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BETTER POLICIES FOR BETTER LIVES

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

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

The Secretariat's draft report was prepared for the Committee by Christian Daude, Christine De la Maisonneuve and Guillaume Bousquet under the supervision of Piritta Sorsa. Editorial support was provided by Anthony Bolton, Inés Gómez Palacio and Mikel Inarritu. The Survey *also benefitted from contributions by Bert Brys, Jane Korinek, Laurent Lambert, Sarah Perret, Julien Pascal, Mikaela Rambali and Virginia Robano.*

The previous Survey *of Colombia was issued in December 2012.*

BASIC STATISTICS OF COLOMBIA, 2013

(Numbers in parentheses refer to the OECD average)[a]

LAND, PEOPLE AND ELECTORAL CYCLE

Population (million)	48.3		Population density per km^2	42.3	(34.8)
Under 15 (%)	27.7	(18.2)	Life expectancy (years, 2012)	73.7	(80.2)
Over 65 (%)	6.2	(15.6)	Men	70.0	(77.5)
			Women	77.3	(82.9)
Latest 5-year average growth (%)	1.4	(0.6)	Latest general election	June 2014	

ECONOMY

Gross domestic product (GDP)			Value added shares (%)		
In current prices (billion USD)	378		Primary sector	19.4	(2.5)
In current prices (trillion COP)	707		Industry including construction	22.9	(27.8)
Latest 5-year average real growth (%)	4.2	(0.8)	Services	57.7	(69.5)
Per capita (000 USD PPP)	12.6	(39.3)			

CENTRAL GOVERNMENT[b]
Per cent of GDP

Expenditure	19.3	(42.4)	Gross financial debt	37.3	(109.5)
Revenue	16.9	(36.7)	Net financial debt	34.8	(69.6)

EXTERNAL ACCOUNTS

Exchange rate (COP per USD)	1 868.4		Main exports (% of total merchandise exports)		
PPP exchange rate (USA = 1, 2012)	1 171.3		Petroleum and crude products	54.4	
In per cent of GDP			Coal and solid fuels manufactured from coal	10.6	
Exports of goods and services	17.8	(52.6)	Gold (including gold plated with platinium)	3.8	
Imports of goods and services	20.2	(48.6)	Main imports (% of total merchandise imports)		
Current account balance	-3.3	(-0.1)	Petroleum oils, other than crude	10.7	
Net international investment position	-27.2		Motor cars and other motor vehicles	4.7	
			Electrical apparatus	3.9	

LABOUR MARKET, SKILLS AND INNOVATION

Employment rate for 15-64 year-olds (%, 2012)	60.3	(65.2)	Unemployment rate, Labour Force Survey (age 15 and over) (%)	9.6	(7.9)
Men	73.3	(73.1)	Youth (age 15-24, %, 2012)	19.5	(16.1)
Women	48.1	(57.4)			
Participation rate for 15-64 year-olds (%)	63.7	(71.1)	Tertiary educational attainment 25-64 year-olds (%, 2012)[c]	22.6	(32.2)
Average hours worked per year	1 956	(1 771)	Gross domestic expenditure on R&D (% of GDP, 2012)	0.17	(2.4)

ENVIRONMENT

Total primary energy supply per capita (toe/1 000 USD, 2010)	0.08	(0.14)	CO_2 emissions from fuel combustion per capita (tonnes, 2011)	1.6	(9.9)
Renewables (%)	25.0	(8.8)	Water abstractions per capita (1 000 m^3, 2007)	0.6	
Fine particulate matter concentration (urban, PM_{10}, μg/m^3, 2011)	53.0	(28.0)	Municipal waste per capita (tonnes, 2012)	0.2	(0.5)

SOCIETY

Income inequality (Gini coefficient, 2012)	0.539	(0.308)	Education outcomes (PISA score, 2012)		
Relative poverty rate (%, 2012)	32.7	(11.1)	Reading	403	(497)
Public and private spending (% of GDP, 2012)			Mathematics	376	(494)
Health care	6.8	(9.2)	Science	399	(501)
Pensions	4.0	(8.7)	Share of women in parliament (%, January 2014)	12.1	(26.7)
Education (primary, secondary, post sec. non tertiary)	3.9	(3.9)	Net official development assistance (% of GNI)	0.20	(0.37)

Better life index: *www.oecdbetterlifeindex.org*

a) Where the OECD aggregate is not provided in the source database, a simple OECD average of latest available data is calculated where data exist for at least 29 member countries.

b) For the OECD, the numbers refer to General Government.

c) For Colombia, this indicator is the share of labour force population with a tertiary educational attainment over total labour force population.

Source: Calculations based on data extracted from the databases of the following organisations: OECD, International Energy Agency, World Bank, WDI, International Monetary Fund, Inter-Parliamentary Union, DANE and Central Bank of Colombia.

Executive summary

- *Main findings*
- *Key recommendations*

Main findings

Promoting more inclusive growth

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

Raising revenues and making the tax mix more efficient and fair

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

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

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

Key recommendations

Main priorities

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

Promoting more inclusive growth

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

Raising revenues and making the tax mix more efficient and fair

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

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

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

Assessment and recommendations

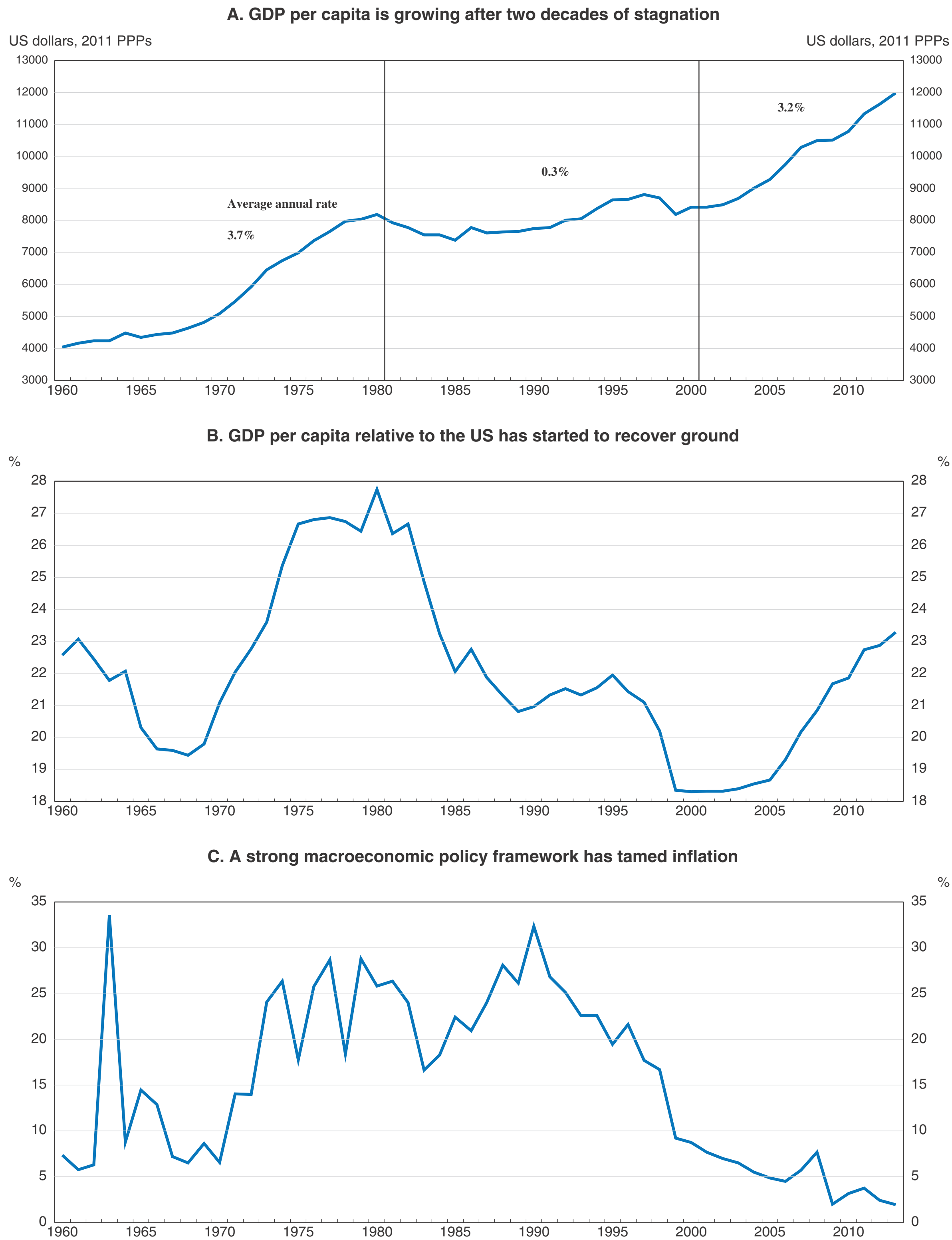
- *Macroeconomic Outlook*
- *Macroeconomic policies*
- *Making the tax system more efficient, fair and green*
- *Promoting more inclusive growth*
- *Reforming the pension system and old age income support*

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

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

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

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



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

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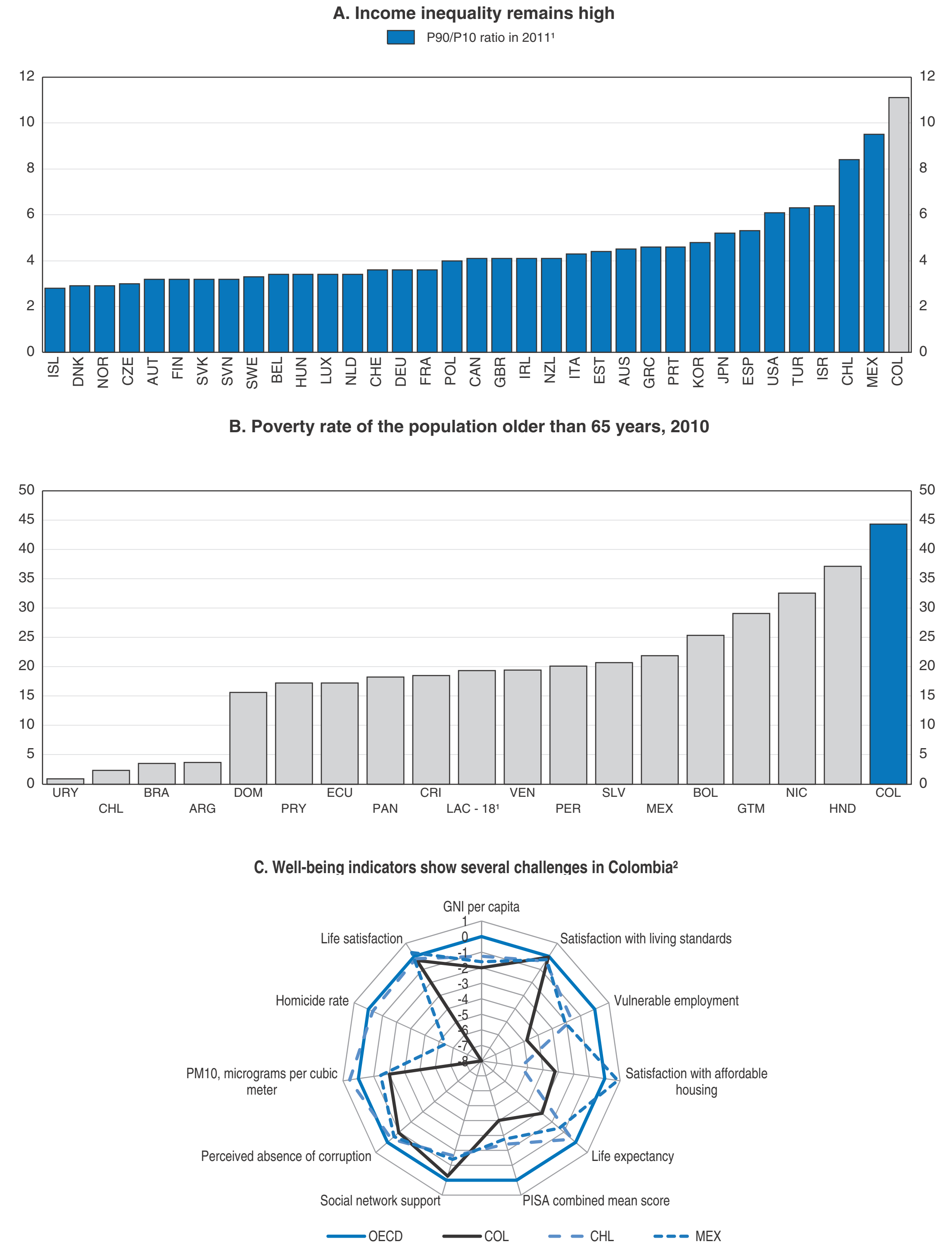
Figure 2. **Inequality, poverty and well-being indicators**



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

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

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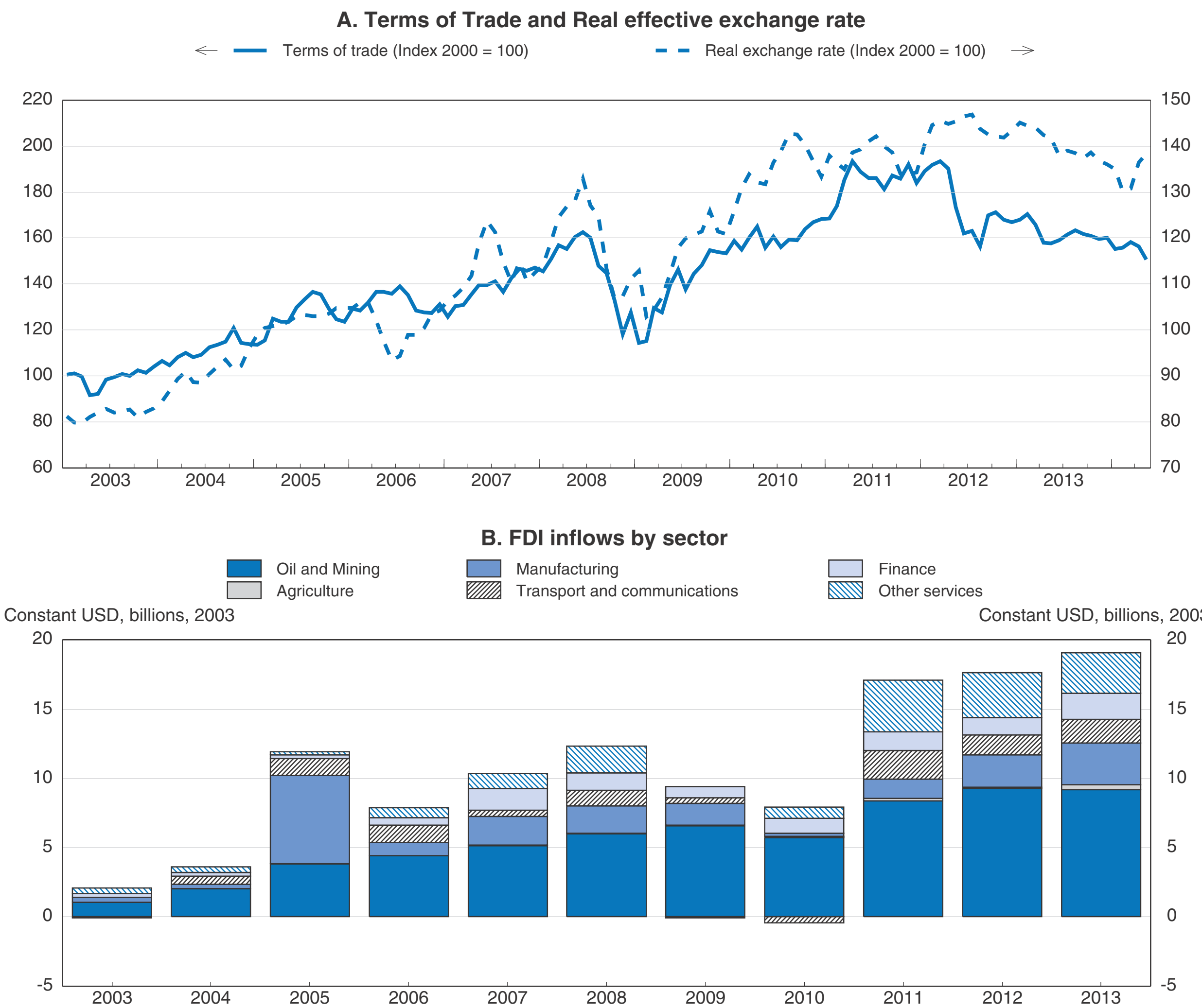
Macroeconomic Outlook

Recent macroeconomic developments

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

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



Source: Banco de la República.

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Table 1. **Macroeconomic indicators and projections**

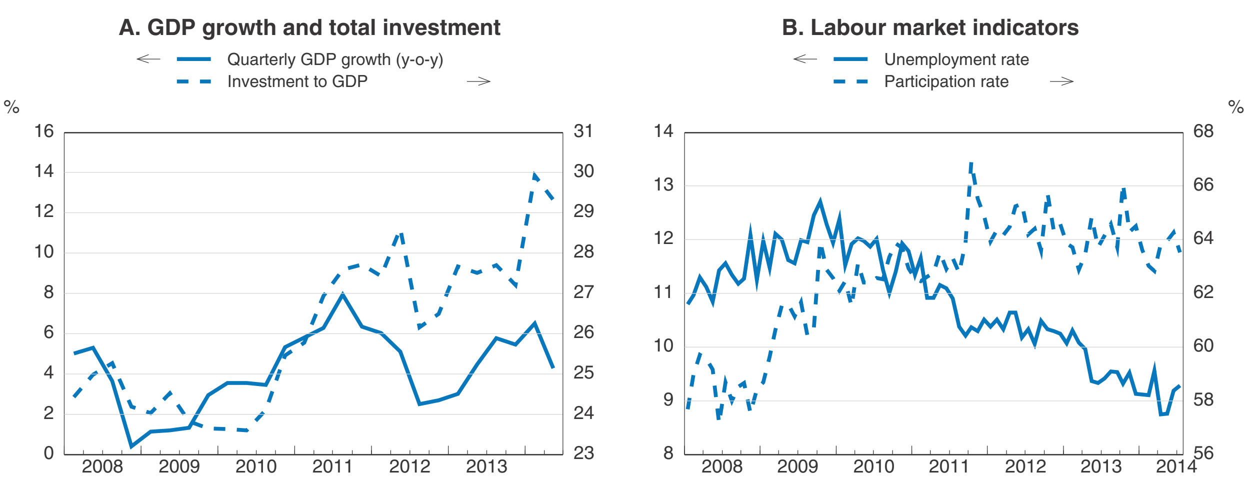
Annual percentage change, volume (2005 prices)

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

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

Source: OECD Economic Outlook 96 database.

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



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

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

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

In percentage points

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

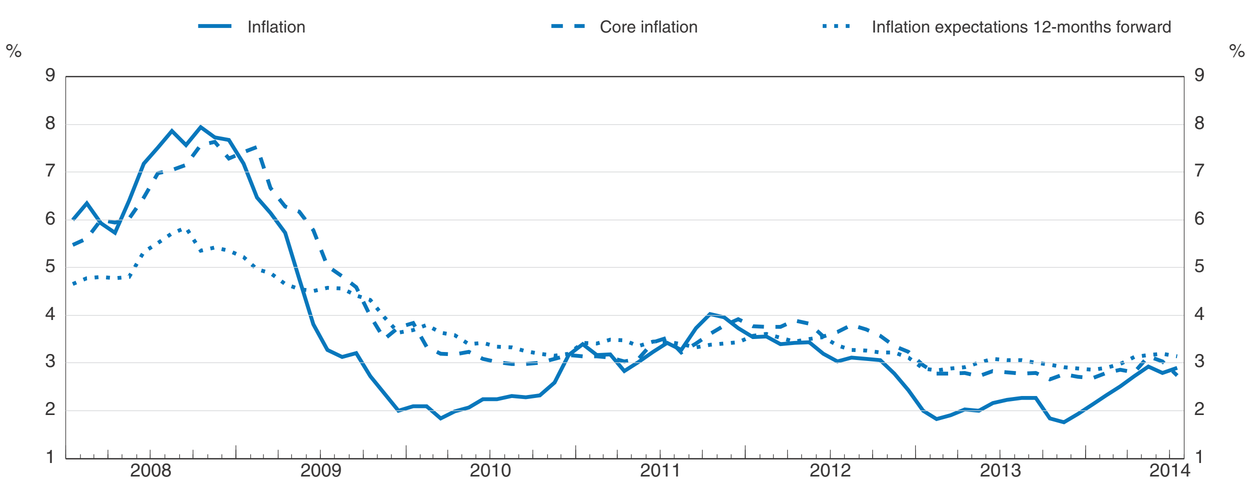
Source: DANE.

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

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

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

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



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

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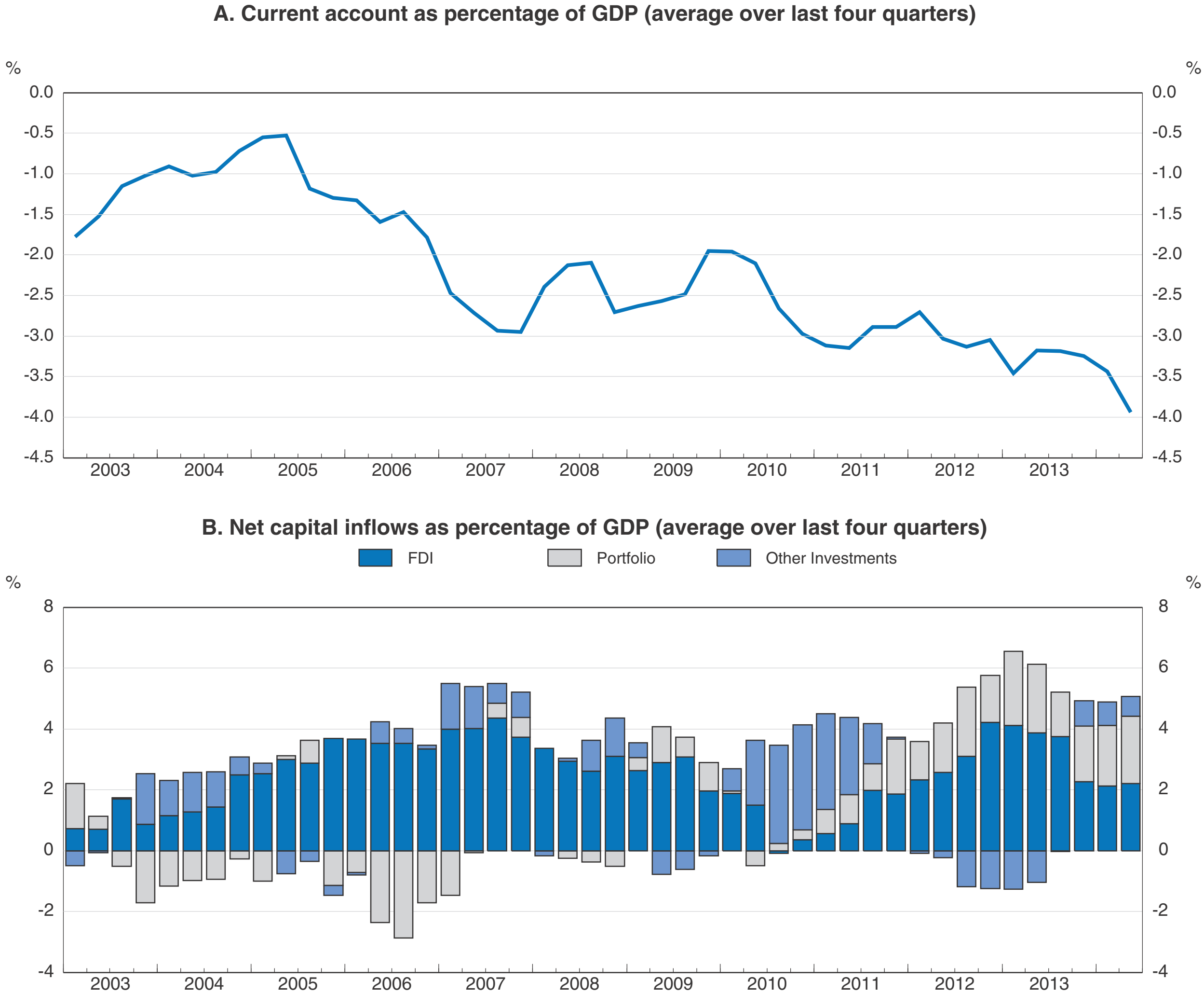
Figure 6. **The current account deficit is widening**



Source: OECD Economics Department database.

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

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

Growth has picked up somewhat in 2014, on the back of strong investment and private consumption. The current monetary policy stance is likely to keep inflation within the 2-4% target range. In 2015, residential construction and private consumption are projected to moderate due to tighter credit conditions, the likely withdrawal of mortgage rate subsidies and a less buoyant labour market. Weaker terms of trade are projected to postpone stronger export growth to the second half of 2015, as the US recovery consolidates and commodity exports recover somewhat from recent supply constraints. Government consumption will also slow down to reach the fiscal balance target for 2015. However, overall investment is projected to remain strong due to subnational investment and private road infrastructure investment under the fourth generation (so-called 4G) public-private partnership (PPP) concession plan during 2015 and 2016 (Table 1).

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

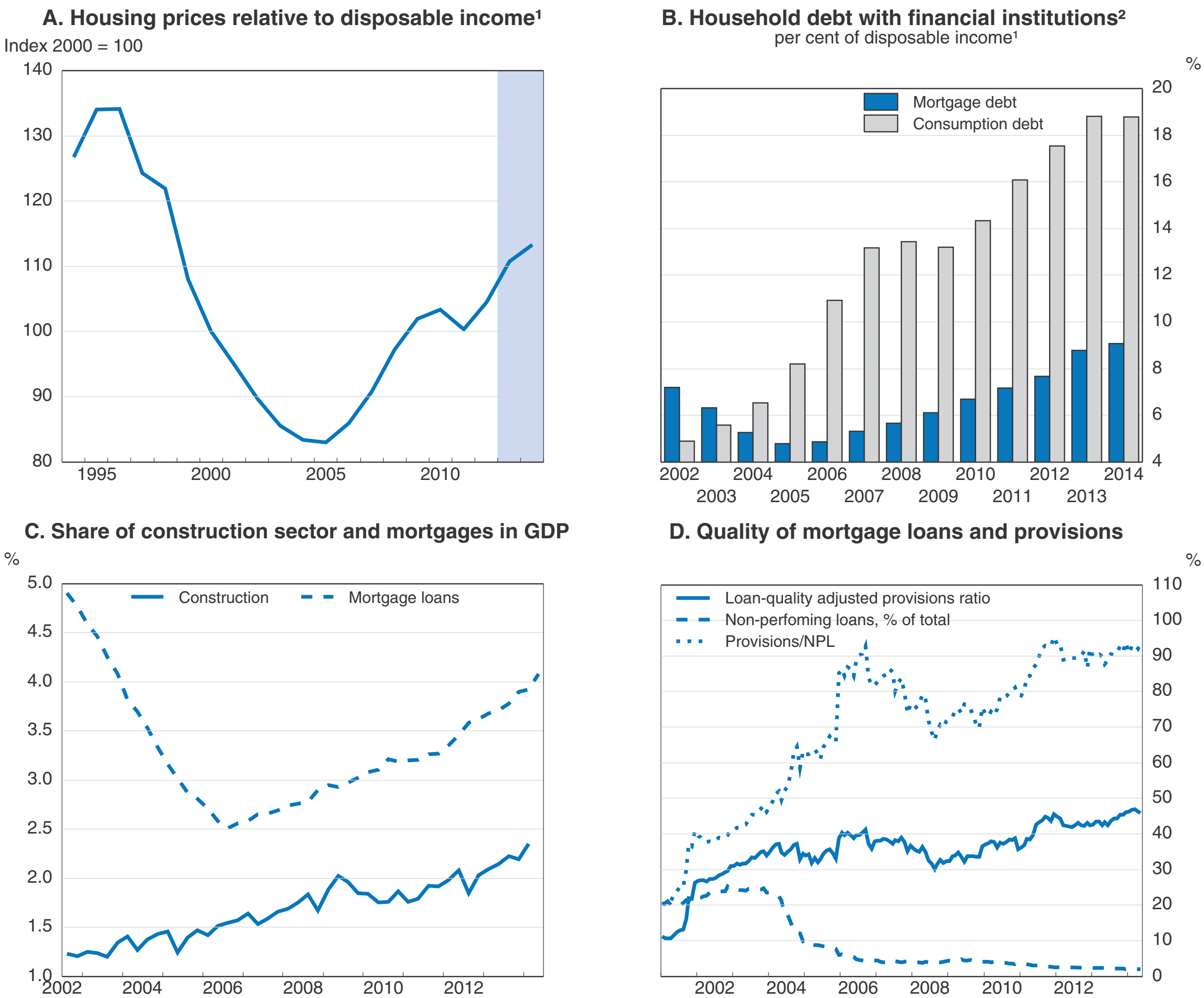
The banking system remains solid, although housing-market vulnerabilities persist

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

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

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

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



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

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

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

Macroeconomic policies

The macroeconomic policy framework is robust

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

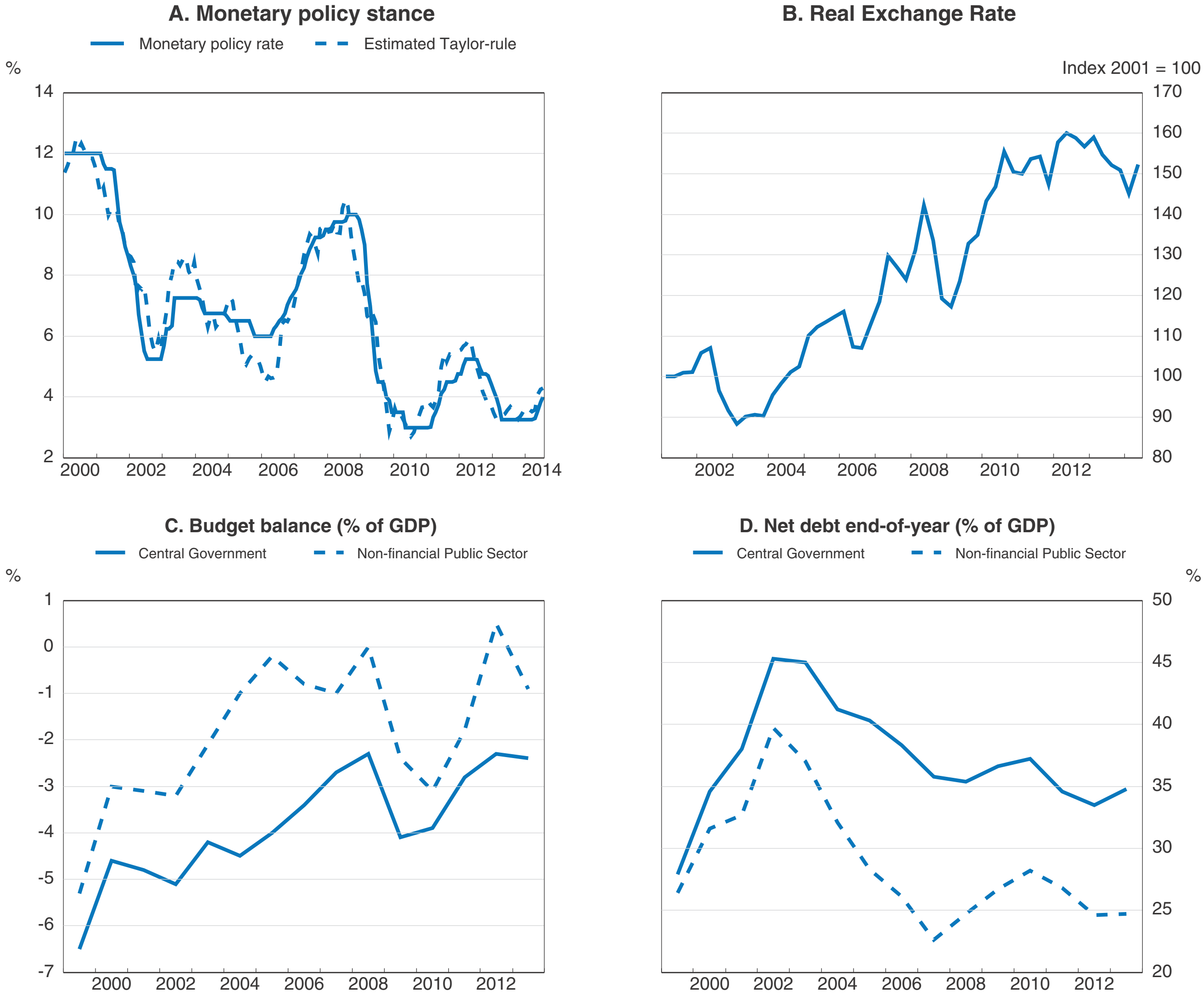
The fiscal policy framework is also strong. In 2011, fiscal sustainability was included in the Constitution as a key guideline for public policy. Furthermore, a fiscal rule that targets the central government's budget balance, adjusted for cyclical factors and oil and mining prices, was created by law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

The short-term macroeconomic policy mix is broadly appropriate

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

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

Figure 8. **Macroeconomic policy indicators**



Source: Banco de la República and MHCP.

