

# POLITICAL ECONOMY OF TAX REFORMS: The Case of Colombia

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This paper explores the aspects of political economy that have influenced processes of tax reform in Colombia over the last two decades. The main limitations to tax reform have come from the high fragmentation of and lack of programmatic discipline in Congress as a result of changes introduced by the Constitution of 1991 and from the strong lobbying power of special interest groups. Increasing revenues, the main goal of successive reforms, has been difficult, especially in the period 1991-2005. Given political constraints, various administrations increased nominal tax rates while at the same time expanding popular tax exemptions. In addition, the need for revenue led to the creation of highly distortionary taxes. As a result, a complicated, inefficient, and inequitable tax system emerged. There have been several efforts to establish a better tax system since 2006, but the same political



The political factors influencing tax reform in Colombia are rooted in the institutional and political changes introduced by the 1991 constitution. Economic reforms undertaken





New electoral rules<sup>1</sup> and changes to campaign financing regulations successfully increased political competition. Greater political and administrative decentralization, reinforced by the 1991 constitution,<sup>2</sup> also contributed to the explosion of new parties (Cárdenas and Pachón, 2010). Unfortunately, most new parties did not clearly articulate new programmatic commitments or impose the discipline needed to accompany this increase in competition. Excessive congressional fragmentation strained the economic decision-making process, making it difficult to build coalitions in support of government reform initiatives.<sup>3</sup> The World Bank directly linked this increase in congressional fragmentation with the implementation of the 1991 Constitution. Subsequent political reforms and the Ley de Bancadas in 2003 and 2005, respectively, seem to have reduced incentives for further political fragmentation, but it nevertheless remains high in comparison to other Latin American countries.

1. 2. 3. 4. 5. \*

\*Measured as the probability that two deputies picked at random from the legislature will be of different parties. Source: Keefer (2010), Political Institutions Database, World Bank.

The 1991 constitution also reduced the powers of the president while strengthening congressional and judicial oversight, thereby improving checks and balances in the Colombian political system. The president, as head of the executive branch, still retains important powers: he defines the economic and social agenda in conjunction with his cabinet. (Bills related to fiscal matters are presented to Congress by the minister of finance.) The constitution also limited the special powers of the president during a declared emergency or in exceptional periods (internal “commotion” or economic emergency). In these situations, the president can issue laws without going through ordinary procedures in Congress. The new constitution limited the duration of states of exception and stipulated that the Constitutional Court must review the constitutionality of the declaration of a state of exception and any laws issued during the special period.<sup>4</sup> It also established—for the first time—that the laws issued by the president would remain in force only if Congress later enacted

<sup>1</sup>The constitution established a low threshold for the creation of political parties or movements. Likewise, the rules for gaining a seat in Congress encouraged candidates to promote actions that favored a portion (geographically-speaking) of the electorate and not all of his or her constituency. Finally, the government’s financial support to campaigns or movements has also been identified



them during a regular session.

The constitution also strengthened the process of judicial review in Colombia, allowing the courts to determine whether laws are constitutional. The Constitutional Court has a mandate to review all laws and constitutional amendments enacted and holds veto power over them. It also considers citizen-initiated lawsuits against legislative decisions and resolves disagreements in legal interpretation between Congress and the executive. In several rulings, the Constitutional Court may have even overstepped its bounds by effectively legislating economic matters (Clavijo, 2001). The Court has become more active since the implementation of the 1991 constitution. The “social rule of law” (Estado Social de Derecho), as detailed in the new constitution, has led to judicial activism as a result of the many social rights and guarantees it confers.

Before the 1991 constitution, the Colombian executive had a monopoly on spending initiatives, while a small fixed percentage of the budget (auxilios parlamentarios) was left under congressional control. The auxilios parlamentarios served as a transparent mechanism that indicated congressional support for government proposals. Under the new constitution, Congress was given greater independence, but the removal of this traditional indicator of support made it more difficult for the government to build legislative coalitions. According to interpretations by the Constitutional Court, Congress gained the power to submit laws directing public spending after 1991 (Fedesarrollo, 2011). Nevertheless, this power is limited as spending initiatives must still be consistent with the established fiscal framework and the country's Fiscal Transparency and Responsibility Law.<sup>5</sup> According to this law, any initiative with an impact on the country's fiscal situation must provide estimates of associated costs and sources of financing. It also requires a favorable assessment by the ministry of finance. An unfavorable assessment does not necessarily invalidate the law, but assessments overall are an important aspect of the approval process. In fact, several congressional initiatives with an unfavorable fiscal review have nevertheless been approved.

