

Distributional Effects of Colombia's 2012 Tax Reform: Lessons from a DPL and PSIA grants

Carlos Rodríguez-Castelán (POV GP)
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ANALYSIS (PSIA)



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DITEx
Distributional Impact of
Taxes and Expenditures

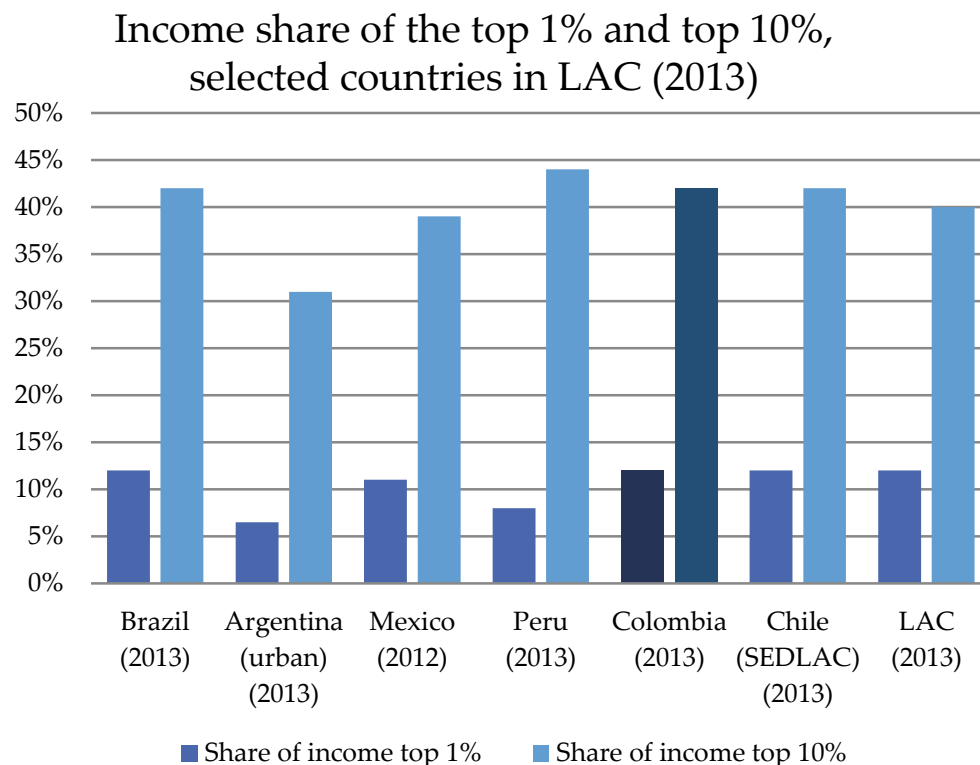
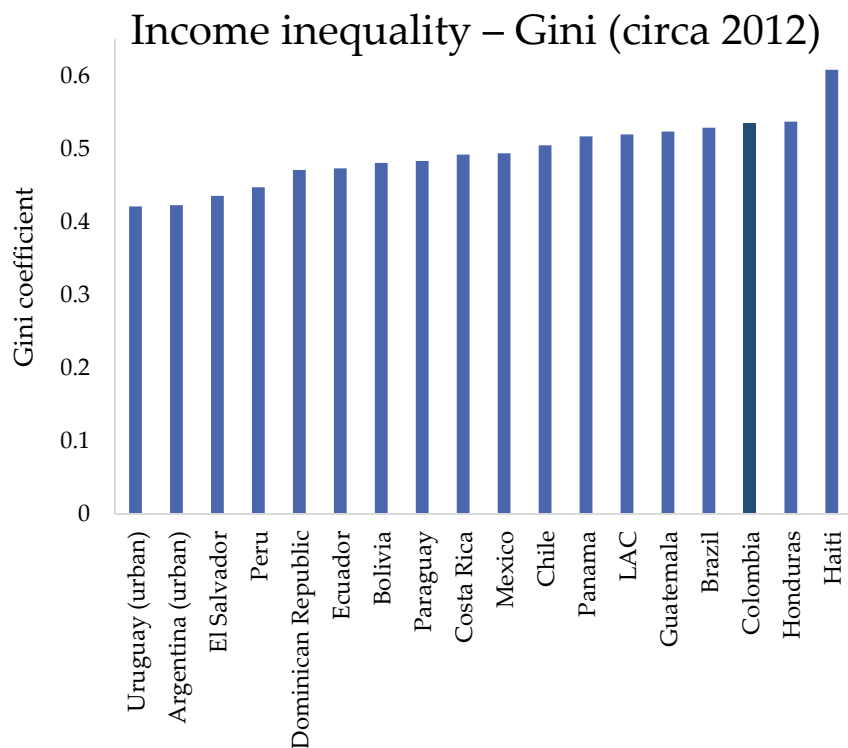
Outline

1. Country context
2. Objectives of the 2012 Tax Reform
3. WB engagement
4. The PSIA: Context and main outputs
5. Main findings on the distributional effects of the Reform
6. What is next?