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

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

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

As percentage of GDP

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

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

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

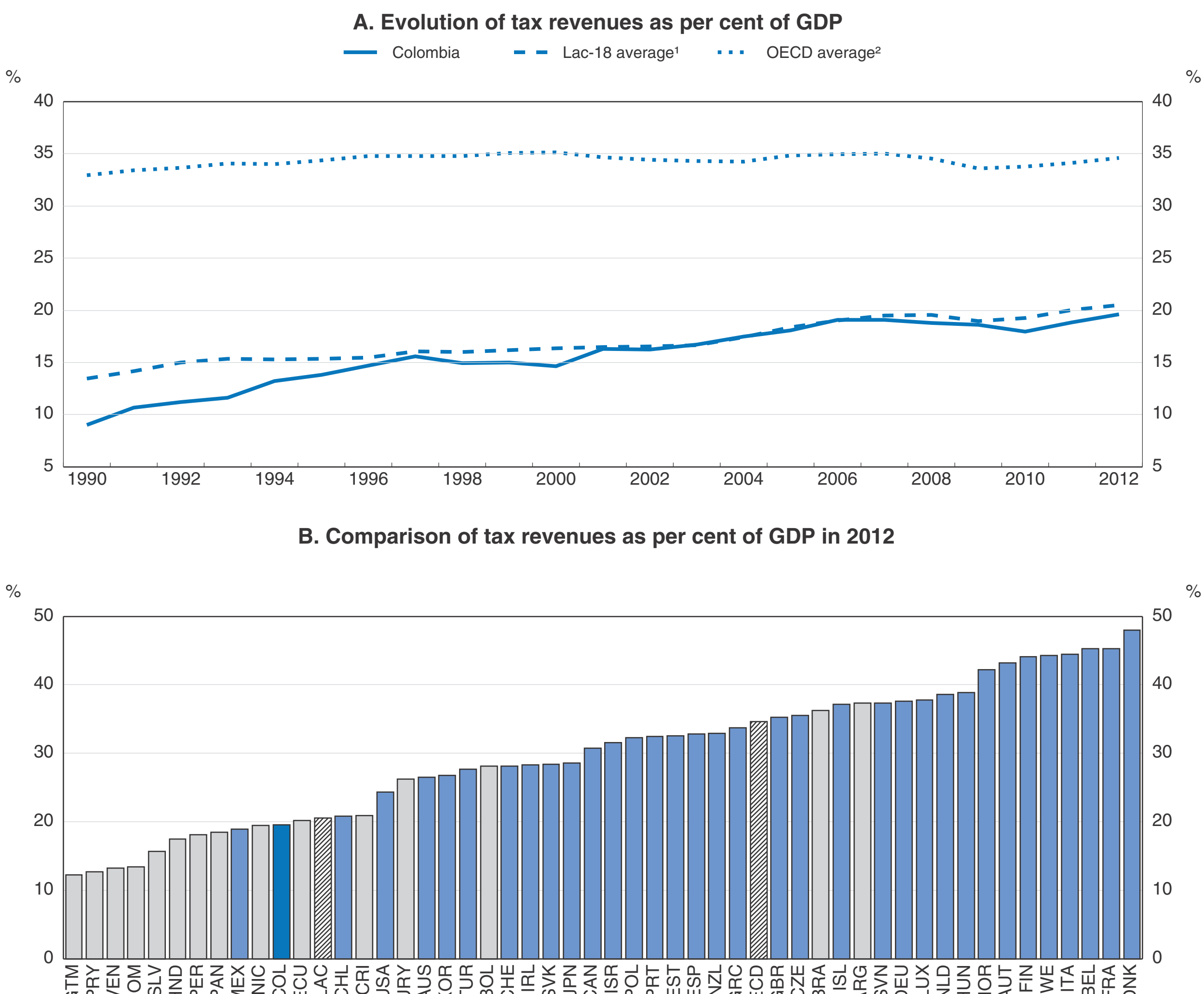
The expected decline in a number of revenue sources in the near future poses a challenge for the consolidation plans. A wealth tax is set to expire at the end of 2014, and the financial transaction tax will be gradually phased out between 2015 and 2016. These taxes together represent around 1.4% of GDP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

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

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

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

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



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

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

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

Recommendations on macroeconomic and financial policies

Key recommendations

- Maintain the strong macroeconomic framework.

Further recommendations

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

Making the tax system more efficient, fair and green

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

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

Tax evasion is pervasive

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

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

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

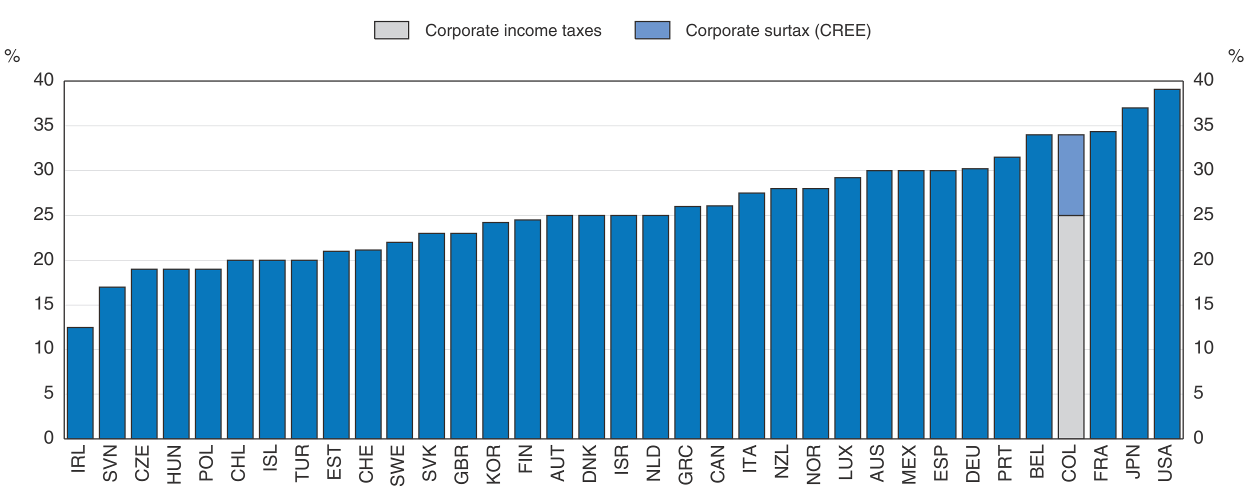
Taxation on corporations is high by international standards

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

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

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

Tax rates as of 2014



Source: OECD Tax database.

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

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

Moving towards a consumption-based VAT would reduce the tax burden on investment. Businesses pay the standard VAT rate of 16% on the purchase of fixed assets but, in contrast to other countries with a VAT, do not receive a refund for the VAT paid on investment. This greatly increases the cost of investment in Colombia. As part of a comprehensive tax reform, Colombia should levy VAT only on consumption and not on investment.

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

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

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

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

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

Subnational governments could raise more revenue

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

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

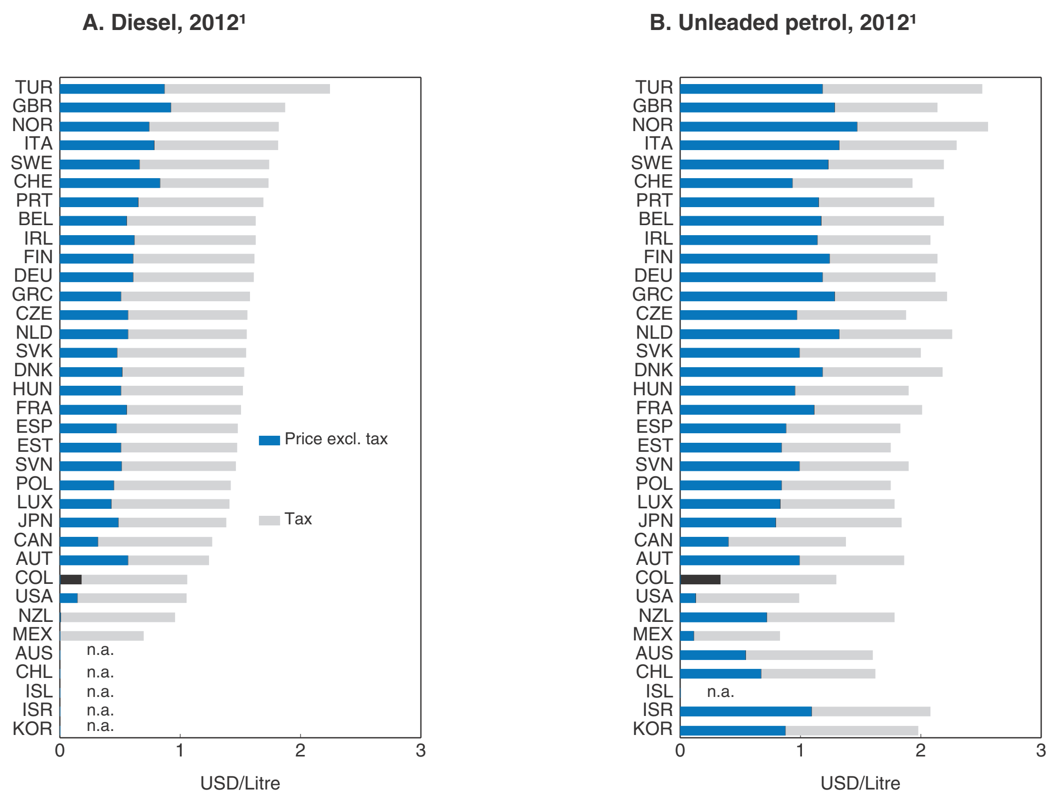
Reforming the system for sharing national tax revenues with subnational governments would improve stable and sustainable financing for the latter. The central government shares around 30% of its total revenues with subnational governments. Transfers are earmarked for current expenditures for education,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

Greening the tax system

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

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

Figure 11. **Road fuel prices**



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

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

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

Key recommendations

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

Further recommendations

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

Promoting more inclusive growth

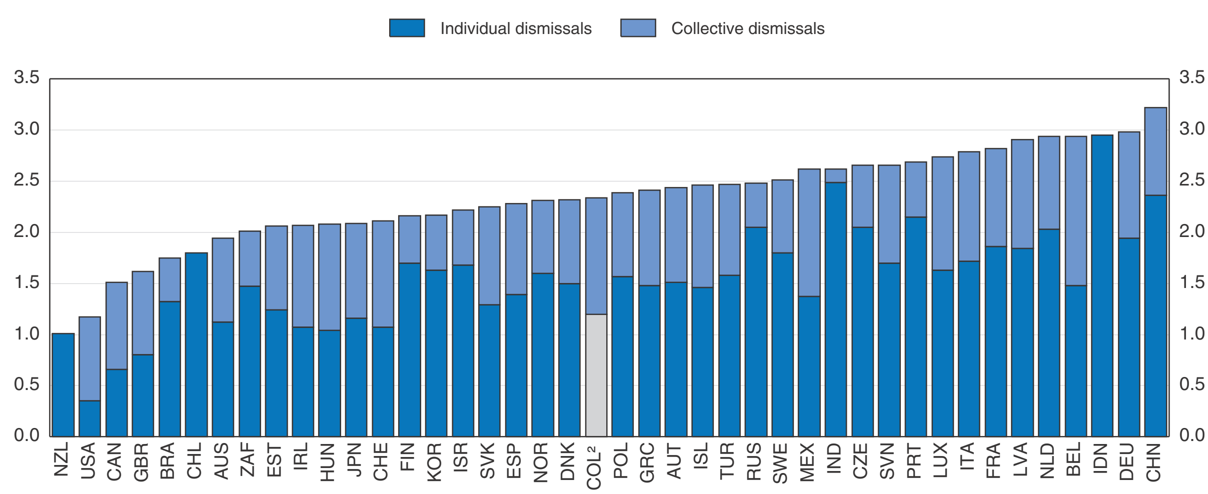
Structural policy settings across product, labour and financial markets support growth, but despite good short-term prospects, sustaining growth and making it more inclusive will be a challenge, especially if the oil and mining wealth starts to run out. It is crucial to raise productivity and competitiveness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

The increased budgetary allocations for education and early childhood development in the 2015 budget are a step in the right direction. This will help to enhance enrolment at the pre-primary and tertiary level. At 50%, pre-primary enrolment remains well below the OECD average (close to 90%) and should be further increased. Access to tertiary education has increased, tripling during the last 20 years. Nonetheless, at around 45%, the Colombian gross tertiary enrolment rate is well below the OECD average (70%) or other Latin American countries (e.g. Argentina 78% or Chile 74%). As recommended in the *2013 OECD Economic Assessment*, the quality of education should be improved, while more training should be provided to teachers to increase and modernise their qualifications.

Labour and product market regulations are close to the OECD average

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

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



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

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

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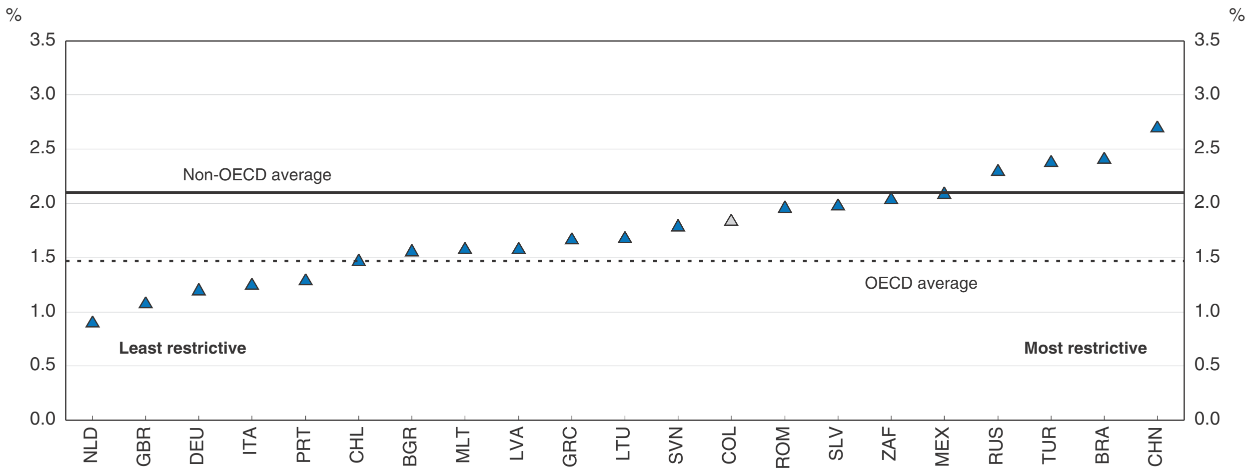
Colombia's product market regulations are less restrictive than in most non-OECD countries but somewhat above the OECD average (Figure 13). In particular, barriers to trade remain high. Lowering these barriers could increase productivity and growth. Productivity is hindered by the lack of competition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

Figure 13. **Product market regulation**

Index scale 0 to 6 from least to most restrictive



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

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

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

Strengthening public sector governance

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

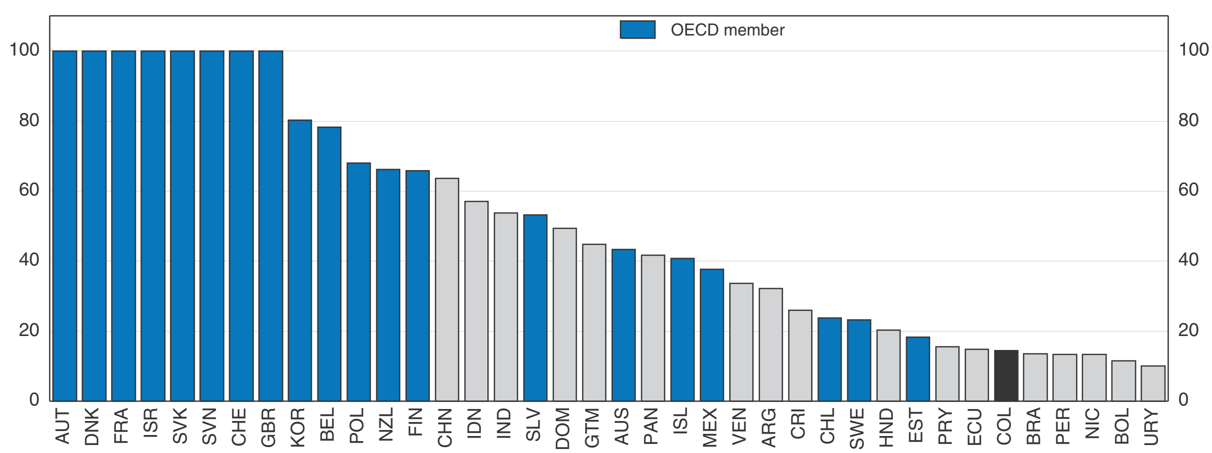
Despite positive developments in enhancing the transparency and accountability of government, corruption remains a problem in Colombia. It still ranks first among the constraints to doing business in Colombia (WEF, 2014). Colombia has joined the Open Government Partnership, and is starting to implement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

Closing transport infrastructure gaps

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

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

2011 or latest date



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

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Transport infrastructure investment increased from around 1% of GDP in 2000 to almost 2.5% in 2011, mostly through more private participation. Nevertheless, this level of investment may be insufficient to close Colombia's infrastructure gap (Clavijo, Vera and Vera, 2013a). The new public-private partnership (PPP) legislation provides a coherent framework to attract more private investment and reduce past problems of costly renegotiations of contracts (Bitran, Nieto-Parra and Robledo, 2013). It also puts emphasis on value-for-money analysis in choosing the contractual form for executing projects. Furthermore, the recent creation of a vice-ministry of infrastructure and a National Infrastructure Agency will increase administrative and technical capacities to strengthen the overall investment project cycle. However, the government should continue monitoring the potential fiscal risks closely, and ensure that the financing (including future liabilities) are transparently accounted for.

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

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

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

More competition in the banking system would boost financial development

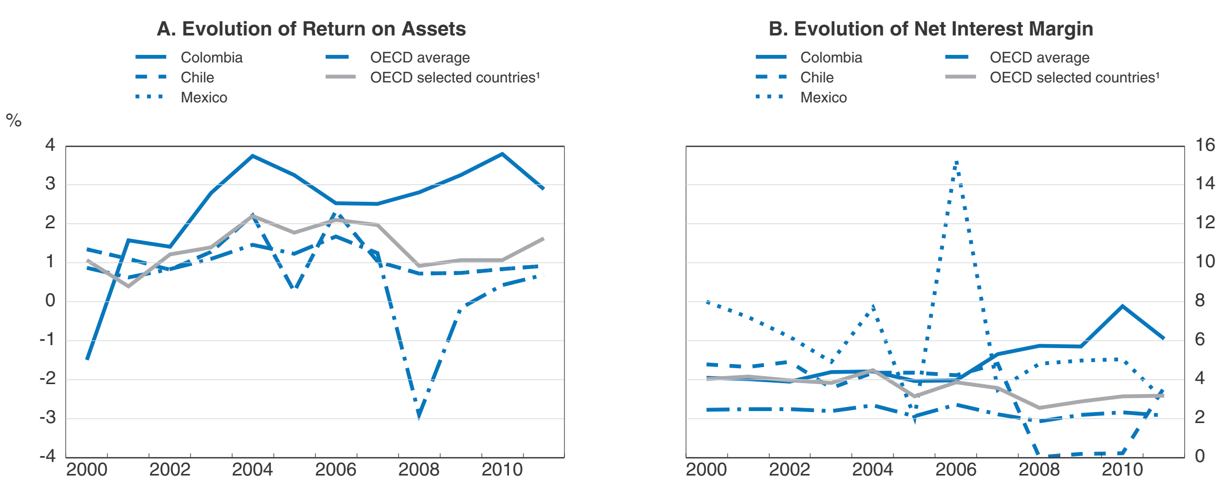
Domestic credit to the private sector has increased significantly, but financial deepening remains limited and firms face important barriers to accessing finance. In the wake of the 1998-2000 banking crisis, credit to the private sector contracted from its peak of 33% of GDP in 1997 to 20% of GDP in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

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

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

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

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



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

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

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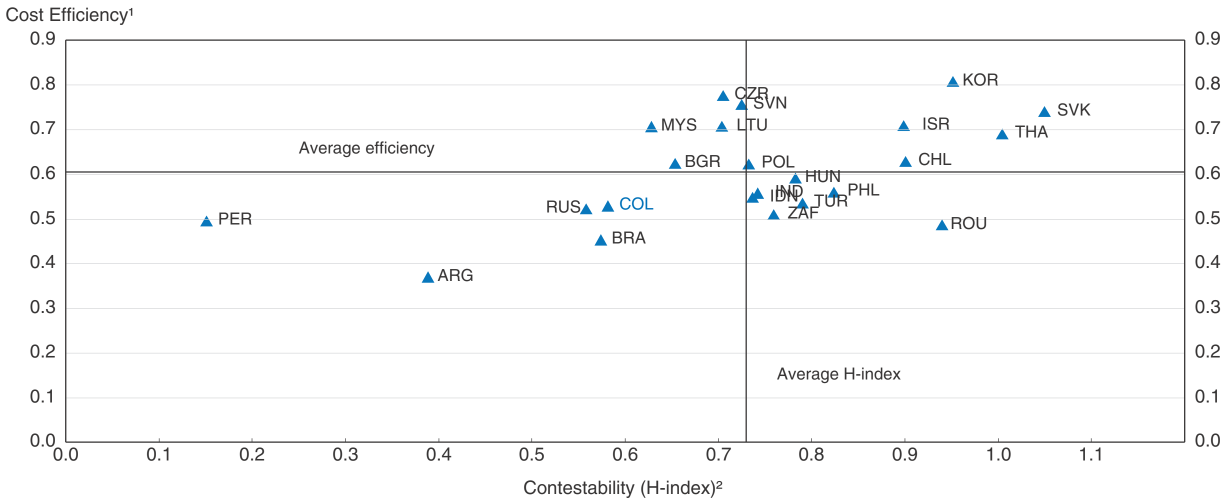
Figure 16. **Efficiency and competition in the banking system are comparatively low**



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

Source: Daude and Pascal (2014), based on *Global Financial Development Database*, World Bank, Bloomberg and SNL Financial.

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Making labour markets more efficient and inclusive

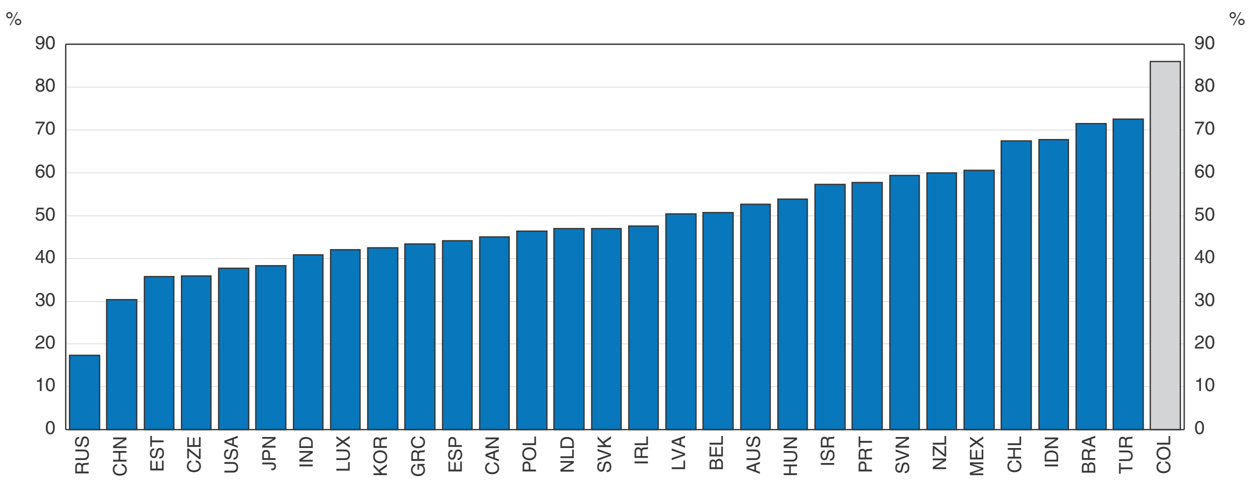
Despite improvements, labour-market inefficiencies are still a source of inequality. The labour force participation rate has fluctuated around 62% since the early 2000s and is around 64% since 2011. The unemployment rate has decreased significantly since 2001 from almost 15% to just above 9%. However,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

High informality reduces productivity and compounds inequalities

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

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

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



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

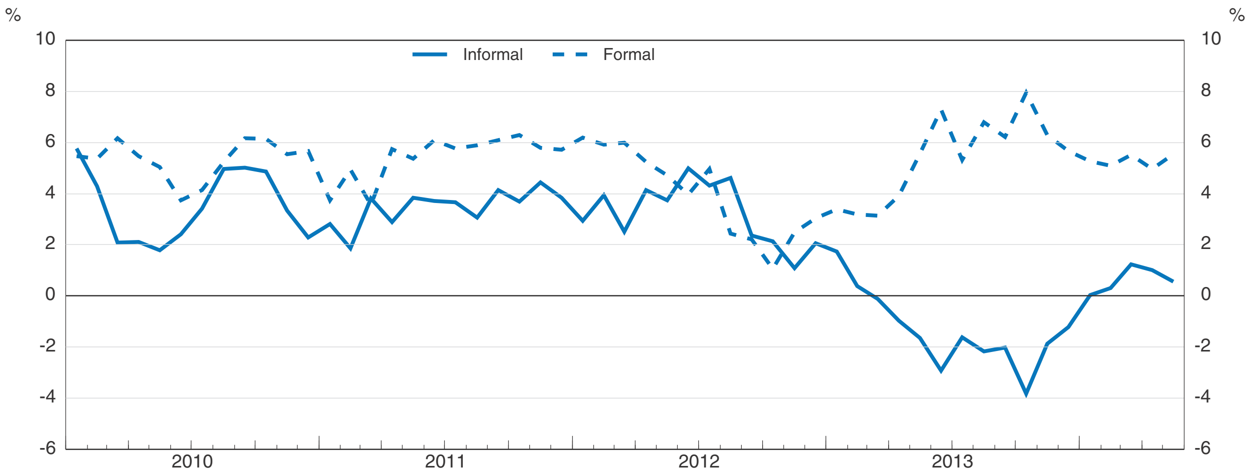
StatLink http://dx.doi.org/10.1787/888933177008

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

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

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

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



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

Source: DANE.

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

Recommendations on promoting inclusive growth

Key recommendations

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

Further recommendations

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

Reforming the pension system and old age income support

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

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

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

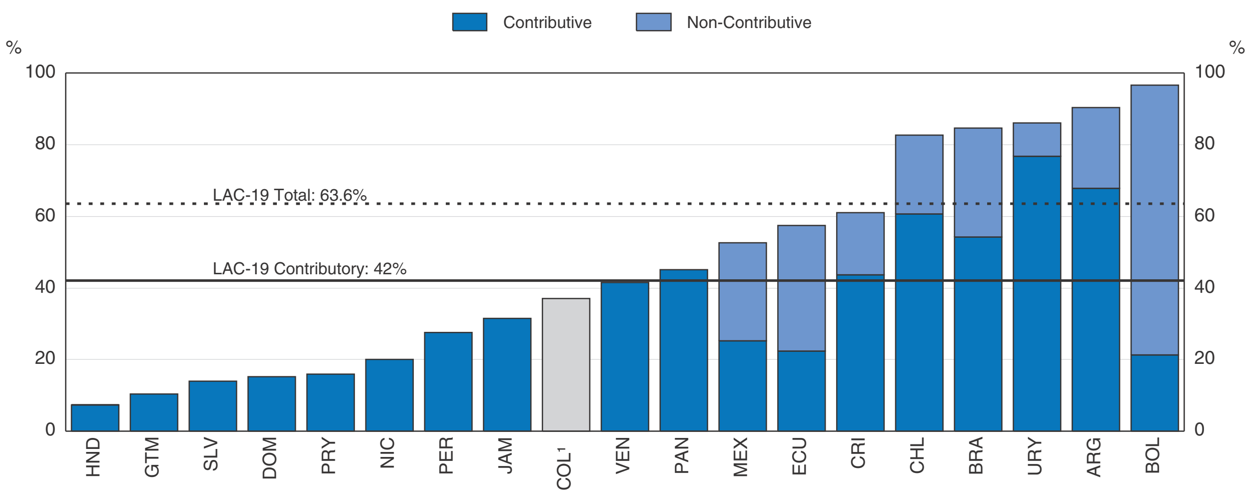
Source: HelpAge International (2013).