While the private sector and interest groups have always influenced the economic policymaking process in Colombia, the new political and economic environment that developed in the 1990s substantially changed lobbying practices in the country (Eslava and Meléndez, 2009). Economic reforms during the 1990s led both to the diversification of the productive sector and to a proliferation of private-sector actors with an interest in influencing the economic decision-making process. Prior to the 1990s, a handful of major private-sector associations had a monopoly on government influence, but these organizations began to lose their lobbying power as a multitude

<sup>5</sup> In 2003, the Fiscal Transparency and Responsibility Law (Law 819) required the government to present annual updates of the Medium Term Fiscal Framework (MTFF). The 10-year macroeconomic framework of the MTFF must be comprised of multi-year fiscal primary balance targets that guarantee fiscal sustainability in the medium term. In addition, the MTFF must present an assessment of the main fiscal risks and a quantification of the fiscal impact of economic decisions adopted in the previous year.



of smaller, specialized associations, large companies and conglomerates, and other economic organizations (such as sector-specific business owners' groups) increased their influence with policymakers.

The target of lobbying efforts also shifted in this period: prior to the 1990s, interest groups concentrated their activities on the executive branch, while post-reform lobbying focused on the legislature given its increased capacity for economic decision making. This new opportunity for influence over economic decisions was due to several factors: (1) a reduction of state intervention in the economy; (2) congressional fragmentation and the absence of programmatic commitments among parties and legislators; (3) the Congress's reduced dependence on the executive; and (4) the increased availability of private sector resources to finance political campaigns. These factors led to increasingly specialized lobbies, resulting in many cases in which members of Congress sought protection for or the extension of an economic benefit for a small sector or company.

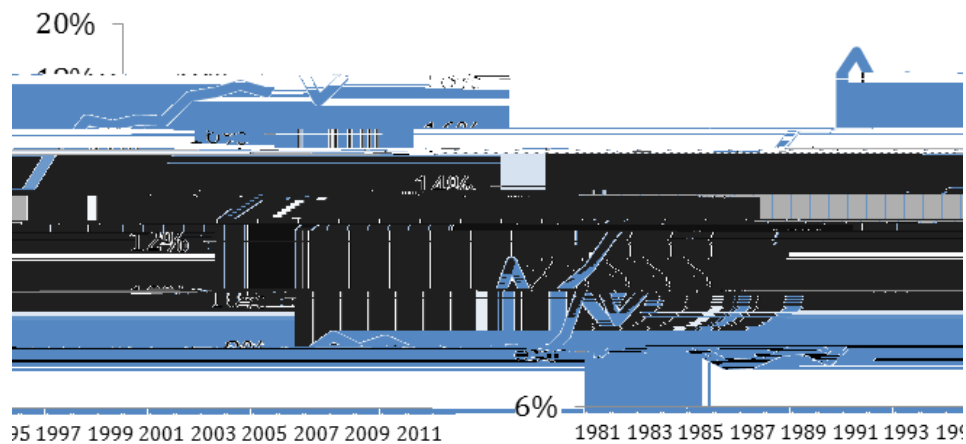


Between 1991 and 2003, public spending in Colombia rose from 8.6 percent to 16.5 percent of GDP, for a total increase of 8 points of GDP (Figure 2). In the previous period, the accumulated growth had been significantly lower, with a spending increase of just 0.3 points of GDP from 1981 to 1990. Similarly, the growth trend of public spending decreased notably after 2003. Between 2003 and 2011, public spending increased from 16.4 percent to 17.3 percent of GDP (an increase of just 0.8 points).

