ANALISIS DEL GASTO TRIBUTARIO EN COLOMBIA

George Zodrow,

Los "Gastos de Impuesto" han sido definidos, en la literatura especializada, como la pérdida de ingresos atribuible s a las leyes que permiten una exención, o una deducción especial de la renta o que proporcionan un crédito especial o un aplazamiento en el pago de los impuestos

Varios países deben preparar e cálculo de los gastos de impuesto dentro de su presupuesto. En Colombia, la Ley 788 de 2002 estableció la obligatoriedad de presentar un informe, en el proyecto de Presupuesto de la Nación, sobre el impacto fiscal de los beneficios y la fuente de financiación de los mismos.

A propósito de esta norma el profesor George Sodrow presentó un análisis de la experiencia de los Estados Unidos en la contabilización del gasto de impuesto con el fin de que pudiera servir de modelo para nuestro país.

Con éste propósito el Profesor Zodrow analiza los argumentos del debate existente entre la conveniencia de utilizar incentivos tributarios para beneficiar a la comunidad sacrificando el ingreso tributario, así como el de los contradictores, que prefieren que los recursos sean dirigidos a través del Gasto Público.

A continuación desarrolla como se está realizando la definición y cálculo de los Gastos Tributarios, y las estimaciones que realizan los expertos en los Estados Unidos; Finalmente menciona los parámetros que podrían ser útiles para su estimación de acuerdo con la estructura impositiva existente en Colombia.

TAX EXPENDITURE ANALYSIS IN COLOMBIA

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INTRODUCTION

The concept of "tax expenditures" was introduced in the late 1960s by Harvard Law Professor Stanley Surrey, and has been the subject of vigorous debate and continuous refinement ever since. The basic idea is relatively straightforward – many provisions in a typical tax code provide for preferential treatment of certain transactions or activities, relative to the tax treatment that would obtain under an "ideal" or at least improved tax system that did not include such special provisions. Surrey argued that these provisions should be viewed primarily as government expenditures that were effected through the tax system rather than as elements of tax policy. For example, the exclusion from the personal income tax base of interest on bonds issued by state and local governments in the US could easily be viewed as a subsidy to the activities of state and local governments financed with such bonds. That is, one could view the "tax expenditure" as taking place in two steps – the collection of tax on interest on state and local bonds as if they were fully taxable bonds, coupled with a government subsidy, equal to the value of the tax exemption, to the activities financed with those bonds.

Surrey, in his role as Assistant Secretary of the US Treasury, applied his theory in constructing the first "tax expenditure budget" which was issued by the Treasury in 1968. Subsequently, the concept of tax expenditures was enshrined in law in the Congressional Budget and Impoundment Control Act of 1974, which defined tax expenditures as "revenue losses attributable to provisions of the Federal tax laws which allow a special exclusion, exemption, or deduction from gross income or which provide a special credit, a preferential rate of tax, or a deferral of tax liability"[1] and required publication of an annual tax expenditure report. This process continues to this day; indeed, tax expenditure reports are prepared by both the US Treasury (which actually compiles two lists) and the Joint Committee on Taxation (JCT). In addition, numerous states in the US (Ladd, 1995) and many countries also compile annual tax expenditure budgets (OECD, 1996). Despite its widespread use, however, the compilation of tax expenditure budgets and the identification of certain tax provisions as "tax expenditures" have – for a number of reasons to be detailed below – proved highly controversial.

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[1] Congressional Budget and Impoundment Control Act of 1974 (P.L. 93–344), sec. 3(3).

Colombia will apparently soon be counted among the countries preparing a tax expenditure report; indeed, in conjunction with the recent tax reform effort, officials in DIAN are currently in the initial stages of this process. This paper summarizes the US experience with tax expenditure reporting in the hope that this information will facilitate the tax expenditure reporting process in Colombia. It begins by describing the rationale for reporting tax expenditures, discussing the method for calculating tax expenditures, and examining several troublesome conceptual issues raised by opponents of the practice. The analysis then considers how tax expenditure reporting in Colombia might be structured to avoid some of these controversies, while simultaneously clearly identifying the limitations that inevitably constrain the process of preparing a tax expenditure report. A concluding section briefly summarizes the findings of the report.