StatLink http://dx.doi.org/10.1787/888933177023

The low coverage of the pension system reflects high informality and stringent eligibility requirements. The public defined-benefit plan and a private defined-contribution plan compete with each other as workers can switch from one to the other several times during their working lives. Only formal sector workers earning at least the minimum wage can contribute to these two plans. The Constitution also requires pensions to be at least equal to the minimum wage, which is costly. The minimum pension represents around 60% of the average wage while, on average in OECD countries, it represent less than 20%. Currently, around 36% of formal employees are in the public scheme and 64% are in the private one. Pension eligibility is also reduced by the requirements (around 25 years of contributions), given the relatively low stability of low-skilled workers in the labour market. Currently, only 22% of the retirement-age population receives a pension from these two plans, which is low by international standards (Figure 20). An additional 15% is covered by a number of special regimes (judiciary, military and police, teachers, among others). As a result of narrow overall coverage, the overall poverty rate increases from around 31% for working-age population to 42% for people at age 60 and above in contrast to many other Latin American countries (Bosch, Melguizo and Pagés, 2013).

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

Percentage of people aged 65+ with a pension



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

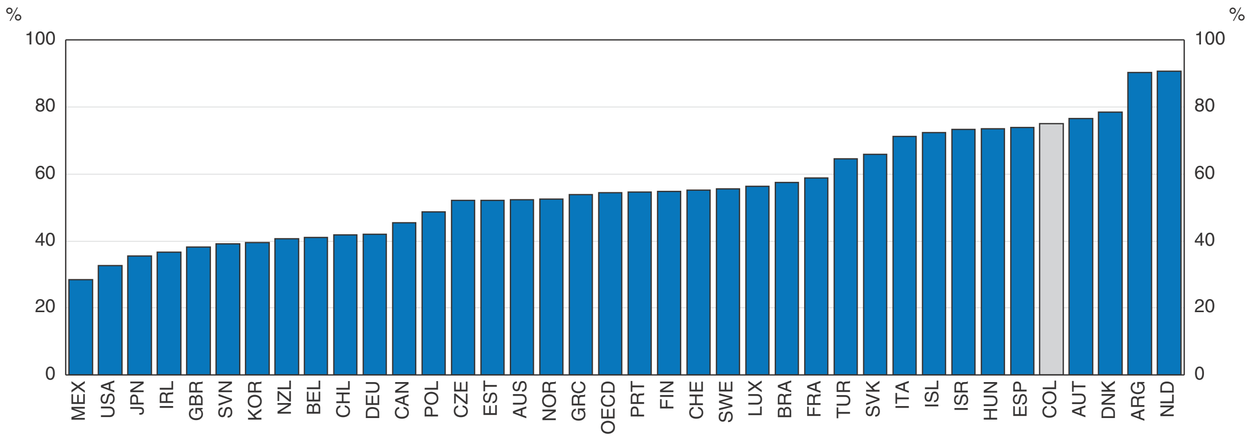
Source: Bosch, Melguizo and Pagés (2013).

StatLink http://dx.doi.org/10.1787/888933177034

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

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

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



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

Source: National Authorities and OECD (2013b).

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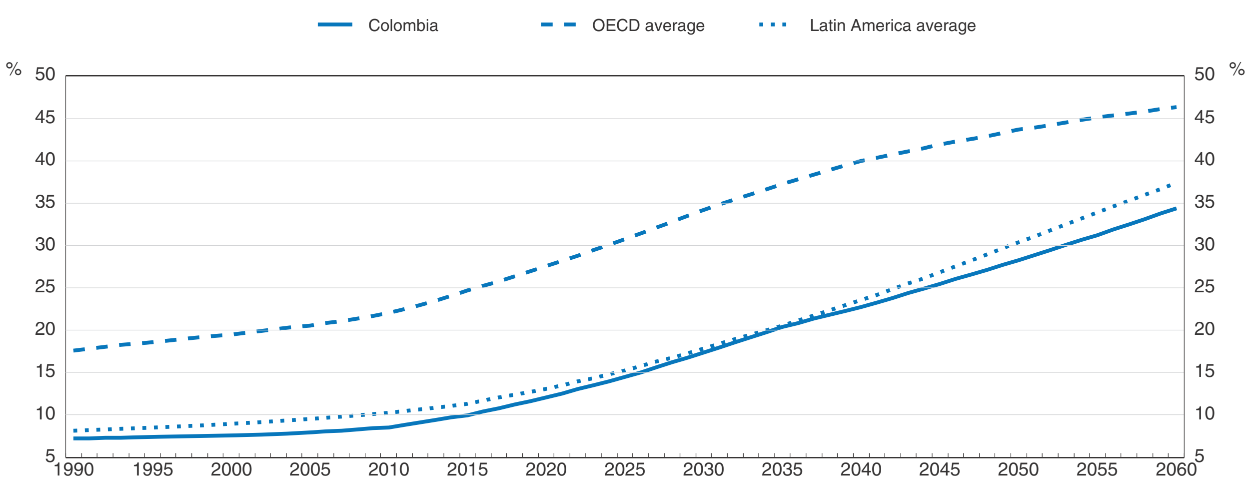
Figure 22. **Dependency ratio**

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



Source: UN population projections database.

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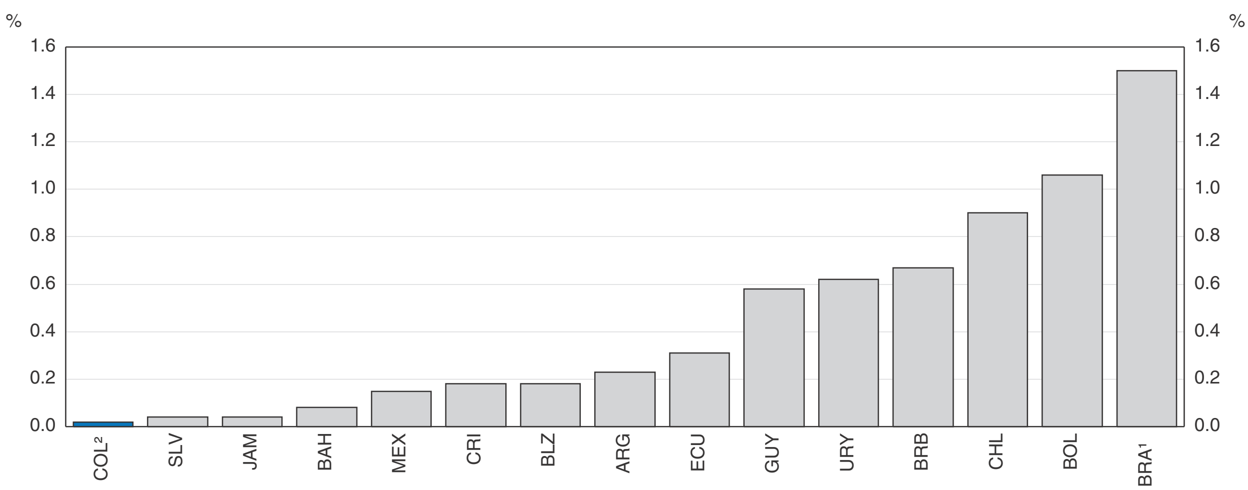
As noted, the two plans described above cover only formal sector workers. To deal with the lack of pensions for workers in the informal sector, the government has recently launched the *Beneficios Económicos Periódicos* (BEPS) programme to extend coverage. However, because pensions are required to be at least equal to the minimum wage, the lower BEPS benefits cannot be called "pensions". The BEPS programme sets up individual retirement accounts, for which the government subsidises 20% of individual contributions for low-income households. People can contribute to the scheme even if they earn less than the minimum wage. Thus, in principle, it allows for a contributory old-age scheme without the minimum wage constraint. The reform is welcome, although so far only a few thousand people have joined the system. This may reflect the difficulty lower-income people face in saving for old-age.

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

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

% of GDP, 2013



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

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

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

Options for pension reform in the near term

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

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

Towards a comprehensive reform

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

Recommendations on pensions and old-age income support

Key recommendations

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

Further recommendations

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

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ANNEX

Follow-up to previous OECD policy recommendations

This annex reviews action taken on recommendations from previous Surveys*. They cover the following areas: macroeconomic policies, improving income distribution and boosting economic growth, facilitating the economy's adjustment to the commodity boom, boosting employment in the formal sector, improving the institutional and regulatory business environment, improving infrastructure and addressing fiscal challenges. Each recommendation is followed by a note of actions taken since the January 2013* Survey*. Recommendations that are new in this* Survey *are listed in the relevant chapter.*

Macroeconomic policies

Recommendations from the 2013 Survey	Actions taken since the 2013 Survey
The government should gradually tighten the fiscal stance, consistent with the fiscal rule.	The gradual tightening of the fiscal stance has continued, in line with the fiscal rule's provisions. The intermediate target of the fiscal rule, a central government structural deficit of 2.4% of GDP in 2013, was met.
Fiscal data should be improved to enable a proper assessment of the fiscal stance and compliance with the fiscal rule.	The Ministry of Finance (MoF) has continued its effort to adopt the guidelines of the *Government Finance Statistics Manual 2001* (GFSM2001) to have a broader analytical framework that incorporates all economic events that occur within the public sector finances based on the budget and the accounting data produced by public corporations. Official statistics are expected to be produced using the GFSM2001 starting in 2016, after a trial period in 2015.
The Central Bank should continue to monitor consumer credit growth and housing prices, and to use prudential measures to contain overheating risks.	No action taken.
Keep the exchange rate market-determined and intervene only to smooth erratic exchange rate movements or to raise international reserves.	The exchange rate remains market determined. The Ministry of Finance and the Central bank have continued to work co-ordinately to smooth erratic, short-term deviations from the equilibrium real exchange rate level.
Further raise international reserves, while sterilising them, to provide a buffer against external shocks.	The Central Bank has continued to accumulate foreign reserves through its programme of sterilised daily purchases, which minimise speculation in the market. During 2013 and 2014, the international reserves have recorded an increase of more than 24%, going from USD 37 billion to USD 46 billion. According to the IMF (2014), reserves are currently adequate to provide buffers again external risk. The flexible credit line (FCL) with the IMF has been extended.

Facilitating the economy's adjustment to the commodity boom

Recommendations from the 2013 Survey	Actions taken since the 2013 Survey
Focus on structural policies to improve productivity, promote diversification and the ability of the economy to respond to changing relative prices.	No actions taken beyond infrastructure. The government has launched an ambitious public-private partnerships plan to build 8.000km of roads and highways between 2014 and 2020. So far 6 concessions out of the 47 planned have been awarded. Going forward, the government has established the improvement of education at all levels as the main development priority for the next four years, which is already reflected by the 2015 budget.
Promote trade openness by cutting tariffs further, making temporary cuts permanent, and reducing the dispersion of tariffs. Lowering the regionally high tariffs on agricultural products could also reduce the price of basic consumption goods and thus contribute to alleviating absolute poverty.	As part of the Plan to Boost to Productivity and Employment (PIPE), on August 2013 Decree 1755 implemented a reduction of tariffs on imported capital goods and raw materials not produced domestically to 0% for two years. No significant action has been taken regarding agricultural products.
Strengthen the fiscal rule by clarifying corrective actions and the path in case of fiscal slippages.	No action taken.

Ensure that the revised distribution of royalties across regions results in viable projects that boost productivity by:

Recommendations from the 2013 Survey	Actions taken since the 2013 Survey
Providing further assistance to sub-national authorities to identify the most effective investment projects and provide advice on how to implement them efficiently.	The National Planning Department has provided training and technical assistance to municipalities to present projects within the national royalty system (SGR). However, little actions have been taken to increase the internal capacity of municipalities on a sustainable basis.
Ensure good governance by strengthening the monitoring and *ex post* evaluation of investment projects.	Within the new SGR a monitoring, control and evaluation system was created (SMSCE by its Spanish Acronym). It also promotes citizen access to information regarding project costs and status within the cycle.
Implementing an incentive mechanism, so that sub-national authorities receive more funds the faster they progress towards achieving critical economic and social objectives.	No action taken.

Recommendations from the 2013 Survey	Actions taken since the 2013 Survey
Ensuring that sub-national governments fully account for the maintenance costs of investment projects.	Within the new SGR, sustainability has been introduced as a main requirement for investment projects to be approved. Sub-national government must guarantee the existence of funds dedicated to the projects' operation, functioning and maintenance. However, the national tax revenue sharing system (SGP) and the SGR are not integrated, such that it is difficult to verify and enforce these budgetary promises.
If the return on investment projects turns out to be low or if royalties increase substantially, reconsider the allocation of royalties or channel a larger share to the sub-national Savings and Stabilisation Fund. Reducing the earmarked component should also be envisaged.	No action taken.
Reinforce environmental policies to ensure that mining projects cover environmental costs and do not threaten biodiversity. Strictly enforce environmental permits. Biodiversity should also be better protected and valued.	No action taken.

Boosting employment in the formal sector

Recommendations from the 2013 Survey	Actions taken since the 2013 Survey
Reduce the very high non-wage labour costs by implementing the planned tax reform and cutting further social security contributions and other mandatory payments on labour.	The tax reform past at the end of 2012 and non-wage labour costs associated with *parafiscales* and social security contributions were reduced from 29.5% to 16%.
Avoid increasing the minimum wage by more than price inflation. Consider differentiating the minimum wage by region and age to align labour costs with productivity and to account for differences in living costs.	No action taken.
Raise human capital by making the education and training system more responsive to the economy's needs and by increasing the quantity and quality of teaching. This would require reducing teacher absenteeism and the prevalence of two- or even three- shift schools. The quality of teaching should also be improved by making the selection and training of teachers more demanding.	Efforts so far have concentrated on producing better information and statistics. In 2012, Dane, The Ministry of Labour and the IDB conducted a Human Capital Survey, collecting data on training and productivity within 23.000 firms. Additionally, since 2012, the National Household Survey collects data on professional training, both from SENA and private providers.
Improve the accreditation of tertiary education institutions. Introduce outcome indicators, and publish them, for the national training service (SENA). A better matching between employers' needs and institutions' outputs could be reached by giving more weight to the regional employment offices and to the existing sectoral round tables organised by the government with the private sector.	The Ministry of Labour, with ILO support, has recently implemented a labour market foresight model, which estimates employment demand using the Employment Household Survey. The ministry has also carried out a qualitative study that identified a group of soft skills prioritised by firms in 14 cities to use it in the training policy guidelines. Furthermore, in 2013 the Ministry of Labour started using a qualitative prospective methodology to identify technological and occupational changes and new educational needs in the private sector. The Ministry of Labour, SENA and *Unidad Administrativa Especial Pública de Empleo* started implementing an occupational and skills monitoring system based on vacancies analysis by sector and regions. This methodology uses big data analysis to identify occupational and skills gaps. Finally, Colombia has been adapting the International Standard Classification of Occupations (ISCO 08), which will allow the articulation of household surveys from *DANE* and *SENA*'s databases, in order to improve the identification skills demanded in the market.

Improving the institutional and regulatory business environment

Recommendations from the 2013 Survey	Actions taken since the 2013 Survey
Review barriers to competition in some product markets, including telecommunications, food production and the financial sector, to ensure that product market regulations do not act as barriers to entrepreneurship.	In order to implement this recommendation, the SIC has strengthened its competition advocacy role, by virtue of which it monitors how regulatory decision-makers employ competitive principles in developing or implementing regulations. Whereas in 2012 15 advocacy concepts were issued by the SIC, in 2013 that number increased to 27. Besides, from January to August of 2014, 25 advocacy concepts have been issued. The telecommunications' sector has been dynamic in competition advocacy matters. A successful public auction of 225 MHz of spectrum for 4G mobile technology took place. Concerns with the initial adjudication mechanism, were raised, as the high concentration in the mobile market could lead to a high concentration in the mobile internet market. The SIC recommended that the entry of at least one new operator should be promoted, in order to induce more competition in the mobile internet market. The auction resulted in the adjudication of 5 licenses over the next 10 years that allowed the entry of two new companies to the Colombian mobile market. No actions have been taken with respect to food production and financial market regulations.
Give the competition authority greater independence and more qualified staff to increase its effectiveness.	From 2013 to 2014, the SIC's budget increased a 21.23% (it grew from USD 48 672 582 approx., to USD 59 005 681 approx.), translated in the hiring of more qualified professionals, raising officials' wages, and providing training to its staff. Moreover, the SIC issued Resolution 16424 of 2014, which created an autonomous group in charge of conducting competition advocacy assessments with respect to proposed government regulations and composed of 6 officials. A specialised group for analysis and collection of forensic evidence has also been created, focusing on collecting and analysing electronic and digital evidence that is gathered within competition cases, with a proper implementation of the chain of custody rules. No actions have been taken to strengthen the independence of the competition authority by altering appointment and removal process of the superintendent.
Better enforce bureaucratic procedures, such as licensing, and enhance the monitoring of institutions vulnerable to corruption.	The law decree 019/12 aims at simplifying, improving and streamlining administrative procedures and enhancing citizen's participation and transparency. A procedure rationalisation group was created to advice the government and so far around 900 procedures have been intervened. Furthermore, the Single Information System of Procedures was created (SUIT by its Spanish acronym) Finally, a law to enhance transparency and access to public information passed in 2014 (Law 1712) and a transparency and anticorruption observatory was created.

Improving infrastructure

Recommendations from the 2013 Survey	Actions taken since the 2013 Survey
Strengthen the prioritising and planning phase of infrastructure projects, which must be governed by value-for-money, affordability and environmental impact assessments. These should include cost-benefit analyses and comparative evaluations among contract frameworks.	No action taken.
Better evaluate the relevance of PPPs for infrastructure projects and their long-term impact on public finances.	The government issued Decree 1610 in 2013, which regulates the procedures and methodologies for the fiscal evaluation of PPPs. Additionally, the Medium Term Fiscal Framework includes a detailed section for PPP related contingencies and future expenditures.
Improve the institutional and regulatory framework for transport infrastructure to ensure an unbiased and thorough assessment of PPPs and a better specification of projects before tendering.	The Law 1682 in 2013 establishes more effective and expedite procedures to purchase land, obtain environmental permits and perform consultations with stakeholder communities. Decree 1553 issued 2014 introduces transparency measures for the evaluation stages of PPP projects. These regulatory changes were complemented by CONPES policy documents 3807 of 2013 and 3760 of 2014, which establish general guidelines for the structuring of PPP airport projects and the prioritisation of 4G road projects, respectively.

Recommendations from the 2013 Survey	Actions taken since the 2013 Survey
Improve co-ordination between transport institutions and better exploit multimodal transport opportunities.	The CONPES issued the policy document 3762 in 2013, which establishes the general policy guidelines for the development of national and strategic projects (PINES by its Spanish acronym). Since then, 9 sessions of the PINES Commission were held to assure the co-ordination among all sectors of government regarding around 50 infrastructure projects.

Fiscal policies to better address social and economic needs

Gradually create fiscal space to finance transfers to those in need and higher quality social and physical infrastructure by:

Recommendations from the 2013 Survey	Actions taken since the 2013 Survey
Ensure that the proposed tax reform raises enough revenue in the medium-term to meet needs. Shifting the tax mix towards more growth-friendly taxes should be considered.	No action taken.
Further reforms should improve equity and enforceability. This would require: broadening the VAT by narrowing exceptions and limiting the use of low rates; cutting tax expenditures for free-trade zones and the personal income tax (in particular pensions); and increasing revenues from environmental and property taxes and considering moving from royalties to less distorting profit taxation. On the other hand, payroll taxes should be reduced further (in particular Cajas) to enhance labour market incentives.	No action taken.
Making the pension system less regressive and expand its coverage. This would require: reducing the implicit pension subsidy benefitting the rich by increasing the legal retirement age and lengthening the reference earnings period; reconsidering the requirement for pensions to be at least equal to the minimum wage; abolishing special regimes; indexing pensions on prices instead of the minimum wage; eliminating tax relief for pensions; and implementing swiftly the BEPS. Options for increasing the minimum income support for the elderly poor (PPSAM) should be studied.	The Pension Familiar allows husband and wife to join contributions as a single unit, easing the requirements to access a pension in the defined-benefit system. The implementation of BEPS has been slow with less than 8 000 persons having joint the programme so far.

Thematic chapters

Chapter 1

Making tax policy more efficient, fair and green

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

Main trends and characteristics of the tax system

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

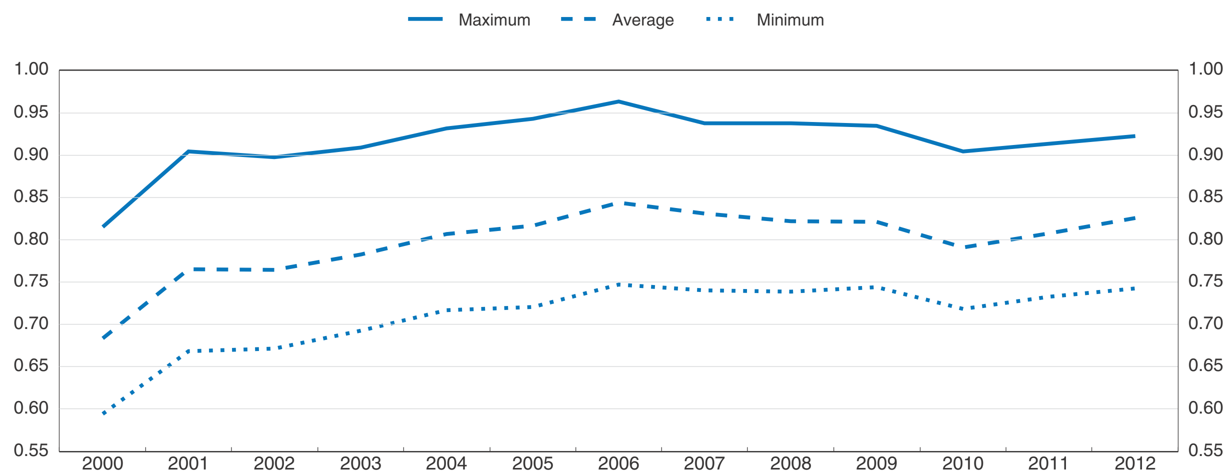
Tax revenues in Colombia are low

Tax revenues have been increasing gradually over time during the last decade, but at 20% of GDP remain low compared to other Latin American countries and the OECD average. Estimates of the tax effort – actual revenue collection compared to potential in view of GDP per capita, trade openness and the economic structure – is 82%, which implies that potential tax revenues are close to 24% of GDP (Box 1.1). The effort remains below potential even when adjusted for non-tax revenues from royalties or mandatory contributions to private pension schemes, which are usually not considered tax revenues (IADB, 2013). Furthermore, the tax effort has stagnated since 2006 (Figure 1.1).

More revenues are needed to meet social and development needs

The rising share in GDP of oil and mining-related revenues – royalties, but especially dividends from Ecopetrol and income tax paid by mining companies – over the past decade has increased the dependency of the budget on mining sector developments (Figure 1.3). Most of these revenues stem from hydrocarbons, with the rest mainly from coal mining. However, the resource boom, especially in oil and coal, is expected to be relatively short-lived, with oil production estimated to peak around 2015-17 (Ministry of Mining and Energy, 2012). Revenues from Ecopetrol are already falling, as supply constraints in production and other factors will reduce its dividend payments to the central government by around half a percentage point of GDP in 2014 and 2015. Lower oil prices and rising production costs are squeezing profits in the oil and mining sector. Therefore, taxing the sector more – e.g. by introducing an excess profit tax – would not bring more revenues in the short term, in addition to the challenges it might pose in terms of implementation. Furthermore, as it is common practice in OECD countries, mining and other types of royalty payments can be deducted from the corporate income tax base in Colombia, such that higher royalties would reduce the income tax paid by oil and mining companies. This puts pressure to find alternative sources of tax revenue to fund public spending, especially

Figure 1.1. **Tax effort has stagnated in recent years**[1]



1. Tax effort is the ratio between the observed tax to GDP ratio and the predicted levels according to the seven alternative econometric specifications. Average, maximum and minimum levels refer to the annual values across the seven alternative estimates (Box 1.1).

Source: Own calculations based on OECD Revenue Statistics; OECD/ECLAC/CIAT (2013), *Revenue Statistics in Latin America: 1990-2012*; and World Bank, *World Development Indicators database*.

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in municipalities that now depend on royalty revenues. Preparing the central government tax system for the period when the resource-related revenues start to decline would allow a smooth transition.

The expiration of a number of other revenue sources also put strains on the budget at a time when social and development spending needs are rising. The expiration of a temporary wealth tax at the end of 2014, and the phasing out of the financial transaction tax between 2015 and 2017 – would reduce revenues by around 0.6% and 0.8% of GDP, respectively. At the same time, additional spending pressures are likely to arise from planned expansions of social policies and a potential peace deal with guerrilla groups.

The fiscal rule requires the structural central government deficit to decline gradually from 2.3% in 2014 to 1% of GDP in 2025. Achieving this fiscal consolidation, without large cuts in spending, will require a major overhaul of the Colombian tax system to raise more revenue. Congress passed a law in December 2014, which among others extend wealth and financial transactions taxes for another four years, to deal with the revenue shortfall in the next four years (Box 1.2), but a more comprehensive approach is needed, given the challenges of the tax system in terms of efficiency and fairness.

The current tax mix is inefficient and regressive

The tax structure is biased towards indirect or consumption taxes. In principle, this makes the system more growth friendly, but regressive (Figure 1.4, Panel A). However, the heavy reliance on corporate income taxes (CIT) among the direct taxes may affect the ability to sustain the high level of investment and incentives for formal sector work (Arnold et al., 2012). The redistributive impact of taxation is also reduced by the fact that most of the income and wealth taxes are paid by firms rather than households. For example, households account only for around 5% of the wealth tax revenues.

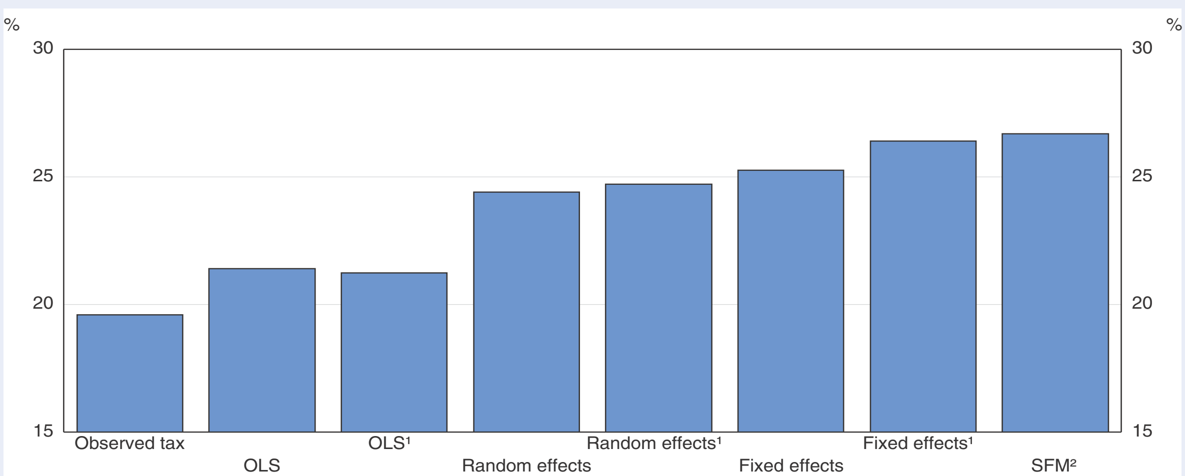
Box 1.1. **Tax effort estimates for Colombia**

Differences in tax revenue across countries depend on structural characteristics and explanatory variables such as GDP per capita, trade openness and the sectorial composition of GDP. In general, high levels of development, trade openness and the size of the manufacturing sector are associated with higher tax revenues (Pessino and Fenochietto, 2010). Estimates for Colombia based on the following equation with a variety of econometric techniques for a sample of 45 OECD and Latin American economies show large shortfalls:

$$\frac{Tax}{GDP_{it}} = \alpha + \beta ln(GDP\ per\ capita)_{it} + \gamma Industry\ share\ in\ GDP_{it} + \theta \frac{Trade}{GDP_{it}} + \varepsilon_{it}.$$

The shortfall varies between 1.8 – for the Ordinary Least Squares (OLS) estimate that renders a predicted value of 21.4% of GDP versus the observed 19.6% (Figure 1.2) – and 7.1 percentage points of GDP (for the Stochastic Frontier estimate) with an average of 4.7, suggesting that tax revenues in Colombia are significantly below their potential. Furthermore, these results for Colombia are consistent with estimates based on larger samples or slightly different estimation techniques and control variables (IADB, 2013; Fenochietto and Pessino, 2013).

Figure 1.2. **Predicted tax revenues according to alternative estimation methods (per cent of GDP)**



1. With time effects.
2. Stochastic frontier model.

Source: Own calculations based on OECD Revenue Statistics; OECD/ECLAC/CIAT (2013), *Revenue Statistics in Latin America: 1990-2012*; and World Bank, *World Development Indicators database*.

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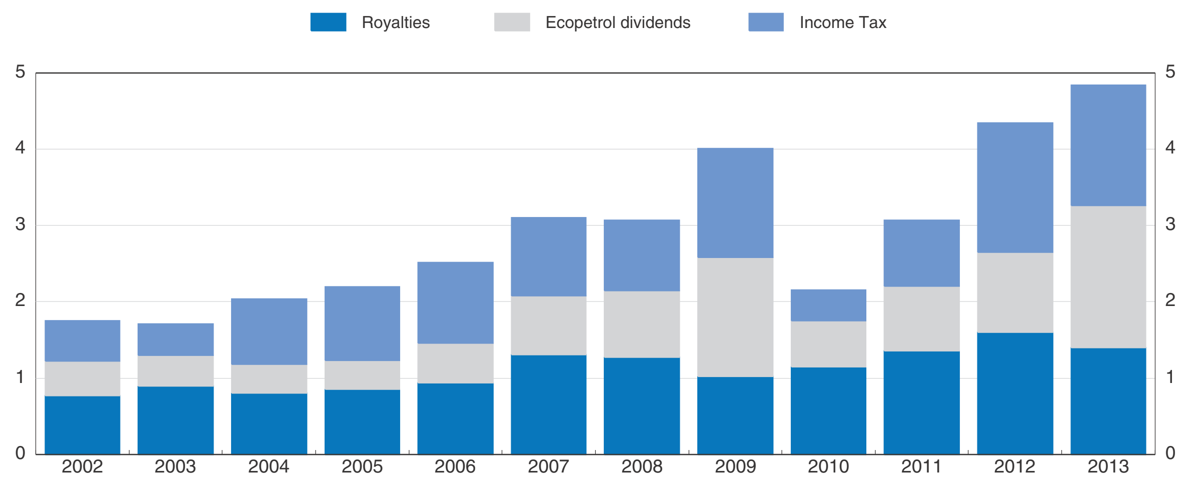
A tax reform in 2012 lowered the tax burden on labour and made the tax system more growth-friendly (Box 1.3), but many challenges, especially regarding equity and efficiency, remain. Overall, reducing employer payroll taxes was a step in the right direction as it reduced non-wage labour costs and should encourage formal employment. However, financing the reduction in payroll taxes by increasing indirect taxes or broadening the personal income tax base would have been less harmful for economic growth than introducing the surtax on corporate income (CREE). Moreover, by shifting part of the tax burden previously imposed on wages to corporate income, this new tax is expected to weigh more on capital-intensive than on labour-intensive firms (Steiner and Medellin, 2014).