The dramatic growth of central government spending between 1992 and 2003 can be explained by several factors, some of them related to the new constitution. The 1991 constitution granted not only fundamental human rights but also economic and social



## Figure 2. Colombia's Public Deficit, (as a % of GDP)



In addition, in the late 1990s Colombia's economy suffered both internal and external shocks. The fiscal deficit, already substantial, worsened. In 1999, central government and consolidated public sector deficits reached 6 percent and 4.9 percent of GDP, respectively. In that same year, an abrupt adjustment in the country's balance of external payments took place, and for the first time since the national and income accounts records were produced, real GDP growth turned negative (-4.2 percent). These developments forced the Colombian government to adopt a structural adjustment program supported by the IMF.

In the period 1990-2012, twelve tax reforms were enacted with the goal of increasing revenues. The main purpose of these reforms was to increase revenues for the central government, although the most recent reforms also contain elements that look for a more efficient and equitable tax system, as will be discussed in detail in the next section. In order to ensure the sustainability of expenditures, the government also enacted reforms to the intergovernmental transfers system<sup>7</sup> and the pension regime.<sup>8</sup>

The government took a number of steps to improve its financial institutions and to ensure that economic decisions were made within a transparent and responsible framework. This includes the 2003 Fiscal Transparency and Responsibility Law and Medium Term Fiscal Framework (MTFF). In order to strengthen fiscal responsibility legislation, a quantitative "fiscal rule" for the central government was passed into law

<sup>7</sup> Constitutional reforms in 2001 and 2007 introduced changes to the formula regulating increases in inter-governmental transfers. The primary change decoupled transfer rates from central government current revenue. Specifically, the constitutional amendment of 2007 established that the growth rate of transfers should equal the previous year inflation rate plus a real growth percentage defined in the norm.

<sup>8</sup> To overcome financial problems, low coverage, and inequitable distribution in the pension system—which persisted for a decade after the 1993 reform—additional adjustments were introduced through two subsequent reforms and a constitutional amendment. Among the most notable measures aimed at improving the financial equilibrium of the system were: increases in contributions, expansion of the contribution base, elimination of generous special regimes, regulation of the transition phase, and the establishment of a ceiling to pension benefits for the pay-as-you-go system.



in June 2012.<sup>9</sup> Finally, to limit the fiscal cost of both constitutional rulings and laws presented by Congress, the notion of “fiscal sustainability” was added as a principle in the Colombian constitution through the Constitutional Amendment 03 of 2011. In 2012, the Constitutional Court upheld the legality of the sustainability principle on its review.

In sum, having recognized the need for more sustainable fiscal policy, the Colombian authorities significantly strengthened the country’s fiscal-institutional framework (IMF, 2011). A variety of reforms since the 1990s have brought public spending back to a more sustainable level. These economic developments since 1991 have had an important effect on the motivations of the tax reforms.



In an effort to increase tax revenue to offset increasing public spending, Colombia introduced twelve different tax reforms between 1991 and 2012: seven in the period 1991-2005 (one every 25 months) and five in the period 2006-2012 (one every 15 months) (Figure 3).



When compared to a sample of Latin American countries (LAC15), Colombia stands out as a nation that has significantly increased its tax revenues; that said, as a percentage of GDP, these revenues have remained below the regional average (Figure

<sup>9</sup> This rule establishes a structural deficit target of 1 percent of GDP from 2022 onwards, with a transition period between 2012 and 2021. The rule allows for some fiscal response to cyclical fluctuations in output and oil revenue. Savings generated through the operation of the fiscal rule are held in a sovereign wealth fund. At the subnational level, the recent royalties’ reform also introduced a counter-cyclical element to local fiscal management, as it creates a subnational saving and stabilization fund to put aside windfall revenues from royalties.





4). As Figure 4 demonstrates, Colombia's total tax revenues were equal to 9 percent of GDP in 1990, well below the LAC15 average of 13.9 percent. In that same year, the ratio of tax revenue to GDP reached 33 percent in OECD countries. Between 1990 and 2006, Colombia's total taxes as a percent of GDP grew from 9 percent to 18.4 percent, whereas in the LAC15, total taxes increased from 13.9 percent to 19.1 percent of GDP.

