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**Income Inequality  
and Poverty in Colombia -  
Part 2. The Redistributive  
Impact of Taxes  
and Transfers**

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Juliana Londoño Vélez**

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**ECONOMICS DEPARTMENT**

**INCOME INEQUALITY AND POVERTY IN COLOMBIA  
PART 2. THE REDISTRIBUTIVE IMPACT OF TAXES AND TRANSFERS**

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**By Isabelle Joumard and Juliana Londoño Vélez**

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## **Abstract/Résumé**

### **Income inequality and poverty in Colombia**

#### **Part 2. The redistributive impact of taxes and transfers**

Income inequality in Colombia has declined since the early 2000s but remains very high by international standards. While most of the inequality originates from the labour market, wealth – and thus capital income – is also highly concentrated and the tax and transfer system has little redistributive impact. The tax-to-GDP ratio remains low. Consumption taxes, which tend to be regressive, account for the bulk. The progressivity of income taxes had been undermined by generous tax reliefs, which benefit the well-off most and increase tax avoidance opportunities. The tax system should be reformed to enhance progressivity and raise more revenue which could be used to expand social policies. Cash transfers to households are small and dominated by non-redistributive schemes such as contributory pensions. Education coverage has increased steadily but quality and equity in access at the tertiary level remain important issues. Though significant progress has been made towards universal health coverage, the financing and organisation of the health care system could be improved to raise the quality of care and reduce adverse incentives to remain in the informal sector.

JEL classification: H23; H24; H31; H4; H51; H53; H55; I14; I24; I38.

Keywords: Colombia; inequality; personal income tax; value-added tax; property tax; pensions; conditional cash transfers; health; education; water and electricity subsidies.

This working paper relates to the 2013 OECD Economic Survey of Colombia.  
([www.oecd.org/eco/surveys/Colombia](http://www.oecd.org/eco/surveys/Colombia)).

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### **Inégalités de revenu et pauvreté en Colombie**

#### **Partie 2. L'impact redistributif des impôts et prestations sociales**

Les inégalités de revenu se sont atténuées depuis le début des années 2000 mais elles restent beaucoup plus fortes que dans la plupart des autres pays. Si le fonctionnement du marché du travail est le principal facteur à l'origine de ces inégalités, il convient de noter que la richesse – et donc les revenus du capital – est aussi très inégalement répartie alors que les impôts et prestations sociales n'ont qu'un faible impact redistributif. Le montant des prélèvements obligatoires en pourcentage du PIB reste faible. Les taxes sur la consommation, qui tendent à être régressives, ont un poids prépondérant. La progressivité des impôts sur le revenu est amoindrie par les dispositifs d'allègements qui bénéficient aux plus fortunés et favorisent l'évasion fiscale. Le système fiscal devrait être réformé afin de renforcer sa progressivité et d'augmenter les recettes qui pourraient être utilisées pour mettre en place des politiques sociales plus ambitieuses. Les prestations sociales sont peu élevées et dominées par des programmes non-redistributifs, en particulier les pensions contributives. Les taux de scolarisation ont augmenté mais la qualité de l'éducation et l'équité d'accès, en particulier pour l'université, restent des défis importants. De même pour la santé, si des progrès remarquables ont été faits concernant la couverture, rendue presque universelle, le financement et l'organisation du système de santé pourraient être réformés afin d'augmenter la qualité des soins et de réduire les incitations au travail informel.

Classification JEL : H23 ; H24 ; H31 ; H4 ; H51 ; H53 ; H55 ; I14 ; I24 ; I38.

Mots-clés : Colombie ; inégalités ; impôt sur le revenu ; impôt sur la valeur ajoutée ; impôt sur la propriété ; pensions ; prestations sociales conditionnelles ; santé ; éducation ; subventions pour l'eau et l'électricité.

Ce document de travail se rapporte à l'Étude économique de l'OCDE de Colombie 2013  
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## Income Inequality and Poverty in Colombia

### Part 2. The Redistributive Impact of Taxes and Transfers

By Isabelle Joumard and Juliana Londoño Vélez<sup>1</sup>

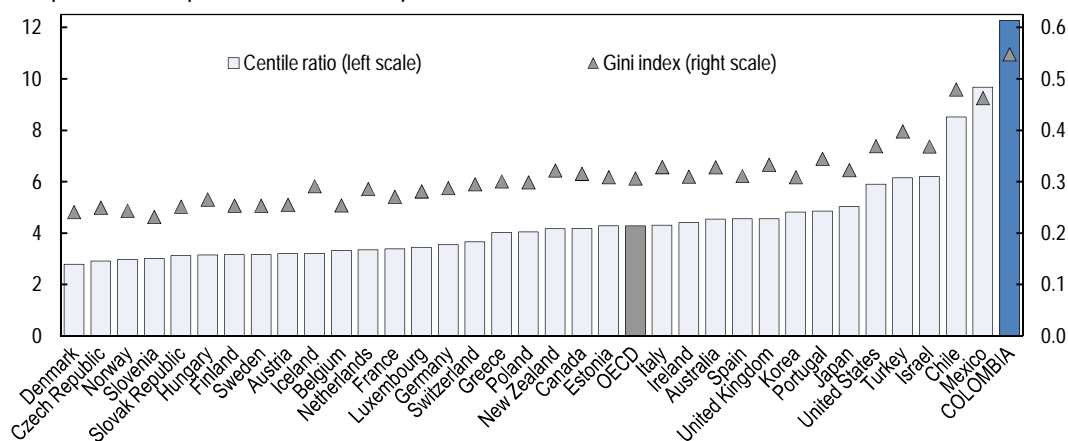
#### Setting the scene: income and wealth inequality is very high by international standards

Economic growth has contributed to a decline in absolute poverty and, to a lesser extent, in income inequality since the mid-2000s. However, Colombia remains one of the most unequal countries in the world (Figure 1). In a companion paper, Joumard and Londoño-Vélez (2013) show that income inequality largely originates from the labour market and highlight the factors driving it: these include a still high unemployment rate, a very large informal sector and a wide wage dispersion in the formal sector. Poor labour market performance contributes to keep many people into poverty or even extreme poverty.<sup>2</sup>

Income is also severely concentrated at the top of the distribution. The top 1% account for 20% of total income, more than doubling the OECD average. Wealth is even more unequally distributed than income in Colombia, as in most OECD countries (Fredriksen, 2011). Official data on national wealth concentration are lacking, but recent estimates suggest that the top 1% holds almost 40% of total wealth (Londoño, 2012). The concentration of wealth in Colombia is thus higher than in countries like France, Spain, Switzerland and the United States, where similar estimations have been made using tax data (Alvaredo and Saez, 2009; Piketty *et al.*, 2006; Kopczuk and Saez, 2004; and Dell *et al.*, 2005).

**Figure 1. The divide between the rich and the poor is pronounced**

Household equivalised disposable income: Gap between the 10th and the 90th centile and Gini index in the late 2000s



Note: Data for France and Ireland refer to the mid-2000s instead of the late 2000s. Data for Colombia are for 2011.

Source: OECD Income Distribution and Poverty, OECD Social Expenditure Statistics (database), DANE for Colombia.

1. Isabelle Joumard is a Senior Economist in the OECD Economics Department and Juliana Londoño Vélez was working as a consultant for the OECD Economics Department at the time of writing. This paper was originally produced for the OECD *Economic Assessment of Colombia* prepared under the responsibility of the Economic and Development Review Committee and published in January 2013. The authors would like to thank Andrew Dean, Robert Ford, Piritta Sorsa, Peter Hoeller, Sebastian Nietto-Parra, Facundo Alvaredo and members of the Colombian Delegation for their useful comments and suggestions, Chantal Nicq and Valéry Dugain for statistical assistance and Deirdre Claassen for her editorial support.
2. In a companion paper, Joumard and Londoño (2013) focus on the role that the labour market plays in affecting poverty and inequality in Colombia.

Information on land distribution – an important component of wealth – further suggests that wealth inequality has increased in Colombia. Colonial history, failed land reforms and internal armed conflict are at the root of the historically high land concentration. In addition, some policies have favoured rich landowners, exacerbating land inequality, such as subsidies and tax incentives for agriculture. Land holding concentration, as measured by the Gini coefficient, is estimated at 0.86, one of the highest in the world (Ibáñez and Muñoz, 2010). Moreover, the unequal distribution of rural property increased during the past decade, as the size of the land owned increased and new pieces of land were purchased by only a few landowners. Forced displacement has accentuated the unequal distribution of land. However, the Victims Law, which gives the displaced population the right to regain access to seized land, may play an essential role in reducing some of the disparities in the distribution of land ownership (Saffon and Uprimny, 2010).

This paper reviews tax and transfer policies and explains why they have, overall, a very limited, if any, redistributive impact.