Figure 1.3. **The share of natural-resource related revenues in GDP has accelerated (in per cent of GDP)**



Source: DIAN, SIMCO and ANH.

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Box 1.2. **Tax policy changes approved for 2015-18**

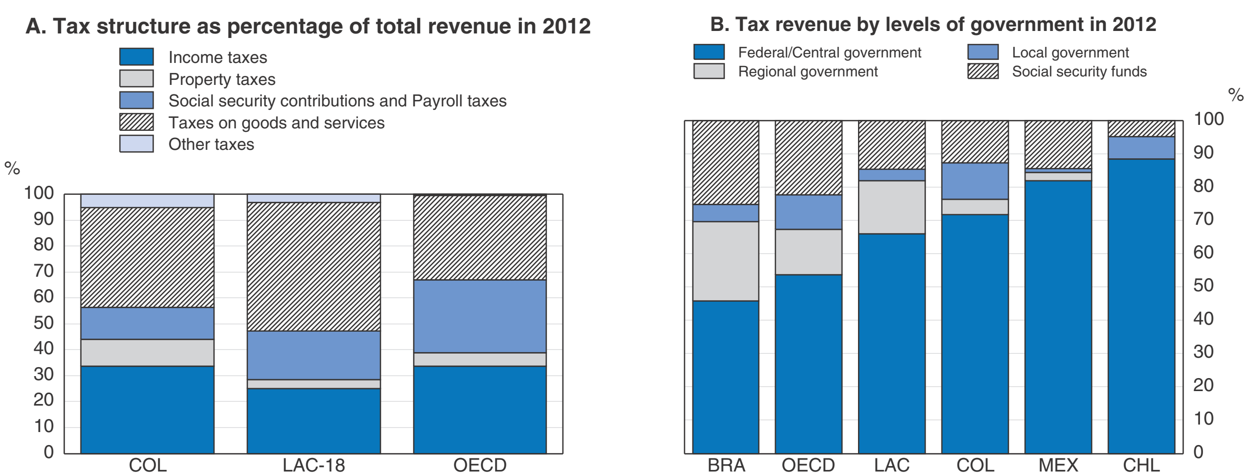
The government presented in early October of 2014 a new law to congress, which was approved in mid-December of 2014, that introduces a series of changes to the tax system to close the projected revenue gap due to the expiring wealth and financial transaction taxes as well as lower oil-related revenues. The main actions proposed are the following:

- The financial transaction tax is extended until 2018 – maintaining its current 0.4% rate – and will be gradually phased out from 2019 to 2021.
- Changes to the CREE ("corporate income contribution to equity") corporate income surtax introduced in the 2012 reform:
  - The 9% rate will be permanent from 2016 onwards, instead of the originally planned reduction to 8%. The additional revenue will be allocated to early childhood programmes (40%) and public tertiary education (60%).
  - From 2015 to 2018, there will be an additional surtax for firms with annual profits above COP 800 million (around USD 400 000). The rate of this surtax will be 5% in 2015, 6% in 2016, 8% in 2017 and 9% in 2018.
- Changes to the net wealth tax:
  - The wealth tax will be extended and levied on net wealth assessed on 1 January 2015 for corporates and individuals with net wealth exceeding COP 1 000 million (around USD 500 000).
  - For firms, the wealth tax will be gradually reduced from 2015 to 2017 and expire in 2018. For instance, the maximum rate will go down from 1.5% in 2014 to 1.15% in 2015, 1% in 2016, and 0.4% in 2017.
  - For individuals, the tax rate for the initial bracket between COP 1 000 million and COP 2 000 million (between around USD 500 000 to USD 1 000 000) is reduced from 0.25% to 0.125%.
  - For both, firms and individuals, instead of paying the tax at a proportional rate, a marginal and progressive rate schedule with rates ranging between 0.125% and 1.5% per annum would be applied. This change will reduce the effective tax rate for the lower brackets significantly.
  - Businesses will be refunded 2 percentage points of the 16% VAT paid on capital goods, through a tax credit in the corporate income tax.

Box 1.2. **Tax policy changes proposed by the government for 2015-18** *(cont.)*

- Assets abroad and income earned have to be reported by individuals and firms that are subject to the income tax. As from 2015 onwards, intentional misreporting above COP 8 000 million (around USD 4 000 000) will be subject to sanctions up to 200% of the amount due in misreported taxes.
- A temporary voluntary disclosure programme for undeclared assets held offshore would be implemented from 2015 until 2017, during which criminal sanctions would be waved; the penalty rates levied on the value of the undeclared assets would be gradually increasing from 10% of net wealth in 2015, 11.5% in 2016 to 13% in 2017.
- Creation of a commission to study and propose legal changes to the special tax regime for non-profit organisations. The commission is to establish the key aspects of a future structural tax reform that, in principle, will be implemented in 2016.

Figure 1.4. **Tax revenue composition in 2012**



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

StatLink http://dx.doi.org/10.1787/888933177115

Revenue mobilisation is concentrated at the national level, despite important expenditure responsibilities at subnational level, especially at the departmental level. Departments in Colombia have significant obligations in terms of managing expenditures in education, health, and water sanitation, but their own revenues are small compared to subnational levels of government in Latin America and OECD economies (Figure 1.4, Panel B).

Box 1.3. **Main aspects of the 2012 tax reform**

The reform aimed to reduce the tax burden on formal jobs, simplify the VAT system and make the personal income tax more progressive; it was to be revenue-neutral.

The reform reduced or eliminated a series of employer's contributions (the so-called *parafiscales*) that financed the contributory health system, and training programmes for unemployed workers provided by the National Training Service (SENA). The contribution for early childhood programmes of the Colombian Institute for Family Well-being (ICBF) was also eliminated for all workers earning less than 10 minimum wages. This reduced mandatory contributions from 29.5% to 16% of gross wage earnings.

To make up for the lost revenue, the corporate income tax was modified. The statutory rate was reduced from 33% to 25%. At the same time, an additional tax with a broader base was introduced – CREE ("corporate income contribution to equity") – to finance the reduced contributions mentioned above (*parafiscales*). Revenues from the CREE surtax are directly earmarked to the budget of the concerned institutions and are not part of the general government budget process. There is an explicit guarantee by the government to provide funding if revenues from the CREE fall short of SENA's and ICBF's budget needs. The statutory rate of the CREE surtax was established at 9% for the period 2013-15 and 8% thereafter.

The reform also introduced an alternative minimum personal income tax (IMAN) that acts as a cap on many of the exemptions to the PIT. This increased slightly the effective tax rate paid by high-income households who benefit the most from exemptions.

The VAT system was simplified by reducing the number of rates from seven (between 0% and 35%) to three (0%, 5% and 16%). At the same time, the reform introduced several excise taxes to substitute higher VAT rates (e.g. on recreational boats and ships, planes, motorcycles and cars). For restaurants and bars, a sales tax of 8% was introduced substituting the 16% VAT, with the rationale that as most of their inputs were exempt from VAT, these services had little incentives to comply with the tax code and evasion was pervasive (Avendaño, 2013).

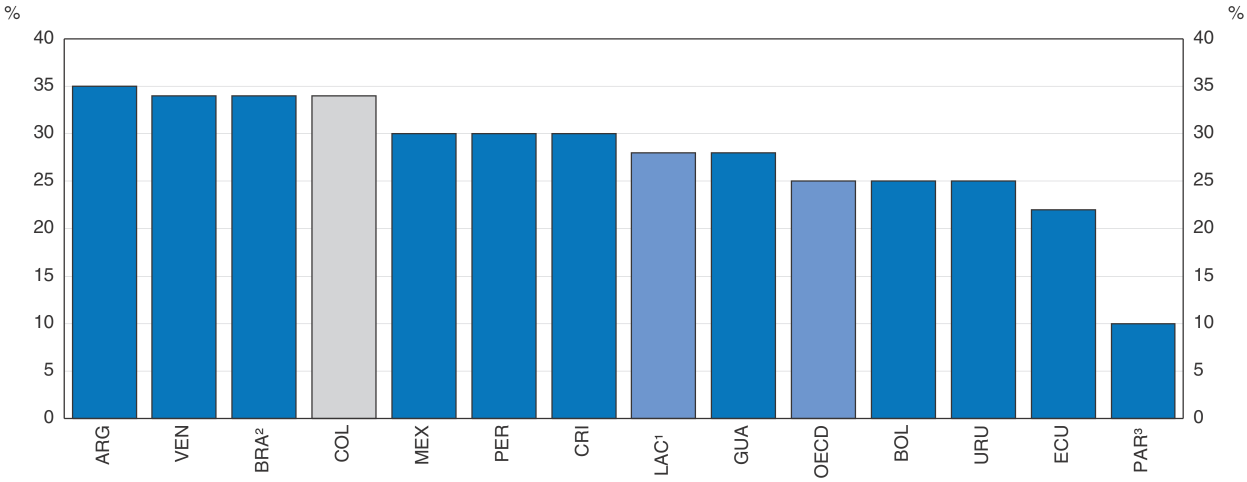
Making the tax system more efficient

Colombia levies a high dual tax on corporate income

The 2012 tax reform reduced the statutory corporate income tax rate from 33% to 25% but introduced a new "equity" tax on corporate income (known as the CREE) to fund social programmes which were previously financed through payroll taxes (*parafiscales*). The CREE applies on a broader base than the corporate income tax at a rate of 9% through 2015 and 8% thereafter, although the government is planning to make the 9% permanent. The combined statutory rate of 34% is above the average for Latin American and OECD countries (Figure 1.5), and results in a high effective corporate tax rate (Box 1.4). While corporate taxation is only one of the factors that shape firms' investment decisions, maintaining high statutory and effective tax rates is likely to have a negative impact on domestic and foreign investment (Hajkova et al., 2007).

The dual tax on corporate income is also characterised by a number of inefficiencies. For both corporate income tax and the CREE surtax purposes, an alternative minimum tax is calculated to ensure that a minimum level of tax is paid. This minimum tax is not based on actual income or profits but on a presumptive return on net wealth, which increases the tax system's complexity. Moreover, the standard corporate income tax is prepaid through a withholding tax, which is sometimes higher than the actual tax due, meaning that many

Figure 1.5. **Top statutory corporate income rates in OECD and Latin American countries**



1. Simple average for countries included in the figure.
2. Includes 9% social security contributions.
3. Surtax for dividends not included.

Source: *OECD Tax database* and KPMG Corporate Tax Rates (2014).

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Box 1.4. **Marginal corporate effective tax rates and cost of capital in Colombia under different scenarios**

Calculations of the cost of capital and marginal corporate effective tax rate allow assessing the burden imposed by the corporate income tax on investment. The cost of capital reflects the required pre-tax real rate of return on a marginal investment such that the investor after-tax breaks-even (i.e. for the investment project to be worthwhile at the margin). Based on this pre-tax real rate of return, the marginal corporate effective tax rate (METR) can be calculated as follows: $tc = (p-r)/p$, where tc is the marginal corporate effective tax rate, r is the after-tax real rate of return and p is the cost of capital. The calculations assume that the after-tax real rate of return on investment that the investor expects is 5% and the inflation rate is 2%.The calculations also assume that tax depreciation allowances follow the economic depreciation of assets, meaning that depreciation does not have an impact on the effective corporate tax burden. The results show a widely varying effective burden of the different taxes on investment but also point to tax-induced distortions in investment decisions (see Table 1.1 in the main text).

In the situation where only the CIT and the CREE apply, the corporate METR for equity investments is 34% (25% CIT + 9% CREE), while with debt-financed investment, the METR is -26%. This is because not only real but nominal interest payments are deductible from the CIT and the CREE bases. Considering in addition the VAT on fixed asset the corporate METR rises from 34% to 52% for equity-financed investments and from -26% to 28.9% for a debt-financed investment. This is because a business needs to earn a return on the *total* cost of investment which includes the unrecoverable VAT. If in addition, the 1.5% wealth tax is considered, which describes the current situation where all taxes apply, the equity-financed METR is around 60%. In the case of a debt-financed investment, the introduction of the wealth tax does not affect the METR as the wealth tax only applies to net wealth (i.e. assets net of liabilities). The cost of capital increases by more than 1.5% because the wealth tax has to be paid from after-tax profits.

Box 1.4. **Marginal corporate effective tax rates and cost of capital in Colombia under different scenarios** *(cont.)*

Table 1.1 also assesses a couple of reform options that are currently being discussed. First, considering that the 25% CIT, 9% CREE, VAT of fixed investment apply and that the wealth tax rate is raised to 2.25%. In this case, to earn an after-tax real rate of return of 5% on an equity-financed investment, a firm would have to earn a before-tax return of 14.2%. Investors requiring a higher after-tax real rate of return will face even stronger tax-induced disincentives to invest. The corresponding METR amounts to about 65%. Again, in the case of a debt-financed investment, the increase in the wealth tax does not affect the METR. Second, instead of raising the wealth tax, the CREE rate is increased to 12%. This reform increases the cost of capital of equity-financed investment to 13.2% and the METR to 62% which is lower than under a reform which increases the wealth tax rate to 2.25%. An alternative is to eliminate the net wealth tax and raise the CREE to 18%, which is the implied structure by 2018 of the tax law approved in December 2014. This reform lowers the cost of capital of equity-financed investment to 11.8% and the METR to 58%, which is slightly below the initial situation. Finally, a last case looks only at the effect of the CREE, VAT on fixed assets and the wealth tax. To simulate this case a 0% CIT rate is assumed. This last case looks at the cost of capital and METR for a small business that decides to incorporate (which is not required to pay CIT in the first year following incorporation). The results show that although small businesses receive a tax incentive to incorporate, the real effect of the incentive is limited compared to the combined effect of the VAT on investment, the wealth tax and the CREE (METR of 48%).

General observations

- The METR of 60% is high for equity-financed investments. The total effective tax burden is even higher than the METRs shown in the table because the calculations do not take into account sub-central taxes on businesses. METRs will further increase if the wealth tax rate is raised. Indeed, with a 2.25% wealth tax, the total corporate tax burden would reach about 65%. Increasing the wealth tax rate to 2.25% is more harmful for investment than increasing the CREE rate to 12%.
- Businesses have a significant incentive to finance investment through debt as interest payments are deductible from the CIT and the CREE and no wealth tax is effectively levied.
- Capital-intensive investments are highly discouraged as they are hit harder by VAT and the wealth tax than other types of investments. This effect was reinforced by the introduction of the CREE to replace payroll taxes which further increased the tax burden on capital-intensive businesses compared to labour-intensive firms.
- Small businesses receive a tax incentive to incorporate and become formal as they are not required to pay CIT in the first year of their incorporation and are then subject to a reduced CIT rate for four years. Effectively, however, the impact of this incentive is relatively limited as the total burden on small businesses of the VAT on investment, the wealth tax and the CREE remains very high.
- As part of the 2012 tax reform, the tax administration introduced stricter transfer pricing rules, thin capitalisation rules and other general anti-avoidance tax provisions which make it harder for businesses to avoid the taxes levied at the corporate level. The introduction of these stricter international tax rules is a step in the right direction and should now be followed with the introduction of a more efficient corporate tax system and a lower effective corporate tax rate to prevent businesses from facing a too high tax burden on investment.

businesses are entitled to refunds that are often delayed by the tax administration. Finally, having different taxes with different tax bases, withholding and reporting systems, increases both compliance costs for taxpayers and enforcement costs for the tax administration.

Reforming the corporate income tax would be growth enhancing. In particular moving towards a lower statutory rate would stimulate investment, especially in activities with narrower profit margins than the commodity sector. However, the short-term revenue costs of lowering the corporate income tax rate are likely to be high and benefits in terms of attracting investment and FDI will only arise in the longer run (Steiner, 2014). This suggests that a gradual decrease in the statutory rate may be more desirable. At the same time, better aligning the yearly withheld tax with the actual tax liability that has to be paid at the end of the year would reduce the cash flow problems that the current system creates for many firms. This would particularly benefit SMEs. In the longer run, the corporate income tax and the CREE surtax should be unified, which would require the CREE surtax to be no longer earmarked to specific expenditure programmes.

Generous tax benefits and special regimes reduce corporate tax revenues

Despite recent efforts to curb tax expenditures, they continue to erode the corporate income tax base. Since 2010, there have been some partial reductions in corporate income tax deductions, exemptions and credits. The most generous tax deduction in the last decade, which allowed investors to immediately deduct 30% of investments in fixed assets from taxable income, was abolished in 2010 (except for firms that had signed a tax stability agreement). In addition, income that used to be fully exempt (*rentas exentas*) originating from activities such as tourism and hotel services, the sale of renewable energies, some agricultural activities, publishing and medicine and software development, is now taxed under the CREE.

Generous incentives and special regimes also reduce revenues from corporate taxes. First, income from the activities mentioned above and covered by the CREE surtax remains exempt from the ordinary corporate income tax, i.e. they face a statutory rate of 9% instead of 34%. Colombia also has a very generous free trade zone regime under which businesses are taxed at a 15% corporate income tax rate and are exempt from VAT and custom duties. Companies can also benefit from an R&D incentive which allows an up to 175% income tax deduction for investments in scientific and technological projects. In addition, Colombia offers a special regime for non-profit organisations with a reduced corporate tax of 20% and tax exemptions for re-invested surpluses in non-profit activities. It is in fact very likely that this special regime has been misused as around one company out of five in Colombia is registered as a non-profit. In this sense, the government's proposal to revise the non-profit regime is a positive development (Box 1.2).

In addition to their substantial fiscal cost, these tax benefits and special regimes generate horizontal inequities between different types of companies and industry sectors. Companies from different sectors end up facing very different effective tax rates (Steiner and Cañas, 2013). Tax incentives are also often poorly targeted. The R&D incentive, for example, benefits mostly the largest companies as they generate most of the R&D and have significant taxable income, which allows them to take advantage of the deduction. Finally, tax benefits and special regimes increase the complexity of the tax system and eventually raise compliance and enforcement costs. The R&D tax allowance should be reduced. The use and impact of other tax benefits and special regimes should also be closely assessed with a view to removing or reforming those that are distortive, inefficient or misused.

Colombia's free trade zone regime is particularly distortive

There are more than 100 free trade zones (FTZ) in Colombia. Between 2013 and 2014, 17 new zones were authorised and the government is considering the creation of a new FTZ for deep-sea offshore exploration. There are two types of FTZs: *permanent* FTZs and *single-enterprise* FTZs. A permanent FTZ is a designated geographical location in which multiple companies operate and which is managed by an FTZ operator, while a single-enterprise FTZ allows an individual company which fulfils specific investment and job creation requirements to benefit from the tax and customs duty incentives irrespective of its location in the country. In addition, Colombia has *Special Economic Zones for Exports* (ZEEE) for businesses located within a few designated cities; these activities do not benefit from the CIT rate reduction but from reductions in payroll taxes and certain labour surcharges instead. Profits from certain infrastructure projects within ZEEEs are exempt from CIT and CREE (Brys and Perret, 2015).

The FTZ regime creates distortions and has often been misused by companies. For instance, companies in FTZs established before and after 2013 are treated differently: the CREE is not applicable to companies declared as FTZs before 31 December 2012 but applies to FTZs established after that date. In addition, the single-enterprise FTZs create disadvantages for domestic SMEs as these will likely not meet the investment and employment creation requirements to be granted the single-enterprise FTZ status. Furthermore, many activities located in free trade zones have been classified as manufacturing when in reality no or only minor transformation occurs. The special border tax regime also increases smuggling problems, according to officials of the tax administration. Moreover, FTZs have generated opportunities for tax avoidance through the manipulation of transfer prices between businesses inside and outside FTZs. From a tax administration perspective, the FTZ regime is very difficult to monitor.

Thus, in parallel to lowering the statutory corporate income tax rate, Colombia should also seek to broaden the corporate income tax base by removing or lowering existing deductions and exemptions. Incentives are often justified as a way to stimulate investment but a similar or greater impact could be reached by reducing the statutory rate for all businesses. Regarding the FTZ regime, Colombia should in the short run tighten the criteria for firms to enter permanent FTZs further and phase out single-enterprise zones as they generate significant distortions between similar companies and are very difficult to audit. In the longer run, if the net wealth tax on businesses is phased out – as currently planned by the government – and the corporate income tax rate lowered, permanent FTZs could be turned into zones which only provide VAT and customs duty benefits.

VAT on fixed assets discourages investment

In most countries VAT is only levied on consumption. Businesses that purchase goods and services, either from the domestic market or from abroad, pay VAT on their purchases but receive a refund for the VAT paid on their inputs (as long as the goods and services are used as part of the regular business activity). A consumption-based VAT provides refunds for fixed assets as well. In Colombia, however, businesses are not refunded for the VAT paid on fixed assets, which increases the cost of capital for businesses (Box 1.4) and strongly discourages domestic and foreign investment.

The government has announced that businesses will be refunded for the VAT paid on fixed assets at a rate ranging from 0% (no refund) to 16% (full refund), with the actual refund rate set depending on whether the tax administration meets its tax revenue target. However, no actual refund rate has been published by the government so far, mainly because of the significant revenue loss of refunding VAT on fixed assets. As the current system is very distortive, Colombia should start refunding VAT on fixed assets at the standard VAT rate of 16% or, if resources are not available in the short run, gradually increase the refund rate over time.

The business wealth tax can deter future investment

Businesses account for about 95% of the revenues collected from the wealth tax. The wealth tax charges taxpayers a lump sum based on their declared net wealth on 1 January 2011, with the amount payable over four years. The top marginal rate was 6% for taxpayers with wealth above USD 2.5 million, equivalent to 1.5% per year over the four-year period. For 2015, the government has proposed to increase until 2018 the CREE surtax rate to 18% and to gradually phase out the wealth tax on firms by 2018 (Box 1.2).

The Colombian wealth tax distorts individuals' savings and investment behaviour. It generates or amplifies the preferential treatment of some forms of savings over others as the value of shares or company interests in Colombian companies and the first USD 160 000 of the primary house value can be deducted from the tax base. The wealth tax also encourages tax planning and capital flight. The wealth tax has not reduced income differentials as the share of top-income households in total income earned in Colombia before and after taxes remains practically unaltered (Alvaredo and Londoño, 2013). Only about 50 000 people pay the tax, or 0.01% of the population.

The wealth tax's distortive effects on businesses are even more pronounced as it comes on top of an already high combined corporate income tax and CREE surtax rate. The cascading effect of the total CIT/CREE/wealth tax can raise corporate effective tax rates up to 51% (Clavijo et al., 2013).The OECD calculated the cost of capital and the total marginal effective corporate tax burden under different scenarios (Table 1.1; Box 1.4). Taking into account the 25% corporate income tax rate, the 9% CREE surtax rate, the 1.5% wealth tax as well as VAT on fixed assets, the OECD calculations find that if businesses wish to earn a 5% real after-tax return on their investment, they need to earn a pre-tax return of 12.7%. The proposal to increase the CREE rate from 9% to 12% increases the cost of capital to 13.2%. This implies that the total marginal effective tax burden on businesses is in the order of 60% (Table 1.1). Considering the changes approved by Congress in December 2014 of increasing the CREE to 18% and eliminating the wealth tax, the cost of capital is reduced to 11.8% and the marginal effective tax rate for equity-financed investment to 58%. This represents just a slight improvement compared to the situation in 2014. More generally, the results highlight that the wealth tax and the VAT on fixed assets account for a significant part of the total effective tax burden on businesses.

Table 1.1. **Costs of capital and marginal corporate effective tax rates (METR) in Colombia**

Per cent

	Equity-financed investment		Debt-financed investment	
	Cost of capital	Corporate METR	Cost of capital	Corporate METR
CIT, CREE, no VAT, no wealth tax	7.6	34	4.0	-26
CIT, CREE, VAT, no wealth tax	10.4	52	7.0	29
CIT, CREE, VAT, wealth tax	12.7	60	7.0	29
CIT, CREE, VAT, 2.25% wealth tax	14.2	65	7.0	29
CIT, CREE + 3%, VAT, wealth tax	13.2	62	7.0	28
CIT, CREE + 9%, VAT, no wealth tax	11.8	58	6.9	27
No CIT, CREE, VAT, wealth tax	9.6	48	7.3	32

Source: Authors' calculations.

An increase in the wealth tax could have some adverse effects on the economy. Individuals would probably be encouraged to further invest in housing, which benefits from a generous allowance under the wealth tax. There is also the risk that wealth could be moved further offshore, such as countries with which Colombia does not have tax information exchange agreements. For businesses the rise in the total marginal effective tax burden to close to 65% on equity-financed investments can strongly reduce incentives to invest and lead to disinvestment by mobile types of companies (Table 1.1; Box 1.4). An increase in the wealth tax could also generate additional incentives to finance investment through debt and to engage into further corporate tax planning. Ultimately, increases in tax planning would put significant pressure on the tax administration. In this sense, the proposal to phase out the wealth tax on businesses by 2018 and replace it by a higher CREE surtax creates a slightly lower effective tax burden on investment than the current situation.

For individuals, the wealth tax could be maintained with lower rates and on a broader base that would include the value of shares in businesses. In this sense, the recent changes approved by congress tend to reduce the effective tax rate (Box 1.2). Although a wealth tax might help lowering the high level of inequality in Colombia, increasing the tax burden on richer households and enhancing the progressivity of the tax system would be best achieved, especially in the longer run, through a broader personal income tax base and more progressive rates as well as an increase in capital income taxation at the personal level, including the taxation of dividends, immovable property and land.

Colombia maintains a distortive financial transaction tax

The Colombian financial transaction tax, which currently amounts to 0.4% of the total transaction amount, was originally introduced as a temporary measure to respond to the economic crisis of 1998. It is charged on all financial transactions including banknotes, promissory notes, internet banking and so on. The government had announced that it would remove it but has recently decided to maintain it until 2018.

Similar financial transaction taxes are common in other Latin American countries and in Asia (Matheson, 2011). They are appealing because they can raise substantial revenue and are relatively easy to administer. However, they tend to hamper financial deepening, which in turn adversely affects business sector growth and encourage cash operations, which usually results in greater informality and revenue losses from other taxes. Revenues from these types of taxes also have a tendency to decline over time, as taxpayers find ways to circumvent them. Governments frequently end up raising the rate in an effort to address revenue erosion, which can lead to an even larger contraction of the tax base (Matheson, 2011). Although revenues have been stable around 0.8% of GDP since some loopholes were closed in 2010, there is some evidence of revenue erosion in the financial transaction tax for Colombia. For example, despite doubling the tax rate in 2004, revenues raised by the financial transaction tax in terms of GDP were the same in 2010 as in 2003.

Despite exemptions for small transactions, the financial transaction tax causes disintermediation and generates costly distortions in Colombia. For example, a study shows that the financial transaction tax accounts for around 20% of the net interest margin and its interaction with forced investments in securities to finance agricultural development could explain up to 40% of the margin (Galindo and Majnoni, 2006). High intermediation margins are one of the main factors holding back financial deepening and inclusion in Colombia (Daude and Pascal, 2015). The structure of the tax also favours less competition among banks, as it creates incentives for individuals to have all accounts and services with the same institution. Furthermore, some studies indicate that the financial transaction tax reduced significantly the demand for financial services (Kirilenko and Summers, 2002) and increased the demand of cash (Arbeláez, Burman and Zuluaga, 2004). The increased use of cash for transactions also contributes to overall tax evasion. Actually, some estimates show that the net effect of the financial transaction tax on tax revenues might be negative, given the high levels of informality that it induces (Clavijo, Vera and Vera, 2013). Overall, the tax is distortive and costly for investment and economic growth (Arias, Carrasquilla and Galindo, 2002; Suescun, 2001).

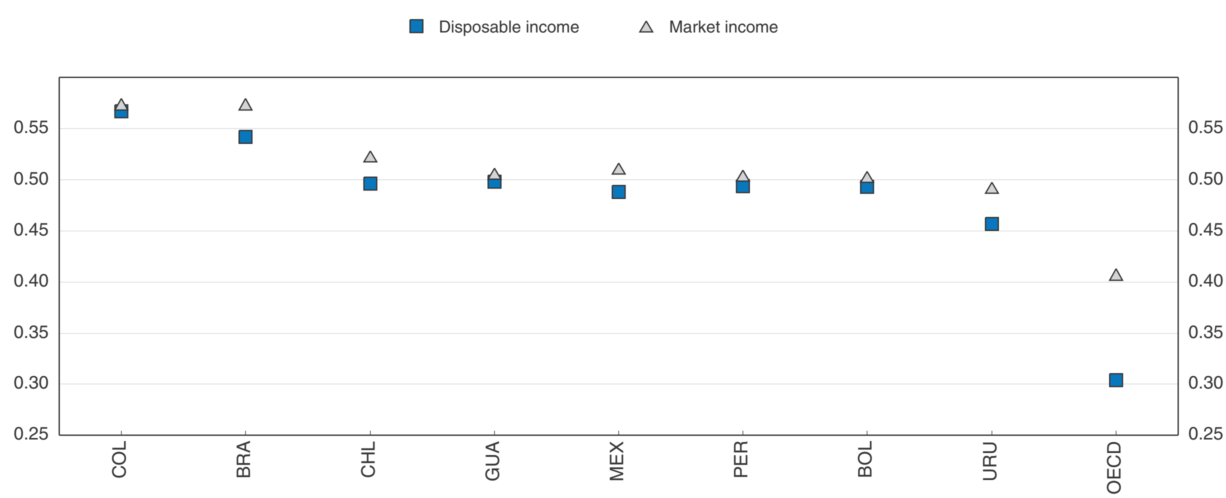
While in the short-term it might not be economically and politically feasible to eliminate, as it levies around 0.8% of GDP, the government should aim to find alternative sources of revenue and phase it out as soon as possible. An alternative would be to levy the financial transaction tax on a different type of transactions. For instance, a tax on high-frequency trading could continue to raise revenue from the financial sector as well as lower the risks of asset price bubbles. However, like other transaction taxes, such a tax would have cascading effects, raising the cost of capital for some businesses more than others and possibly increasing financial disintermediation (Matheson, 2011).

Towards a more progressive tax system

Income inequality in Colombia is among the highest in the world and the tax system does little to reduce it. In contrast to most OECD economies, but similarly to other Latin American countries, income inequality in Colombia remains broadly unaltered by direct taxes and cash transfers (Figure 1.6). In part, this reflects the relatively low overall tax intake – even if taxes and transfers were progressive, their incidence would be small. But it also reflects a regressive tax mix and pervasive exemptions that are not progressive (Figure 1.7).

Figure 1.6. **Taxation has little redistributive power**

Gini coefficient at market income and after direct taxes and transfers (circa 2010)[1]



1. The Gini index has a range from zero (when everybody has identical incomes) to one (when all income goes to only one person). Increasing values of the Gini coefficient thus indicate higher inequality in the distribution of income.

Source: OECD Database on Household Income Distribution and Poverty; Lustig et al. (2013), "The Impact of Taxes and Social Spending on Inequality Argentina, Bolivia, Brazil, Mexico, Peru and Uruguay: An Overview", *CEQ Working Paper*, No. 13, August; Lustig and Melendez (2014), "The Impact of Taxes and Transfers on Inequality and Poverty in Colombia", *CEQ Working Paper*, No. 24, Center for Inter-American Policy and Research and Department of Economics, Tulane University and Inter-American Dialogue, forthcoming.