Figure 4. Total Tax Revenue as a Percent of GDP, 1990-2006

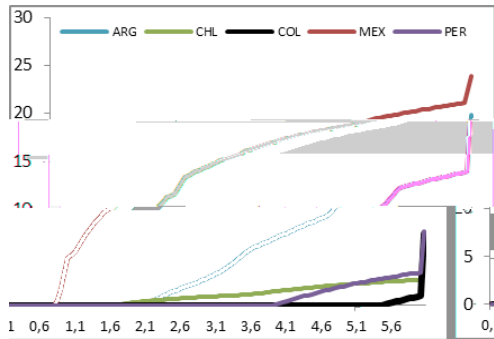
Unfortunately, this series of reform efforts failed to have a sufficient revenue impact to fully offset the government's accelerated increase of public spending. Central government revenues (excluding social security contributions) grew from 6.4 percent of GDP in 1991 to 13.9 percent of GDP in 2012 (an increase of 7.5 percentage points). Over the same period, central government spending grew from 7.7 percent to 18.6 percent of GDP (an increase of 10.9 percentage points) (Figure 5). Not only did successive tax reforms fail to produce a sufficient increase in revenues to cover





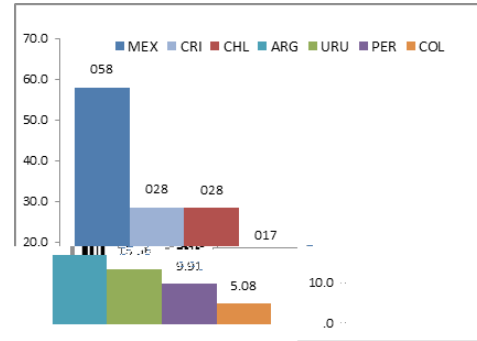


**a. Average Personal Income Tax Rates by Income (relative to national median labor income, percentage)**



Source: OECD (2010).

**b. Percent of Households which are Net Payers of Personal Income Taxes**

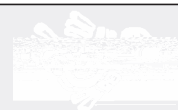


In addition, people in lower income brackets pay the highest effective income tax rate. This is due to tax withholding on low-income workers who typically do not file annual income tax forms. Hence these workers do not have access to deductions or exemptions that usually benefit middle- and high-income brackets. According to the Ministry of Finance (2012), only 20 percent of the working age population (4.6 million out of 23 million) pay income tax. While non-filers (3.5 million) pay an income tax that is equivalent to 7 to 11 percent of their gross income, those who have monthly wages of around COP\$8 million (about US\$4200) pay on average only 2 percent of that income in taxes.



Source: Ministry of Finance (2012).









The analysis of the political economy of tax reforms presented here divides these reforms into two periods. The first period covers reforms from the early 1990s until 2005, while the second extends from 2006 to 2012. Between these two periods, the primary motivation behind tax reform shifted from a need to increase tax revenue to offset rapid increases in public spending, to later efforts that aimed to simplify the tax system and make it more efficient and equitable.



The rapid growth in public spending beginning in the 1990s was a result of requirements imposed by the new constitution, along with growing resource needs in the pension and defense sectors in particular. Together, these created great demand for new fiscal revenues, which spurred the tax reforms of this era.

The country's urgent need for additional resources and the new political conditions under the 1991 constitution together significantly influenced the structure of the Colombian tax system. With the high levels of heterogeneity and political fragmentation in the legislature, inadequate programmatic representation and party discipline, and less dependence of Congress on the executive, it became very difficult to build coalitions to support government initiatives. In addition, individual incentives for members of Congress to protect private interests increased due to new lobbying efforts. In this environment, the government decided to increase nominal tax rates while at the same time extending special tax benefits to the private sector in order to increase revenues while recognizing new political realities. Tax revenues increased but were accompanied by lower tax productivity and efficiency and higher costs in terms of equitability.

The low productivity of traditional taxes led to the creation of new taxes with greater distortionary effects in economic terms, but less political opposition. For example, the financial transaction tax was established on a temporary basis, originally to cover part of the costs of the financial crisis of the late 1990s, and was later extended to cover the cost of damages caused by an earthquake in the coffee-growing region. Because the Colombian constitution prohibits the establishment of national taxes with a specific destination, since 2001 the revenues from this tax have been diverted to finance the general budget, in compliance with court decisions. In later tax reform discussions, Congress showed a preference for preserving this tax over making changes to traditional taxes (specifically the VAT). In fact, in 2006 this tax became permanent as a result of congressional initiative.