THE RATIONALE FOR A TAX EXPENDITURE REPORT

The traditional rationale for preparing a list of tax expenditures is the one stressed by Surrey (1973) and subsequently by Surrey and McDaniel (1985) – tax preferences primarily represent an indirect form of government expenditure and should be treated as such. Several arguments support this position. The most important is simply that a special tax preference, by reducing the tax liability associated with some activity, effectively acts as a subsidy to that activity (relative to the "standard" tax treatment afforded other activities) and thus should be treated primarily as a government expenditure rather than a tax provision.[2]

The distinction between direct and tax expenditures is more than merely a matter of semantics for several reasons. Historically, at least in the US, tax preferences have arguably not been subject to the same scrutiny as explicit expenditure programs, especially during difficult fiscal times when direct expenditures are being reduced or eliminated. In addition, reducing tax preferences is often viewed as "raising taxes" and thus often perceived to be less desirable than cutting expenditures. As a result, there is a tendency over time for inefficient over-expansion of activities supported through tax provisions relative to those financed with direct expenditures, and continuation of tax preferences that might be terminated if they were more visible as explicit subsidies.[3]

Direct expenditure programs are also likely to be more effective at meeting their goals than tax expenditures. Direct expenditure programs can be targeted more accurately than tax expenditures and thus achieve their goals at lower (and more certain) cost (Thuronyi, 1988). Direct expenditures can also be administered more effectively by agencies charged primarily with overseeing expenditure responsibilities rather than agencies with limited funds designated primarily for tax collection. Coordination of various programs may be

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[2] Ladd (1995) notes that the distinction between government expenditures and tax expenditures is likely to be especially arbitrary in the case of direct expenditures that take the form of government transfers.

[3] The experience in the US, however, suggests that tax preferences that are highly popular — e.g., the deduction for home mortgage interest — will survive regardless of how they might be labeled.

achieved more easily if they are all direct expenditure programs administered by the same agency with congressional oversight by the same set of committees (Thuronyi, 1988). Efforts at expenditure reform may be facilitated if all government programs affecting a given area are structured and accounted for similarly and administered by the same agency; health care reform provides an example (Aaron, 1994). Of course, opponents of tax expenditures have counterarguments to these claims. In particular, tax expenditures may reduce the stigma associated with means-tested support programs, and reduce overhead by informing people about and administering programs through the existing tax system (Ladd, 1995) and provide a market-based means of providing subsidies to various activities (King, 1984).

Another point often stressed by proponents of tax expenditure accounting is that tax expenditures that take the form of deductions or exemptions from a progressive personal income tax effectively provide an "upside down subsidy" to the preferred activity, since they are worth much more to high income taxpayers who face high marginal tax rates than to lower income taxpayers who face lower marginal tax rates and may not itemize deductions. Indeed, Surrey argued that many expenditure programs that were effected through the tax system would never survive the more careful scrutiny afforded direct expenditure programs. A standard example is the home mortgage interest deduction, which provides no benefits to the very poor who don't itemize, relatively small benefits to low income taxpayers who face low marginal tax rates and have interest deductions only slightly in excess of the standard deduction, and very large benefits to high income taxpayers who face high marginal rates and whose deductions far exceed the standard deduction.

The implication of this analysis is clear – most if not all tax expenditures should be either eliminated or converted to direct expenditure programs. In practice, most proponents of tax expenditure budgets favor the former course for most current tax expenditures. For example, Neubig and Joulfaian (1988) argue that a measure of the success of the Tax Reform Act of 1986 in the US is that it reduced the size of the tax expenditure budget by roughly 40 percent (with about 40 percent of this reduction attributable to base broadening and the rest attributable to rate reduction that decreased the value of the remaining tax expenditures). Thuronyi (1988) notes that virtually none of these provisions were replaced with direct expenditure programs.

This discussion suggests a second important role for tax expenditure analysis – a role that may in fact be more important in the Colombian context than the "accurate fiscal accounting" role stressed in the discussion above. Specifically, a tax expenditure report provides a list of potential tax reforms that are likely to be desirable on efficiency grounds and perhaps on equity and simplicity grounds as well. Although the reform enacted in Colombia in December 2002 will certainly increase revenues and thus help reduce both Colombia's short run fiscal deficit problem and long run fiscal sustainability problem, it is certainly possible that further revenues will be needed. Moreover, the corporate income tax rate increases (surcharges) enacted in the recent reform make the Colombian statutory tax rate among the highest in the region. This suggests that concerns about competitiveness in attracting foreign direct investment – as well as concerns about attracting

deductions and losing revenues due to transfer pricing and other accounting manipulations by tax-avoiding multinationals – may make future base-broadening rate-reducing reform of the corporate income tax desirable.