Source: National Agency for Infrastructure (ANI)

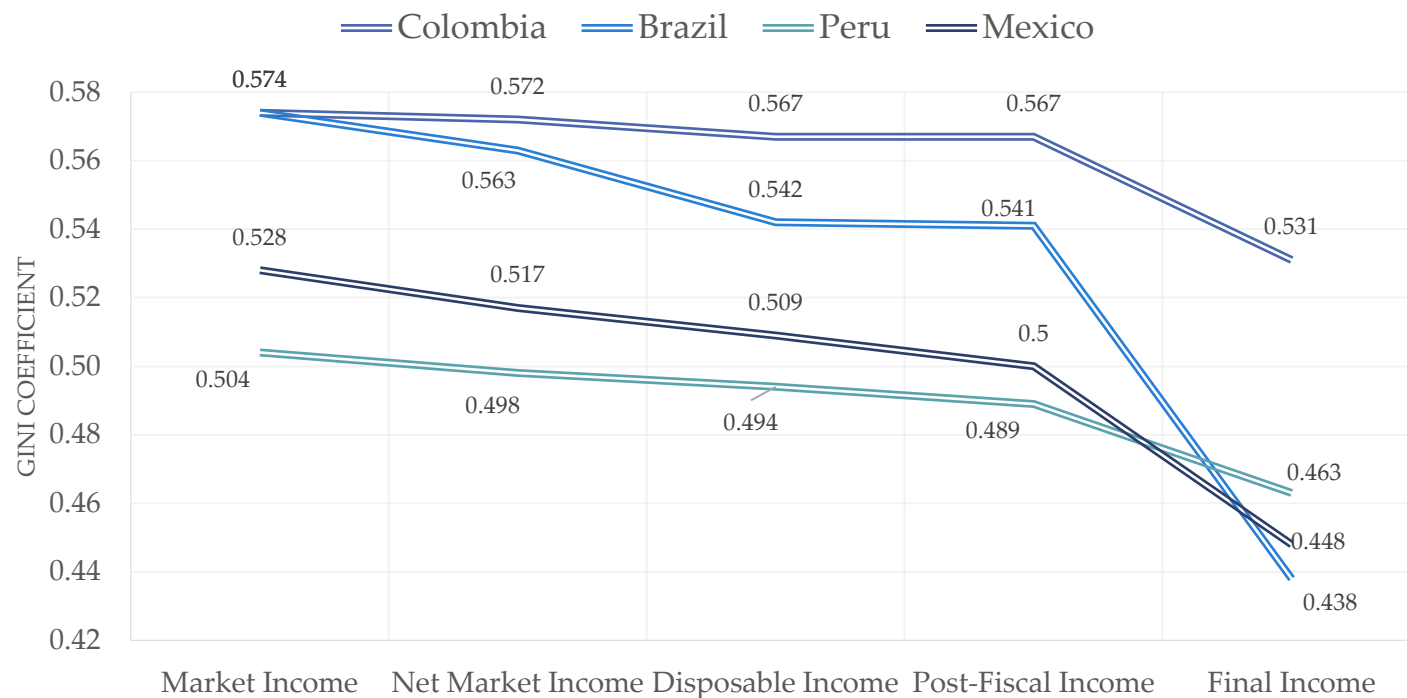
Country Context

Colombia has been among the most unequal countries in the world with high levels of income inequality (third in LAC behind Haiti and Honduras).



Source: LAC Equity Lab tabulations of SEDLAC (CEDLAS and the World Bank) and World Development Indicators (WDI).

Compared with other LAC countries which observed a decline in income inequality over the last decade, before 2012 fiscal policy in Colombia remained an underutilized policy.



Source: Higgins and Pereira (2014), Scott (2014), Jaramillo (2014), Lustig and Meléndez (2014). ©The CEQ Compendium of Indicators presented here is the property of the Tulane Educational Fund and the Inter-American Dialogue. Note: The figure shows the Gini coefficients calculated using each of the five CEQ income definitions (For a complete overview of the methodology, see Lustig and Higgins (2012)) using 2009 data in every country except for Mexico, which is 2010. Dashed lines represent the change in Gini coefficient attributed to in-kind transfers, which unlike the other income definitions in CEQ are based on a non-cash transfer.