Similarly, in order to finance increased costs in the defense sector, the administration of President Álvaro Uribe introduced a wealth tax in 2002. Major private sector contributors and the defense sector were to monitor these revenues to ensure they were used for their intended, defense-related purpose. This tax, although temporary, has been periodically extended without opposition from the private sector, due to support for higher defense expenditures and the relative efficiency of its implementation. As the burden of this tax rests heavily on larger corporations and higher-income individuals, the wealth tax has not been opposed by the Congress.

## 2002 2012

By 2005, structural reforms of the expenditure process had started to show some results in terms of public spending control and stability. This opened political space to think about a new series of reforms aimed at improving simplicity, efficiency, and equity in the tax system. From 2005 to 2009, five tax reforms were approved, although due to the political economy constraints under which they were adopted, none of these reforms could be called structural or comprehensive. Nevertheless, almost all the reform efforts of this period focused on developing a simpler, more efficient, and more equitable tax system.

## 2005

In 2005, during the height of the Uribe administration's popularity, Finance Minister Alberto Carrasquilla proposed a comprehensive structural tax reform package. The initial proposal, presented to Congress, included the writing of a new simplified tax code. The new reform contained a series of structural elements, including:

- Elimination of corporate income tax rate surcharges and a reduction of the tax rate to 32 percent.
- Elimination of all personal income tax exemptions and deductions except the minimum threshold. In the proposal, this threshold was increased from 4.7 to 7 times the minimum wage.
- Introduction of a corporate income tax deduction of 100 percent of investment in fixed capital assets (without regard for depreciation) and removal of the 30 percent depreciation deduction.
- ↳ • Reduction in the number of different VAT rates from 9 to 5.
- ↳ • Taxation of previously exempted and excluded goods and services at a 10



percent rate, with the implementation of a compensatory measure for low income households.

- ↳ . The Ministry of Finance initially intended to eliminate the financial transaction tax; however, after discussions with Congress, the tax was kept on a temporary basis.<sup>12</sup>
- ↳ . Elimination of the remittances and stamp duties. The initial proposal also removed the wealth tax. The Ministry of Finance intended to replace it with another wealth tax with a broader tax base, but this would be presented in a future reform.

This structural reform effort was unsuccessful. In the approved reform, little of the initial proposal was kept:

- . The idea of introducing a completely new tax code was abandoned and the reform only produced changes to the existing code.
- . The 3.5 percent corporate income tax surcharge was effectively eliminated but the general corporate rate was reduced to 33 percent.
- . The deduction percentage on fixed assets investment was increased from 30 percent to 40 percent.
- ↳ . The reform did not affect the numerous exemptions and deductions on the personal income tax.
- ↳ . Eight of the nine VAT rates were kept and special conditions were increased.
- ↳ . The financial transactions tax became permanent. (However, an income tax deduction of 25 percent on the paid tax was allowed.)
- ↳ . The wealth tax was extended.
- ↳ . The tax on remittances and stamp duties were removed.

Fierce opposition to the reform came from a number of different sectors. As with previous reform efforts, special interest groups offered incentives to Congress in order to protect their benefits. In addition, political concerns and poor understanding about the distributional effects of measures such as the expansion of VAT base or a more progressive personal income tax led Congress to extend the financial transactions tax and wealth tax. Finally, certain elements of the reform also found resistance from members of the government themselves (Perry et al., 2010; Fedesarrollo, 2006).

<sup>12</sup> El Colombiano (July 2006) "No fue posible eliminar el 4 por mil: Minhacienda," available at [http://www.elcolombiano.com/BancoConocimiento/N/no\\_fue\\_posible\\_eliminar\\_el\\_4\\_por\\_mil\\_minhacienda\\_/no\\_fue\\_posible\\_eliminar\\_el\\_4\\_por\\_mil\\_minhacienda\\_.asp](http://www.elcolombiano.com/BancoConocimiento/N/no_fue_posible_eliminar_el_4_por_mil_minhacienda_/no_fue_posible_eliminar_el_4_por_mil_minhacienda_.asp)





Political obstacles were the primary cause of failure for this attempt at structural reform. The Ministry of Finance had worked carefully to design a robust structural reform, but it did not take into consideration the plan's potential political difficulties. In particular, this integrated, structural reform affected a great variety of private interests without creating clear "losers" and winners." As each interest saw a similar risk of "losing," all fought the reform and created a powerful opposition to the ministry's initiative.