In any case, a tax expenditure report will prove essential in evaluating the costs of existing tax preferences and in estimating the revenue potential of possible reforms. For example, the recent corporate income tax reforms included the phasing-out of several tax preferences coupled with the inclusion of numerous new preferences. Only with something like a tax expenditure analysis can one obtain a feel for the relative magnitudes of the revenue impacts of these various changes in order to ascertain the costs of the new preferences, the revenues raised with the eventual elimination of the old preferences, and the net effect of the 2002 reform (or any other reform proposed in the future) on the breadth of the corporate tax base.

ISSUES IN CALCULATING TAX EXPENDITURES

In principle, the calculation of tax expenditures is straightforward. To begin, one must define a "reference" tax system. First, the base for the tax in question – for example, some version of a comprehensive income base for the corporate or personal income taxes, or a reasonably comprehensive consumption base for a destination-based value-added tax – must be specified. Unfortunately, as will be discussed in detail below, the definition of this reference base, which is absolutely critical to the analysis, is often highly controversial. Second, the appropriate rate structure to be applied to the reference base, including whatever degree of progressivity is deemed to be desirable, must be determined. Typically, the existing tax rate structure is used for this purpose, but alternative rate structures could easily be imagined. Finally, tax expenditures are calculated as the static revenue cost associated with all of the deviations in the actual tax code from the reference tax system constructed using the chosen base and rates.[4]

In the US (and elsewhere), several of the criticisms of tax expenditure reports focus purely on the calculation methodology that is typically used (rather than the conceptual issues discussed below). If deemed desirable, these problems could in principle be addressed with more sophisticated calculation methods.

The most-often cited issue is that tax expenditure calculations typically ignore any behavioral responses that might occur when the tax system is changed, and in particular tend to overstate the revenue gains that would be obtained if a tax preference were eliminated. For example, the elimination of a research and development (R&D) credit would be likely to reduce R&D expenses. In this case, a tax

[4] The tax expenditures associated with a proposed reform of the existing tax system can also be calculated using the same methodology.

expenditure estimate that simply took the amount of existing R&D expenditures and multiplied by the credit would overstate the revenue gain obtained from eliminating the credit by ignoring the induced reduction in R&D expenditures. To the extent reliable data are available on the magnitude of such responses, they could be factored into tax expenditure calculations. Indeed, in the US, Treasury and JCT revenue estimates have long been adjusted to reflect estimates of various microeconomic behavioral responses and are currently being adjusted to reflect estimates of tax-induced macroeconomic economic effects as well (Diamond and Moomau, 2003). Such procedures could also be incorporated in the tax expenditure process if deemed desirable. Note, however, that such calculations would be fairly complex, as they would also require estimates of the "feedback" effects on revenues that occur when a tax preference is eliminated. For example, elimination of the R&D credit might reduce R&D expenditure but stimulate other forms of investment (which would become relatively more attractive). The revenue gains associated with such increases in investment should also be factored into the estimate of the revenue effects of eliminating the tax preference for R&D expenditures. Given the complexity of such calculations – and the possibility that the net revenue effects of all reform-induced changes would be small – it is perhaps not surprising that even though behavioral reactions could in principle be incorporated into estimates of tax expenditures, they are typically ignored.

