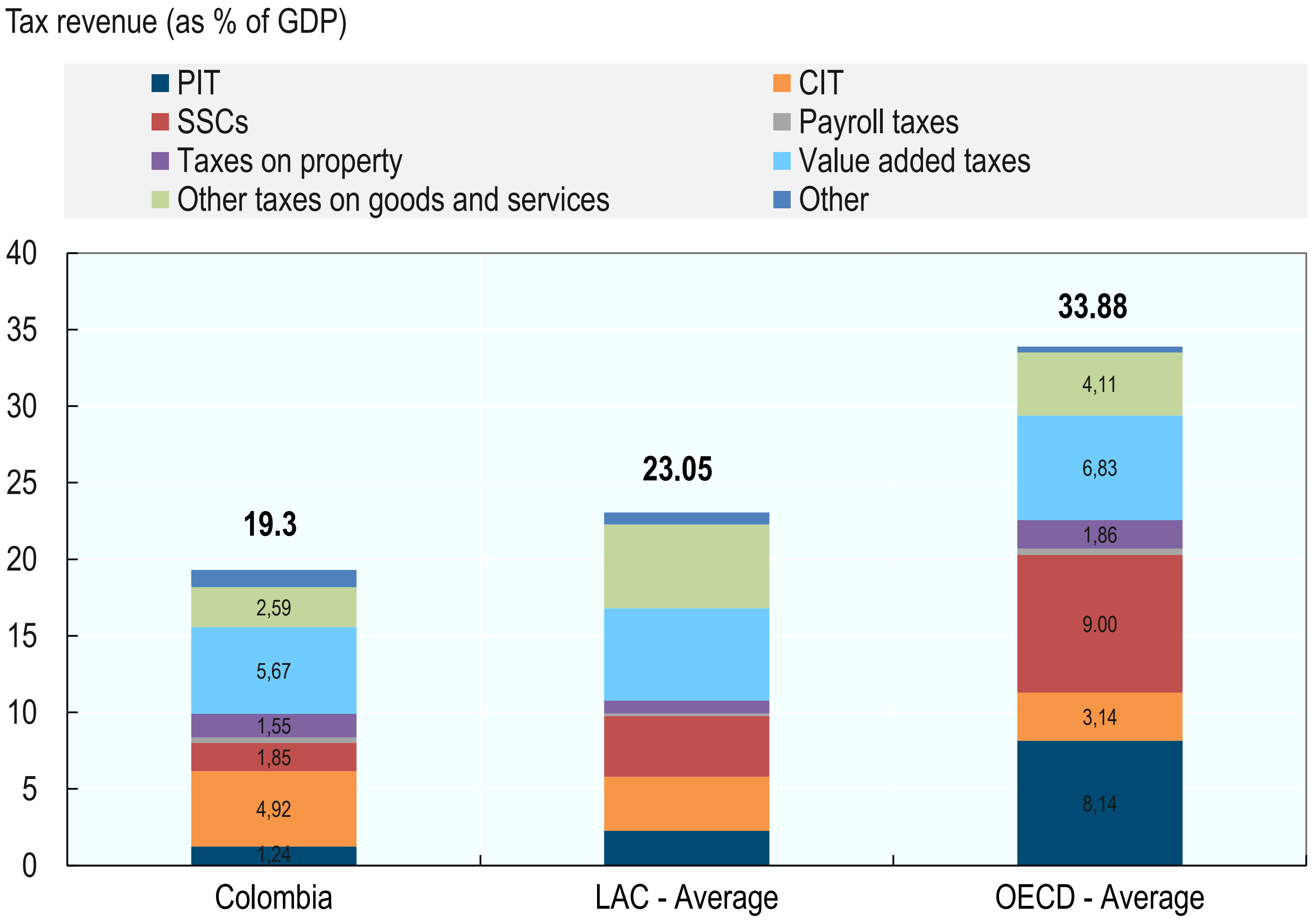
The proliferation of tax expenditures and insufficient monitoring result in extremely low effective tax rates

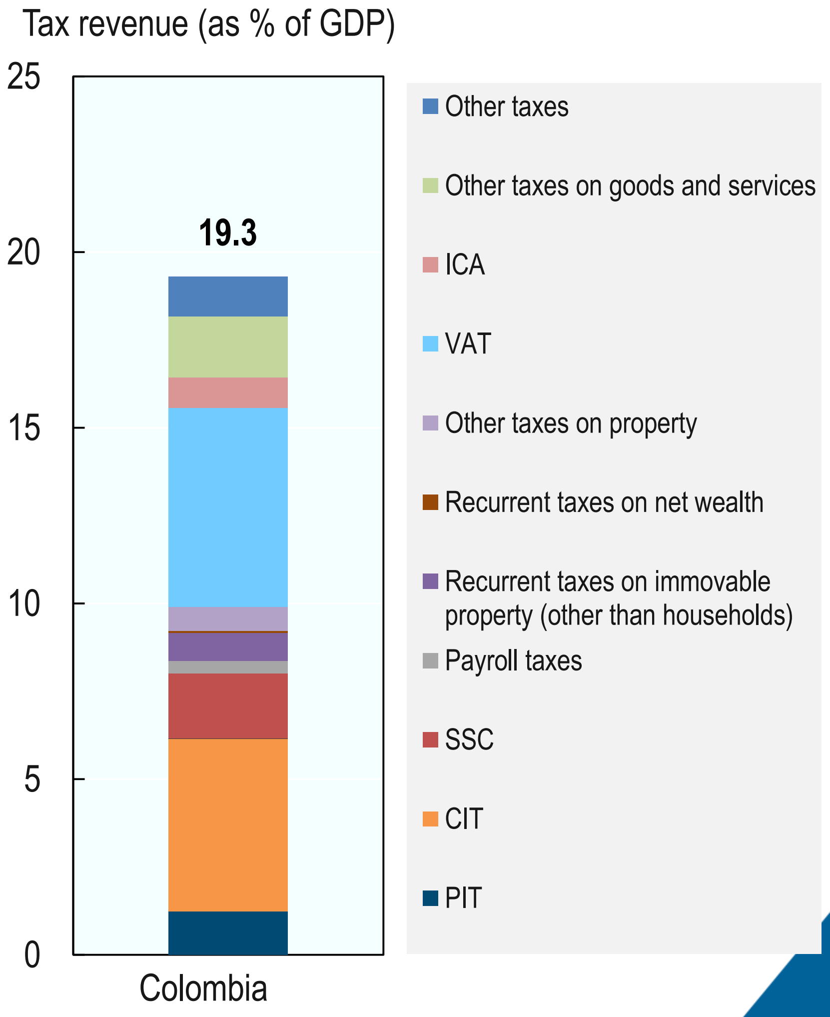
Effective tax liability on income earned at the individual level as a % of total income, 2018