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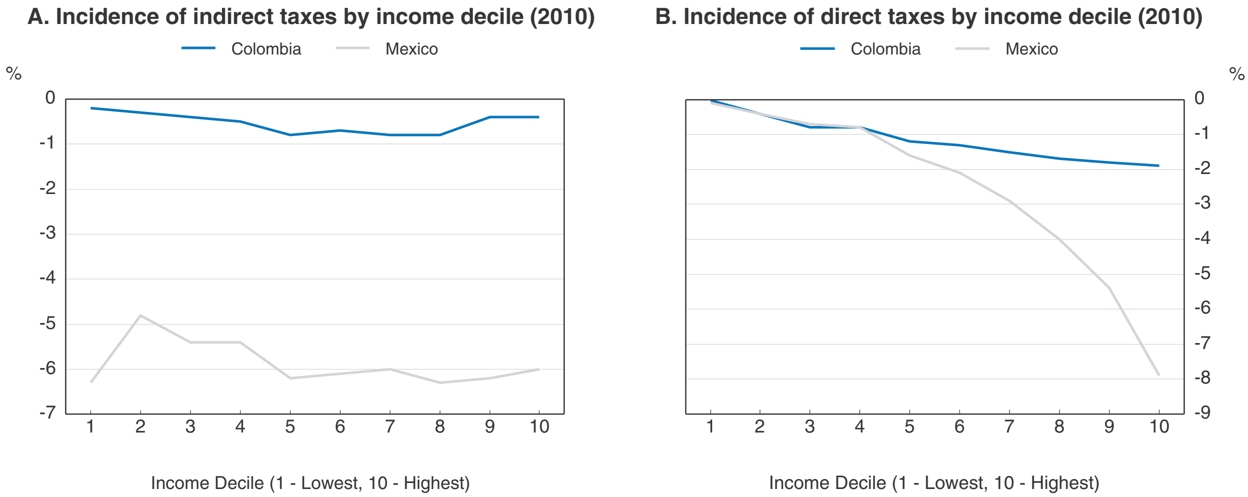
Figure 1.7. **Taxes in Colombia are less progressive compared to Mexico**



Source: Lustig et al. (2013), "The Impact of Taxes and Social Spending on Inequality Argentina, Bolivia, Brazil, Mexico, Peru and Uruguay: An Overview", *CEQ Working Paper*, No. 13, August; Lustig and Melendez (2014), "The Impact of Taxes and Transfers on Inequality and Poverty in Colombia", *CEQ Working Paper*, No. 24, Center for Inter-American Policy and Research and Department of Economics, Tulane University and Inter-American Dialogue, forthcoming.

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VAT remains relatively regressive despite exemptions on basic foodstuffs

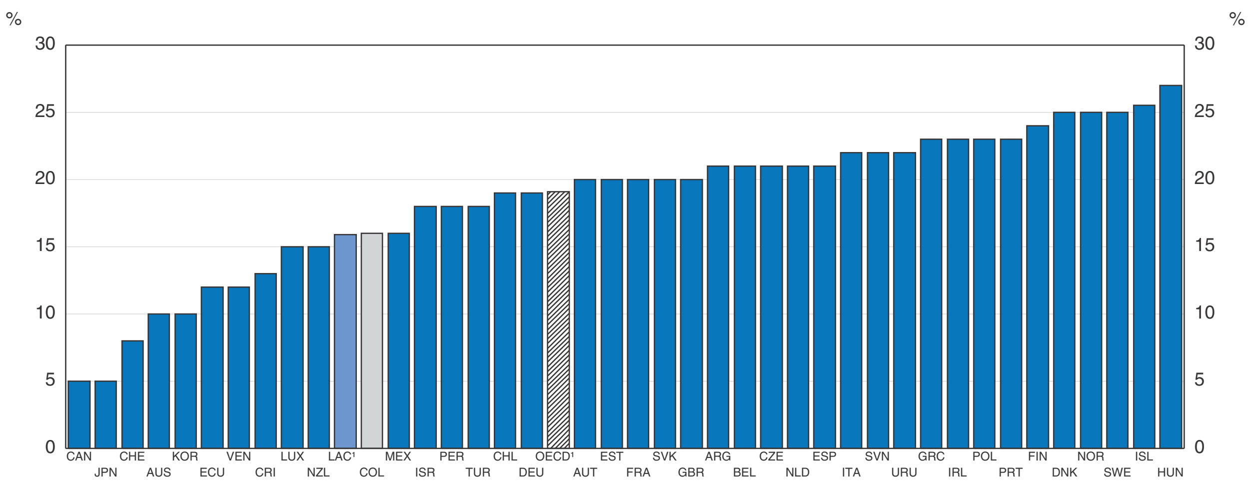
The VAT and other indirect taxes are regressive despite the existence of reduced (5% and 0%) rates. As a result indirect taxes reduce the income of the deciles in the middle of the distribution two times more than for the richest decile. This stands in contrast with other Latin American countries, for example Mexico, where indirect taxes are higher and have a more progressive profile (Figure 1.7, Panel A). Furthermore, in many OECD countries and several Latin American countries the VAT is progressive when the tax is expressed as percentage of household consumption expenditure (instead of income to net out the effect of savings). By contrast, in Colombia the VAT is regressive also in terms of consumption expenditure (IADB, 2013).

Broadening the VAT tax to excluded activities could boost revenues. In addition to exemptions and reduced rates on foodstuffs and other essential items, many activities – especially services – are excluded from the VAT system. VAT exemptions and reduced rates represent around 0.5% of GDP in terms of foregone tax revenue (MHCP, 2014a). The Constitutional Court has ruled several times that these exemptions are needed to guarantee the fundamental rights of the poor to access affordable basic goods. In the medium run, existing cash-transfer programmes to the poor would need to be expanded and adapted to compensate the poor for the negative effects on purchasing power of eliminating exemptions and reduced rates. This would only cost around 0.1% of GDP (Steiner and Medellin, 2014). However, the gains of doing so are small compared with the estimated revenue loss from not taxing the excluded activities – including construction, electricity, transport, education, financial and other services – of about 2.4% of GDP (Yori Parra et al., 2013). Many of these items are not essential for the vulnerable population and are usually subject to VAT in other Latin American and OECD countries. Therefore, there is significant room to broaden the base by including more sectors into the VAT system.

There is also room to increase the standard VAT rate if more revenues are needed. The standard VAT tax rate is relative low by international standards (Figure 1.8). While it is around the average for Latin America, several emerging markets in the region have a higher general rate, e.g. Peru (18%) or Chile (19%). Furthermore, many OECD countries have much higher VAT rates. Shifting the tax mix towards more indirect taxation would benefit growth, as VAT is one of the least distortive taxes (Arnold et al., 2011). However, such an increase should be part of a comprehensive tax reform that is overall progressive.

Figure 1.8. **Colombia's standard VAT rate is relatively low**

Tax rates as of 2013



1. For OECD and LAC the data are simple average of countries' rates.
Source: *OECD Tax Database* and CIAT.

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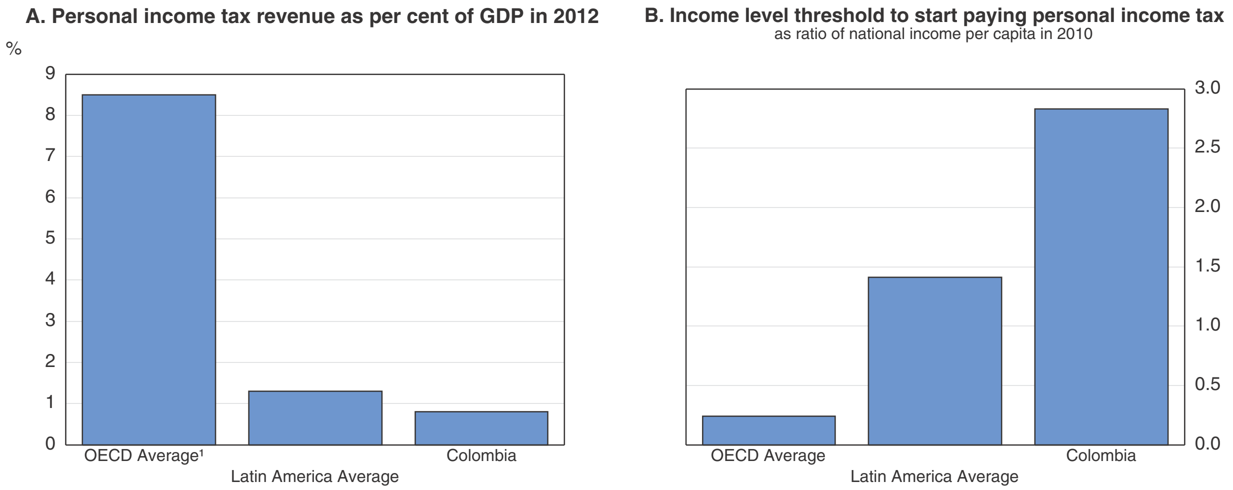
Furthermore, the productivity of the VAT – defined as the revenue relative to consumption or GDP divided by the general VAT rate – in Colombia is low compared to Latin American and OECD economies. The main reasons are tax evasion and a relatively weak tax administration (IADB, 2013). Therefore, fighting evasion and improving the tax administration could yield more revenues from VAT, even with the current tax structure.

Personal income tax: A few paying too little

Revenues from the personal income tax in Colombia at 0.8% of GDP are low. The OECD average is 8.5% of GDP (Figure 1.9, Panel A). Few households are subject to the personal income tax, as informality is widespread and the minimum exemption level is relatively high. While in OECD countries individuals start paying personal income tax from above one fourth of the average national per capita income, in Colombia the threshold is three times the average national per capita income (Figure 1.9, Panel B). As a consequence, less than 10% of the population have to present a tax declaration and only around 5% pay personal income taxes. While the lower absolute income levels and highly unequal income distribution in Colombia make it difficult to reach revenue levels as in the OECD in the short term, countries in Latin America – which share similar constraints – collect on average two times more personal income taxes than Colombia (Figure 1.9, Panel A).

Figure 1.9. **The personal income tax levies little revenue in part due to a high minimum exemption level**



1. OECD refers to 2011 data. The graph presents only income tax revenues that are identified as personal income tax revenues by the OECD Revenue Statistics, while sometimes a significant amount is unclassified between corporate and personal income.

Source: OECD Revenue Statistics; and OECD/ECLAC/CIAT (2013), *Revenue Statistics in Latin America: 1990-2012*; IADB (2013), *More than revenue: Tax policy as a development tool.*

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The top marginal tax rate of 33% is also low compared to top rates in the OECD, but close to the Latin American average. However, the taxable income that falls into the highest income bracket is extremely high in Colombia at ten times the average per capita income. In Mexico it applies at three times the average income and it is slightly above two times the average income in other OECD economies (IADB, 2013). This implies that individuals start to pay the top marginal rate in Colombia, when they are in absolute terms almost 40% richer than the average OECD person subject to the top marginal rate (accounting for differences in purchasing power across countries).

Tax exemptions benefit the rich and reduce revenues

Generous exemptions reduce revenue and progressivity of the personal income tax, as they mainly benefit the rich. According to estimates by the tax administration (DIAN), the effective tax rate is almost flat along the income schedule at just around 5%. Therefore, progressivity only arises between those paying this effective tax rate and those who do not pay the personal income tax, e.g. those below the minimum exemption level (which includes the poor but also middle-income households).

The tax treatment of pensions is extremely generous further benefitting the few better off who get a pension (see Chapter 2). First, pensions below 50 times the minimum wage (around USD 15 000 per month) are completely exempt from the personal income tax, which in practice implies that almost no pensions are taxed. Second, mandatory contributions to pension funds or the public pension scheme as well as health care are fully exempt, and there are generous exemptions for voluntary savings in pension funds. Finally, returns on investments by pension funds are also exempt. In all OECD countries, pensions are at least taxed at one of the three stages. Given the generosity of the current defined-benefit public pension scheme, it seems that the most progressive measure would be to tax high pensions in the pay-out phase at progressive personal income tax rates.

According to IMF estimates, taxing pensions above five minimum wages at a moderate 10% rate would increase revenues by 0.2% of GDP.

In addition to pensions and health care, taxpayers can deduct many other items. There is a general deduction of 25% of income (capped around USD 3 500 per annum) as well as a 10% deduction per dependent. Mortgage interest payments can be deducted and voluntary savings for real estate are also exempt up to generous amounts. Richer households also benefit more from the privileged tax treatment of savings (see below).

The 2012 reform introduced an alternative minimum tax (IMAN) for salaried and independent workers, which puts a cap on some of these exemptions for high-income households. The alternative minimum tax allows less exemptions and deductions and applies to workers with monthly income above 1.548 tax unit values per annum, equivalent to around USD 23 000. According to estimates by DIAN, this would make the personal income tax more progressive, raising the effective tax rate for high-income persons up to 15% from 5%. Official simulations imply a reduction of almost 2 percentage points in the Gini coefficient due to the IMAN from 0.57 to 0.55. However, other analysts find more modest results on inequality (Hurtado, Lustig and Melendez, 2014).

The taxation of personal capital income is low

Colombia does not tax dividends at the personal shareholder level. Capital gains are taxed at a rate of 10%, but gains realised from the sale of certain assets, including immovable property, are taxed at lower rates or are tax-exempt. Interest payments are taxed under ordinary personal income tax rates (i.e. rates ranging from 0% to up to 33%), with an adjustment for inflation. The low taxation of personal capital income partly accounts for the relatively small share of the personal income tax paid by top income households in Colombia and low progressivity of the tax (Alvaredo and Londoño, 2013).

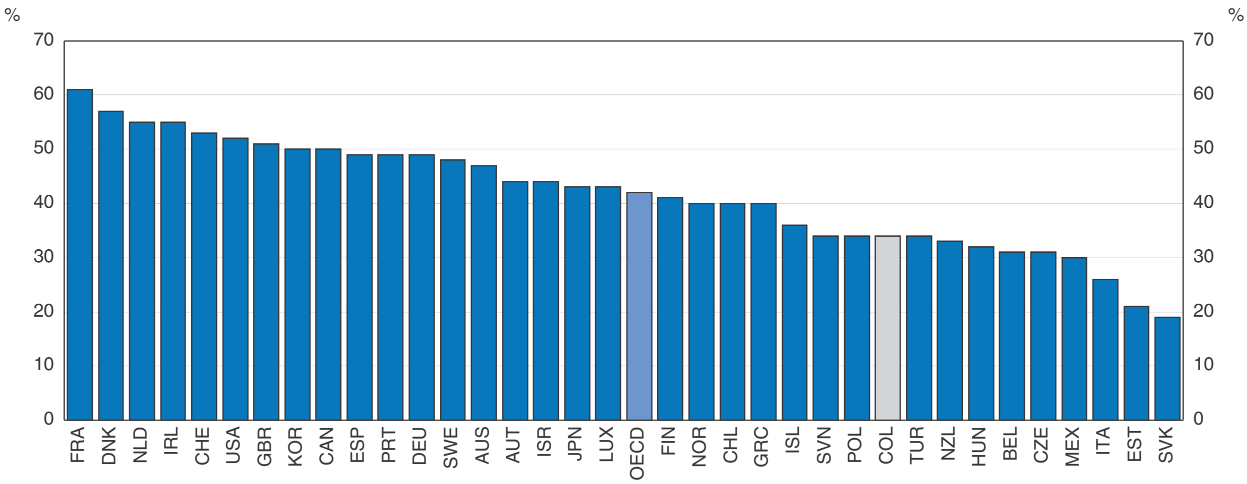
In the OECD, despite large differences across countries, the combined statutory tax rate on dividends usually exceeds 40% when the statutory corporate income tax rate and the taxes on dividends at the shareholder level are taken into account. Colombia's taxes on dividends are lower than the OECD average as dividends are taxed at the statutory rate of 34%, which combines the corporate income tax and the CREE surtax (Figure 1.10). The main advantage in Colombia of not taxing dividends at the personal level is that the system is simple and, in contrast to most OECD countries, there is no economic double taxation of profits (although the overall tax burden matters more than whether dividends are taxed once or twice). However, to increase the overall progressivity of the tax system but also to potentially use the revenue to lower the corporate income tax rate, Colombia should consider introducing a dividend tax levied at the personal shareholder level.

Given the significant imbalance between the taxation of capital income at the personal and corporate levels, the introduction of a dividend tax at the shareholder level would require lowering corporate taxation. The statutory CIT rate would have to be significantly reduced to avoid having very high combined corporate and individual rates. While the overall level of taxation on dividends and capital gains at the personal level is very low (CIT and CREE), the tax burden on distributed dividends is very high when VAT on investments and the business wealth tax are also taken into account. The combined tax burden then exceeds 60% (see above).

To tax capital more at the personal level, Colombia could introduce a tax levied on dividends distributed to Colombian shareholders but withheld at the corporate level, as was recently implemented in Mexico. A dividend tax withheld at the corporate level is

Figure 1.10. **Combined statutory tax rates on dividends**

Corporate and personal shareholder level



Source: Author's calculations.

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easier to administer – there are less corporations that distribute dividends than there are shareholders receiving dividends – and would be more difficult to evade (e.g. by Colombian tax residents whose dividends are paid to an offshore account). However, such a tax would not allow taxing dividends at progressive personal income tax rates.

Moving towards a dual personal income tax scheme could be a good option for implementing a more progressive personal income tax system. Some OECD countries tax capital income together with labour income at progressive personal income tax rates. Most OECD countries, including Denmark, Finland, Norway or Sweden, have a dual income tax system in which labour income is taxed at progressive rates and capital income is taxed separately at proportional and typically lower tax rates. Recently, several countries in Latin America have moved towards similar schemes (IADB, 2013). While a dual income tax might be slightly less progressive than an income tax system that taxes capital income at progressive PIT rates, the dual scheme has a series of characteristics that make it an attractive option for Colombia. Their tax administration is easier than comprehensive schemes, as they can be implemented with a withholding at the source scheme and can be levied on a broad capital income tax base. Furthermore, if rates are set coherently, there are fewer incentives for tax avoidance. This makes them often more progressive than integral schemes in countries with weak tax administrations and where the capital income tax base is narrow. Compared to the current situation, this would allow taxing capital income at higher rates and increase therefore progressivity.

Dividend taxation should be consistent with capital gains taxation. A shift of the capital income tax burden from the corporate towards the personal shareholder level may have to be accompanied by an increase in the capital gains tax rate. If dividends were to be taxed at higher effective tax rates than capital gains, corporations would no longer have an incentive to distribute profits but rather retain and reinvest them. As a result, profits would be "locked-in", which would reduce the possibility for young and growing companies to attract external equity financing.

Tackling tax evasion

Tax evasion is widespread

Widespread tax evasion is a significant drag on tax revenues in Colombia. Official estimates of VAT evasion are currently around 25%, which represents around 2% of GDP (Cruz, 2011). However, a recent IMF assessment of VAT evasion put it at 40%, which is close to the estimates of some private analysts (Steiner and Medellin, 2014). While part of the high evasion reflects the overall high informality of the economy, it is also explained by some institutional weaknesses in the tax and customs administration. In particular, a large share of VAT evasion occurs due to weak border and customs controls, as well as corruption. The tax administration (DIAN) has little effective control over VAT on imports, because of personnel constraints, regulations and segmented information systems.

Official estimates of tax evasion rates in the corporate income tax are around 30% over the 2007-11 period on average. The Inter-American Development Bank estimates 2.3% of GDP. While there are no reliable estimates of evasion for the personal income tax, the international evidence shows that in general it is more pervasive than for VAT or corporate income taxation (IADB, 2013). Therefore, curbing tax evasion would increase revenues even without changing the current tax mix.

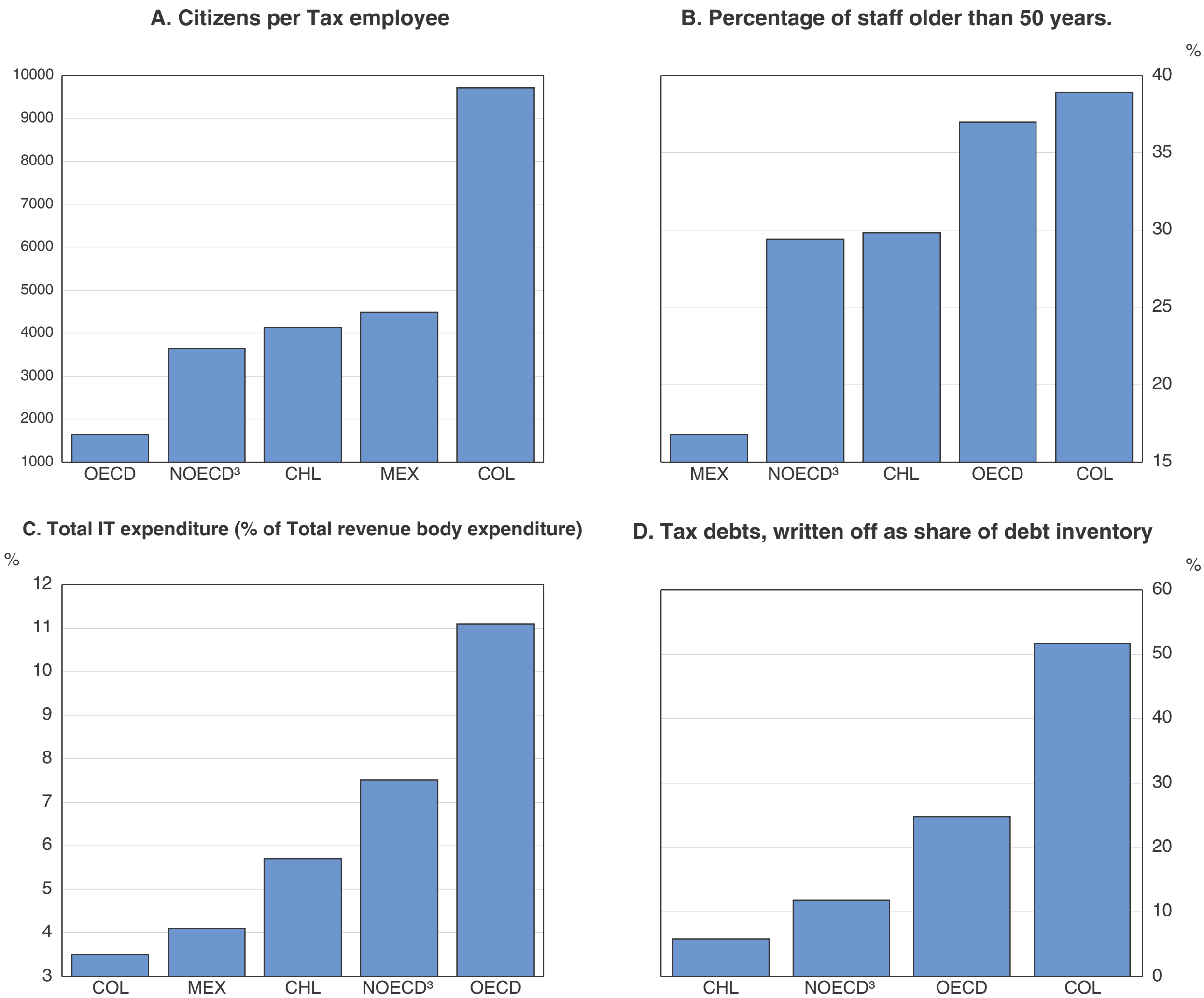
The financial disintermediation caused by the financial transaction tax also tends to contribute to tax evasion. As the tax has increased cash transactions in the informal sector, evasion may rise. The banking system often plays a crucial role in facilitating information for tax collection and enforcement (OECD, 2007). Moreover, according to one estimate, the tax would have reduced collection of other taxes such as income tax and VAT by 10%, implying an overall reduction of 0.3% of GDP in total tax revenues (Clavijo, Vera and Vera, 2013). Therefore, removing the financial transaction tax would contribute to reducing informality and tax evasion, in addition to removing the financial sector distortions discussed above.

The Colombian tax system also suffers from high levels of offshore tax evasion. Offshore evasion often involves placing assets in neighbouring Panama or islands in the Caribbean. Tax evasion has been encouraged by highly distortive taxes (e.g. the net wealth tax), illicit activities and instability from the armed conflict in the case of offshore evasion. Colombia has recently joined several multilateral and bilateral information exchange agreements, and passed legislation to tax transactions with jurisdictions that do not collaborate in the exchange of information. This will potentially help to curb tax evasion, but a less heavy tax on wealth would also facilitate voluntary disclosure and compliance.

Strengthening the tax administration to fight tax evasion

Strengthening the tax administration (DIAN) would help reduce tax evasion. A restructuring proposal to give DIAN more effective supervising powers over customs services is under consideration in congress. Expanding tax controls would also help. DIAN inspects only 0.1% of taxpayers, compared to around 3% in other Latin American countries. This is in part a consequence of its relatively small staff. There are less than half of employees in the tax administration per person in Colombia than in Mexico, Chile or other emerging economies (Gómez Sabaini and Jiménez, 2012; Figure 1.11, Panel A). In addition, the average age of DIAN's staff is relatively high and staff sometimes lacks adequate language skills or technical knowledge on issues such as transfer pricing or specific sectors (Figure 1.11, Panel B). Moreover, the large number of employees who are on temporary contracts cannot receive training. DIAN's capacities are also constrained by the lack of efficient IT systems.

Figure 1.11. **There is room to strengthen the tax administration**



1. Note by Turkey: The information in this document with reference to "Cyprus" relates to the southern part of the Island. There is no single authority representing both Turkish and Greek Cypriot people on the Island. Turkey recognises the Turkish Republic of Northern Cyprus (TRNC). Until a lasting and equitable solution is found within the context of the United Nations, Turkey shall preserve its position concerning the "Cyprus issue".
2. Note by all the European Union Member States of the OECD and the European Union: The Republic of Cyprus is recognised by all members of the United Nations with the exception of Turkey. The information in this document relates to the area under the effective control of the Government of the Republic of Cyprus.
3. NOECD is an average of 18 countries: Argentina, Brazil, Bulgaria, China, Colombia, Cyprus, Hong Kong (China), India, Indonesia, Latvia, Lithuania, Malaysia, Malta, Romania, Russia, Saudi Arabia, Singapore and South Africa.

Source: OECD (2013a), *Tax Administration 2013: Comparative Information on OECD and other advanced and emerging economies.*

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The use of information technologies (IT) and mass audits and other similar tools is less frequent than in other countries (IADB, 2013). This is reflected in the relatively low IT expenditures compared to peers (Figure 1.11, Panel C). A broader use of IT would simplify the tax administration and enforcement, and also lower compliance costs for taxpayers. For example, only around 25% of firms file their CIT and VAT returns electronically in Colombia, while in other Latin American countries such as Argentina, Brazil, Chile or Mexico, all firms use electronic filing (OECD, 2013a).

Positive changes were introduced regarding the auditing methods carried out by DIAN. DIAN used to conduct exclusively in-depth audits, which resulted in a heavy caseload and opportunities for corruption. Efforts are now being made to implement automated basic checks ("*fiscalización masiva*") to detect basic errors and omissions. This will increase the number of audits performed every year and raise the perceived risk associated with non-compliance. An audit manual was also developed and audit cases are now managed centrally. Finally, a new system of joint audits between the different tax auditing units (tax, customs, exchange control and transfer pricing) was put in place.

DIAN is also constrained by several regulations that limit its powers to enforce payments of tax debt. DIAN writes off more than half of the outstanding tax debt per year, twice the level in OECD countries and well above also other emerging market economies (Figure 1.11, Panel D). In part this low level of collection is linked to restrictions DIAN faces to enforce payments. For example, businesses do not require a tax clearance certificate to be contractors of the public sector or cannot be denied certain government services in case of uncollected tax debts, as is standard in most OECD countries. Furthermore, DIAN cannot request a search warrant without the help of other state agencies, offset tax debt with outstanding tax credits of the same taxpayer, or initiate bankruptcy procedures.

DIAN's audit function could be further strengthened by modernising the IT systems, increasing the number of staff and ensuring that they have the adequate expertise. The criteria used for audit risk-scoring should also be clearly specified and the risk-based selection programme should be run regularly during the tax year to ensure inclusion of late filers (USAID, 2013). More focus could be put on PIT evasion, which has received less attention than CIT evasion. Finally, while the audit function aims to control registered taxpayers, efforts should also be made to address the issues of non-filers and the informal economy which typically fall under the responsibility of other units in the tax administration (e.g. fraud investigations). The objective is to increasingly bring Colombians who currently operate in the informal sector within the reach of the tax administration.

A voluntary disclosure programme of unreported income and wealth could increase tax compliance

The law approved in December 2014 increases sanction for tax evasion and introduces a tax amnesty for unreported assets held abroad by Colombians (Box 1.2). With this amnesty, taxpayers who come forward would be subject to the wealth tax and a penalty. Taxpayers who do not come forward would face higher fines. Currently, taxpayers are criminally liable only when they do not pay withheld taxes and VAT within the two months following the due date. Making tax fraud a criminal offence would help in this regard.

However, such an amnesty raises a number of issues. The amnesty might not be credible because of previously unsuccessful tax amnesties in Colombia (in 1995, 2003 and a failed attempt in 2012). In addition, the tax administration's relatively weak audit capacity could also make the amnesty less credible. Finally, if the amnesty is not perceived as a credible one-off offer, it could end up being counter-productive as honest taxpayers may resent the amnesty and stop paying their taxes and evaders may wait for a future amnesty.

To successfully repatriate assets held abroad, a step-by-step approach to voluntary disclosure is needed. First, tax fraud penalties could be increased, by following general practice in OECD countries and by making domestic and offshore tax evasion a criminal offence, as proposed initially in the Tax bill to congress in October 2014, but finally not approved by Congress. Such measures should go hand in hand with efforts to strengthen the tax administration and to remove highly distortive taxes (e.g. wealth tax). Once these broad reforms signalling the credibility of the government's fight against tax evasion are put in place, Colombia could introduce a special offshore voluntary disclosure programme for a limited period of time to encourage taxpayers to amend incorrect or incomplete tax declarations or to disclose previously undeclared income, wealth and unpaid taxes. The programme should also stipulate that taxpayers who report their assets will not be prosecuted retro-actively and will remain anonymous to avoid possible risks for people disclosing their assets.