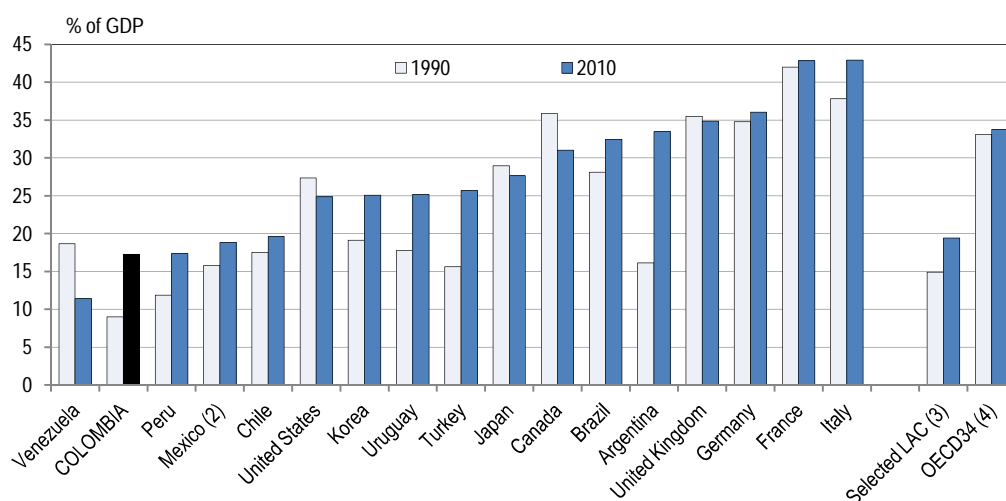
### The tax system has little redistributive impact

The tax system has only a very small redistributive impact. This reflects a low tax-to-GDP ratio, a high share of consumption taxes in total tax revenues, and a personal income tax riddled by tax expenditures which benefit mostly the rich.

### *Tax revenues have increased but remain low and consumption taxes account for the bulk of taxation*

Tax revenues have almost doubled since 1990 but, at 17.3% of GDP in 2010, they remain well below the OECD average and the average of other Latin American countries (Figure 2). Taxes on goods and services account for the bulk of tax revenues – 45% in 2010, compared with 33% in the OECD area (Figure 3). Income and wealth taxes are paid mostly by firms (Table 1). Dividends received by individuals are not taxed, which avoids the double taxation of distributed profits but reduces the progressivity of the tax system.

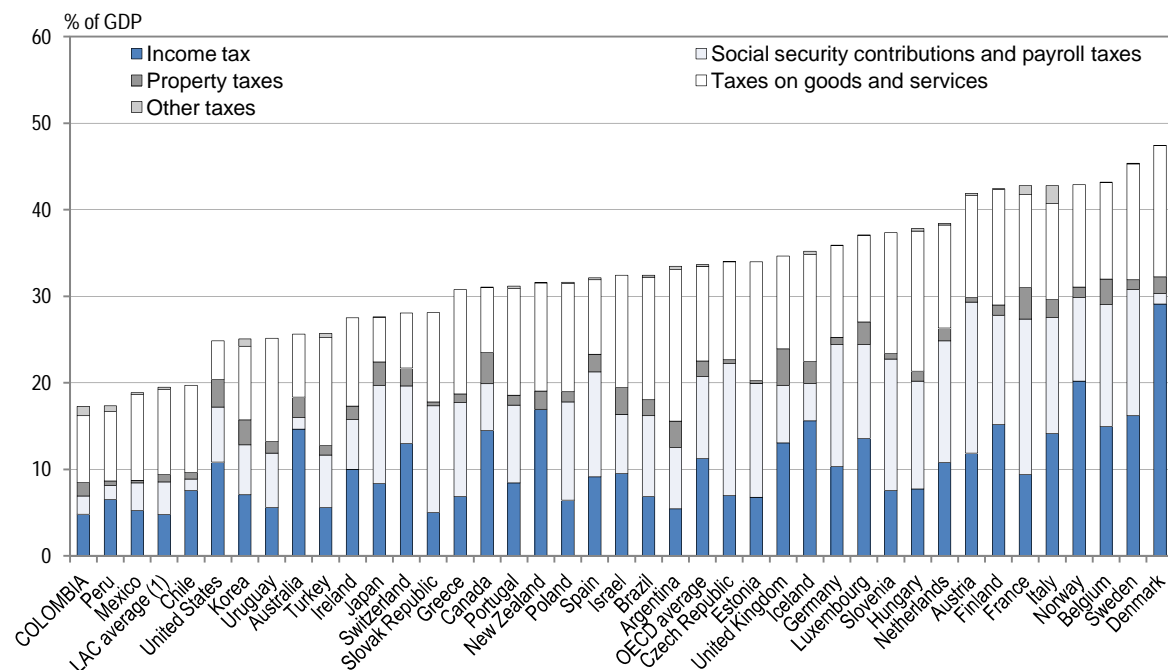
Figure 2. Tax revenues have increased but remain low  
Tax revenues as a share of GDP<sup>1</sup>



1. The data exclude local government revenues for Argentina, Peru (in 1990), Uruguay and Venezuela.
2. Fees levied on hydrocarbon production are treated as non tax-revenues.
3. Represents a selected group of Latin American countries. Chile and Mexico are also part of the OECD 34 group.
4. Represents the unweighted average for OECD countries.

Source: Revenue Statistics in Latin America, OECD 2011; OECD Revenue Statistics.

Figure 3. Tax revenues are low and consumption taxes account for the bulk  
2010



1. LAC: Latin American and Caribbean Countries.

Source: OECD, Revenue Statistics Database; Revenue Statistics in Latin America, OECD 2012.

Table 1. The personal income tax raises little revenue while consumption taxes play a dominant role  
(2010)

	% of total tax revenues			% of GDP		
	Colombia <sup>2</sup>	LAC	OECD	Colombia <sup>2</sup>	LAC	OECD
<b>Taxes on income and profits</b>	<b>27.9</b>	<b>24.5</b>	<b>33.3</b>	<b>4.8</b>	<b>4.8</b>	<b>11.3</b>
Personal income tax	6.1	6.0	24.9	1.1	1.2	8.4
Corporate income tax	21.7	12.2	8.6	3.8	2.4	2.9
<b>Social security contributions</b>	<b>12.2</b>	<b>18.8</b>	<b>27.0</b>	<b>2.1</b>	<b>3.6</b>	<b>9.1</b>
<b>Payroll taxes<sup>1</sup></b>	<b>0.0</b>	<b>0.7</b>	<b>1.1</b>	<b>0.0</b>	<b>0.1</b>	<b>0.4</b>
<b>Property taxes</b>	<b>8.9</b>	<b>4.3</b>	<b>5.3</b>	<b>1.5</b>	<b>0.8</b>	<b>1.8</b>
Recurrent taxes on immovable property	3.4	1.7	3.1	0.6	0.3	1.0
Recurrent taxes on net wealth	2.1	1.2	0.5	0.4	0.2	0.2
Taxes on financial and capital transactions	3.4	1.9	1.3	0.6	0.4	0.4
<b>Taxes on goods and services</b>	<b>44.8</b>	<b>50.8</b>	<b>32.5</b>	<b>7.7</b>	<b>9.9</b>	<b>11.0</b>
General consumption taxes	35.2	34.3	20.3	6.1	6.7	6.9
Specific consumption taxes	9.5	15.6	10.3	1.6	3.0	3.5
<b>Other taxes</b>	<b>6.3</b>	<b>1.2</b>	<b>0.6</b>	<b>1.1</b>	<b>0.2</b>	<b>0.2</b>
<b>Total</b>	<b>100.0</b>	<b>100.0</b>	<b>100.0</b>	<b>17.3</b>	<b>19.4</b>	<b>33.8</b>

1. The so-called "parafiscales" (SENA, ICBF, and CCF) are under social security contributions in the OECD database.

2. The breakdown of income taxes between corporate and personal income taxes is based on Jorratt (2010).

Source: OECD Revenue Statistics; Revenue Statistics in Latin America, OECD 2012; Jorratt (2010).



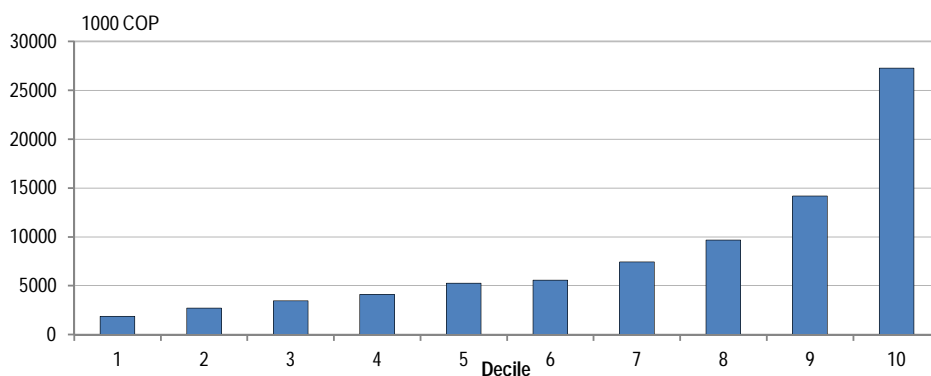
**The VAT is regressive despite large tax expenditures for basic consumption goods**

The VAT standard rate stands at 16%, only somewhat below the OECD average (18.7% in 2012). However, there are many reduced rates and exemptions. To alleviate the tax burden for low-income households, goods belonging to the family shopping basket are excluded from the VAT or taxed at 0%. Because the richest household quintile consumes over half of the exempted goods, the rich end up capturing a large share of this implicit subsidy (Figure 4). This is thus an inefficient way to protect the purchasing power of poor households. It is also expensive as the revenue foregone is estimated at 1.5% of GDP (Moller, 2012).

