Colombia: Fiscal Reform Proposals Unveiled

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- **The government has unveiled its long-anticipated proposals to increase fiscal revenue by 2% of GDP and maintain social programs created during the pandemic**

On Thursday, April 15, the Colombian government presented to Congress its long-awaited fiscal reform proposals. We lay out their key features below.

In 2020, Colombia faced significant challenges amid the COVID-19 outbreak—tax revenues fell by 11.2% y/y versus 2019, while fiscal expenditures increased by 21% y/y in response to the health and social crisis. Together, these developments led to a widening in the central government's fiscal deficit from -2.5% of GDP in 2019 to -7.8% in 2020; it is projected to widen even further in 2021 to -8.6% of GDP. Gross central government debt rose from 50.3% to 64.8% of GDP. The country's fiscal rule was suspended under commitments to resume compliance with it by 2022.

KEY FEATURES OF THE PROPOSALS

With these developments in mind and with a broad goal of ensuring fiscal sustainability, the government committed to the development of a fiscal reform package that would also consolidate a more equitable social infrastructure framework. The set of proposals announced on Thursday cover four key elements: (I) redefinition of the fiscal rule; (II) strengthening social programs; (III) redistribution of fiscal burdens (tax reform); and (IV) other items.

I. Fiscal rule changes

The Ministry of Finance (MoF) proposed the adoption of more easily observable variables to define the fiscal rule.

- **The proposal would change the definition of "government"** from "central government" to "general government". This is a more ample definition and standard in international metrics. The move would bring in the performance of regions and municipalities in the rule's fiscal metrics.

- **The calculation of the fiscal rule would be augmented to include a ceiling on the stock of net liabilities exclusive of pension obligations.** The new rule would feature two parts: a maximum limit on the general government's primary balance, and an upper bound on the stock of general government debt net of pension liabilities.

In our view, these changes are positive: the new parameters and calculations would give the authorities some added flexibility. Additionally, the key fiscal metrics would be more transparent and better reflect Colombia's public finances by encompassing data on general government developments.

It is important to note that the new fiscal rule wouldn't be comparable with its previous incarnation. Both the definition of the rule and its target level would change. Under the newly proposed revised fiscal rule, the initial primary deficit would be limited to -1.8% of GDP for 2022, -0.7 % of GDP in 2023, and -0.2% of GDP in 2024. The primary balance in 2019 was 0.4% of GDP, -4.1% of GDP in 2020, and it is projected to hit -4.8% of GDP in 2021.

II. Strengthening social programs

At the beginning of the pandemic, the government created a new pool of social assistance programs, some of which it wishes to maintain after the public-health crisis has passed. In particular, the government wants to preserve the *Ingreso solidario* program, which consists of direct and periodic payments to low-income populations, specifically households living in poverty and extreme poverty. Additionally, it wants to continue with a program that reduces labour costs to promote employment for young people, older people who can't be pensioned, women over 40-years old, and people with disabilities. Lastly, the government seeks to provide ongoing subsidies for undergraduate studies to low-income people and to support culturally-related sectors.

III. Redistribution of fiscal burdens via tax reform

Proposed tax changes would increase levies on wealthy people while adjusting some taxes to enhance the promotion of productive sectors (table 1).

Table 1

Colombia: Fiscal reform uses and sources

Sources	COP tn	% of GDP	Uses	COP tn	% of GDP
Total	**23.4**	**2.0**	**Total**	**23.4**	**2.0**
VAT	7.3	0.6	Social prgms (Ingreso Solidario)	4.6	0.4
Personal taxes	17.0	1.4	Employment impulse / education	0.8	0.1
Corporate Taxes	3.7	0.3	VAT compensation	1.8	0.2
SGP*	-4.6	-0.4	Net effect	16.1	1.4

*SGP: Sistema General de Participaciones, i.e., mandatory transfer to regions.
Sources: Scotiabank Economics, Ministry of Finance.

- **VAT changes (would generate 26.1% of potential new fiscal revenue).** Despite the MoF's earlier intentions to add essential goods, mainly foodstuffs, to the VAT base, this initiative was dropped from the final draft of the reform package due to its unpopularity. Other items would be taxed with a VAT rate of 19%, while the government would extend low tax rates for capital goods and some essential services.

- **Personal taxes (to account for 60.7% of potential new fiscal revenue).** High-income people would face increases on taxes applied to salaries, dividends, and wealth under the proposed reforms. The package includes a one-time levy on monthly wages that exceed COP 10 mn (USD 2,700), to be introduced in H2-2021; a wealth tax on assets greater than COP 4.5 bn; and a 15% tax on high incomes from dividends. The proposals also aim to reduce some exemptions to income taxes and bring down tax thresholds to capture more middle-income payers. Under the reform package, gradually more people would be taxed over time. At present, receipts stemming from personal tax collection represent only 6.2% of total fiscal revenue, well below the OECD standard of 24%. These ambitious changes would aim to close this gap.

- **Corporate taxes (13.2% of potential new fiscal revenue).** The government wants to keep corporate taxes competitive; according to OECD statistics, corporate taxes represent 24.5% of fiscal revenue in Colombia, while in OECD countries, the standard average is 9.6%. Still, in the proposal, the government plans to reduce exemptions and postpone some tax reductions planned for 2022. Additionally, the proposed initiatives would preserve some stimulus for the creative sectors of Colombia's so-called "Orange economy" and tourism.

- **General Participation System (*Sistema General de Participaciones* in Spanish).** By law, the central government must transfer to the regions part of any extra revenues and this would subtract -0.4% of GDP in new fiscal revenues from the MoF's coffers.

IV. Other items proposed in the fiscal-reform package

Other proposals include some green taxes, most of which are charges on fossil fuels and a tax on single-use plastics.

More importantly for markets, the proposals would also reduce the withholding tax from 5% to 0% for foreign holders of public debt instruments and related derivatives. It is worth noting that the withholding tax reduction was included in previous reform proposals and didn't pass. In this case, the elimination of the withholding tax on foreigners could be a potential bargaining chip that could be sacrificed in negotiations with Congress.

SUMMING UP

The proposed fiscal reforms aim to generate new revenue and savings equivalent to over 2% of GDP from the beginning of 2022 (table 1, again) and reduce Colombia's Gini coefficient by 2.3 points (from 51.3 in 2019, which is at the higher end of Latam's 38 to 58 range in World Bank data). The proposal looks unrealistically ambitious since tax reform initiatives in Colombia, on average, tend to raise fiscal revenues by around 0.6% of GDP. The MoF has indicated that the government needs around 1.5% of GDP in new revenues to ensure long-run fiscal sustainability; therefore, we expect Congress to water down these proposed reforms at their margins. Still, even after any modifications, we expect that the Colombian government will be able to raise the roughly 1.5% of GDP in resources needed and send a message of fiscal responsibility to international credit-rating agencies and markets. This should allow Colombia to keep its investment-grade status.

Looking ahead, the government expects to gain approval of the fiscal-reform package before mid-June when the first legislative session ends. The authorities already emphasized that social programs currently set to expire in June will be made permanent, which increases the government's incentive to negotiate with Congress in an expeditious fashion.