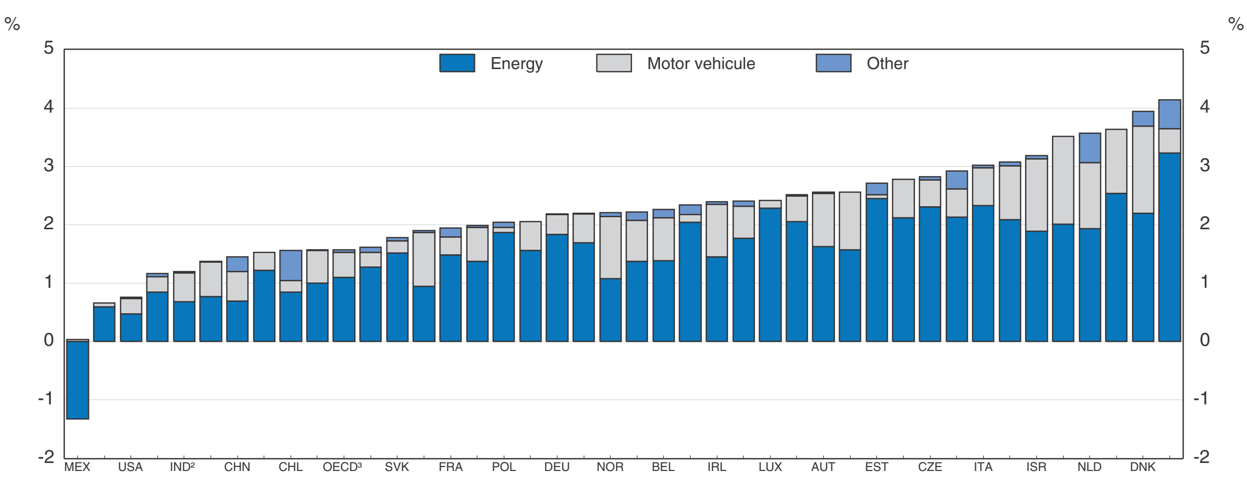
Making the tax system greener

The recent expansion of extractive industries, urbanisation, road traffic and livestock grazing (OECD/ECLAC, 2014) is increasing the stress on biodiversity. Greenhouse gas emission intensity is also relatively high due to emissions from agriculture. The surface area used for oil extraction and mining has also increased significantly, and some activities, particularly illegal mining, pollute water and soil. Despite progress in formalising some informal and illegal mining activities, it continues to be widespread, reducing royalty and tax revenues and generating considerable environmental damage. However, energy-linked CO_2 emissions are low thanks to heavy reliance on hydropower.

Environmentally related tax revenues are low

Environmentally related tax revenues in Colombia, at 0.9% of GDP (net of the implicit fuel subsidies but including royalties for mining), are low compared to OECD and Latin American countries (Figure 1.12). About two thirds of all environment-related tax revenues in Colombia in 2012 originated from taxing energy use. The remainder stems from taxing motor vehicles and other environmentally related goods. Since 2012, Colombia levels excise duties on gasoline and diesel on quantities (*ad quantum*) not values (*ad valorem*) and indexes it to inflation.

Figure 1.12. **Environmentally related taxes are low**



1. 2011 data.
2. 2010 data.
3. GDP weighted average 2011.

Source: OECD/ECLAC (2014), *OECD Environmental Performance Reviews: Colombia 2014*.

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The 2012 tax reform took steps in the right direction. In particular, the pre-existing *ad quantum* and *ad valorem* taxes on gasoline and diesel were merged to one *ad quantum* tax. This is welcome as *ad quantum* taxation of fuels corresponds more closely to the energy service received from fuels and to their emissions. The indexation of this tax to inflation should be sustained as it prevents a decline of environmentally related tax revenue in real terms. In addition to the national taxes on fuels used in transport there are also subnational surtaxes on gasoline and diesel. While the diesel rate is centrally determined at 6% of the net sales price, subnational governments can set the surcharge on gasoline. Some selected rates are 6.5% of the net sales price in Valle del Cauca and Santander, 18.5% in Cundinamarca, 25% in Bogotá, all higher than the national tax rate on diesel (Bogotá Municipality, 2014). Although Colombia taxes energy more than many oil producing countries, energy tax rates are low compared to other Latin American countries and significantly lower than the OECD average (Table 1.2). A particular constraint to raising more fuel taxes are extremely low prices in Venezuela that have encouraged significant smuggling into Colombia.

Table 1.2. **Tax rates on gasoline and diesel, selected Latin American countries and OECD average**

	Colombia	Chile	Argentina	Uruguay	OECD average
Gasoline (EUR/GJ)	**4.7**	10.3	6.9	13.2	15.5
Diesel (EUR/GJ)	**3.2**	2.2	4.2	12.5	10.5

Source: OECD calculations based on Colombian Government (2014) and OECD (2013b). Tax rates are as of August 2014 for Latin American countries and as of 1 April 2012 for the OECD average.

Eliminating the gasoline-diesel taxation differential and taxing fuels beyond transportation

Lower taxation of diesel than gasoline has contributed to a higher demand for diesel, such that the share of diesel in fuel consumption has doubled since 2000. From an environmental perspective, a lower tax rate on diesel fuel is not warranted. Diesel has higher emissions of carbon and of harmful air pollutants (notably particulate matter) per litre of fuel used. The fuel efficiency advantage of diesel vehicles over their gasoline counterparts does not justify this differential in taxation on a per litre basis. Furthermore, increasing the diesel rate to the same level as the rate on gasoline could raise significant revenues (Harding, 2014).

Currently, only energy used for transportation is taxed in Colombia, whereas the OECD average effective tax rate on heating, process, and electricity generation is EUR 0.9 per GJ (OECD, 2013b). Three quarters of all energy in Colombia is used for heating, process use, and electricity generation. Almost half of electricity is made from hydropower, a third of natural gas and 16% from coal. The generation from coal has increased in recent years increasing carbon emissions (OECD/ECLAC, 2014) and local air pollution. A more coherent taxation regime would tax emissions from heating and process use of energy as well as electricity. Enlarging the energy tax base to these energy uses would also allow for increasing the revenue from energy taxation.

Price stabilisation schemes act as implicit fossil fuel subsidies

Fuel prices are regulated at below-market rates, resulting in implicit fuel price subsidies. The Colombian fuel price stabilisation fund for gasoline and diesel was meant to reduce subsidies, but it has accumulated a debt of 0.3% of GDP between 2008 and 2011, implying continued price subsidies (Kojima, 2013). Changes in the fund's price formula in 2011 and 2012 increased transparency of price regulation and achieved a 28% reduction in the fund's deficit (Garcia and Calderon, 2013). Further strengthening the link between international and domestic prices is needed. A series of gradual price increases, as currently done in Mexico, may be a way forward to contain resistance and potential protests that have happened in the past due to price hikes.

Better targeting support for poor families

Cross-subsidised utility prices (electricity, gas, water and waste) are not well targeted and do not create incentives for efficient resource utilisation. Subsidised utility prices reduce prices for households classified as low-income, financed by a 20% surcharge on households in higher-income categories and commercial and industrial users (OECD/ECLAC, 2014). These programmes are not well targeted, allowing almost 90% of Colombian households to benefit from utility price subsidies (OECD, 2013c). Targeting assistance better to low-income households could be achieved via using conditional cash transfers, as for example, in Brazil (OECD, 2013b), where the government first included vouchers for fuels. Later, payments were included in the cash-transfer programme *Bolsa Familia*. These payments are not directly linked to fuels consumption, allowing therefore for more spending flexibility and efficient use of fuels.

A carbon tax would deal with emissions in a cost-efficiency way

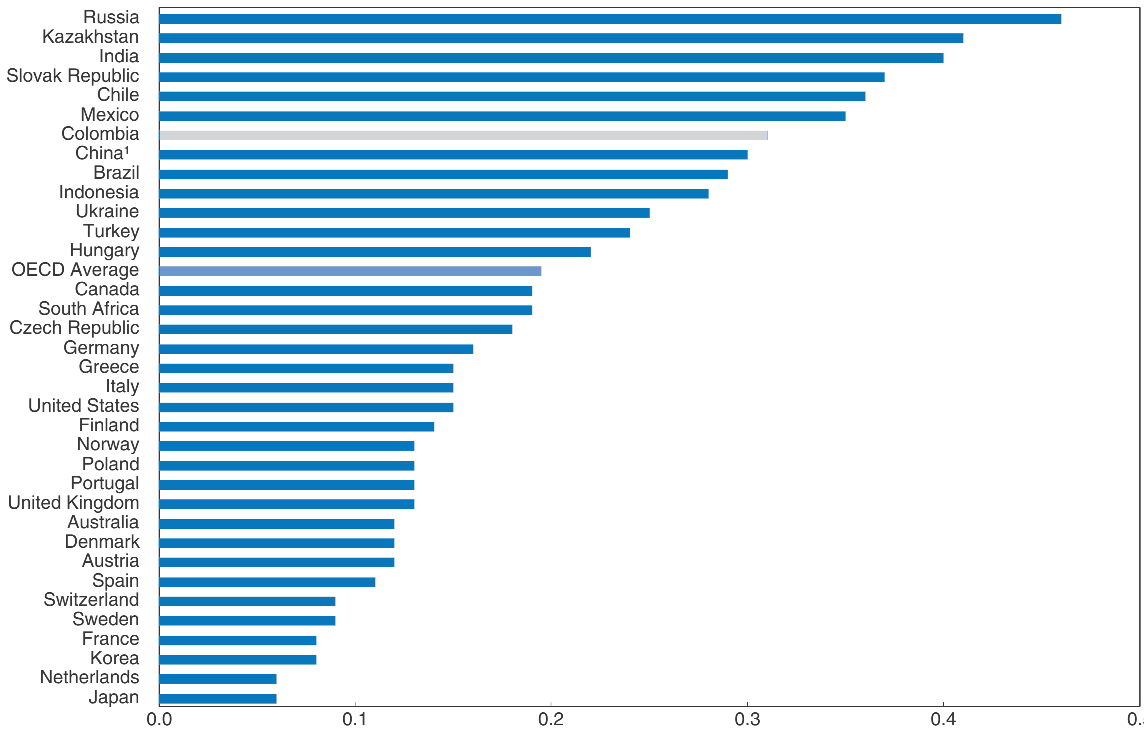
A tax on the carbon content of fuels would make polluters pay for the social costs of their carbon emissions. By increasing the price of fuels a carbon tax incentivises an increase in fuel efficiency, a switch to cleaner fuels and renewable energy sources and sends a signal to invest in cleaner infrastructure. If the carbon tax is implemented at the level of fuel importers and extraction companies and the tax is passed through to fuel users, all sectors of the economy will pay the tax, even informal activities. Collecting tax revenues from a "bad" such as carbon emissions minimises economic distortions and is thereby a very efficient form of taxation. By applying a carbon tax broadly across all fuels and uses Colombia would also substantially increase its energy tax base. Implementing a carbon tax would also help Colombia to steer its economy towards a green growth path by signalling investors to invest in clean infrastructure today and avoid a likely more costly grow first and clean-up later policy. OECD countries in the region, Mexico and Chile, have also moved towards implementing carbon taxation recently. In this sense, the government should consider implementing such a tax, as it already proposed in 2012.

Strengthening fiscal relations across levels of government

There are few signs of convergence in living standards across departments, despite significant efforts in fiscal decentralisation over the last two decades (Bonet, 2006). Inequality in GDP per capita across departments is high compared to OECD economies and other large emerging market economies (Figure 1.13). A recent study finds that it would take the department of Choco 200 years to converge to Bogota's income per capita levels (Galvis and Meisel, 2012). The revenue sharing system between the central and subnational

Figure 1.13. **Income per capita inequality across regions is high**

Gini coefficient across regions



1. For China, the autonomous regions of Hong Kong (China), Macau (China) and Chinese Taipei were excluded.

Source: OECD (2013d), *OECD Regions at a Glance 2013*.

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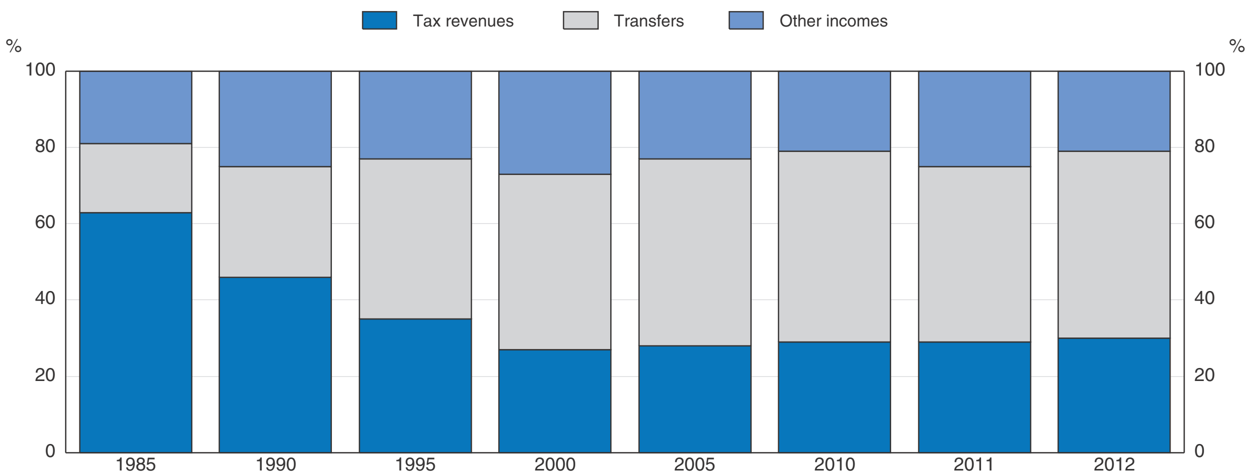
governments (SGP) does little to change these inequalities, as fiscal equalisation has not been a priority. The system also does not compensate for the better ability of well-off departments and municipalities to raise their own revenues from local and departmental taxes compared to the poorer departments.

Subnational governments have significant financial resources and spending responsibilities. Subnational expenditures currently amount to one third of total general government expenditures, slightly below the OECD average of around 40%. More than half of public investment is done by subnational governments. However, their tax revenues represent only 18% of overall tax revenues, almost half the OECD average (OECD, 2014). This vertical fiscal imbalance is not necessarily a problem, as it might be more efficient to raise revenues at the national level while decentralising expenditures would better address demands for local public goods, but it poses some challenges.

The effective degree of autonomy of subnational governments in Colombia in using the funds is limited, however. Most of sub-national taxes and transfers from the revenue sharing system are earmarked, mainly for education, health and water sanitation. The central government sets targets for coverage and quality standards in each sector. The main objective is to guarantee that everybody has access to these key public services with similar quality. Subnational governments are allowed to use any surplus resources in areas of their choice only if these targets and standards have been accomplished. Thus, in general sub-national governments basically execute expenditures with no autonomy and little incentive regarding how to improve these services.

Most of subnational financial resources come from transfers from the general budget, which amount to half of their municipal and departmental revenues. While transfers represented just 20% of total subnational revenues in 1985, they increased significantly after the Constitution of 1991, representing today around half of all revenues. At the same time, own tax revenues fell from above 60% to just 30% of total revenues (Figure 1.14).

Figure 1.14. **Composition of subnational (municipal and departmental) revenues**



Note: Other income includes royalties, non-tax revenues, and co-financing of investment projects.
Source: OECD (2014), *OECD Territorial Reviews: Colombia 2014.*

StatLink http://dx.doi.org/10.1787/888933177219

Towards co-ordinating better the revenue and royalty sharing systems

The royalty sharing system (SGR) was reformed in 2012 to spread oil and mining revenues more broadly across producing and non-producing regions and to take advantage of the commodity boom to close some infrastructure gaps. Previously most of the royalties had been allocated to the oil and mining producing departments and municipalities, and spent on recurrent expenditures for education, health care, water sanitation and some basic infrastructure. As several resource-rich regions were institutionally weak, lot of the resources were diverted towards unproductive projects due to corruption (Echeverry et al., 2011). After the reform, all departments and most municipalities receive funds from the SGR for investment projects. The projects have to be approved by a collegial body (OCAD) that include public authorities from all levels of government and technical experts. Furthermore, Colombia has a substantial problem of illegal mining in some of its more remote regions. There is potential for greater collection of royalty from extractive industries, mainly from gold mining. The National Mining Agency has been carrying out a significant auditing effort among all firms with mining permits and has found that around 58% of firms have failed to comply with their royalty payments.

As a result departments and municipalities currently rely on transfers from the national government and own tax revenues to finance current expenditures, while capital expenditures are mainly financed by the SGR. In principle, this division is reasonable. Royalties are transitory one-off revenues that should be used to foster investment projects, while current expenditures are excluded from the SGR due to their recurrent nature.

While the new SGR has brought improvements, it also presents some challenges. The new system has increased significantly the allocation of resources towards poor regions compared to the old system (Bonet and Urrego, 2014). Nevertheless, the increase in subnational investment will require higher recurrent maintenance expenditures from the SGP in the medium-term. This will put pressure on the system, as departments and municipalities have too little own revenues. Therefore, co-ordinating better both systems and encouraging subnational revenue mobilisation would improve efficiency in subnational expenditures (OECD, 2014).

Subnational fiscal sustainability works but risk sharing can be improved

After fiscal sustainability problems of several subnational governments during the 1990s, a series of amendments and changes managed to bring subnational finances into order. In particular, the reform of the SGP in 2001 and the fiscal responsibility law of 2003 introduced changes in terms of revenue distribution, targets and rules for subnational budget balances, lending and debt that have improve subnational fiscal sustainability significantly (MHCP, 2014b; Box 1.5).

Until 2016, the Constitution states that transfers to subnational governments have to grow 3% per annum in real terms. Additional one-off resources are transferred when real GDP grows above 4%. While the current formula has the advantage of being very predictable and stable for subnational governments, it puts a significant burden on the central government in terms of macroeconomic stabilisation. Although the central government is in a better position to hedge some of the aggregate risks, if a significant growth slowdown should occur, the current scheme would put significant pressures on the central government's fiscal accounts. Furthermore, it is also not very effective in sharing idiosyncratic risks across regions (Bousquet, Daude and de la Maisonneuve, 2015).

There will be an opportunity to reform the system in 2016, as the current scheme expires. If no reform is proposed, by default, transfers will grow at the same rate as revenues in the four previous years. While a four-year average smoothes out part of the potential short-term fluctuations, it would be better if transfers were linked to changes in structural revenues in line with the central government's fiscal rule. Furthermore, the overall system should be evaluated in terms of its effectiveness to share risks and reduce regional inequalities.

There is room to raise more local property taxes and simplify the tax system

Despite having significant expenditure responsibilities, subnational governments mobilise little revenue. Departmental revenues amount to less than 1% of GDP (around 5% of total tax revenues) from excise taxes on beer, tobacco, liquors, a register tax as well as vehicle tax. Apart from their own responsibilities, departments often take over basic services delivery from small municipalities with lower capacities.

Box 1.5. **Evaluating subnational fiscal sustainability**

A simple way to evaluate if fiscal policy is sustainable is to evaluate if the policy framework forces subnational governments to increase their budget balance – i.e. savings – if its level of indebtness rises (Bohn, 1998). This box presents an evaluation of this issue at the departmental level in Colombia, following De Mello (2005) in estimating a subnational fiscal reaction function.

In particular, the following equation is estimated:

$$pb_{it} = \alpha pb_{it-1} + \gamma debt_{it-1} + \theta_i + \mu_t + \varepsilon_{it},$$

where *i* stands for the department and *t* are years, *pb* is the primary balance, *debt* the debt level. In addition to a white noise error term, departmental fixed effects and time effects are included.

Fiscal policy is sustainable if the coefficient γ is positive, which means that the department saves more if debt increases, such that the debt level is stabilised. In the table below, the variables are expressed as shares of departmental GDP or population.

	Primary balance		
	% of GDP	Per capita	Per capita
Lagged dependent variable	0.049	0.397***	0.385***
	(0.09)	(0.11)	(0.11)
Lagged debt/GDP	0.148**		
	(0.06)		
Lagged debt/population		0.068	-0.119
		(0.05)	(0.13)
Post 2001 dummy × lagged debt/population			0.190**
			(0.08)
Constant	0.006***	0.053***	0.054***
	(0.00)	(0.01)	(0.01)
Number of observations	343	544	544

Note: Standard errors in parentheses. ***, **, * significant at 1%, 5% and 10%, respectively.

The results show that the current system of fiscal responsibility actually induces fiscal sustainability at departmental level. In terms of magnitudes, a one-percentage point increase in debt leads to an improvement of around 0.15 percentage points in the primary balance. Furthermore, the regression in the last column of the table shows that this has been the result of the reforms in the early 2000s, as the coefficient on debt is not statistically significant before they took place. These results are robust to excluding transfers from the central government from current income in the dependent variable (Bousquet, Daude and de la Maisonneuve, 2015).

There are significant differences in the revenue raising capacity across departments. In the seven largest departments own tax revenues amount to almost 40% of their total revenues, while the smallest department raise less than 10% of the revenues through departmental taxes. There is limited evidence that these differences are due to a "fiscal fatigue", such that higher transfers from the central government or royalties diminish significantly the incentives to increase taxation at the subnational level (Bousquet, Daude and de la Maisonneuve, 2015). Other factors such as the administrative capacity, economic structure and institutional quality also matter (Cortes and Vargas, 2012).

There is room to improve the tax intake from property taxes at the municipal level. As in most OECD economies, local governments rely mainly on property taxes. In Colombia, they are entitled to set the tax rate within a band between 0.1% and 1.6% (although the maximum can be 3.3% in some cases). However, the average rate is just at 0.5%, which shows that some space to raise local tax effort exists. Few municipalities have up-to-date cadastral and land registries, as they currently have to compensate the national technical office (IGAC) in charge of computing property values and they are often pressured by local lobbies for not doing so. Therefore, the national government should provide cadastral services free of charge – or with a subsidy – and reward greater subnational tax effort (e.g. linking increases in transfers from the central government to subnational revenue growth). This would also help develop land markets needed to increase efficiency in the use of land.

Simplifying municipal taxation would reduce compliance costs and raise efficiency. Although municipalities raise more than 80% from three taxes: property taxation, a turnover tax on businesses, and a gasoline surtax, there are currently more than 19 local taxes and fees. Therefore, while many of these taxes do not raise significant revenues, they increase the complexity of compliance and raise costs for businesses. An overall simplification and elimination of some of these taxes would therefore be beneficial for the local business climate without affecting revenues significantly. Furthermore, the tax base of turnover taxes varies across municipalities, which also makes the system extremely complex. The national government should define a common tax base and parameters for these taxes, while municipalities could be allowed to set rates within a pre-established band.

Towards a comprehensive reform of the tax system

Colombia will need to raise considerably more tax revenues in the near future to finance social expenditures and other investments needed. At the same time, Colombia should adjust its tax mix to make the tax system less distortive and more inclusive. This will require a comprehensive tax reform.

To make the tax system more investment friendly, Colombia should shift the capital income tax burden partly from the corporate towards the personal shareholder level. The corporate tax rates will have to be lowered and the corporate tax base significantly broadened. A comprehensive tax reform implies also taxing dividends and increasing the capital gains tax rate, and abolishing the wealth tax on businesses. Many different options exist, but a dual income type of tax system where taxes on capital income can be withheld at source seems an attractive way forward.

Colombia needs to develop a strategy that brings more taxpayers within the reach of the tax administration. The tax and benefit system should no longer provide incentives for businesses to stay informal. The recent reform in Mexico is an example to follow. The financial transaction tax should therefore be phased out; abolishing the business wealth tax will also induce more businesses to go formal. The resources of the tax administration (DIAN) have to be increased such that more effective audits can be carried out and non-filers are identified; a better identification of taxpayers is crucial, including through reporting obligations by third parties such as financial institutions and pension funds.

A larger formal sector would allow Colombia to raise more revenues from personal income taxes as well as to fund the benefit system partly through social security contributions. The advantage of such a reform is that richer taxpayers will bear a larger share of the tax burden. Broadening the base of the VAT, and especially abolishing VAT exemptions on non-essential items, is part of such a reform strategy. The VAT should be turned into a pure consumption tax.

Colombia should also aim at raising more revenues from environmentally related taxes, immovable property and especially land. This will require a better property valuation system. Sub-central governments can be given more taxing powers and the current sub-central funding system needs to be revised.

Finally, Colombia needs an explicit strategy that identifies the exact revenue requirements and presents tax reform options to raise revenues in a growth-friendly and inclusive way. Such a strategy, possibly through a thorough review of the tax system involving different stakeholders, would help building a consensus within society about the tax reform strategy outlined above that would allow Colombia to catch up with OECD economies.

Recommendations on tax policy

Key recommendations

- Undertake a comprehensive reform of the tax system to increase fairness and growth.
- Reduce the tax burden on investment by gradually lowering the corporate income tax rate, phasing out the net wealth tax on firms and eliminating VAT on investment.
- Make the personal income tax more progressive by taxing dividends and eliminating regressive exemptions.
- Reduce tax evasion by strengthening the tax administration and by increasing penalties.
- Increase the standard VAT rate, if more revenue is needed. In the medium-term, broaden the base and eliminate exemptions on non-essential items.
- Introduce a carbon tax to deal with emissions in a cost-efficient way.

Making tax policy more progressive

- Consider implementing a dual personal income tax scheme to tax dividends and make the personal income tax more progressive.
- Significantly reduce the personal income tax exemption level for pensions, such that pensions are taxed effectively at a progressive rate.
- Include shares of businesses in the wealth tax base for individuals and reduce the tax rate.

Towards a more efficient tax system

- Broaden the corporate income tax base by eliminating exemptions and special regimes. Unify the corporate income tax with the CREE surtax in the medium term.
- Tighten the criteria for firms to enter permanent free trade zones and phase out single-enterprise free trade zones.
- Adopt the new customs code to strengthen the tax administration control over imports invoicing.

Greening the tax system

- Adjust tax rates on transport fuels to reflect their environmental impact.
- Extend fuel taxation also to other uses, such as heating and electricity.
- Gradually eliminate fuel subsidies within the price stabilisation scheme.

Recommendations on tax policy *(cont.)*

Strengthening fiscal relations across levels of government

- Assist subnational governments in updating cadastral property values. Link increases in transfers from the central government to subnational revenue growth.
- Co-ordinate the revenue sharing system better with the oil and mining royalty sharing system. Link transfer growth to the central government's structural revenues.
- Simplify the subnational tax system by eliminating taxes without revenue raising potential and defining a uniform base for municipal turnover taxes.

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Chapter 2

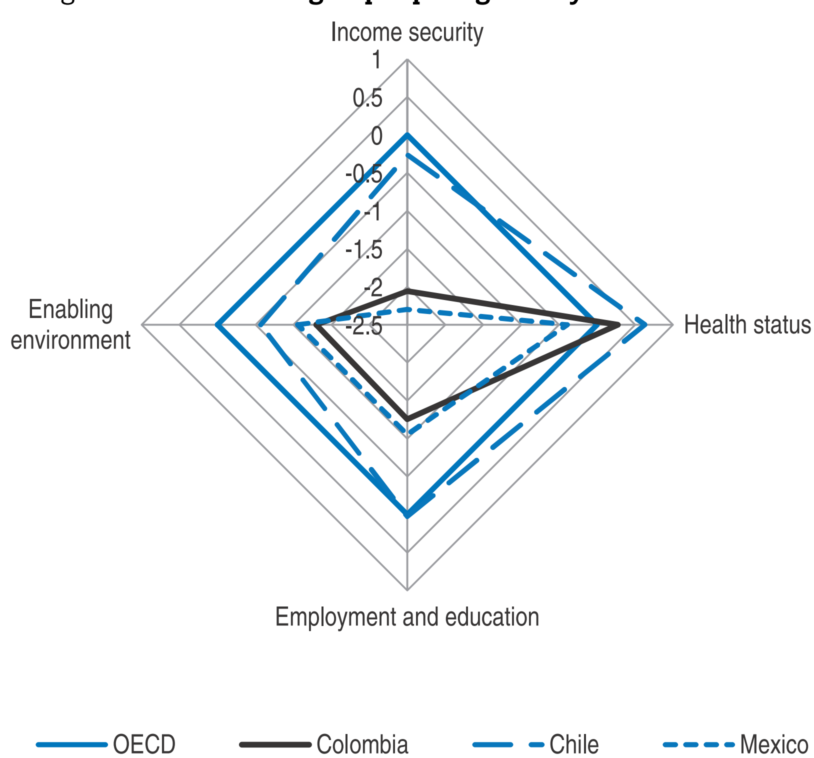
Reforming the pension system to increase coverage and equity

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

Elderly well-being is affected by a high poverty rate

Income security is a key element of the elderly well-being (Figure 2.1). Colombia ranks particularly low, well below the OECD, on this indicator, which measures pension income coverage, poverty rate in old age, relative welfare of older people and GDP per capita. This shows that the Colombian pension and elderly income support system fails to provide an adequate income to most of the elderly. Colombia fares better on other dimensions of elderly well-being. Their health status is better than the OECD average, probably due to the universal health insurance coverage. The perception of the enabling environment, another dimension of elderly well-being, is also better than income security, but well below the OECD average. The enabling environment relates to social connections, physical safety, civic freedom and access to public transport, and is likely to reflect insecurity that prevailed in the country during the past decades as well as the deficient infrastructure.

Figure 2.1. **Well-being of people aged 65 years and more**[1]



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

Source: HelpAge International (2013).

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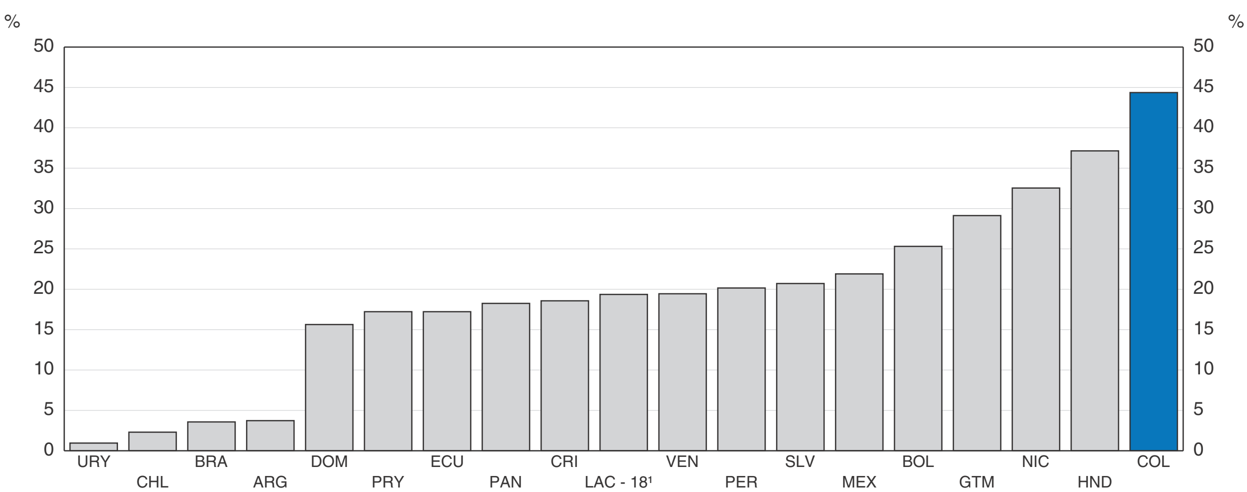
Elderly income insecurity is explained by the fact that most Colombians have no pension and half of the elderly live below the national extreme poverty line. The pension system only covers the few formal sector workers. As a result less than 40% of elderly (mostly the better off) get a pension, with large subsidies from the general budget. The elderly poverty rate is the highest among 18 Latin American countries (Figure 2.2). The narrow overall coverage leads to a rise in poverty rate from around 31% for working-age population to 42% for people at age 60 and above in contrast to many other Latin American countries (Bosch, Melguizo and Pagés, 2013). The government provides old-age income support for the poor through *Colombia Mayor*, but the support is well below the poverty line income. It is reflected by the level of spending which is the lowest among Latin America countries (Figure 2.3). To improve saving for the old age, the government recently introduced a saving scheme, the *Beneficios Económicos Periódicos* (BEPS), for low-income informal workers but so far the BEPS take-up is low. Financial and material support for the elderly is essentially provided by family members. But population ageing and changing family structures might make this support insufficient. Reforming the pension system and old-age income support is thus becoming urgent to enhance equity, reduce income inequality and improve elderly well-being.