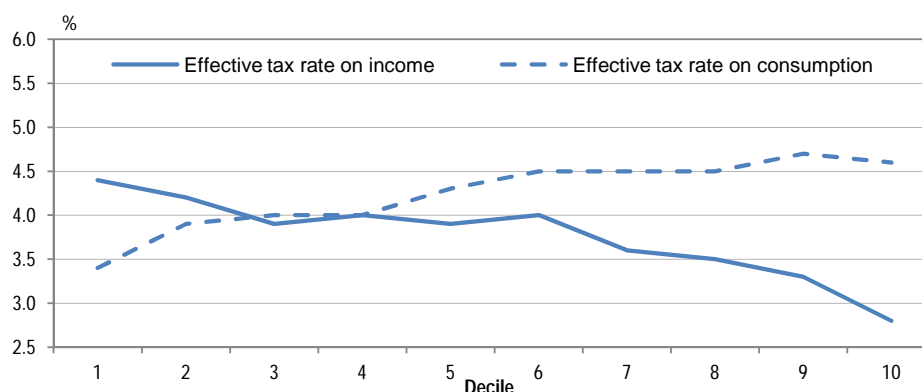
Such a complex VAT system further fosters tax evasion and informality, and compromises efficiency. Indeed, recent studies estimate VAT evasion in Colombia to be 23.5%, compared with 11% in Chile and 20% in Mexico (Gómez-Sabaini and Jiménez, 2011). Direct transfers to low-income households, depending solely on their socio-economic characteristics, would be better for both equity and efficiency purposes. However, designing an effective targeting scheme is not easy in practice. In addition, past reform proposals going in this direction have faced strong political opposition. The 2012 tax reform simplified the VAT regime and encouraged compliance by reducing the number of tax rates to three: 0%, 5%, and 16%.

Figure 4. **The rich benefit disproportionately from VAT relief**  
2006-07

Panel A. **Implicit subsidy associated with reduced rates and exemptions by income decile<sup>1</sup>**



Panel B. **VAT payment related to income and consumption by income decile**



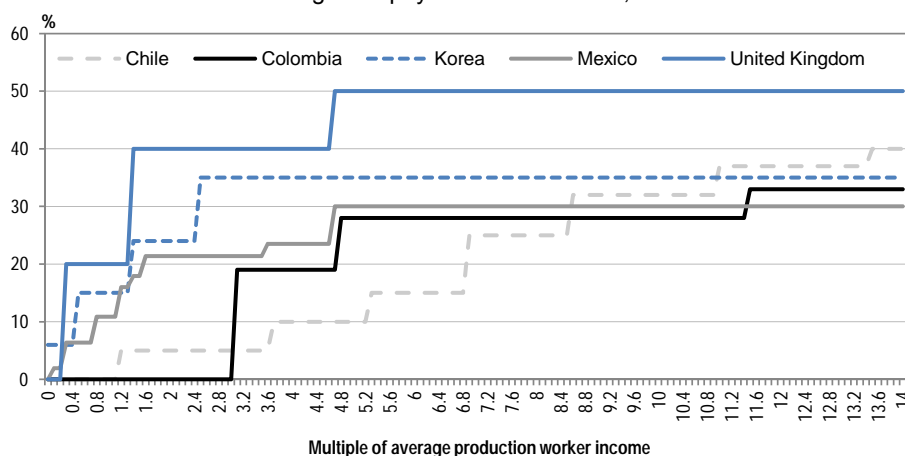
1. The implicit subsidy refers to products that are excluded and/or exempted from the VAT.

Source: Steiner and Cañas (2012); World Bank (2012).

### *The personal income tax embodies only weak progressivity*

The redistributive impact of the personal income tax (PIT) is small. The PIT contributes to an extremely small share of total revenues (7% compared with 25% in the OECD area). Tax receipts are low because the number of workers operating in the informal sector, who do not pay the income tax, is large. In addition, because the initial exempted bracket is large (Figure 5) and other tax reliefs are extremely generous, only half of those filing a return pay the income tax, *i.e.* less than 3% of the adult population. The progressivity of the tax is low because a wide range of tax expenditures benefit mainly high-income earners (Box 1).

Figure 5. **Statutory marginal personal income tax rates by income level**  
For a single tax payer without children, 2010<sup>1</sup>



Note: Only standard allowances in the form of a fixed amount are taken into account. Tax credits are not deducted.

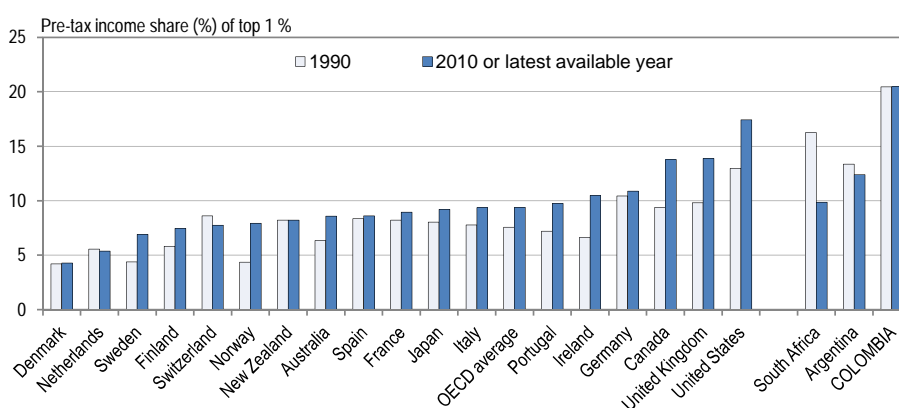
1. 2011 for Colombia.

Source: OECD Taxing Wages database; DANE.

### Box 1. The taxation of top incomes in Colombia and the OECD

The pre-tax income share of the top 1% in Colombia has remained stable in the last two decades while it was increasing in many OECD countries (Figure 6 and Hoeller, 2012, for a review). It is, however, extremely high by OECD standards.

Figure 6. **The top 1% captures a very large share of income in Colombia compared with OECD countries**

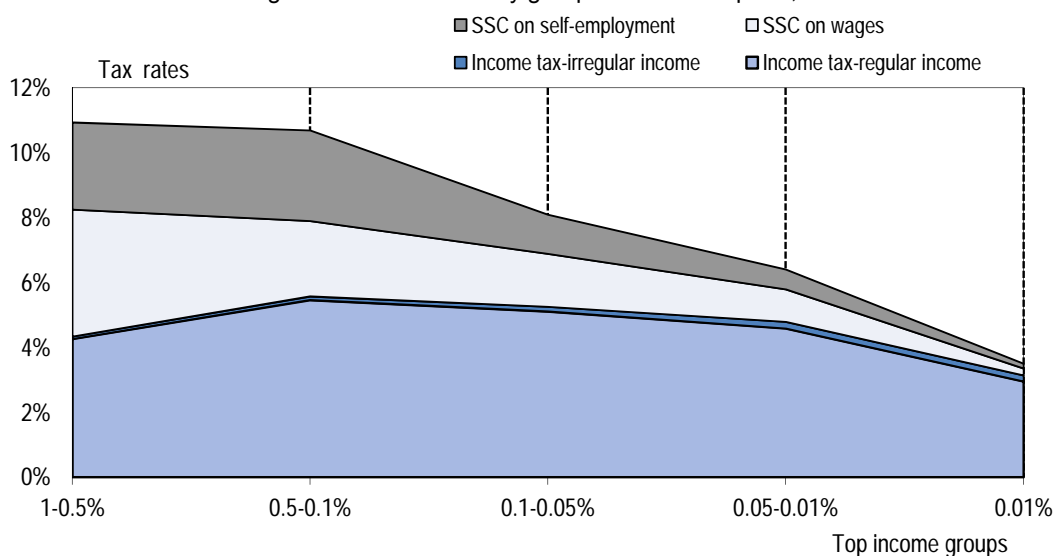


Notes: The OECD average is an unweighted average for the 18 OECD countries shown here. 1990 estimates for all countries except Colombia (1993), Switzerland (1991), and Germany (1992). Estimates exclude capital gains for Canada, Germany, Japan, Spain, Sweden, Switzerland, and the United States. For Portugal, estimates exclude most capital gains. For Italy, estimates exclude most capital gains and several components of capital income (such as interest income).

Sources: Alvaredo and Londoño (2013) for Colombia; and The World Top Incomes Database.