Source: DIAN and MoF

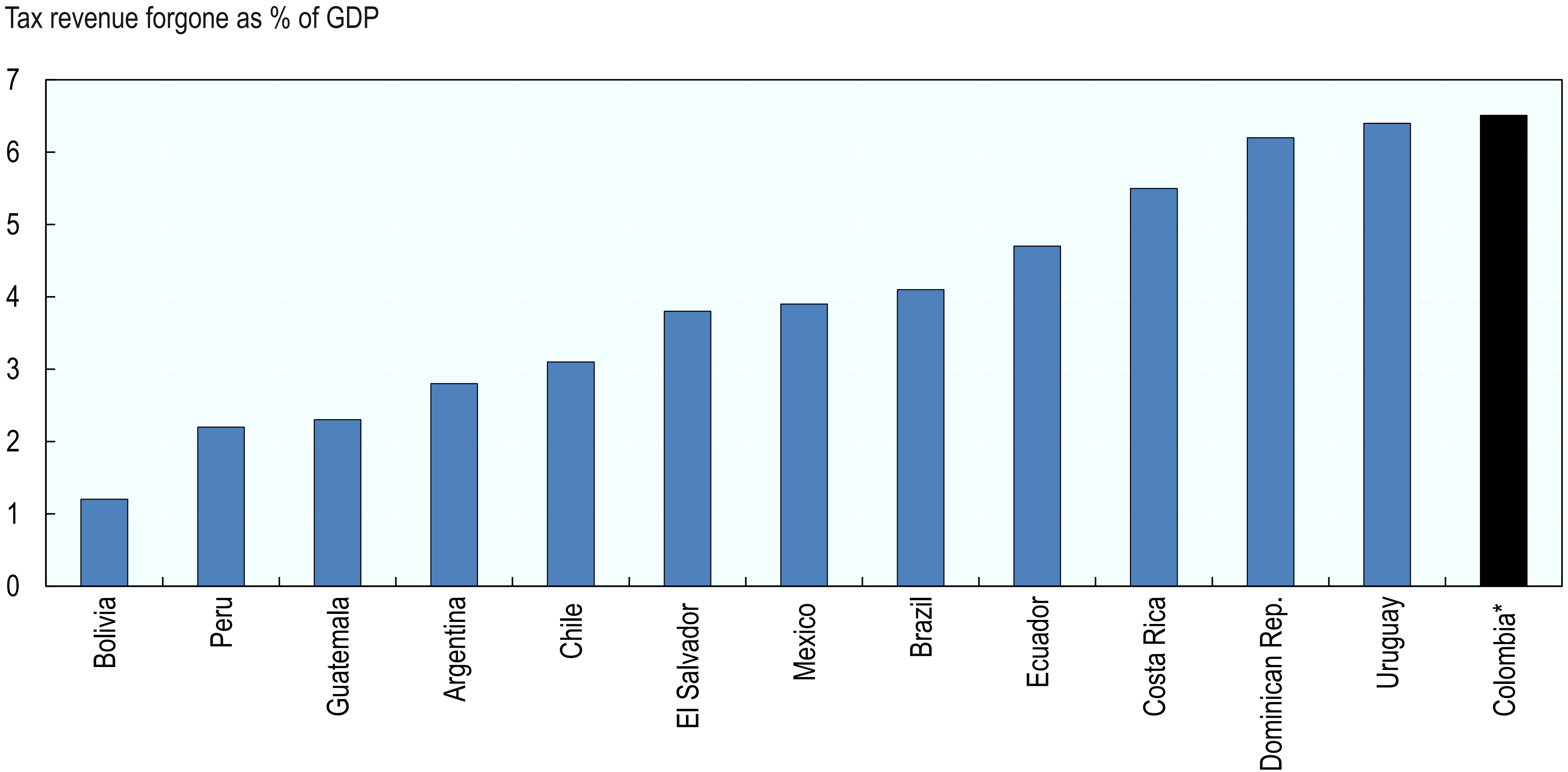
The narrow tax base limits revenue raising capacity, despite Colombia's multitude of taxes





Source: OECD Revenue Statistics (2018)

Colombia forgoes more tax revenue than any other Latin American country



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!

The TIC members and the OECD & DIAN TIC Technical Secretariat wish to thank the Minister of Finance and the DIAN Director General, the DIAN and MOF members of the Working Parties, national experts and contributors from the Ministries and the private sector for their excellent work and collaboration during the course of the Commission