Figure 2.2. **Poverty rate of the population older than 65 years (2010)**



1. Poverty line USD 2.5/day at PPP. LAC-18 correspond to the weighted average for the 18 countries.
Source: Cotlear (2011), Banca Interamericano de Desarrollo, *HelpAge International Database*.
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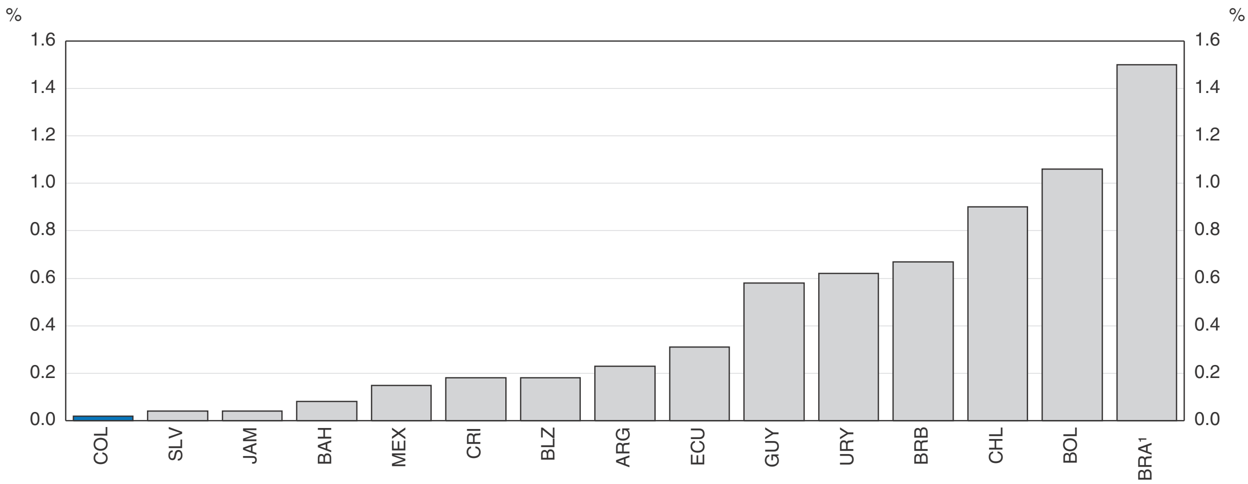
The pension system

In the late 1950s, Colombia created a defined-benefit system for national public employees. In 1967, the *Instituto de Seguros Sociales* was established to cover people working in the private sector. In 1994, a private defined-contribution plan was implemented. The Colombian General Pension System (GPS) has now two parallel schemes: a public defined-benefit plan and a private defined-contribution plan.Workers must choose between the two schemes, which compete instead of being complementary (Box 2.1).

New entrants to the labour market now mostly choose to contribute to the private defined-contribution plan (Figure 2.5), as historically (since 1994), average returns in the private defined-contribution plan have been more than 8% above inflation providing more generous benefits than the public defined-benefit plan. Another difference is that in the

Figure 2.3. **Public spending on non-contributory pensions**

% of GDP, 2013



1. For Brazil, it concerns only the rural part of the country.

Source: Cotlear (2011), Banca Interamericano de Desarrollo, *HelpAge International Database*.

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public defined-benefit plan workers not fulfilling all the requirements for the minimum pension at the end of their careers receive the accumulated contributions adjusted for inflation, while in the private defined-contribution plan the adjustment is for inflation and interest. However, many workers who fulfil the requirement to get a pension, choose to join the public defined-benefit plan when retiring as it is much more generous. Both systems are mandatory.

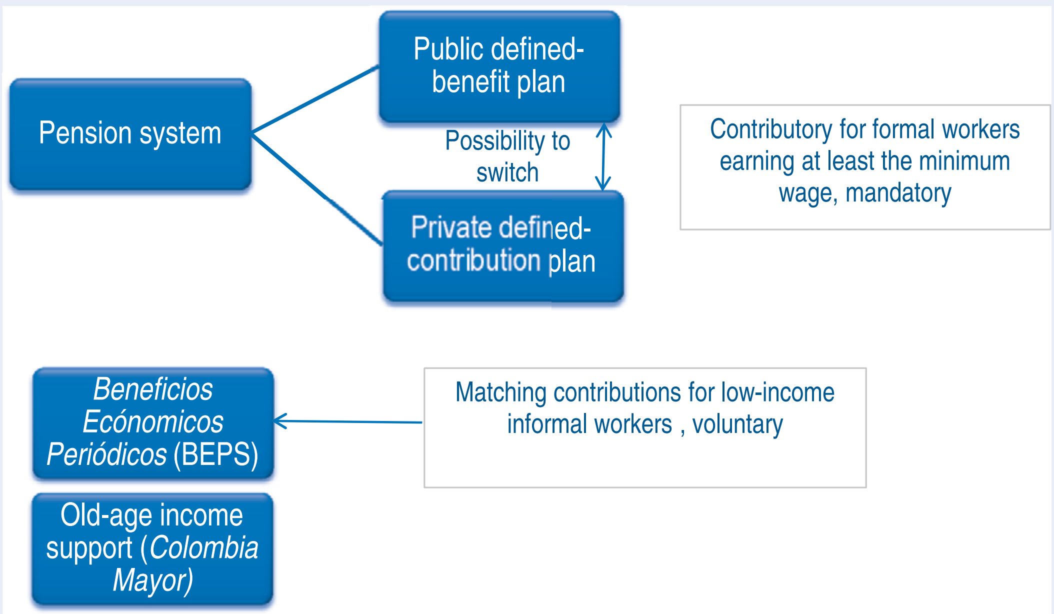
Around 36% of the formally employed are affiliated to the public plan and 64% to the private plan. Several special regimes complicate the system further (teachers, military, police and oil-company workers). Currently, most of the retirees (96%) receive a pension from the public defined-benefit plan (including the special regimes) as the private defined-contribution plan has been in place only for 20 years. In both systems, workers contribute 4% of their salary and employers 12%. Self-employed contribute 16% on their revenue. 24.5 years (25 years as from 2015) of contributions are required for a full pension, which is low compared to OECD and LAC countries (36 years on average in EU countries and 30/35 in Argentina, Brazil, Ecuador and Uruguay and around 38 years in Costa Rica).

By Constitution, the minimum pension cannot be lower than the minimum wage. The retirement age is 62/57 for men/women. Only formal workers, earning at least the minimum wage, can contribute to the system. The replacement rate in the public defined-benefit plan ranges between 65% and 80% of the average contribution wage for low incomes, between 60% and 75% for middle incomes and between 55% and 70% for high incomes. It is equal to 100% for people earning the minimum wage. OECD expected gross average replacement rates are lower – 71% for a worker earning half the average wage, 54% for average wage and 48% for 1.5 times the average wage. Pension benefits are indexed annually to inflation, as in most OECD countries. The minimum pension, however, increases in line with the minimum wage, which has reflected both inflation and productivity gains.

Box 2.1. **The pension system and the old-age income support**

The pension system comprises two parallel schemes: a public defined-benefit plan and a private defined-contribution plan. Workers must choose between the two schemes, and can switch every five years up to the last ten years before their legal retirement age. In practice, many workers were able to switch after that by going to court. As a consequence, there is competition and overlap between the two schemes, and differing benefits and parallel administrations create inefficiencies (Figure 2.4). Only formal workers earning at least the minimum wage can contribute to the plans. Contributions are mandatory.

Figure 2.4. **The pension system and old-age income support**

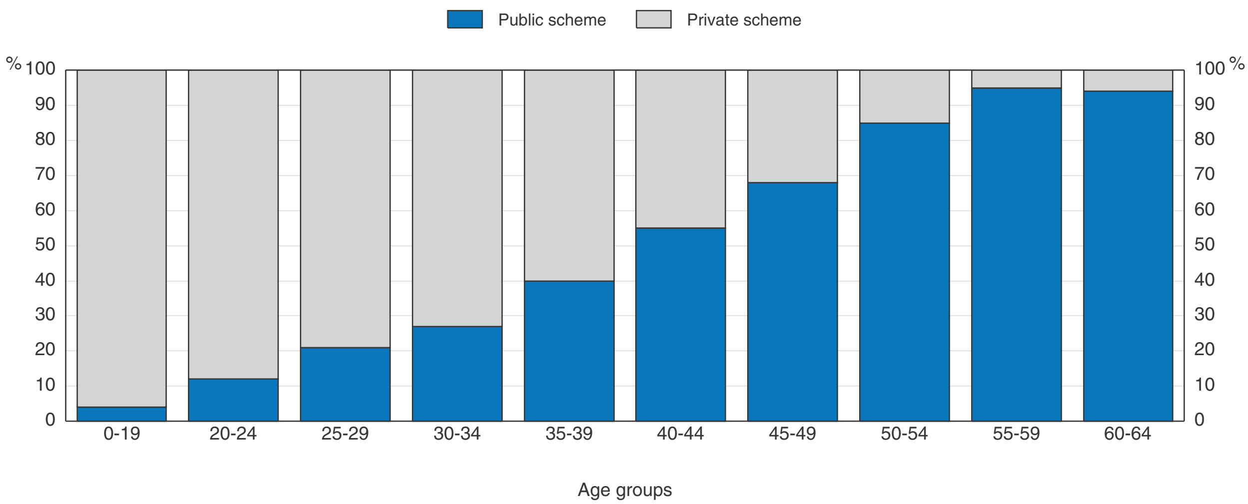


Moreover, for low-income informal workers, the government has introduced a matching-contribution scheme called *Beneficios Ecónomicos Periódicos* (BEPS). The BEPS target workers with irregular wages due to phases of informal activity. Workers who have not contributed enough to be entitled to a pension can apply for the BEPS.

Finally, for people who spent their entire working life in the informal sector and accordingly have no access to a pension, and who have very low income, the government provides an old-age income support, *Colombia Mayor*.

Since 2007, *Colpensiones* is the main administrator of the defined-benefit pension system. Other public defined benefit administrator entities are the *Caja de Sueldos de Retiro de la Policía Nacional (Casur)* and the *Policía Nacional* (both comprise the police regime); the *Caja de retiro de las Fuerzas Militares* and the *Ministerio de Defensa (Cremil)* (both comprise the military regime); the *Fondo de Prestaciones Sociales del Magisterio* (Public Teachers regime) and the *Fondo de Previsión Social del Congreso* (Congressional regime). The private system is managed by pension funds.

Figure 2.5. **Distribution of contributors by age and scheme, 2013**



Source: Ministerio de Hacienda y Crédito Público calculation based on information received from the Financial Superintendency and Colpensiones.

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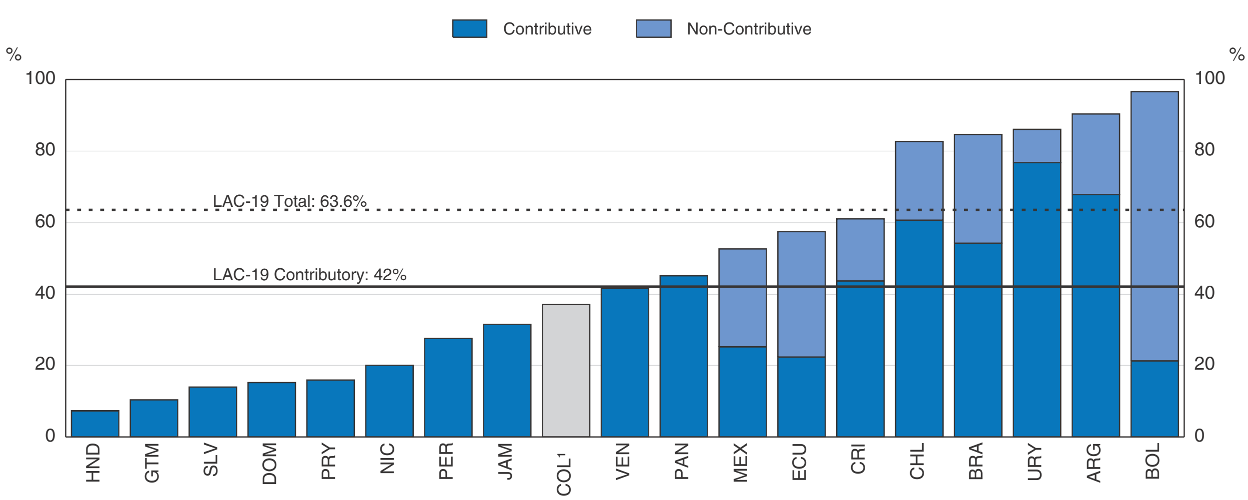
The pension system faces many challenges

The low coverage contributes to inequality

Despite some progress over the past decades, only 37% of the elderly get a pension, which is low compared to the OECD average (around 90%) and many Latin American countries–80-90% in Argentina, Brazil, Chile and Uruguay (Figure 2.6). Colombia also has lower coverage than countries with similar level of development (Figure 2.7). There is a strong correlation (around 80%) between the level of coverage and the level of development measured as the GDP per capita (Holzmann et al., 2009). Part of the elderly (15%) are

Figure 2.6. **Pension coverage in LAC countries**

Percentage of people aged 65+ with a pension



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

Source: Bosch, Melguizo and Pagés (2013).

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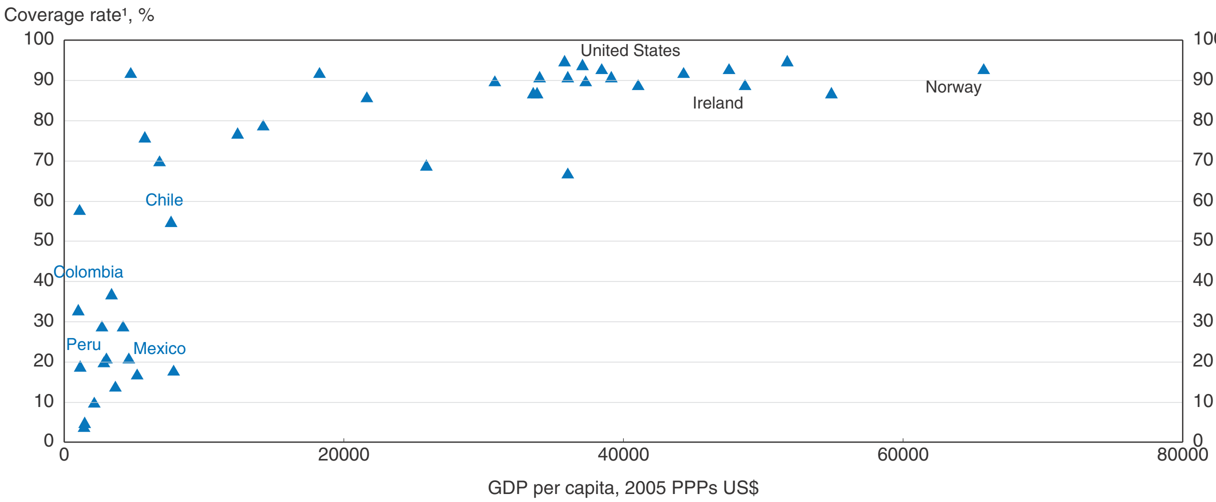
Figure 2.7. **Coverage rates and GDP per capita**



1. Total old-age beneficiaries as a percentage of population aged 65 and over.
Source: Pallares-Miralles, M., C. Romero and E. Whitehouse (2012).

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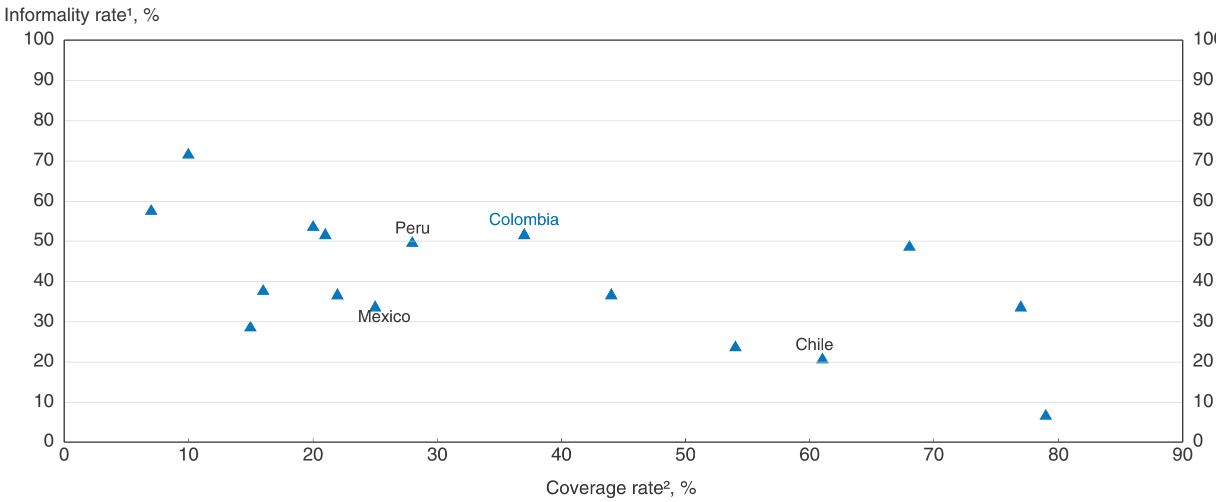
currently covered by special regimes (judiciary, military and police, teachers, among others) that were complementary to the public defined-benefit plan and have now been abolished and transferred entirely to the public defined-benefit plan. Coverage is the lowest among vulnerable groups such as women, workers with low- and medium incomes, working in small businesses or self-employed (Bosch, Melguizo and Pagés, 2013). In rural areas only 10% are covered, as most of rural workers are informal or earn too little to be able to contribute to the pension system

The low pension coverage partly reflects the high level of informality. Informal workers, that by definition cannot contribute, account for 50 to 70% of total employment, depending on the definition (Figure 2.8). Informality also affects contribution periods. On average people contribute only around 15 years (instead of the 25 required), as most workers face periods of informality. A distinction needs to be made between rural and urban workers. While rural workers often spend their entire life in the informal sector, urban workers face periods of informality followed by periods of formality.

The Constitutional requirement that the pension can not be lower than the minimum wage also affects the level of coverage and benefits. It is costly as the minimum pension represents around 60% of the average wage while, on average in OECD countries, it represents less than 20%. Many people reach retirement age without having contributed enough to qualify for benefits at all, as it is difficult to find enough work at the high minimum wage [Only around half of the employed population earns more than the minimum wage (Ministerio de Trabajo, 2012)]. In the private defined-contribution plan, the minimum wage requirement affects the nature of benefits. It discourages insurance companies to participate in the annuity market, as it is difficult to insure against unpredictable changes in the minimum wage. As a result many are forced to take a lump sum at the end of their working lives, instead of annuity that would ensure for longevity risks.

To allow more people to be covered by the public defined-benefit plan, the government has implemented the Family pension (*Pension Familiar*) in 2014. This allows a couple to sum their respective contributed years to fulfilling the requirements. If the joint value is equal

Figure 2.8. **Labour informality and pension coverage in selected LAC countries**



1. People employed in the informal sector as a percentage of total labour force. Informality is defined as workers employed in firms with 5 employees or less.
2. Old-age beneficiaries as a percentage of people aged 65+.

Source: ILO, *Key Indicators of the Labour Market* (KILM) database.

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or greater than 1.300 weeks (25 years) the couple will obtain one pension. The most important condition to have access to this pension is being in level I, II or III of the *Sisbén* socio-economic group. The *Sisbén* system classifies people into 6 socio-economic strata according to income and living conditions and is used to assess eligibility for cash transfers and in-kind services. The introduction of the Family pension will lead to a 5 percentage points increase of the coverage (Montenegro et al., 2013a).

BEPS to increase coverage in the informal sector

To facilitate savings for old-age income (pensions) for the low-income informal workers, the government has introduced a contributory scheme, the BEPS. The BEPS are individual retirement accounts for workers with irregular wages or wages below the minimum wage, or for those who have not contributed enough to the formal sector pension schemes to get a pension. The BEPS targets mostly workers facing phases of informal activity during their working lives. As the scheme has started to be implemented recently, very few retirees have applied for it. The scheme aims at covering 6 to 7 million potentially elderly poor over the next 20 years. People can make voluntary contributions during their active life, for instance, when they face periods of informal work.

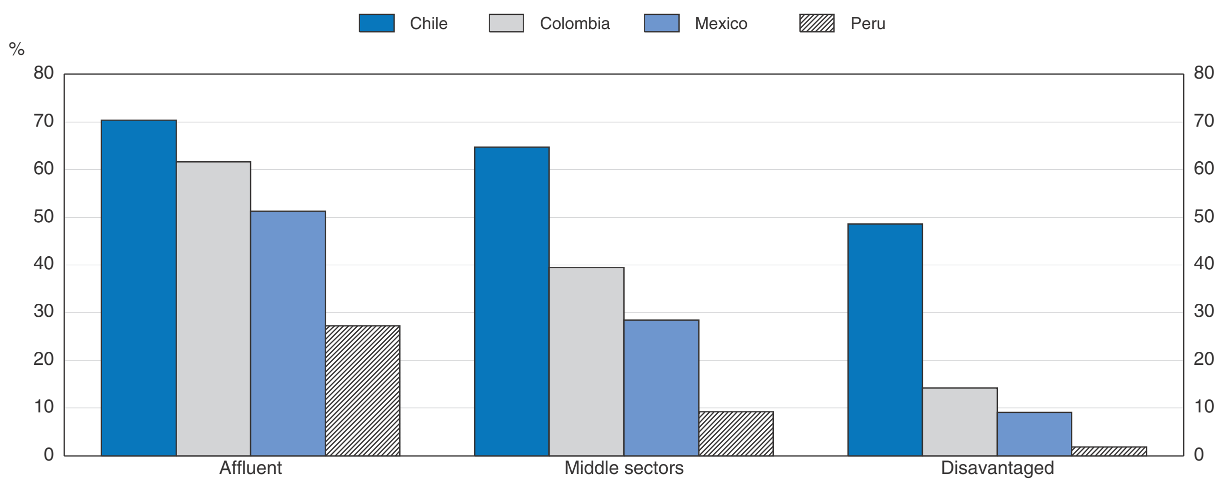
The BEPS system specifically targets low-income households: only those from the three lower *Sisbén* level can be covered. The benefit at retirement cannot be more than 85% of the minimum wage and at least equal to the benefit of *Colombia Mayor*. However, the coverage of the system is still low, as many low income workers may find it hard to save for some future income in some decades away. At retirement the government subsidises the individual contributions by adding 20% to the workers' own savings. While this puts fiscal pressure to the future, the lack of subsidy during working lives can undermines participation in the scheme as individuals do not see a direct impact of the incentive. It would thus be useful to provide financial education and information programmes directed specifically towards vulnerable groups to increase awareness and participation. It can be useful, for people facing periods of informality during their working life, to consider combining BEPS with some kind of soft compulsion/auto-enrolment programme to increase participation in the scheme.

Voluntary saving to the BEPS can also expand contributors

Coverage could also be increased by voluntary saving, especially among people who are not currently saving but who would have some capacity. Labour informality is also a middle-class issue. There are more informal than formal workers among the middle-class (Daude, de Laiglesia and Melguizo, 2014) defined as all individuals living in households with adult-equivalent per capita labour income between 50% and 150% of the median for the country. In Colombia they represent 50% of urban workers, of which only 39% contribute to the pension system. Most of the urban middle-class workers declare their income significantly above the national lines of poverty (three times) which suggests that they have some saving capacity (Figure 2.9). However, the average amount of the earnings reported is close to the legal minimum wage under which people cannot contribute to the pension system. This is a potentially important pool of people to save for pensions that fall between the BEPS and the formal pension system.

Figure 2.9. **Workers contributing to the pension system by level of income**

Percentage of the total workers – 14 to 64 years old



Note: Affiliates who receive a salary in Mexico, contributors in Chile, Colombia and Peru.
Source: Carranza et al. (2012); and Daude de Laiglesia and Melguizo (2014), calculations on household surveys.

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Many people have moved into the middle-class as wage and employment growth and conditional cash transfers and other social benefits have reduced poverty. Nonetheless, there is a non-negligible risk that many households that have recently moved out of poverty and joined the so-called emerging middle class will prove vulnerable to falling back into poverty if hit by illness, disability or job loss (Daude, de Laiglesia and Melguizo, 2014). These workers may thus face periods of informality during their working career and fail to have all the requirements to have access to a full pension.

Many Latin American countries provide incentives to voluntary saving through a so-called "matching-contribution" scheme. These incentives increase the pension savings' financial return by: i) reducing the amount of contributions to access the same level of pension benefits (namely progressive or targeted reductions of social contributions); or ii) increasing the level of pension benefits for the same volume of contributions (by granting a subsidy *ex post*) (Daude, de Laiglesia and Melguizo, 2014). It is important that incentives from these schemes are lower than those for contributing to the formal scheme.

The matching contribution system can provide more tangible incentives for lower-income individuals in the informal sector to participate in pension schemes for the old age than the more traditional approach of mandating participation and providing preferential tax treatment. Informal workers in principle don't benefit from tax incentives. In principle, matching contributions could be provided for public pension programmes, BEPS or by the sponsors of private occupational plans (Hinz et al., 2013). In all of these systems, the matching design feature has the common goal of increasing system participation and saving levels. Directly matching contributions provides an immediate and easily understandable value proposition to prospective entrants to the system. Funding of the accumulated contributions and returns with financial institutions, like the BEPS, should offer credibility, portability, and appropriate returns.

Coverage can thus be increased by letting people working in the informal sector (to which belong most of the self-employed and the middle class) and earning less than the minimum wage to contribute to the BEPS. This will reinforce the link between earnings, contributions and pensions. This would imply increasing the eligibility to the BEPS to middle income workers in the informal sector, namely the growing middle-class described above. Moreover, the BEPS should also be extended to more *Sisbén* strata. Indeed, there are many people who do not earn the minimum wage but are above *Sisbén* 1 to 3. They should also be allowed to apply for the BEPS. For the time being, the fiscal cost of the BEPS represents only 0.1% of the GDP per year.

Increasing the coverage requires labour market reforms

A particular problem for pensions is that many workers enter and exit the formal labour market several times in their career. This results in low contribution densities and therefore insufficient accumulated savings for old-age to fund an adequate pension. Out of 19 million people currently affiliated to the pension system, 5.5 million have not contributed in the last 6 months and an additional 1.4 million have not contributed in the last month. A survey showed that 25% of workers who are currently in the formal sector will not be within a year. Approximately 6% will be inactive, 7% unemployed, 4% self-employed and 9% informal salaried (Goñi, 2013). These figures may underestimate rotations as they do not capture movements within a year. Moreover, they may be biased as they use cross-sectional data and consequently fail to follow workers over time. Nonetheless, they show the extent of the problem. Greater coverage can thus be achieved by either labour market reforms that create more formal jobs or amending the system to enable more contributions while in informal employment. One key constraint is the requirement of a minimum wage for contributions, and that around 50% of workers earn less than that.

Thus, reforming the minimum wage becomes key to both pension and labour market reforms. The problem is more acute in the low income regions of Colombia. The minimum wage as such is not the problem but the fact that it has been increased in recent years by inflation and formal sector productivity. This explains the high level compared to average wage, and is pricing many workers out of the formal sector. The increase of the minimum wage should thus be limited to inflation only and possibly differentiated by age.

High non-wage labour costs is another factor keeping workers in the informal sector. For instance, a 10% increase in payroll taxes in the 1990s lowered formal employment by between 4% and 5% (Kugler and Kugler, 2008). Other countries' experience shows that lowering social security and other non-wage labour costs contributions can help broadening the contribution base e.g. by including the self-employed (Chile and MEI programme in Brazil), the youth, the SMEs (Brazil SIMPLES programme) (Bosch, Melguizo and Pagés, 2013). More should be done to reduce non-wage labour costs further. One option is to remove the 4% contribution on wages that finance the *Cajas de Compensación* system, which are non-profit private entities that provide family allowances, unemployment insurance and commercial and recreational activities. Recreational and commercial activities should become voluntary. This lowering of the contribution would boost job creation and increase the number of contributors to the system.

Raising the level of education should also help increase formal jobs and thus coverage. The latest PISA survey shows some improvements but overall the Colombia score remains low compared with OECD countries. Pre-primary and tertiary enrolments should be further increased in particular by targeting students with low socio-economic backgrounds. The quality of education should also be increased (OECD, 2013a). The education system should ensure that tertiary qualifications match the skill requirement of the labour market which is often not the case.

Another option in the near term is to relax the constraint that pensions must be at least equal to the minimum wage, but this would require a difficult constitutional reform. Another possibility is to give people, who reach retirement age with less than the required number of years, a partial pension. This pension would be equal to the minimum pension adjusted for the difference between the effective contribution period of the retiree and the mandatory 25 years. Then, if the retirees find their income too low, during the first years of retirement they could have the possibility to buy weeks of contributions. In practice, this means that they will keep paying contributions to the pension system while in retirement. Once they have reached the mandatory 25 contribution years, they will receive the full minimum pension (which will then be equal to the minimum wage).

The public defined-benefit plan also raises equity and sustainability issues

Since 2012, *Colpensiones* has been the main administrator of the public defined-benefit plan and managed about 48% of total public pensions. Pension benefits paid by *Colpensiones* are financed on a pay-as-you-go basis, in which the government fills the gap when contributions fall short of outlays, as has been the case since 2004. Overall, in 2013, the number of pensions amounted to around 2.3 million and the public expenditure to above 35 trillion of COP, or around 5% of GDP.