Personal income and payroll taxation are regressive at the top of the income distribution in Colombia (Figure 7). The personal income tax base is severely eroded by a large tax relief that benefit the rich disproportionately. Tax allowances (e.g. voluntary pension contributions, long-term savings to finance construction, dividends that have been taxed at the company level), deductions (e.g. mandatory and some voluntary healthcare contributions, mortgage interest payments for residential housing) and exemptions (e.g. 25% of wages under a threshold, most pension payouts) are so generous that less than 40% of the income of the top 1% is deemed taxable (Alvaredo and Londoño, forthcoming). This percentage decreases further with income – for the top 0.01% only 11% of their income is taxable. Payroll taxes are also regressive at the top because the contribution base for payroll taxes has a cap and mandatory healthcare and pension contributions only apply to earned income, which falls with rank. Thus, the lowest-ranking individuals end up paying higher effective rates than richest and both income and payroll taxes are trivial for the ultra-rich (Alvaredo and Londoño, 2013).

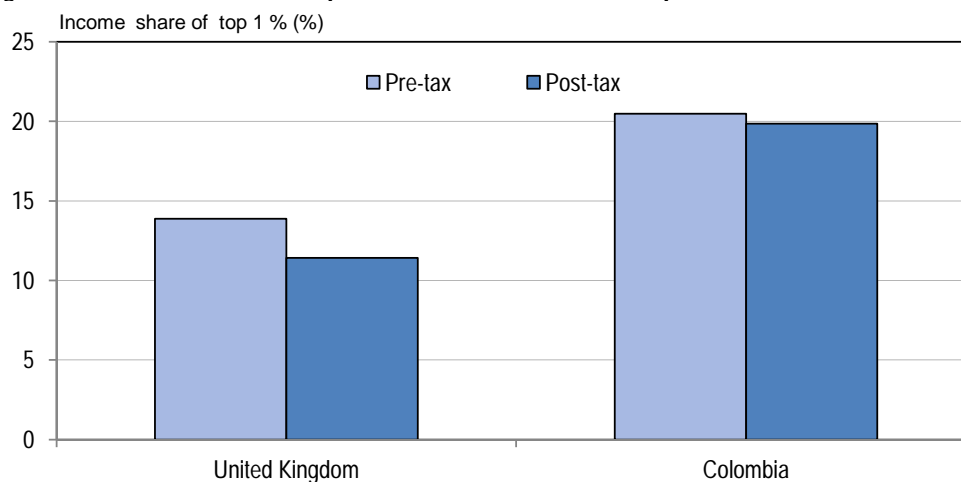
**Figure 7. Income tax and social security contributions are regressive at the top**  
Average effective tax rates by groups within the top 1%, 2010



Note: Social security contributions (SSCs) include employee health care and pension contributions. Irregular income refers to "occasional gains" following the Colombian tax code. It includes some capital gains, inheritances, gifts, lotteries, prizes and bets.

Source: Alvaredo and Londoño (2013) based on tax return data.

Given the lack of progressivity at the top, income taxation reduces income disparities in Colombia much less than in most OECD countries. Income taxes reduce the top 1% share by almost 18% in the United Kingdom, but by less than 5% in Colombia (Figure 8). The relatively small share of income taxes paid by top incomes can partly be attributed to the low taxation of capital income, which is concentrated at the top of the income distribution. Capital gains on the sale of residential properties and shares are subject to progressive taxation in Colombia – in contrast, capital gains on principal residences are exempt, sometimes subject to holding period restrictions or reinvestment in most OECD countries; capital gains on equities held for several years are not taxed in about a third of OECD countries; and in many countries, short-term gains are subject to flat taxes (Price and Dang, 2011). In Colombia, however, capital gains benefit from generous tax allowances. In addition, to avoid double taxation, dividends are untaxed for shareholders if distributed profits have been taxed at the company level. Inheritances and gifts are subject to progressive tax rates but tax allowances are so large that revenue from these two taxes is negligible (less than 0.02% of GDP).

Figure 8. **The redistributive impact of income taxation for top incomes is low in Colombia**

Notes: Latest year available is 2009 for the United Kingdom and 2010 for Colombia.

Sources: Londoño (2012) for Colombia; and Atkinson (2007) for United Kingdom, available in the World Top Incomes Database.

The very generous tax reliefs combined with pervasive tax avoidance and evasion (estimated at 30% by Clavijo and Vera, 2010) likely play an important role in explaining the low taxation of top incomes. Factors spurring tax avoidance and evasion include: *i)* a high jump in statutory tax rates as income increases above the exempted level (the first marginal rate, at 19%, is higher than the 13.7% OECD average); *ii)* large tax expenditures that generate perverse incentives (one illustration is the preferential tax regime for small companies, which has been exploited by high-income individuals); and *iii)* the high complexity of the tax code that creates tax avoidance opportunities which are likely to be exploited most by well-advised, richer individuals. In spite of this, regular estimates of personal income tax evasion are lacking in Colombia.

The personal income tax has also penalised the self-employed, many of whom are poor. The law has hitherto stated that if an individual is not required to file a PIT return because gross income is lower than the filing threshold, then the withholding tax operates as a definitive tax. The majority of the 3.5 million self-employed are not allowed to file a tax return and get a tax refund. Until recently, the self-employed were penalised because tax was withheld at higher rates than for employees, reinforcing income inequality. Moller (2012) estimated that this system raised the Gini coefficient by 1.9 points. The tax code has been adjusted in 2010 and 2011 to reduce this problem. However, horizontal inequality remained an issue given the volatility of self-employed income. The 2012 reform (Box 2) aims at correcting this by allowing voluntary tax filing for those not required by law to do so, which enables them to claim deductions.

#### Box 2. Key features of the 2012 tax reform

The tax reform adopted by the Parliament in December 2012 has three main objectives: raising the redistributive impact of the personal income tax, promoting formal employment and reducing tax avoidance and evasion. It is supposed to be revenue-neutral in the short-term but may result in an increase in revenue over the medium and long run by reducing tax-related distortions and promoting formalisation and economic growth.

**The personal income tax will be simplified and made progressive.** Voluntary filing will be allowed, benefiting low-income self-employees who were hitherto penalised with high withholding rates and were unable to claim reimbursements due to high filing thresholds. An alternative minimum income tax, “IMAN”, will be implemented. It ensures effective progressivity at the top of the distribution. The poor and middle classes – *i.e.* those earning less than COP 3.46 million per month after employee and employer social security contributions - could face an effective tax rate of 0%, down from over 6%. This would exempt 96% of the population from contributing to the personal income tax. For the remaining 4% of the population, the effective rate will be progressive, with a maximum rate of around 15% for the richest.

**Non-wage labour costs will be reduced.** Some *parafiscales* – those financing the Childcare Institute ICBF (2%) and Training Institute SENA (3%) – and the employers' health care contributions (8.5%) will be abolished starting July 2013 for firms employing workers with monthly wages under 10 times the monthly minimum wage. SENA, ICBF, and the healthcare system will be funded through the corporate income “contribution to equity” levied at a rate of 8%.

**The corporate income tax base will be broadened.** The reform reduces the standard corporate income tax rate from 33% to 25%, while creating an additional 8% tax (temporarily set to 9% for 2013, 2014, and 2015) called “contribution to equity” applied on a broader tax base – taxable income *plus* some exemptions and deductions (e.g. investment spending on fixed assets). This new tax would fall mainly on mining and construction companies, as well as banks, with proceeds earmarked to finance ICBF, SENA and health care. To secure resources to finance SENA, ICBF and health care, the government has committed to maintain the 2013 budget, with a 2 percentage points increase in real terms per year.

**The VAT will be simplified.** The number of tax rates will be cut from seven to three to encourage compliance and reduce tax evasion.

A series of laws to **reduce evasion and avoidance** will be put in place. In particular, the tax agency will be able to initiate a tax audit before the tax judiciary system has proved that there was a tax fraud. Moreover, capital gains, inheritances and lotteries will be taxed at a flat rate (10%, 10% and 20%, respectively), instead of a higher and progressive rate.

**Expected results of the reform:** With income tax progressivity due to IMAN, the reform could reduce the Gini coefficient from 0.573 to 0.554 according to government estimates. By reducing social contribution rates by 13.5 percentage points, the reform aims at creating between 400 000 and 1 million formal jobs.

The 2012 tax reform will increase the redistributive impact of the tax system through two main channels. *First*, the creation of a progressive alternative minimum income tax (IMAN) will *de facto* cap tax expenditures which have benefited the rich most (e.g. tax relief for housing investment or pensions). *Second*, efforts to raise tax compliance would increase the amount of taxes effectively paid by the well-off. However, the proposal is a second-best approach since it will increase administrative costs by requiring multiple tax liability calculations (e.g. the traditional calculation, IMAN, and a simplified IMAS for employers with low income). Indeed, the first-best approach would be to reconsider the underlying tax expenditures (e.g. the 25% wage exemption, pension allowances). Moreover, the potential redistributive impact remains limited as the tax is expected to be levied only on the richest 4% of the population. Thus, the overall tax take, as a share of GDP, will remain extremely small (the reform is designed to be revenue-neutral in the short term). To reinforce the progressivity of the personal income tax and promote formalisation, Colombia could consider introducing an earned income tax credit (Box 3).