A second important and often-cited point is that tax expenditure estimates typically ignore interaction effects among different tax expenditures. That is, each tax expenditure is estimated assuming that all other features of the tax code, including all other tax expenditures, are held fixed. As a result, aggregating several tax expenditure estimates to obtain an estimate of the combined effect of eliminating all of them – as is sometimes done, especially in discussions of sweeping tax reforms – is inappropriate and may be quite misleading. For example, consider the case in which a personal income tax has numerous exclusions. As one or more of these exclusions is eliminated, taxpayers will move into higher tax brackets, so that the revenues gained from eliminating further deductions will be greater than that predicted in the tax expenditure calculation. Alternatively, suppose that a number of deductions exist under a personal income tax that also has a standard deduction. In this case, the same rate effect operates as in the case of multiple exclusions discussed above. However, a second effect also obtains. Specifically, as one or more of the deductions is eliminated, more taxpayers will choose the standard deduction rather than itemize deductions, in which case the elimination of further deductions has no revenue effect, and the tax expenditure estimate will be too high. Neubig and Joulfaian (1988) show that these interaction effects can be significant – as much as 22 percent of the combined individual effects in the example they cite. Again, if one is willing to accept the additional complexity, such interaction effects can in principle

be incorporated into the calculation of the combined effect of eliminating any particular set of tax expenditures, as long as the relevant data are available.[5]

A third issue arises in measuring the tax expenditure associated with tax preferences that take the form of tax deferrals, such as deductible contributions to retirement savings plans that are subsequently taxed, including interest, when the contributions are withdrawn. In this case, the magnitude of the tax expenditure should be measured in present value terms, balancing the current tax reduction against the expected (and discounted) future tax payment. Approaches that are based on current deductions or on current net cash flows are likely to overstate the true cost of the tax preference; in the US, Treasury estimates currently calculate the tax expenditures associated with some deferral preferences in present value terms (Ladd, 1995; Bartlett, 2001).

Thus, in all three of these cases, the primary issue is one of accurate measurement, which is of course a critical issue in any type of revenue estimate. Such issues can, in principle and if deemed desirable, be addressed with more complex calculation methodologies. However, tax expenditure reporting has been subject to two much more fundamental criticisms, each of which is addressed in the following section.

Additional Controversial Issues in Tax Expenditure Reporting

The Choice of the Reference Tax System

Although the measurement questions described in the previous section are certainly important, most of the controversy surrounding the use of tax expenditure budgets has involved more conceptual issues. The most fundamental issue is the determination of the reference tax system. Surrey's view was that the reference system should be the one that is "generally accepted" by tax specialists, which he interpreted as a Haig-Simons comprehensive income tax, modified to reflect historical and administrative realities regarding what can reasonably be included in the income tax base.[6] It is clear that simply adopting the Haig-Simons definition of comprehensive income – including all forms of consumption plus all changes in net wealth – is not a feasible approach. The Haig-Simons definition is so broad that defining tax expenditures with respect to such a reference point would result in a tax expenditure list that would be so expansive that it would inevitably be viewed as unrealistic and would thus be ineffective (Thuronyi, 1988). For example, a true Haig-Simons tax base would include accrued but unrealized appreciation on all forms of capital assets including housing and collectibles, the services obtained from housing (imputed rent) and other consumer durables, and the leisure time of non-working spouses.

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[5] Neubig and Joulfaian (1988) describe the relevant techniques.

[6] Note that such an approach was essentially followed in the development of the Tax Reform Act of 1986 in the US (McLure and Zodrow, 1987).

Unfortunately, however, once one starts deviating from a "pure" tax base – no matter how unrealistic that base may be – the choice of a reference tax system becomes rather subjective. As a result, the tax expenditure concept becomes somewhat arbitrary and ambiguous and thus loses at least some of its theoretical appeal. This point is made forcefully by Bittker (1969), who argues that in the absence of a widely accepted reference tax system the calculation of any particular set of tax expenditures primarily reflects differences between the current tax system and what the analyst thinks that tax should be.[7]

Under these circumstances, the classification as tax expenditures of many critical provisions of the tax code becomes problematical. For example, Surrey argues that the double taxation of corporate income that characterizes a classical income tax is appropriate, which implies that departures from that standard should be classified as tax expenditures. On the other hand, one could easily argue that even the broad Haig-Simons standard requires only one level of taxation (in principle, at the individual level under a progressive marginal tax rate system), and that additional layers of tax represent "negative" tax expenditures. Furthermore, under the latter approach, taxation of capital gains at the individual level is undesirable to the extent that real gains reflect retention of after-tax corporate earnings. Even if one concludes that capital gains should be included in the reference tax base, the precise nature of that inclusion is unclear – administrative concerns suggest that taxation should occur only upon realization rather than as accrued and the issue of whether inflation indexing should be provided is contentious.[8] Similar arguments could be made for many other common tax provisions, including deductions for charitable contributions, subnational taxes, medical expenses, uninsured losses, etc. Indeed, one could argue that uncertainty about the appropriate reference tax system extends to basic issues such as the choice of taxable unit (family or individual?) and the marginal rate structure and personal exemptions and standard deductions (should a proportional tax on all income be the reference tax system?).