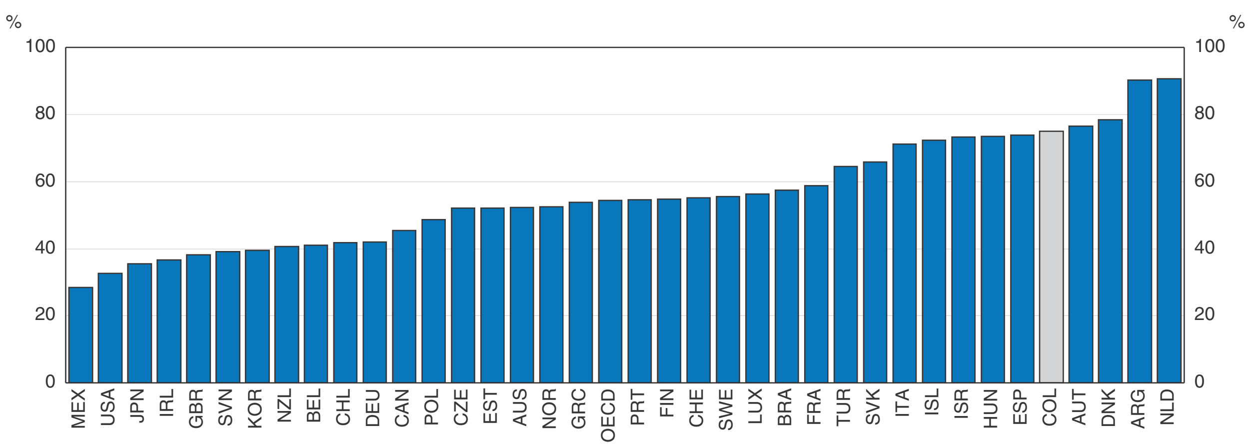
A generous and unequal system

The public defined-benefit plan raises serious equity issues by exacerbating inequality as it mainly benefits high-income formal workers. More than 80% of pensions go to the highest income quintile while the two poorest quintiles receive less than 2% (Santa María et al., 2010). For instance, the reference salary is calculated using the last 10 years of earnings, which benefits those with steep earnings profiles (Montenegro et al., 2013b). They are often the best educated and high-income individuals (OECD, 2013a). By contrast, in 21 OECD countries, the pension is based on lifetime earnings and in some others on 25-35 years of earnings (OECD, 2013b).

Colombia should consider increasing the number of years on which the reference salary is based. It will help people facing period of informality at the end of their career, namely the low educated people, to enjoy a higher pension. It is estimated that the subsidies to the higher income can be largely reduced by taking into account 40 years as reference salary (Montenegro et al., 2013b). Nonetheless, this adjustment will not be sufficient to eliminate all the subsidies to high income workers, in particular for women in the top income decile. An increase in the retirement age for both men and women until 65 will almost eliminate all the subsidies to high income earners (Montenegro et al., 2013b). The equity of the system will thus be enhanced as public subsidies will benefit mostly low-income people (especially women belonging to the 1st to the 5th income decile).

The generosity of the public defined-benefit plan for the few who have access to a pension also makes it expensive to extend eligibility. The replacement rate is high in comparison with OECD countries (Figure 2.10), and is particularly high at 100% for people earning the minimum wage. Lowering the gross replacement rate from above 70% (for the median earner, OECD, 2014) towards around 37% (or slightly above that number as it is based on a rate of return of 3.5% which may be on the low side) of the private defined-contribution plan would eliminate the arbitrage between plans and reduce the subsidies to the rich OECD/IDB/WB (2014).

Figure 2.10. **Gross pension replacement rates in 2013**[1]



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

Source: National Authorities and OECD (2013b).

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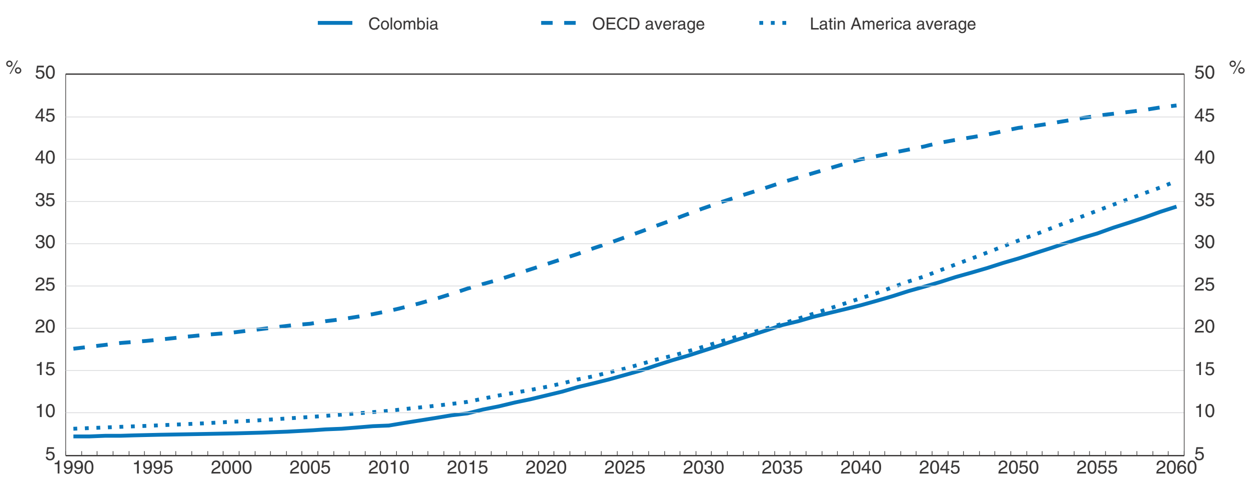
Generous tax treatment also leads to inequality. The contributions are deductible from the income tax base, the returns on pension investment are not taxable, and the benefits are largely tax exempt. These very generous features also add to the low revenue collection problems faced by the Colombian tax system. They need to be addressed in a broader tax reform (see Chapter 1). The personal tax system plays an important role in old-age support in OECD countries. The average tax rate on pension income is typically less than the tax rate on earned income. In addition, most income tax systems give preferential treatment either to pension incomes or to pensioners, by giving additional allowances or credits to older people (OECD, 2013b). Colombia should consider taxing pension benefits in a progressive way as in most OECD countries (see Chapter 1).

The long-run sustainability of the system is not guaranteed

The long-run sustainability of the system may also be at risk. The dependency ratio will rise from 10% today to around 35% in 2060, approximately the same trend as the Latin America average (Figure 2.11). The situation is worse when looking at the economic dependency ratio which compares the number of people aged 65 and over with the number of total employed people (the ones potentially contributing to the pension system, i.e. including informal employed). As a consequence of population ageing, the non-contributory part of the regime will also increase significantly and put pressure on public finances. According to recent projections, the highest level of pension expenses in the national budget would be between the years 2014 and 2018. Current pension liabilities are estimated at about 129% of GDP in net present value terms for the next 50 years (Santa María and Piraquive, 2013). This is relatively modest compared to OECD and emerging markets, but large in view of the low coverage.

Figure 2.11. **Dependency ratio**

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



Source: *UN population projections database.*

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Changing the current generous parameters can bring some important savings. Simulations show that lowering the replacement rate of the public plan towards that the private one, increasing the number of years of contributions from 10 to 20 or raising the retirement age by 5 years for both men and women would decrease the net present value (NPV) of pension liabilities from 129% to 120%, 126% and 122%, respectively. Overall, if the three parameters are modified, the reduction will be quite significant, amounting to almost twenty percentage points of GDP at below 110% of GDP. These adjustments will help financing the extension of the BEPS and *Colombia Mayor* programmes whose liabilities are estimated at about 8.5% of GDP in net present value terms over the next 40 years (Santa María and Piraquive, 2013).

IMF estimates also suggest that modifying the system parameters can lead to a substantial reduction of the NPV of pension liabilities, calculated at 106% of GDP over the period 2012-50. For instance, a simulation of several combined adjustments – reducing the replacement rate of the public system; increasing the number of years of the reference wage (from 10 to 20); equalising the retirement age of men and women and then linking it to the evolution of life expectancy; eliminating the 13th month payment; reducing the pensions of the armed force by 20%; and imposing an extra 10% solidarity surcharge on pensions above 5 minimum wages – leads to a reduction of the NPV of pension liabilities by 23 percentage points.

Raising the retirement age further should also be considered in the medium term. The retirement age, at 62 for men and 57 for women, is low compared to the average OECD countries (65 and 63.5, respectively). Life expectancy at birth has increased by more than 3 years per decade since 1960, slightly above the OECD average. It is now at 78 years for women and 70 years for men in Colombia, while it is at 83 years for women and 77 years for men on average in OECD countries. The IMF estimates that life expectancy at retirement age will rise in Colombia by 2.6 years for men and 3.3 years for women from now to 2050 (Table 2.1). The share of people aged 80 and over in total population will rise from 1% currently to more than 6% in 2060.

Table 2.1. **Statutory retirement age and life expectancy at retirement**

2010-50

	Statutory retirement age		Life expectancy at retirement age 2010		Life expectancy at retirement age 2050		Increase in life expectancy at retirement age 2010-50	
	Men	Women	Men	Women	Men	Women	Men	Women
Argentina	65	60	15	19	18	22	3.0	3.3
Bolivia	58	58	19	21	24	26	4.7	5.3
Brazil	65	60	17	19	19	22	2.9	3.0
Chile	65	60	17	20	19	23	2.5	2.8
Colombia	**62**	**57**	**19**	**25**	**21**	**28**	**2.6**	**3.3**
Costa Rica	65	65	18	20	20	23	2.5	3.0
Dominican Republic	60	60	21	23	23	26	2.4	2.6
Ecuador	60	60	21	23	24	26	2.7	2.9
El Salvador	60	55	20	23	23	26	3.0	3.3
Guatemala	60	60	19	22	22	25	2.9	3.4
Honduras	65	60	16	18	18	21	2.3	2.9
Mexico	65	65	17	19	19	22	2.6	3.1
Nicaragua	60	60	20	23	23	26	3.2	3.4
Panama	62	57	19	26	22	29	2.5	3.3
Paraguay	60	60	19	21	22	24	2.4	2.7
Peru	65	65	62	18	18	21	2.5	3.1
Uruguay	60	60	19	23	22	27	3.5	3.3
Venezuela	60	55	17	19	21	28	3.7	8.7
Average	***62***	***60***	***18***	***21***	***21***	***25***	***2.9***	***3.5***

Source: IMF staff calculations.

The retirement age has just been increased by two years this year so it may be politically difficult to increase it further in the near future. Nonetheless, in a first step, equalising the retirement age between men and women would raise female pension coverage through longer contribution periods and higher chances to fulfil the requirement while addressing part of the sustainability issue. In the longer term, as it is done in most OECD countries, Colombia should gradually move towards a scheme that links, to some extent, the retirement age to life expectancy. This would raise long-term sustainability. For that purpose, the experience of many OECD countries could help Colombia to implement this reform.

The private defined-contribution plan shies from annuities raising longevity and financial risks

The private defined-contribution plan provides three kinds of benefits to its affiliates: i) Disability pension plan; ii) Survivor's pension plan; and iii) Retirement pension plan. The market is concentrated in only 4 funds: *Protección, Porvenir, Colfondos* and *Old Mutual*. The market share of the two largest funds is over 80% in terms of both members and assets. They are owned by the main economic conglomerates of the country. This level of concentration is quite common in Latin American countries (for instance in Chile, Costa Rica, and Peru), and can lead to high costs and fees. Compared with other Latin American countries, operating costs are higher in Colombia. However, a smaller market can facilitate a closer supervision of the actors, provided that the independence of the supervision is guaranteed.

Since their creation, the private pension funds have developed an important role in the financial system and have been vital to boosting the development of local capital markets. Since the mid-90s, they have been active participants in the public debt market and now, by the level of assets they have on their balance sheet, they are major investors in government treasury securities. In macroeconomic terms, the Pension Fund Administrators (PFA) play a key role in generating and allocating savings. Through the PFA, private savings are channelled, delivered to professional managers and used to finance projects of public and private investment. In the near future, the pension funds will have an important role in the development of large infrastructure programme in Colombia. They will be part of the investors who will be financing a set of projects such as roads and airports, in partnership with the government agency of infrastructure, through the mechanism of public-private partnerships.

Participants can choose between various portfolios for their pension savings. The *multifondos* consist of three different portfolios with different investment regimes, depending on the affiliates' age and risk preferences– the conservative fund, the moderate fund and the high risk fund:

- Conservative fund: For members with a low risk profile. Its priority is to preserve the capital of the individual account and its target are members who are close to receive their pension benefits and prefer to obtain less returns than to be worried about possible investment losses.
- Moderate fund: For members with a moderate risk profile. These members should be willing to accept possible investment losses due to the risk exposure of this fund, looking for greater returns in the long term, in comparison with the conservative fund.
- High-risk fund: For members with a high risk profile. These members are far from receiving their pension benefits and are willing to accept higher volatilities that can result in important investment losses as a consequence of the risk exposure of this fund, looking for greater returns in the long term, in comparison with the moderate fund.

The member of the pension fund must choose between one of these funds based on the information given by the pension fund manager. In all cases the investments must be made and must be directed by the pension fund manager, according to the risk regime chosen by the member. The aim of this mechanism is to have a better return rate at the end of the capitalisation period.

Retirement benefits are based on the amount accumulated in the member's individual account. Accordingly, they depend on both the salary of the worker and the return of the saving. The gross replacement rate ranges roughly between 34% and 107% – the latter corresponding to the minimum salary earners. These estimates do not reflect actual salary development of the contributors or additional insurance companies' operating fees. In reality salary development can take a parabolic shape for low- and medium-income workers, while it keeps growing for high-income workers. This might translate into an overestimation of the high-income workers' replacement rate and an underestimation of the medium income worker´s one.

Many pensioners in the private scheme have included in their accounts a bond ("*Título pensional*"). This is a transitory measure applied after the 1993 reform. The *Títulos pensionales* are guarantees for the pensions that firms were paying directly to their employees before the 1993 reform. These rights can be included in the individual accounts of workers. It accounts for years of contribution raising thereby the replacement rate. In many cases it gives them a replacement rate higher than what current contributors can expect. In some cases the replacement rates for people who could include this bond are even higher than those in the public scheme.

Members can decide between seven benefit options (Box 2.2). The member can retire at any time from the PFA if the balance in a member's account is sufficient to finance a monthly benefit of more than 110 percent of the minimum monthly national salary. Members aged 62 (men) and aged 57 (women) who have contributed for at least 1.150 weeks, but whose individual account balance is not sufficient to finance a monthly benefit of at least the minimum monthly national salary, are entitled to obtain the minimum pension from the Minimum Pension Guarantee Fund. This minimum benefit is financed with 1.5 percentage points out of the total 16% contribution rate. Members aged 62 (men) and 57 (women) who have contributed for less than 1.150 weeks, and whose individual account balance is insufficient to finance a monthly benefit of at least the minimum monthly national salary, are entitled to a refund of their individual account balance.

Given that the private defined-contribution plan is a capitalisation one, the age of retirement and the benefits depend on the sum that is accumulated on the affiliate's saving account. It gives rise to two types of risks: longevity and financial. Longevity risk describes the case where the worker/insured lives longer than his or her life expectancy and thus faces the risk of exhausting accumulated funds to pay the pension. Financial risk stems from the value of pension savings being tied to the return on investments made in financial markets, whose volatility can, in poor market conditions, generate negative return rates (Bosch, Melguizo and Pagés, 2013).

In defined benefit systems, the government, or the public or private entity promoting the plan, assumes both the longevity and the financial risks during the active and retirement life of the contributor. In defined contribution systems, the contributor assumes the longevity and the financial risks during his or her active life. Upon reaching retirement age, the contributor can opt for two different products: an annuity or a scheduled withdrawal, or, sometimes, a full withdrawal of the funds. If the insured opts for an annuity, he or she must hand over the accumulated capital to an insurance company that will then assume both the longevity and financial risks. If the insured chooses a scheduled withdrawal, he or she maintains control of the accumulated amount and the fund administrator will pay the insured a monthly sum, which will be recalculated

Box 2.2. **Benefit options in the private defined contribution pension system**

- Life pension annuity, in which case they transfer the accumulated capital in their individual account to a life insurance company of their choice to purchase a monthly annuity of at least the minimum benefit. Once made, this choice is irrevocable.
- Programmed withdrawal, in which case the Pension Fund Administrator holds the accumulated capital in the individual account and pays the retirement benefit. Whilst a member is receiving programmed withdrawal benefits, the remaining accumulated capital in the individual account must be enough to finance a life annuity at least equal to the minimum monthly national salary.
- Programmed withdrawal with deferred life annuity, in which case part of the accumulated capital in their individual account is transferred to a life insurance company of their choice to purchase a life annuity payable from an agreed date. The remaining capital is used to provide a temporary income until this date. The deferred annuity must not be lower than the minimum benefit.
- Defined Temporary income with deferred life annuity, in which case the beneficiary arranges the payment with a life insurance company of a specific income and a deferred life annuity, which will begin at the moment the defined temporary income period ends.
- Variable temporary income with deferred life annuity, in which case the member can elect to receive a higher benefit payment during the variable temporary income period and lower during the deferred life annuity, or vice versa, depending on the member's needs.
- Programmed withdrawal without negotiating the recognition bond, in which case the member begins to receive the benefit before redemption of the recognition bond issued, under the programmed withdrawal programme without negotiating such bond.
- Variable temporary income with immediate life annuity, in which case an insurance company pays the member an immediate life annuity at the moment of retirement, holding in the individual account the necessary resources for the PFA to pay simultaneously a variable temporary income during the period agreed with the PFA.

annually based on financial performance and the updated estimated life expectancy. Therefore, the contributor also assumes the longevity and financial risks during his or her passive life.

Currently, only around 15% of payments are done through life-time annuities, compared to between 20 and 75% in OECD countries. This rather low level is influenced by the requirement that the minimum pension has to equal the minimum wage, which discourages insurance companies to participate in the annuity market, as it is difficult to insure against changes in the minimum wage. The government is planning to cover this risk. If the increase in the minimum wage is above inflation, the government will guarantee the payment. By contrast, if the increase is lower, insurance companies will be indebted to the government. A minimum level of annuitisation for the benefit pay-out phase should be encouraged to improve protection against longevity risk. A combination of programmed withdrawals with a deferred life annuity that offers protection against inflation could be seen as an appropriate default (OECD, 2012). The demand for annuities could be also promoted by financial education initiatives stressing that they are insurance products designed to protect people from outliving their resources (OECD, 2012).

A more ambitious reform of the pension system is needed in the long run

In the short term, some adjustments should be implemented to make the pension system sustainable and increase its coverage and equity. The eligibility to the BEPS should be extended to all workers earning less than the minimum wage, which includes most of the self-employed and the middle class. Some characteristics of the public defined-benefit plan may also be adjusted. The replacement rate should be decreased towards the private defined-contribution one and the reference salary based on more years of earnings. In the medium-term, the retirement age should be increased and linked to life expectancy. Nonetheless, all these adjustments will probably not be sufficient to ensure the long-run sustainability and equity of the system.

The complexity of the system and the many adjustments required to make it more equitable and sustainable suggest that a comprehensive pension reform is needed in the medium to long term. Such a reform should aim at building a comprehensive multi-pillars system. It should extend the old-age income support (*Colombia Mayor*), which would become pillar 0. The competition between the public defined-benefit and the private defined-contribution plans should be removed as it is costly and inefficient. There are several options regarding the contributory part of the system. The current private defined-contribution plan (pillar 2) could be complemented by a basic public defined-benefit plan (pillar 1). In this case, the generosity of the public plan should be reduced significantly. Alternatively, the public defined-benefit plan could be gradually phased out. Relaxing the constraint of the minimum pension to be at least equal to the minimum wage would also be key to increase coverage. Through the BEPS, the Government would subsidise the contributions of low-income workers inside pillars 1 or 2. Voluntary contributions to the private defined-contribution plan would form the 3rd pillar.

Phasing out the public defined-benefit plan (and moving to a contributory system) would lower liabilities by more than 18 percentage points of GDP in the next 50 years (Santa María and Piraquive, 2013). This scenario stipulates that from now on, no new worker would be allowed to contribute to the public system. The first 10 years will see no impact as working people will keep on contributing for retirees. In the following 15 years, the transition will cost between 0.3 and 0.6 percentage points of GDP compared to the baseline. After 2035, the cost will be lower than in the baseline. Overall, with such a reform, the net present value of pension liabilities will reach around 110% of GDP from almost 130% in the baseline.

In the case of the phasing out the public defined-benefit plan, the transition to the new system should be as smooth as possible. Only new workers would be obliged to contribute to the defined-contribution system. Workers already in the labour market should make a definite choice between the defined-benefit and the defined-contribution plan. Attention should be paid to transitional costs to the budget, which can be financed, for example, by a "pension bond", which as a one-off payment could fall outside the fiscal rule. Over the long term it will allow the pension system in Colombia to be sustainable and more equitable.

Colombia could benefit from OECD experiences in reforming pension systems. Defined-contribution plans are available in around one third of OECD countries while defined-benefit or point systems are available in the rest. None of the OECD countries has a parallel system like the one in Colombia. Most OECD countries have implemented pension reforms in recent years to reduce old-age poverty and to address ageing of their population and the subsequent unsustainability of the systems. First, reforms of public pension systems have introduced higher pension ages (at least 67 years in most OECD countries by around 2050), automatic adjustment mechanisms and modified indexation rules. These are to improve financial sustainability of pension provision. Second, governments have been looking at private pension arrangements. For instance, the Czech Republic, Israel and the United Kingdom have introduced defined-contribution pension schemes (OECD, 2013b).

The minimum income support for the elderly

To deal with old-age poverty, Colombia has recently introduced *Colombia Mayor* – previously called *Programa de Protección Social al Adulto Mayor* (PPSAM) – and the PSAP (*Programa de Subsidio al Aporte en Pensión*) financed from the social security system. *Colombia Mayor* is financed by levies on higher salaries. Employees with a monthly contributory base salary higher than four times the minimum wage must make additional contributions to the Solidarity Pension Fund, which finance *Colombia Mayor* (on a scale from 1 per cent on four times the minimum wage to 2 per cent on 20 or more times the minimum wage).

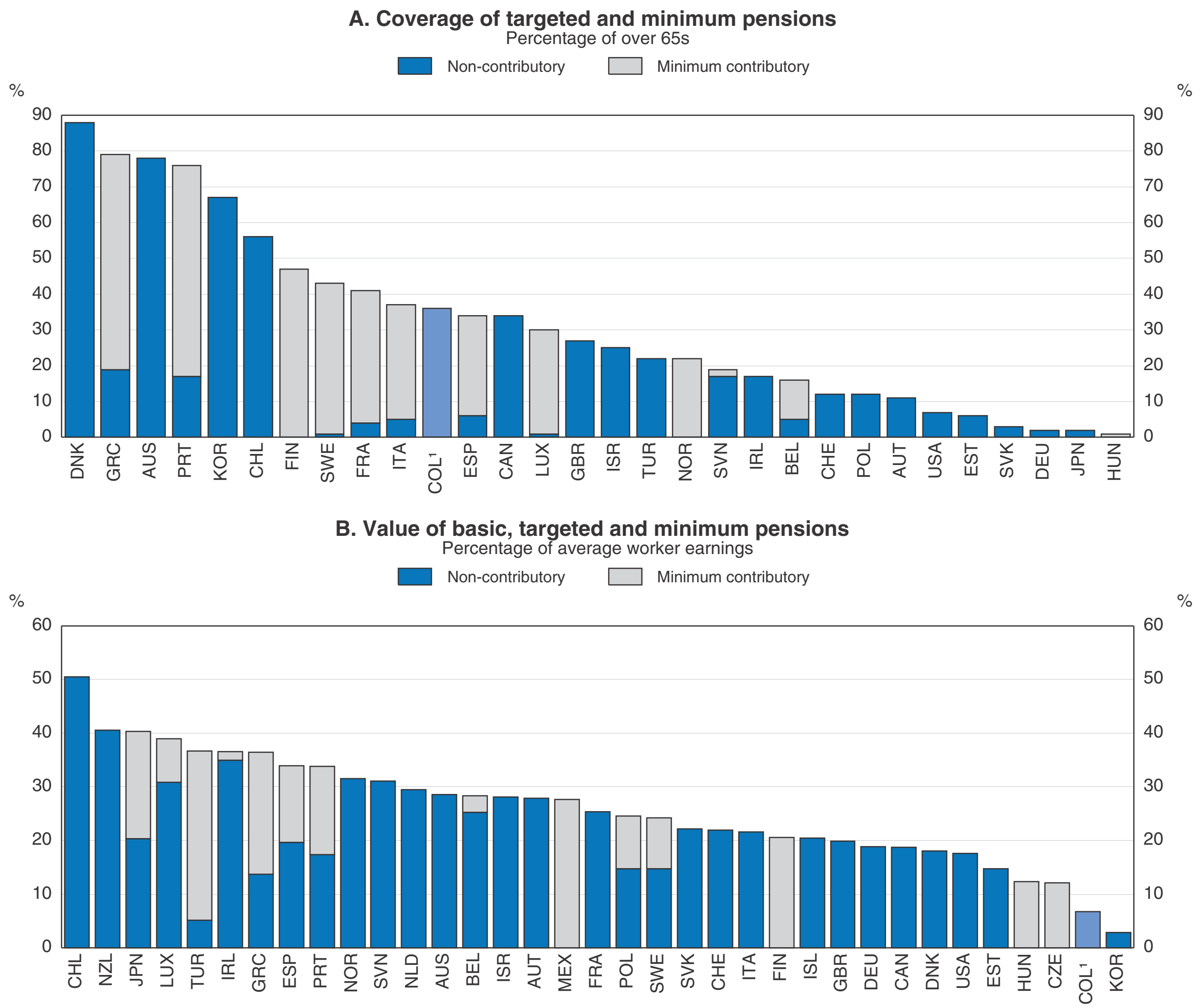
The coverage of *Colombia Mayor* has been extended from almost 900 000 recipients in 2010 to more than 1.2 million in 2014. It covers 36% of the population aged 65 and over. The PSAP programme has around 200 000 beneficiaries, of which 82% are independents workers in cities, 16% rural workers, 1% communitarian mothers, 1% town councillors and 0.3% disabled people. The coverage of both schemes together is about the average of OECD countries for old-age income support (Figure 2.11, Panel A). To be eligible, a person should be at least 65 years old and belong to the *Sisbén* 1 and 2 groups (social groups based on income levels).

However, the average benefit in relative terms is below all OECD countries except Korea (Figure 2.11, Panel B). The recent significant expansion of the coverage has led to a decrease of the benefit by 50%. At currently around 10% of the minimum wage or 7% of the average wage, it is below the national extreme poverty line.

Colombia should increase old-age income support, while ensuring that work incentives are preserved. The level of income support and pensions may impact the decision of people to participate in the labour market as indicated by the experience of some Latin American countries. Having access to a non-contributory pension can seriously reduce the labour supply of eligible beneficiaries (Bosch, Melguizo and Pagés, 2013). For instance, a number of programmes to reduce poverty and inequality among elderly especially in rural areas – *Previdencia Rural* in Brazil, the moratorium programme in Argentina, and the rural programme 70+ in Mexico – have resulted in a considerable reduction in the labour supply of individuals eligible for a non-contributory pension, ranging from 5 to 11 percentage points (Carvalho Filho, 2008; Bosch and Guajardo, 2012; Rodrigues de Oliveira and Kassouf, 2012; Juárez and Pfutze, 2012). However, the labour supply effect is smaller when the programme is targeted to the poor (Olivera and Zuluaga, 2014).

Colombia Mayor avoids the incentive problem by targeting people with very low or no income. Those covered are mainly workers who spend all their life in the informal sector, mostly in rural areas and with low education levels. The welcome extension of *Colombia Mayor* to 2.4 million beneficiaries as envisaged by the government, should not create bad incentives to stay in the informal sector. However, the average benefit should be raised to allow more people to get out of poverty. It should be at least double to get closer to the average relative support levels in OECD countries. The NPV of liabilities of such a change will be less than 10% of GDP over the next 40 years compared to 4.4% with the current settings (Santa María and Piraquive, 2013). There should be budgetary room to increase support, as elderly income support is a small share of the budget and the lowest among Latin America countries (Figure 2.12).

Figure 2.12. **Coverage and value of minimum pensions**



1. For Colombia, the data refer to the coverage and value of *Colombia Mayor* benefits.
Source: National Authorities and OECD (2013b).

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Recommendations on pensions

Key recommendations

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

Further recommendations

- Encourage annuitisation for the pay-out phase to protect pensioners against longevity risk.
- Lower the replacement rate of the public scheme and base the reference wage on more years of earnings.
- Equalise the retirement age between men and women. In the medium term, increase the retirement age and link it to life expectancy evolution.

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Glossary

AHELO	OECD's Assessment of Higher Education Learning Outcomes
ANIF	National Association of Financial Institutions (*Asociación Nacional de Instituciones Financieras*)
BEPS	Individual retirement accounts targeted at low-income workers (*Beneficios Económicos Periódicos*)
BIS	Bank for International Settlements
BPS	Basis points
CAF	Development Bank of Latin America (*Corporación Andina de Fomento*)
CREE	Corporate income surtax (*Impuesto sobre la renta para la equidad*)
CIT	Corporate Income Taxes
COP	Colombian peso
CONPES	National Council for Economic and Social Policies (*Consejo Nacional de Política Económica y Social*)
DANE	National Statistics Bureau (*Departamento Administrativo Nacional de Estadística*)
DIAN	National Tax and Customs Agency (*Dirección Impuestos y Aduanas Nacionales*)
DNP	National Planning Department (*Departamento Nacional de Planeación*)
ECLAC	Economic Commission for Latin America and the Caribbean
FCL	Flexible credit line
FDI	Foreign Direct Investment
GDP	Gross Domestic Product
GFSM2001	*Government Finance Statistics Manual 2001*
GPS	Colombian General Pension System
ICBF	Child care institute (*Instituto Colombiano de Bienestar Familiar*)
IADB	Inter-American Development Bank
IGAC	Agustin Codazzi Geographic Institute (*Instituto Geográfico Agustín Codazzi*)
ILO	International Labour Organisation
IMAN	Alternative minimum income tax (*Impuesto Mínimo Alternativo Nacional*)
IMF	International Monetary Fund
ISCO 08	International Standard Classification of Occupations
IT	Information technologies
LAC	Latin American and Caribbean countries
METR	Marginal Effective Tax Rate
MHCP	Ministry of Finance (*Ministerio de Hacienda y Crédito Público*)
NPL	Non-performing loan
NPV	Net present value
OCAD	Councils deciding on the projects to be financed out of royalty revenues (*Órganos Colegiados de Administración y Decisión*)
OLS	Ordinary Least Squares
PAYG	Pay-as-you-go

PINES	Development of national and strategic projects
PFA	Pension Fund Administrators
PIPE	Plan to Promote Productivity and Employment
PIT	Personal income tax
PMR	Product Market Regulation
PPP	Public-Private Partnership
PPSAM	Social protection programme for the elderly (*Programa de Protección Social al Adulto Mayor*)
R&D	Research and Development
SEDLAC	*Socio-economic database for Latin America and the Caribbean*
SENA	National Training Service (*Servicio Nacional de Aprendizaje*)
SIC	The competition authority (*Superintendencia de Industria y Comercio*)
SFC	Superintendence of Finance (*Superintendencia Financiera de Colombia*)
SGP	National Tax Revenue Sharing System (*Sistema General de Participaciones*)
SGR	National Royalty Sharing System (*Sistema General de Regalías*)
SISBEN	System to identify elegibility to social programmes (*Sistema de Selección de Beneficiarios para Programas Sociales*)
SME	Small and Medium Enterprises
SMSCE	Monitoring, control and evaluation system created within the new SGR
SUIT	Single Information System of Procedures
UNODC	United Nations Office for Drugs and Crime
USAID	United States Agency for International Development
UVT	Tax value unit (*Unidad de Valor Tributario*)
VAT	Value-added tax
WDI	World Development Indicators
WEF	World Economic Forum
WHO	World Health Organization

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