### Box 3. The Earned Income Tax Credit: a tool to promote employment and reduce poverty in Colombia?

Many OECD countries have adopted government-managed income support programmes like the earned income tax credit (EITC). The EITC aims at promoting employment while reducing poverty incidence using the tax system as a redistributive tool. The evidence for existing in-work benefits points at significantly positive employment effects among those primarily targeted by the payment. Overall participation effects are also found to be positive. OECD experience suggests that an EITC is more effective than a minimum wage in reducing poverty and encourages employment in contrast to minimum wages (Pearson and Scarpetta, 2000). The probability of EITC positive effects is highest in countries where the earnings dispersion is wide, or tax rates and benefits are low (Immervoll and Pearson, 2009). As some of these conditions hold in Colombia, an EITC may be a useful tool to reduce inequality and poverty.

The 2012 tax reform in Colombia abolishes the income tax for individuals receiving less than COP 3.4 million per month, independent of their source of income (e.g. wage, self-employment) and introducing voluntary filing. This helps in correcting the regressivity of the personal income tax, which particularly affects the self-employed. A step further in this direction would be to introduce a refundable EITC. However, an EITC may not be a panacea. The tax credit is often based on individual income, but workers with relatively low wages may live in high-income households. Experience in high-informality countries like Mexico suggests that more thorough assessments of the extent to which this tax credit reduces in-work poverty and promotes formal employment are needed (OECD, 2011b). In 2009, Chile introduced an in-work benefit (*subsidio al empleo joven*) for low-wage workers under 25 whose family belongs to the 40% poorest in the country. The subsidy can reach up to 20% of wage income for those workers with the lowest wages and is gradually withdrawn with rising wages, with a third of the subsidy going to the employer and two thirds to the employee (OECD, 2012b). A recent evaluation suggests that participation and employment of those targeted by this scheme has been boosted (Centro de Microdatos, 2012).

***Property taxes account for a relatively large share of revenue but are not highly redistributive***

Property taxes have increased and currently account for a large share of total revenue (8.7% in 2009, compared with 5.5% in the OECD area). The main components are: a tax on financial transactions, a wealth tax paid mostly by companies, an inheritance tax that does not raise much revenue, and a real estate tax (*predial*) which is the main source of local government revenue.

Various factors limit the progressivity and efficiency of the real estate tax. While the tax rates are set by municipal councils and the tax is collected by local authorities, the cadastre and appraisals generally fall under the responsibility of a national office (IGAC), although self-assessment is used in some large municipalities (*e.g.* Bogotá and Barranquilla). The cadastre is unreliable and out of date. This significantly compromises progressivity and efficiency. Indeed, past experience in Colombia, as in OECD countries, suggests that the most expensive properties are also the ones assessed at the most outdated property values. Outdated assessments of properties reduce tax revenues significantly; it is estimated that updating generated an additional tax revenue of USD 123 million in 2010. Colombia has recently made efforts to update the cadastre. A 2011 Law requires each municipality to update the cadastre every five years. In 2012, 74% of municipalities did so. To redress horizontal and vertical inequity in real estate taxes, the government should ensure that the updating of the cadastre proceeds swiftly.

Because real estate taxes tend to be regressive, even with up-to-date registers, some countries have granted relief to low-income households so as to introduce some progressivity (Joumard *et al.*, 2012). This, however, may come at a very high cost for municipalities in deprived areas, which would need to be compensated, *e.g.* through central government transfers. A priority should thus be to ensure more progressivity from other property taxes, in particular inheritance taxes.

The progressivity of the wealth tax has been increased in 2010, with the reduction in the filing thresholds for both companies and individuals from COP 3 to 1 billion. Individuals with a taxable net wealth from COP 1 to 2 billion are subject to a 1% rate and those between COP 2 and 3 billion face a tax rate of 1.4%. Moreover, marginal tax rates have been temporarily increased by 25% for taxpayers with wealth above COP 3 billion to finance humanitarian aid after the extreme 2010 winter conditions. Those with COP 3 to 5 billion now face a marginal tax rate of 3% and those above COP 5 billion a top marginal tax rate of 6%. As a result, revenues increased from 0.4% of GDP in 2010 to 0.7% in 2011. However, the revenue collected by the wealth tax could be further increased by reducing the tax allowance for primary houses (COP 319.2 million; or USD 178 800 in 2011).

The inheritance tax is progressive but does not raise a large amount of revenue. Inheritance taxes have the advantage of generating less distortion than annual wealth taxes and of being very difficult to avoid. In Colombia, progressivity is achieved through a tax-free allowance and increasing marginal rates. However, the revenue-raising power is dampened by the generous tax allowance, coupled with the large initial bracket taxed at 0% (US\$ 17 415 and 15 820 for spouses and descendants, respectively, in 2012, *i.e.* 8.8 times the annual minimum wage). As a result, the tax on “occasional gains” (*i.e.* on some capital gains, inheritances, gifts and bets) raised less than 0.02% of GDP in 2010 while these “occasional gains” amounted to more than 2% of GDP. This suggests that there is scope to increase inheritance tax revenue. The reform proposal, however, envisages introducing a flat tax rate of 10% on inheritances to dissuade individuals from evading this tax.

**Cash transfers: some are redistributive but pensions account for the bulk and are regressive*****Pension coverage is low, leaving many elderly in poverty***

The pension system raises serious equity issues. The contributory pension system accounts for the bulk of total transfers to households and absorbs a large share of central government spending (more than 18% of central government spending in 2011). Yet, its coverage is low, given the pervasive distortions in the labour market (Joumard and Londoño, 2013). Moreover, the absence of a first tier minimum pension leaves many elderly in poverty. Only 30% of the retirement age population received a pension in 2012, compared with 80 to 90% in countries such as Argentina, Brazil, Chile and Uruguay. To qualify, workers have to contribute long enough in the formal sector and have earnings at least at the minimum wage. Thus, only the most affluent are entitled to a pension.

As the present value of benefits is well above contributions (Santamaría *et al.*, 2010), the public pension system is extremely generous for the happy few. By using the last 10 years of earnings to calculate pension rights, the system also tends to benefit those with steep earnings profiles, who are often the best educated and high-income individuals. In contrast, some 20 OECD countries use lifetime earnings and in Canada, the Czech Republic and the United States, the pension is based on 30-35 years of earnings (OECD, 2011a). Furthermore, the tax regime for pensions is extraordinarily generous by OECD standards. Pension contributions are deductible from the income tax base and benefits are largely tax exempt. More than 80% of the pensions go to the highest income quintile while the 2 poorest quintiles receive less than 2% (Santamaría *et al.*, 2010). Overall, the pension system is estimated to raise the Gini coefficient by 1.6 percentage points (Moller, 2012). Despite efforts to correct this situation, the 2012 tax reform did not reduce the extremely generous tax allowance for pension payouts.

Social assistance programmes to protect the elderly poor are not very generous and the take-up is low. Overall, their budget amounted to only 0.1% of GDP in 2011. The Social Protection Programme for the elderly (PPSAM) targets the poor (Sisbén 1 and 2) above 65 years old who are entitled to a monthly transfer of COP 62 500 (about US\$ 35). However, only 38% out of the 2.2 million elderly poor actually receive the benefit, reflecting budget constraints. Access is prioritised by age and there is a waiting list: when a recipient dies, the next person on the list moves onto the programme. The government aims at increasing coverage gradually over the coming year. In addition, 388 000 elderly poor received food assistance in 2011. Social assistance programmes to protect the elderly poor should be made more generous. Their take-up rate should also be increased, as currently planned by the government for the coming years.

To better protect the elderly poor, the government is considering implementing the so-called *beneficios económicos periódicos* (BEPS) which are expected to benefit 6 million elderly poor over the next 20 years. The BEPS are individual retirement accounts that target those working in the informal sector, those with irregular wages or with wages below the minimum wage, and those who have not contributed enough to the contributory regime to be entitled to a pension (that, by law, must be at least equal to the minimum wage). The BEPS specifically targets low-income households: only those in the so-called Sisbén 1 to 3 can be covered by the BEPS. The government's top up rate on individuals' voluntary contributions to the BEPS would be 20%. The maximum level of subsidised savings is set at COP 885 000 per year (*i.e.* US\$ 485) and the benefit at retirement cannot exceed 85% of the minimum wage. The BEPS will help broaden pension coverage and should be implemented swiftly.