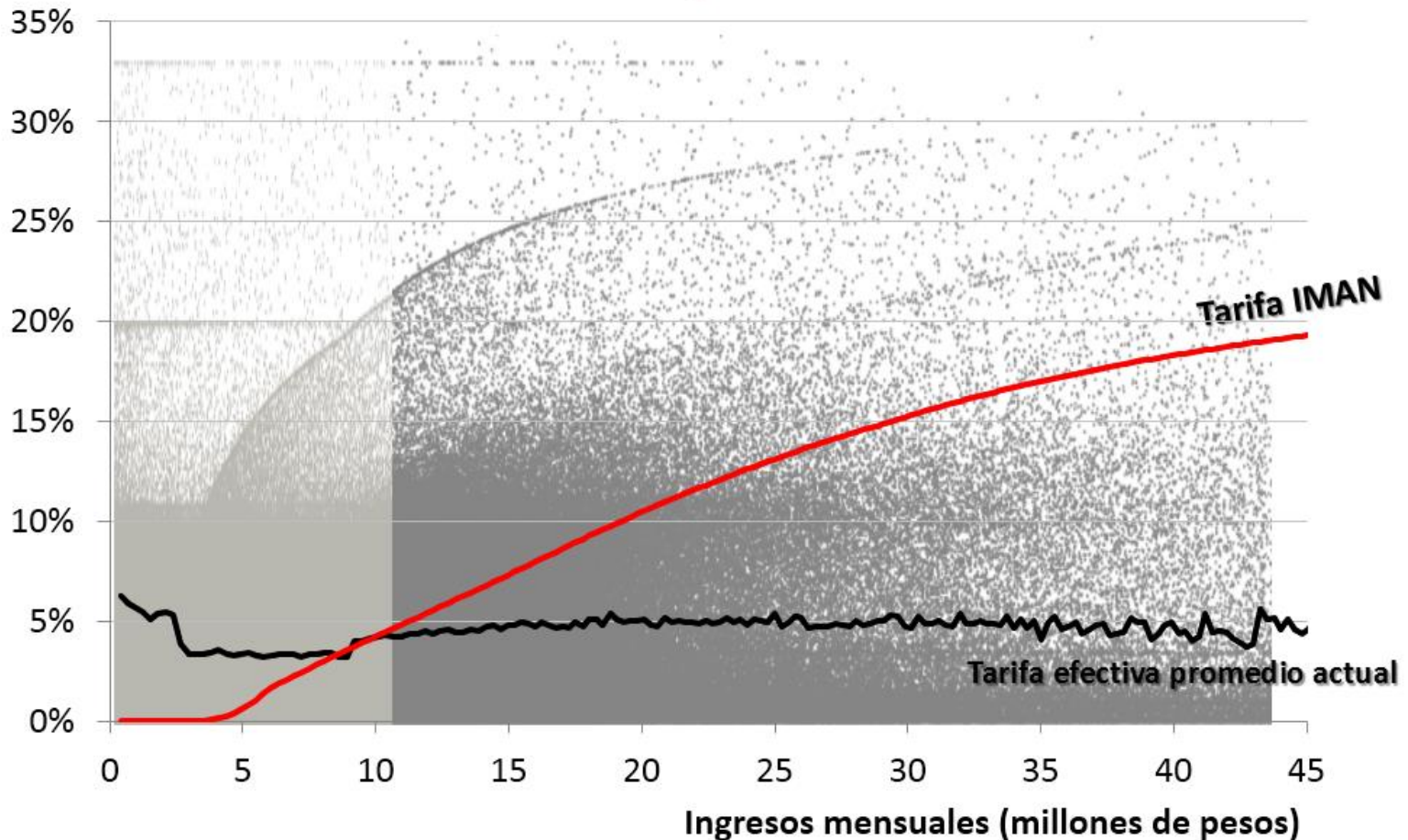
Objectives of the 2012 Tax Reform

In December 2012, the Government of Colombia (GoC) enacted a comprehensive **Tax Reform designed to improve the redistributive impact of fiscal policy without decreasing government revenues** (revenue neutral).