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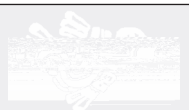
primary drivers for reform, giving less prominence to the goal of returning to a simpler, more efficient, and more equitable tax system. Therefore, the starting point of the reform was to reduce payroll taxes and to find ways to compensate for the lower revenues through other types of taxes. The ministry also announced at the outset that this would not be a comprehensive structural reform but only the first step in a broader reform project, focusing on improving specific deficiencies.

This reform proposal included a variety of measures, including:

- . Reducing payroll taxes from 25.5 percent to 16 percent.
- . Reducing the corporate income tax rate from 33 percent to 25 percent.
- . Creating a new tax on profits to compensate for the lower revenues resulting from reforms (i) and (ii). This new tax was designed to place a lower tax burden on firms with high personnel costs.
- ↳ . Adopting the IMAN guidelines from the previous proposal for personal income tax requirements for employees of firms, self-employed workers, and capital income recipients.
- ↳ . Taxing high pensions.
- ↳ . Reducing the number of different VAT rates from 8 to 3.
- ↳ . Establishing a consumption tax on luxury goods.

At first glance, this reform was presented under favorable conditions, especially from an economic point of view. The detailed technical design of the reform would require little additional tinkering. The economy was strong and major efforts to control tax evasion had shown positive results, reducing the urgency for revenue that earlier reforms had faced. The timing of the proposed reform was also somewhat favorable, as it was presented during the transition phase from the early years of an administration (when it was more likely to be successful) but before pre-electoral political discussions around the 2014 elections had begun. The governing coalition, La Mesa de la Unidad Nacional, was strong (Cepeda 2012), although the recent failure of a judicial reform package had created tensions between the executive and Congress. Despite these tensions, both branches of government expressed interest in working amicably together. The greatest initial concern about the proposal was having adequate time for Congress to discuss the proposal. In fact, there was an expectation that Congress would carefully review the proposal in order to avoid the problems that had impeded judicial reform.

Although the essential elements of the reform were approved in Congress and became law in December 2012, several changes emerged during the legislative debate. The IMAN-related elements were particularly affected. While the very creation of this







The new constitution enacted in 1991 increased political participation and the representation of different sectors in Colombia's economic decision making process. It also gave rise to the proliferation of political parties and to the fragmentation of Congress. This made it much more difficult for the executive to build coalitions in the legislature. At the same time, the lobbying platforms of special interest groups grew more influential: because of its financial importance to political campaigns, the private sector found a more divided Congress to be an effective channel for influencing economic decisions. Meanwhile, demands of the new constitution and other specific government needs drove a rapid increase in public spending, forcing the government to seek additional resources through several tax reforms.

The urgent need for additional resources and the new political landscape combined to significantly influence the structure of the Colombian tax system. The government increased nominal tax rates while extending special tax benefits to the private sector in order to raise revenues while limiting or minimizing political opposition. Tax revenues increased but were accompanied by reduced tax productivity and efficiency and high costs in terms of equity. The low productivity of traditional taxes led Congress to create new, more distortionary taxes, which nevertheless faced less political opposition.

Structural reforms began to show positive results in controlling public spending and improving fiscal stability by 2005. This success opened the political space to discuss a structural reform aimed at making the Colombian tax system more simple, efficient, and equitable. From 2006 to 2009, five different tax reforms were approved. Due to political constraints, none of these reforms was a truly structural and comprehensive reform, although nearly all contained elements oriented to this objective.