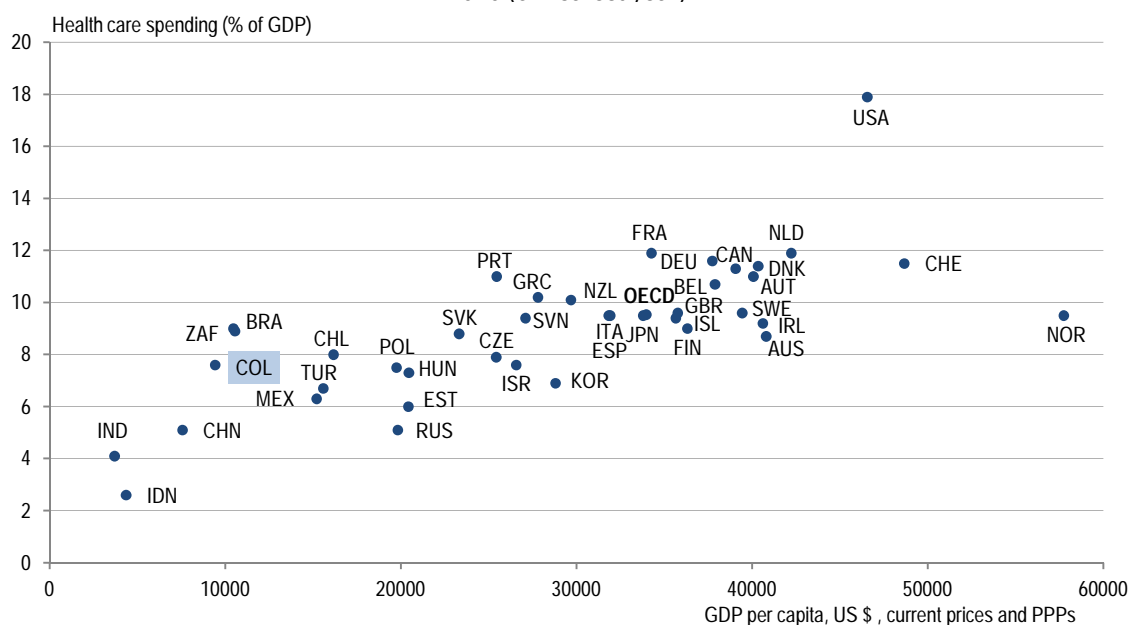
Increasing pension coverage would also require gradually extending the contributory regime. To ensure future sustainability, the existing system should be reformed as a prerequisite. Indeed, transfers to the pay-as-you-go (PAYG) pension system, at 3.3% of GDP in 2011 (excluding the costs of tax expenditures associated with the pension system), are not very high by OECD standards. Still, they

amounted to more than 18% of central government spending in 2011. Expanding the pension system will involve significant budgetary outlays and should be undertaken in connection with parametric reforms. The legal retirement age is very low by international standards, at 55 years for women and 60 years for men. The 1993 pension reform will raise them by 2 years from 2014, which will still leave them low. The pension age should thus be raised further, and adjusted in the future to reflect changes in life expectancy. The replacement rate – between 65 and 85% of the average wage over the previous 10 year period, compared with 57% of lifetime earnings for the OECD average (OECD, 2011a) – is also high. It may need to be reduced as the coverage of pensions is extended. In addition, the indexation of pensions to the minimum wage is generous and, judging by OECD experience, will probably have to be changed to a system based at least in part on price inflation. Finally, the requirement for pensions to be at least equal to the minimum wage will need to be reconsidered.

***Health care coverage has been widely extended but the system could be more efficient and create less incentives to remain informal***

Progress towards an almost universal health care coverage has been achieved gradually since the 1993 health reform. Over 90% of the population was covered in 2011 - a commendable move in a country with large income inequality. The benefit basket has also gradually been made more generous for the poor. This partly explains why health care spending is high compared with countries with a similar income level (Figure 8). Health care is mostly publicly financed, with public spending on health care absorbing a very high share of the general government budget compared with most OECD countries (Figure 9).

Figure 9. **Health care spending is relatively high for the income level**  
2010 (or nearest year)

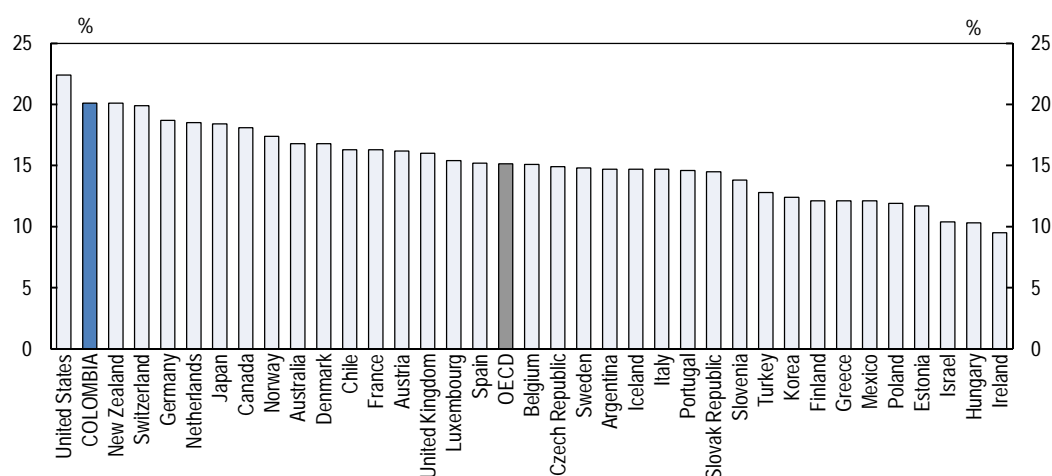


Source: OECD National Accounts database; World Bank database; OECD Health Data; World Health Organisation database.



Figure 10. **Health care absorbs a large share of general government spending**

General government expenditure on health as a share of total government expenditure, 2010 (or nearest year)



Source: World Health Organisation.

Health care financing is designed to be redistributive but creates adverse incentives to remain informal. Formal sector employees pay social contributions, and are thus part of the “contributory regime”, which give them and their direct dependents (spouse, children or one parent) access to a range of health services and drugs known as the *Plan Obligatorio de Salud* (POS). The “subsidised regime”, financed by a 1% transfer from the contributory regime and local and central government funds, gives poor households (*i.e.* Sisbén 1 and 2) free access to a package of services and drugs known as the *Plan Obligatorio de Salud Subsidiado* (POSS). The financing gap is large and growing, reflecting the expansion of the subsidised (as opposed to contributory) health coverage for the poor and the convergence in the benefits basket. Imperfections in the targeting system (Sisbén) also play a role. In 2008, 32% of income quintile 4 and 13% of quintile 5 were affiliated to the subsidised regime (Nunez, 2009). And only 47% of the total population was covered by the contributory regime in 2012. The new Sisbén model introduced in 2012 is expected to reduce this problem. Still, the dual system, by raising labour costs in the formal sector, will continue to encourage informality which is an important factor contributing to income inequality (Joumard and Londoño, 2013).

Improving the organisation of the health care system would raise spending efficiency and improve health care coverage in remote areas. Colombia's health care system relies on more than 99 private and public insurers. These insurance companies buy services from providers, but vertical integration between insurers and providers is frequent – it was estimated at 50% by Clavijo (2009) but may have declined since then. This fragmented silo approach reduces competitive pressures at the provider level. It also makes it difficult to use spare resources efficiently and exploit economies of scale.

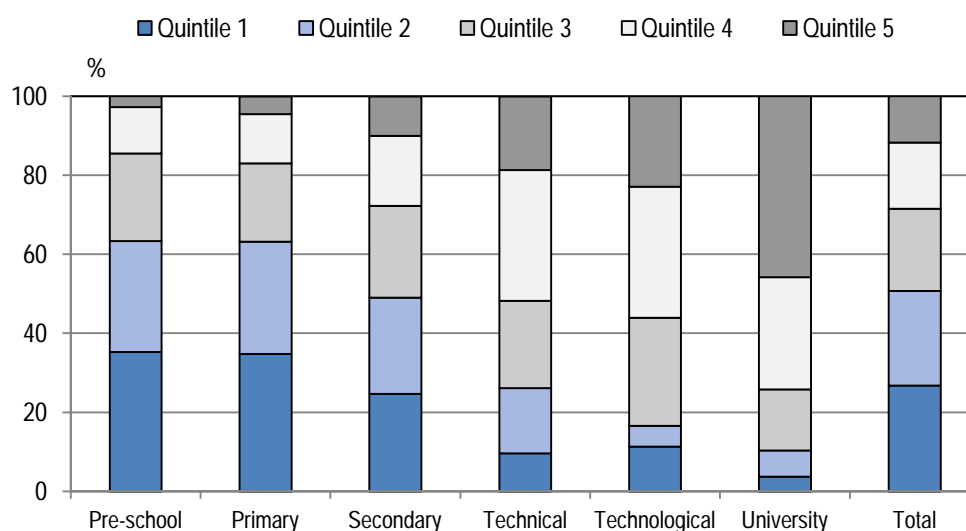
In OECD countries, insurance fragmentation is often accompanied by large administrative costs and it reduces payers' monopsonist power, thus resulting in higher health care prices (Joumard *et al.*, 2010). This may also be the case in Colombia although data are lacking. In Colombia, insurance fragmentation has also been accompanied by corruption (Bernal *et al.*, 2012; Clavijo, 2011). Raising value for money in the health care system would require reducing the fragmentation of the insurance system and the degree of vertical integration between insurers and providers. Consolidating the health insurance funds would further bolster their bargaining power in setting provider prices and would cut administrative costs.

Defining priorities better, and in particular the health benefits covered, would also help in increasing public spending effectiveness. Individuals have increasingly petitioned the constitutional court to grant them access to specific health care services or because waiting times have increased - a process known as *tutela* (Bernal *et al.*, 2012; Yepes *et al.*, 2010). The number of successful *tutelas* reached more than 141 000 in 2008, an increasingly recurrent practice dubbed *tutelitis* by Colombians. To improve prioritisation and the visibility of health care rights and costs, the government should revise and better define the basic package of care – no significant revision has been made since 1993. The government's plan to move in this direction is welcome.