The essential assumption of Surrey's analysis – that the appropriate reference tax base reflects some measure of comprehensive income – has also been called into serious question. Many economists have long argued that consumption is preferable to income as the base of a system of direct taxation (Bradford, 1986; Zodrow and McLure, 1991),[9] and efforts at "fundamental tax reform" in the US and elsewhere have focused on the implementation of various forms of consumption taxation (Aaron and Gale, 1996; Zodrow and Mieszkowski, 2002). Indeed, all income tax systems are in practice hybrid consumption-income taxes, with many features that are appropriate only under

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[7] Indeed, one can imagine a situation in which all tax preferences are deemed to be appropriate elements of the reference tax system, so that all tax expenditures are defined away.

[8] If one accepts taxation upon realization as a principle, then only real gains should be taxed. However, since taxation upon realization implies deferral of gains, the taxation of nominal gains can be viewed as an offset to the benefit of tax deferral until realization.

[9] For a discussion of consumption taxation in the Colombian context, see McLure, Mutti, Thuronyi and Zodrow (1990).

a consumption-based system of taxation. If a consumption base were deemed to be the reference tax system, then it would be inappropriate to characterize as tax expenditures many common income tax provisions – including corporate income taxation in excess of that associated with cash flow taxation, individual level taxation of capital income, and most pension plans and other forms of retirement saving (Ture, 1990; Saxton, 1999).

Thus, the issue of the appropriate reference tax system for the calculation of tax expenditures is a contentious one. Clear evidence of this point is provided by the fact that the reference tax systems used in the reports issued by the Joint Committee on Taxation and the US Treasury differ in numerous respects, with the base used in the JCT analysis generally broader than its Treasury counterpart.[10] Moreover, partly in response to some of the measurement issues noted above, Treasury issues two sets of calculations – a standard "revenue loss" calculation and an alternative "expenditure outlay equivalent" report that more closely attempts to calculate the level of expenditure that would be required to provide a taxpayer benefit equal to that afforded by the tax preference being analyzed.[11] [12]

Nevertheless, one must be careful not make too much of this point. The typical tax system has many provisions that would be characterized as tax expenditures under any reasonable definition of a reference tax system. The fact that the definition of the reference tax system is to some extent subjective does not mean that the concept of tax expenditures is vacuous and that there are not many provisions that virtually all would agree should be so classified.

Underlying Presumption of Tax Expenditure Analysis

Finally, opponents of the tax expenditure concept often violently object to what they perceive to be its underlying presumption – that the government in some sense has "ownership" of all private resources (since tax preferences are treated as government-granted subsidies rather than simply as tax reductions). This point is expressed forcefully by Fried (1995) who argues that, "Lurking behind the concept of tax expenditures is a more sinister premise. It is the subtle disposition to think of all income as virtual state property, and forbearance to tax away every last penny of it as itself a tax expenditure."[13] Although this seems to be somewhat exaggerated, it has an element of truth – the idea that tax expenditures and direct expenditures together comprise a "combined government budget," stressed by

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[10] See Joint Committee on Taxation (2002) for a detailed discussion of the differences between the lists of tax expenditures contained in the Treasury and JCT compilations.

[11] The outlay equivalent figures are generally the larger ones, as they assume that subsidies received by taxpayers would be taxable and thus would have to be larger to provide the same level of benefit (Neubig and Joulfaian (1988).

[12] Treasury also issues tax expenditure calculations for the gift and estate tax. Colombia plans to issue estimates of tax expenditures for its value-added tax.

[13] See Saxton (1999) for a similar viewpoint.

some proponents of tax expenditures, certainly implies a much larger government sector than is actually observed. However, creating this implication does not appear to be the intent of most proponents of tax expenditures, who instead stress the advantages of the concept noted previously.