In December 2012, the Colombian Congress approved a new tax reform with important structural elements. Although it was a stepping stone towards, rather than a comprehensive reform, it embodied a new government strategy aimed at reducing opposition to reform by creating "winners." This strategy involved limiting the scope of reform, moving incrementally towards the ultimate objective of a more efficient and equitable tax system. The creation of a minimum tax threshold (IMAN) for personal income tax may well have helped, even though only the least important part of it survived. While the 2012 reform may not have achieved the larger goal of overhauling Colombia's complex, inefficient, and inequitable tax system, it serves as a model



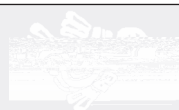
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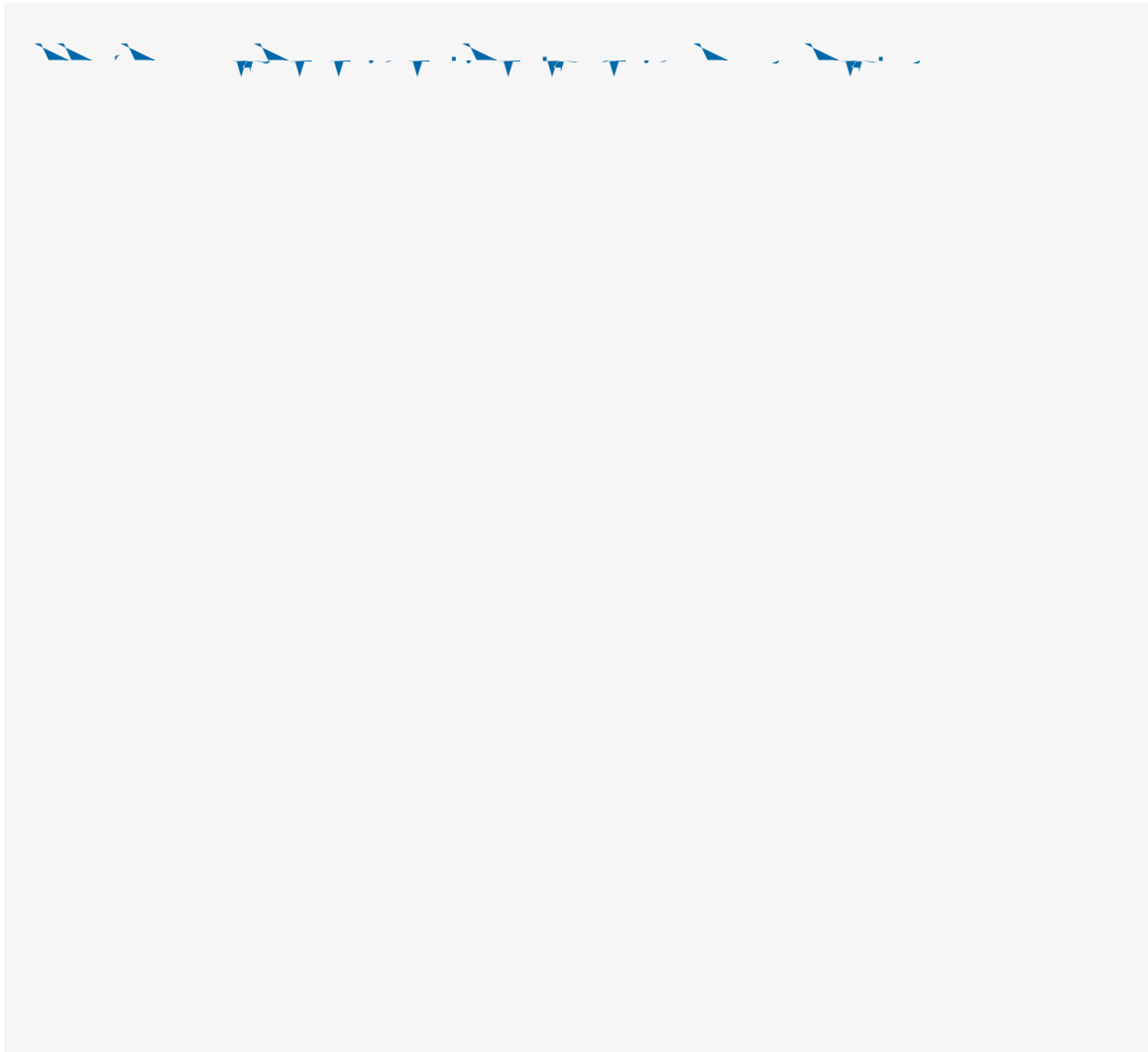




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