### **Better targeting educational spending on the poor**

Public spending on education is progressive: the poorest quintile receives 27% of the subsidy, while the richest quintile receives only 12% (Figure 11). Pre-school and primary education expenditure is particularly well targeted to the poor. In contrast, university-level education is captured by the rich: the highest income quintile receives 46% of total public spending, while the bottom quintile receives less than 4%.

Figure 11. **The rich benefit most from public spending on post-secondary education**



*Note:* This graph reveals that the rich benefit most from public spending on tertiary education: the richest quintile captures 46% of total public spending at the university level, while the poorest quintile accounts for only 4%.

*Source:* Núñez (2009) based on household survey for 2008.

Colombia has made efforts to improve equity in access to tertiary education. The student support system (ICETEX) provides students with loans, which include a grant element whose amount depends on the beneficiaries' income level. The number of loans has almost tripled between 2003 and 2011. However, because of the increase in the enrolment rate, a lower proportion of students receive loans (OECD, 2012a). In addition, ICETEX is not targeting all its resources on those most in need, because of serious flaws in the way income is assessed through the *Estratos* system (Box 4).

#### Box 4. Targeting social programmes via household and housing characteristics - Sisbén and Estratos

Two registers are used in Colombia to identify social benefit recipients: *i)* the *Sisbén* focuses on characteristics of people and is used to assess eligibility for cash transfers and in-kind services (health in particular); *ii)* the *Estratos* focuses on housing characteristics and is used mainly to determine eligibility to subsidised utility prices.

#### **Sisbén (Sistema de Selección de Beneficiarios para Programas Sociales – system to identify eligibility for social programmes)**

Sisbén is a system to identify eligibility for social transfers. It was created in 1994 to assess households' eligibility for the subsidised health care system. In 2010, 8 institutions and 31 social programmes were using the Sisbén score as eligibility criteria (including *Familias en Acción* and SENA). Sisbén aims at assessing households' quality of life, based on interviews (29 million people are covered) with questions along 5 main dimensions (health status; education; housing and access to public services; individual vulnerability (mainly age and disability); and social vulnerability (environmental and public health risks, security conditions). On the basis of their answers, households are grouped into one of the six Sisbén levels – level 1 is the most deprived group; levels 1 and 2 are entitled to the subsidised health system.

#### **The Estratos**

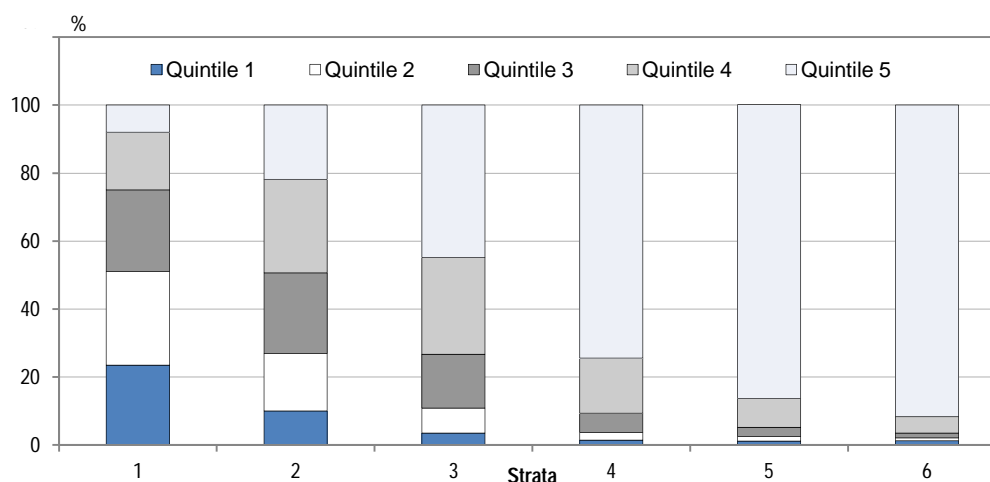
*Estratos* (strata) are socio-economic categories created to price utility services (in particular water, electricity, gas and telephone), but they have since been used to target other programmes (e.g. student loans, ICETEX). This system classifies each individual's housing into six strata according to physical characteristics (e.g. type of garage, facade conditions, type of roof, etc.), urban environment (e.g. road conditions, presence of pavement, etc.), and town-planning (e.g. location), strata 1 comprising the poorest group.

#### **Limitations of these instruments**

These two systems suffer from a number of drawbacks, including that they are not integrated since having two systems may duplicate costs and create inconsistencies. In addition:

- Both systems suffer from high inclusion and exclusion errors. Camacho *et al.* (2010) reported that almost one fifth of the poor failed to be included in Sisbén 1 and 2 and one fourth of those in Sisbén 1 and 2 were not poor. The latter may partly reflect the fact that Sisbén is managed by the mayors and has given rise to clientelism. Indeed, Camacho and Conover (2011) report an increase in the number of people covered just before elections and/or manipulation of answers to ensure that voters qualify for social programmes with a concentration of scores just below the eligibility criteria thresholds. The new statistical method used from 2012 (3<sup>rd</sup> Sisbén version) is expected to reduce this problem. For *Estratos*, studies by both the World Bank and the government suggest that this classification system no longer aligns well with the distribution of income (Figure 12). Some 90% of Colombians are in strata 1, 2 and 3. Moreover, because any house in a given area can be classified according to the mean for that neighbourhood, inaccuracies are inherent as many households living in these poor average strata belong to the upper income quintiles. As an illustration, nearly 50% of those in the second-poorest strata are in the two richest income quintiles, up from 31% in 2003. Anecdotal evidence suggests that measurement has been altered to widen access to subsidies for political purposes. This calls for a more systematic cross-checking of information, e.g. by using a unique identification number such as the *cédula* for all social and tax purposes.
- They are slow to reflect changes in a household's material conditions. The Sisbén is updated every 3 years, which may not be often enough to reflect changes in the personal situation (e.g. loss of job). To avoid losing access to some social programmes (e.g. subsidised health care), people may prefer staying in the informal sector. The 2010 Formalisation and Job Creation Law partly addresses this: individuals can now keep receiving Sisbén benefits (e.g. subsidised health care) for two years after they have reported being employed in the formal sector.
- They often create abrupt changes in benefit payments for households with slightly different scores – e.g. one household is covered fully, or not covered at all, by the subsidised health system, if its Sisbén score changes only slightly.

Figure 12. Relationship between strata and income deciles  
2010



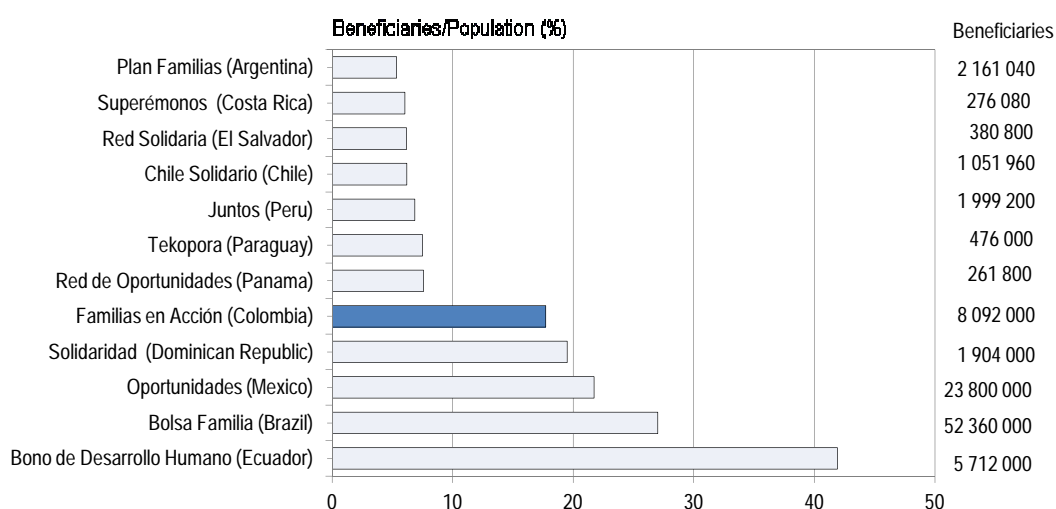
Note: This figure shows how the strata relate to income quintiles. For instance, of those living in stratum 2, 28% are in the fourth income quintile, and 22% are in upper income.

Source: Colombia's National Statistics Department (DANE), 2010 Household Survey.

### Conditional cash transfers have helped to reduce extreme poverty and promote education and health

Conditional cash transfers have been instrumental in supporting families living in extreme poverty, but they remain limited in size. *Familias en Acción* is the main conditional cash transfer programme. Created in 2001 to protect the rural poor during the severe crisis of the late 1990s, it has since been expanded to urban areas and now benefits poor, displaced and indigenous households. It covers 98% of the municipalities and benefits roughly a fifth of the population – a higher proportion than many similar conditional cash transfer programmes in Latin America (Figure 13) – for a fiscal cost amounting to 0.2% of GDP in 2011. The average benefit amounted to about COP 110 000 per household every two months, which annually represents about 5% of GDP per capita. It is paid to mothers with children aged below 18, conditional on school attendance and regular medical check-ups.