Ladd (1995) argues that this concern can be tempered by renaming the tax expenditure "budget" as a tax expenditure "report" to avoid creating the image that the government disburses the funds associated with tax expenditures. However, this would not deal with the issue that the concept of tax expenditures, for the reasons noted above, explicitly compares tax preferences to expenditures. In some cases, arguably including Colombia, the focus of the analysis is not on the comparison of tax preferences with direct expenditures but with identifying a list of tax preferences that might be eliminated as part of a tax reform package. If so, and if the largely cosmetic issue of the interpretation of the concept of tax expenditure proves to be important in Colombia, it may be useful to attempt to defuse it simply by constructing a list of "tax preferences" rather than a "tax expenditure budget". At a more substantive level, figures regarding the total costs of various tax expenditures could be supplemented with data on how much average tax rates could be lowered if the tax expenditure were eliminated, creating a list of tax preferences presented in a revenue neutral context.

STRUCTURING A TAX EXPENDITURE REPORT IN COLOMBIA

What lessons can Colombia draw from the US experience as it embarks upon the path of charting the tax expenditures or tax preferences embedded in its tax laws? Perhaps the most important is that the limitations of tax expenditure analysis should be made explicit at the outset. In particular, tax expenditure analysis relies heavily on the construction of a reference tax system that is to a considerable extent subjective, and accurate measurement of tax expenditures is difficult. It should be made clear that these factors imply that the calculation of tax expenditures must be viewed with caution – as suggestive of the relative magnitudes of the revenues involved rather than precise revenue estimates – but that such problems do not negate the advantages of attempting to quantify the magnitudes of the tax preferences in the existing tax code. If the goal of the exercise is primarily the identification of tax preferences that might be eliminated in subsequent tax reforms rather than the identification of expenditures made through the tax system that should be treated as part of the expenditure budget, the focus of the reporting process could be on "tax preferences" rather than "tax expenditures." Such an approach might limit the political problems that often arise when opponents of tax expenditure analysis argue that it assumes that all income is the property of the government. Similarly, if is deemed desirable to emphasize the rate reductions that might be obtained with elimination or reduction of tax preferences, the report might also estimate the magnitude of such potential reductions in average tax rates, thus presenting the analysis in a revenue neutral context. Finally, once a reasonable reference tax system is defined, any tax provisions that result in over-taxation should, in

the interests of full disclosure and to avoid charges that the analysis is biased toward increasing revenues, be characterized as "negative" tax expenditures – provisions that increase revenues but are inappropriate given the reference tax system.

The task of defining a reference tax system is made somewhat easier in Colombia since the histories of the income tax and the value added tax suggest solutions to several of the problems that plague tax expenditure analysis. Certainly no attempt should be made to include in the reference tax base items that have never been taxed in Colombia and very seldom elsewhere, including leisure time, imputed returns to owner-occupied housing and other consumer durables, and unrealized capital gains on any types of assets. However, given these caveats, the reference tax base should be as comprehensive as possible. Furthermore, Colombia has for quite some time provided for integration of its business and individual level taxes in the form of the exclusion of dividends from individual level taxation; in addition, until the 2002 reform, capital gains were exempt from individual level tax. This suggests that the reference tax system in Colombia should provide for only a single level of taxation of capital income, at the business level. Note, however, that this implies that the recent move to tax capital gains should be viewed as a "negative" tax expenditure, at least to the extent that capital gains reflect retained earnings, rather than other factors such as changes in expectations about future returns or changes in the interest rate used to discount such future returns. Given that capital gains are indexed for inflation and taxed only upon realization, the magnitude of this "negative" tax expenditure is not likely to be large, and taxation of capital gains can be justified as an attempt to limit avoidance and evasion in the form of converting labor income to untaxed capital gains.

In addition, although the Colombian income tax certainly has provisions that reflect the principles of consumption-based rather than income-based taxation, Colombia has seriously considered but then explicitly rejected a move to full consumption-based direct taxation (McLure, Mutti, Thuronyi and Zodrow, 1990).[14] Accordingly, the reference income tax system should reflect income tax treatment of capital income, subject to the provision (noted above) that such income should be taxed only once. Nevertheless, given the uncertainty in the literature about the appropriate base for direct taxation, it would be useful to group together and list first those tax expenditures that reflect preferential treatment of (1) retirement saving, and then (2) other forms of saving, so that such expenditures can be discounted by those who believe that direct taxation based on consumption is preferable to income taxation in Colombia.

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[14] It should, however, be noted that this decision was, at least to a large extent, dictated by external considerations. Colombia, like all countries contemplating consumption based direct taxes, was highly concerned that the US would not deem a cash flow business tax — an essential element of most direct consumption tax plans — to be creditable against the domestic income tax liability of US-based multinationals. Such treatment, which would result in double taxation of some investment income (economic rents) earned in Colombia, was sufficiently harsh to rule out adoption of a consumption based plan. For further discussion of this issue, see McLure and Zodrow (1998).

A final general point is that the Colombian tax system has for some time been indexed for inflation, so that the tax base is in principle real income. Thus, inflation adjustment should be assumed in the reference tax system used to calculate tax expenditures. In particular, inflation indexing of capital gains should not be treated as a tax expenditure.

In addition to these general issues, several points are relevant for each of the three major taxes considered in this report – the corporate income tax, the individual income tax and the VAT. These are discussed below. Note, however, that the discussion is by no means comprehensive. Rather it is meant to be suggestive of some of the issues that will arise in constructing estimates of tax expenditures in Colombia.

Corporate Income Tax

Under the corporate income tax, the primary general issue is the treatment of depreciation allowances. One could argue that current deductions for depreciation are somewhat excessive, since depreciation allowances were not reduced when Colombia introduced inflation indexing of its tax system, including deductions for depreciation (McLure and Zodrow, 1997). It does not, however, seem wise to attempt to define the extent of any excess depreciation and include it as a tax expenditure, especially since the data required to do so with any degree of accuracy are not available and there seems to be a sense in Colombia that the current level of depreciation deductions is roughly appropriate. Accordingly, the reference corporate income tax system should simply allow deductions for depreciation equal to those under current law. The reference tax rate should simply be the current tax rate, including the 10 percent surcharge in 2003 and the 5 percent surcharge thereafter (which results in a corporate rate of 36.75 percent).

Any further deductions or exemptions should be treated as tax expenditures under the reference corporate income tax base. The calculation of these tax expenditures (or tax preferences) will provide extremely useful estimates of the revenue gains that might be obtained by eliminating the many preferences that characterize the current Colombian corporate income tax, including the preferences enacted in the recent reform. Since under Colombian law even those firms that currently benefit from tax exemptions are required to file returns, the calculation of tax expenditures under the corporate income tax should be relatively straightforward. In addition, especially given the high corporate tax rate in Colombia relative to neighboring countries, it would be useful to estimate the magnitudes of the rate reductions that could be financed with elimination of these preferences. Note that such a calculation could take into account the magnitude of the final rate reduction in calculating the size of the revenue gains attainable with elimination of all, or any combination, of these preferences.

Finally, although the Colombian tax system in general provides a comprehensive integrated approach to inflation indexing, this system does not extend to inventories, which are unindexed. Since there is no reason for inventories to be singled out for such harsh treatment under the income tax (which creates tax distortions favoring investment in assets other than inventories and creates a tax bias

against those firms that use production processes that are relatively intensive in their use of inventories), this provision should be listed as a negative tax expenditure.

Personal Income Tax

The major issue under the personal income tax is the treatment of the new 25 percent wage exemption (reduced from 30 percent), which was capped at 4 million pesos per month under the reform enacted in 2002. Since the personal income tax thresholds in Colombia are relatively high, one could argue that all of these wage exemptions should be treated as tax expenditures. An alternative approach would be to assume a standard deduction under the reference personal income tax system equal to some fraction of the cap, and then treat any wage exemptions in excess of that amount as tax expenditures. Rates under the reference personal income tax system could equal existing rates.

Given this reference individual tax system, the preferences for retirement saving and other forms of saving should be grouped and listed as the first set of expenditures under the personal income tax.[15] The report would thus identify clearly all tax expenditures attributable to provisions that reduce the tax burden on capital income and thus move the tax system in the direction of a direct tax on consumption. The remaining list of tax expenditures should then include all other exclusions, exemptions and deductions, relative to the reference personal income tax. This would include preferential treatment of all forms of labor compensation, including bonuses, vacation pay, severance pay, fringe benefits etc.