Figure 13. Coverage of selected conditional cash transfers in Latin American countries



Source: Latin American Economic Outlook 2012: Transforming the State for Development, OECD.

*Familias en Acción* has had positive effects on school enrolment and attendance, especially in rural areas and among 12 to 17-year-olds (Attanasio *et al.*, 2005). Its impact on cognitive achievement and graduation rates, however, is less clear (García and Hill, 2010; Báez and Camacho, 2011). To improve incentives, the government launched pilot programmes making transfers conditional on graduation and tertiary enrolment, with positive impacts on attendance and enrolment at secondary and tertiary levels (Barrera *et al.*, 2011). However, the sluggish response in the quantity and quality of educational resources may also partly explain the mixed educational results. Indeed, the implementation of the programme has resulted in a higher student to teacher ratio and school infrastructure has also lagged behind (Benson, 2012).

*Familias en Acción* has also had positive effects on health and nutritional status, especially among younger children (Attanasio *et al.*, 2005). More preventive health care visits, but also the increase in household income leading to greater spending on food, child wardrobe and schooling (Attanasio and Mesnard, 2006) may have played a role. However, Forde *et al.* (2011) find that obesity risk increases among mothers receiving the cash transfer, calling for interventions to help households adopt a healthier diet and more physical activity. Other indirect benefits of conditional cash transfers are: financial inclusion with electronic cash transfers paid through a saving account (Maldonado and Tejerina, 2010), reduced teenage pregnancy (Cortés *et al.*, 2010), and lower criminality (Camacho *et al.*, 2012). Still, improving the targeting of these conditional transfers is important to maximize the benefits: only 62% of the poorest households identified as Sisbén 1 were in the programme in 2012, and some poor households are not eligible, reflecting flaws in the targeting system (see Box 4).

#### ***The system of cross-subsidised prices for utilities suffers from serious flaws***

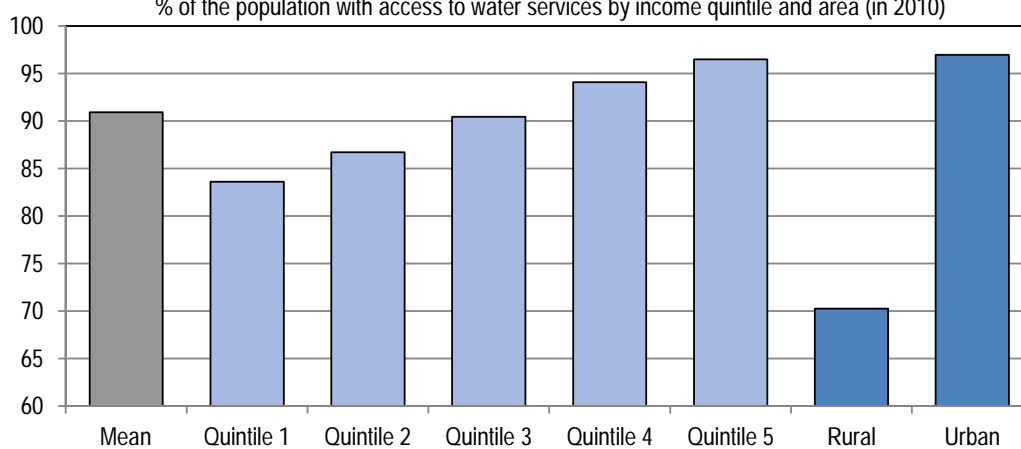
A system of cross-subsidised prices for utilities (electricity and gas, water and telecommunication) aims at keeping prices low for those in need. Households in *estratos* 1, 2 and 3 receive subsidies on their utility bills (up to 50, 40, and 15%, respectively). Those in *estrato* 4 pay the standard rate, and those in *estratos* 5 and 6 pay a premium of up to 20% which partly finances the subsidies to the lower *estratos*.

The redistributive impact of such cross-subsidies is in practice low. Flaws in the targeting system are a major limitation (see Box 4). The system is increasingly unbalanced, as the share of households paying the surcharge is low and has declined steadily (3.5% in 2008, down from 5.7% in 1997 according to Parra, 2011), thus requiring the central government and municipalities to step in and subsidise the consumption of energy, water and telecommunication. The central government's contribution for the electricity sector amounted to close to 0.1% of GDP in 2011. By reducing the price of energy and water use, these subsidies may be detrimental to the environment. In addition, although the coverage for water, electricity and other public utilities has improved dramatically over the past decades, remote areas remain under-serviced (Figure 14). Households with no access to public services, i.e. in most cases the poorest, are *de facto* excluded from the subsidy. The lack of access to water and sewage disposal is also an important factor contributing to multi-dimensional poverty in rural areas. For those connected to the system, the reduction in utility prices tends to be reflected in higher housing prices (Medina and Morales 2007), thus reducing the benefit of the subsidy on poor households.

**Figure 14. The rich benefit most from the water subsidy**

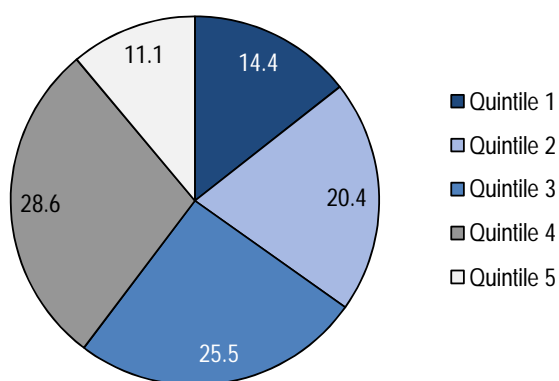
**Panel A. The poor and those living in rural areas have less access to water**

% of the population with access to water services by income quintile and area (in 2010)



**Panel B. The water subsidy is largely captured by the rich**

% of the water subsidy captured by income quintile (in 2010)



Source: SEDLAC (CEDLAS and The World Bank) using household data from 2010; Núñez (2009) based on household survey data from 2008.

#### Box 5. Policy recommendations to improve the redistributive impact of the tax and transfer system

The government has recently announced a series of reforms to improve the redistributive impact of the tax and transfer system. The planned introduction of a progressive alternative income tax (IMAN) and subsidised retirement savings plans (BEPS) for those who are not covered by the pension system are welcome initiatives. More ambitious reforms should be considered, however, to increase the redistributive impact of the tax and transfer system. This would require in particular better targeting social support programmes, revisiting the regressive nature of contributory pensions and enlarging social programmes for those not employed and/or suffering from poverty.

##### **Towards higher and more progressive taxes**

- Initiate a new tax reform that expands revenues in the medium run so as to fund social programmes, improves equity and enforceability. This would require: broadening the VAT by narrowing exceptions and limiting the use of low rates; cutting tax expenditures for the personal income tax (in particular the large 25% income tax allowance and tax relief for housing investment and pensions). Inheritance and real estate taxes should also be raised, and the land and real estate register be updated regularly. If the tax cuts for inheritances imposed by the 2012 tax reform do not result in better compliance, measures should be taken to raise inheritance tax payments, including reducing the generous tax allowances and introducing new rates to enhance progressivity of the tax schedule.
- Simplify the tax code by reducing loopholes (including by better controlling the simplified SAS system for individual entrepreneurs) and encourage both filing and tax compliance. Pursue efforts to fight against tax avoidance and evasion.
- VAT expenditures (reduced rates and exemptions) on goods and services included in the basic household consumption basket should be replaced by a means-tested refund, or transfers targeted to those most in need to improve the cost-effectiveness of redistributive policies.

##### **Towards more redistributive cash transfers**

- Make the pension system less regressive and expand its coverage. The regressive nature of the contributory pension system should be tackled by reconsidering the restrictive eligibility criteria (*i.e.* a long enough contribution period at, or above, the minimum wage) and by lengthening the reference earnings period to calculate pension rights. The pension age should be raised to match changes in life expectancy.
- Study options for increasing the minimum income support for the elderly poor. The individual retirement accounts targeted on the poor (BEPS) should be implemented swiftly. In addition, social assistance programmes should be made more generous and measures should be taken to increase their take-up rate.
- Better target support to those in need with conditional cash transfers. Ensure that targeting systems (the so-called *sisbén* and *estrato* systems) for social policy are up-to-date and reflect actual needs. The cross-checking of information on needs, social transfers and taxes could be improved by using a unique identification number (*e.g.* the *cédula*). If targeting systems cannot be updated swiftly, alternative insurance mechanisms that allow individuals to cope with temporary shocks and that smooth withdrawal rates for social benefits may be needed.
- Make the cash transfer *Familias en Acción* conditional on educational achievement and not only school attendance while aligning the quantity and quality of educational resources with increases in educational demand.
- Expand support to those in need to compensate for the phasing out of reduced VAT rates and exemptions as well as the price subsidies for water and electricity.

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