Value-Added Tax

The reference tax system for the value-added tax is also arguably relatively straightforward in the Colombian context. In principle, the VAT should be applied to all domestic consumption of final goods and services, with exports zero-rated. However, like virtually all other countries, Colombia makes no attempt to tax most financial services (although brokerage commissions are taxable under the 2002 reform), and exempts the health, education, welfare, public transportation and public service sectors. These features should be incorporated into the reference tax base, with the reference tax rate set equal to the "standard" rate of 16 percent.

Moreover, since Colombia established in the 2002 reform the fundamental principle that all other currently zero-rated goods and services should be taxed (as of 2005), it seems reasonable to treat all remaining untaxed or under-taxed (relative to the 16 percent rate) goods and services as tax expenditures. For those goods that zero-rated or taxed at preferential rates, the magnitude of the tax expenditure will be straightforward to calculate, as it will equal the product of consumption of the good and the difference between the standard 16 percent

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[15] The report might note that interest income is generally subject to withholding at a 7 percent rate which, given very low reporting of interest income on individual returns, implies that interest income is far from fully taxed. However, since such interest income is supposed to be reported on individual returns, this is primarily a compliance issue.

rate and the current VAT rate. (Note that in some cases, such as automobiles that are taxed at a 25 percent rate, the tax expenditure will be negative, and should be presented as such.) The situation is more complicated for goods or activities that are currently tax exempt. The sellers of exempt goods pay no VAT at the point of final sale, but do pay VAT on inputs which is never credited since final sales are exempt. These pre-retail taxes must be taken into account when estimating the revenue gains attainable from taxing formerly exempt goods. In addition, under the new law, credits are provided for capital goods, but are spread out over three years. The reduction in the present value of the credit for capital goods attributable to the delay in allowing the credit should be treated as a negative tax expenditure.

These calculations should also estimate the tax expenditure associated with a very unusual provision in the new law. Under the current version of this law, all goods that were formerly zero-rated will be taxed at a 2 percent rate, beginning in 2005. For consumption goods, this will increase revenues somewhat. The reform, however, also specifies that for producer goods that are taxed at the new 2 percent rate, a credit will be allowed as if the goods had initially been taxed at the standard 16 percent rate. There is no justification for such input subsidies, which will lead to significant revenue losses and large distortions of input choices. This provision should be treated as a subsidy to the use of the affected inputs and included in the tax expenditure calculation (which will hopefully help prompt efforts to remove this provision).

On a somewhat related issue, numerous final consumption goods are currently taxed at a 7 percent rate under the Colombian VAT. However for inputs into the production of such goods, current law allows credits only at the 7 percent rate, even if the inputs were taxed at the 16 percent rate. This treatment increases the effective VAT rate applied to goods that are nominally taxed at the 7 percent rate,[16] and this factor should be taken into account in estimating the tax expenditure associated with the current 7 percent "preferential" rate.

Finally, note that imposing the "standard" 16 percent rate on the broad consumption base envisioned under the approach described above would raise significant revenues. Accordingly, it would again be useful to estimate the magnitude of the rate reduction that could be financed with such a broad tax base. Note that such a tax expenditure calculation could take into account the magnitude of the final rate reduction in calculating the size of the revenue gains attainable with comprehensive base broadening.

Conclusion

As Colombia begins the process of preparing a tax expenditure report, the experience of the US offers some guidance. Perhaps the most important lesson is that the limitations of such an analysis should be acknowledged from the outset. Estimates of tax expenditures

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[16] Indeed, if most of the inputs are taxed at the 16 percent rate, the effective rate on the "7 percent" good approaches the standard rate of 16 percent.

are exactly that – estimates – and depend on the degree of sophistication used in their construction, the quality of the available data, and the somewhat subjective process of defining the reference tax base from which the tax expenditures will be measured. Nevertheless, estimates of tax expenditures provide a useful input into the fiscal process – both in terms of identifying and estimating the cost of effective "expenditures" that occur through the tax side of the budget and in identifying tax preferences that might be targets of future tax reform efforts. In particular, such estimates will facilitate an examination of the costs of various special preferences and the revenue gains or rate reductions that might be obtained with their reduction or elimination. Thus, the preparation of tax expenditure estimates in Colombia, if done carefully and not oversold, will be a very useful addition to the ongoing debate regarding the evolution of fiscal policy.

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