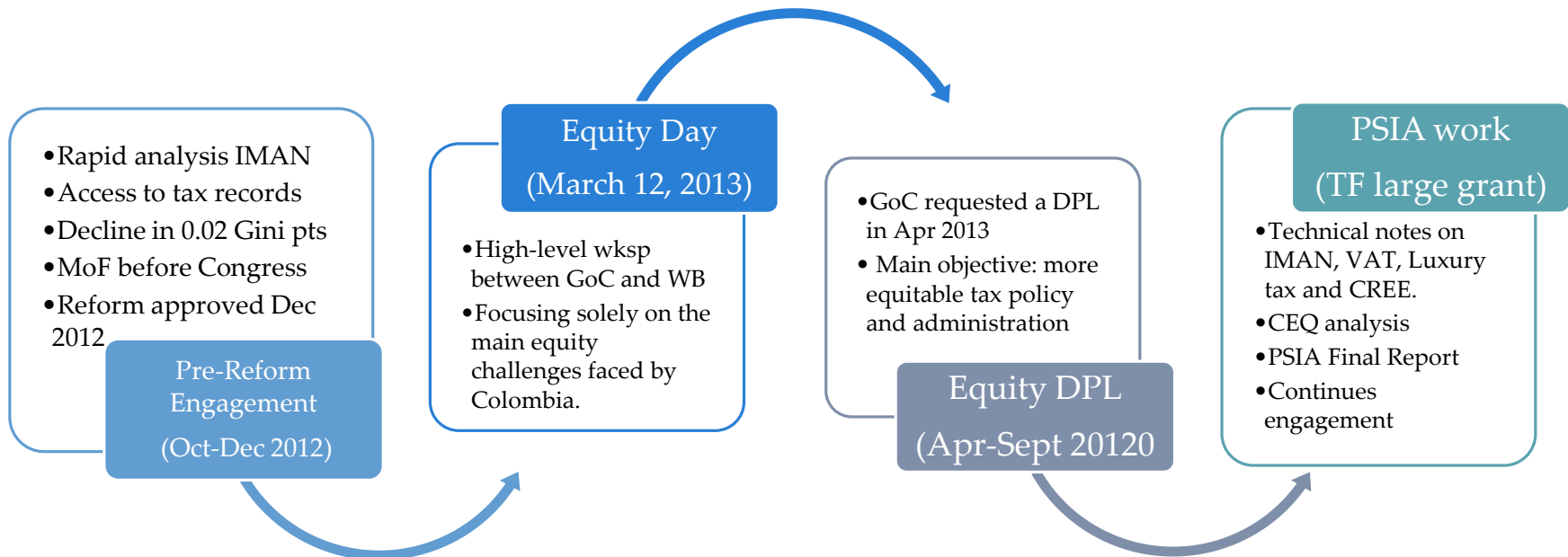
The main components of the reform included:

1. A new income tax system (IMAN) targeting top earners;
2. Simplification of the value added tax (VAT) system,
3. Introduction of a luxury tax, and;
4. Cuts in social security costs in labor-intensive sectors replaced by a tax on capital-intensive sectors (CREE).

Progressivity of the proposed Tax Reform – IMAN



WB Engagement



WB Pre-reform engagement

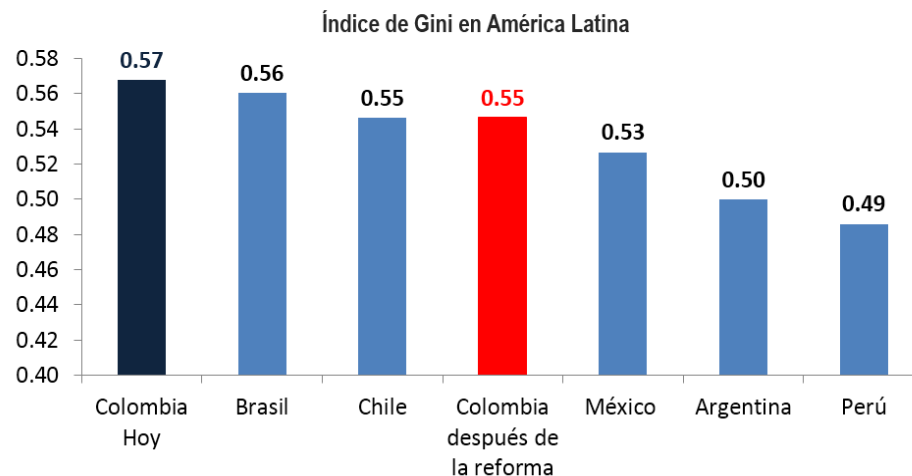
Before the discussion of the reform in Congress the GoC requested support by the WB to conduct a rapid analysis on the potential effects of IMAN.



Efectos esperados de la Reforma: Menor desigualdad



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Fuente: Ministerio de Hacienda, Banco Mundial

“Colombia Equity Day”

- In March 12, 2013 the team organized a “Colombia Equity Day.”
- A one-day, closed door workshop on equity with high-level participants from the Colombian government including the Ministers of Finance and Labor, four vice ministers, and other senior government officials. Also WB management, experts from other international organizations (OECD, IADB, UNDP), academics and international experts.
- Enabled a conversation between decision-makers and international experts about the identification of priority policy areas fundamental to reducing the high and persistent inequality in Colombia.
- The WB responded to these emerging priorities with the support of a DPL and technical assistance on the prospective effects of reforms.

DPL Enhancing Fiscal to Promote Shared Prosperity

- US\$600 Million
- Led by POV GP, in collaboration with GOV and MFM GPs
- Board date: September 2013; Closing Date: December 2014.

Key policy areas:

- (a) More equitable tax policy and administration**
- (b) Inter-regional equity and broadening local revenue sources
- (c) Equity in social spending
- (d) Gender equity
- (e) Open access to national financial management information systems
- (f) Monitoring of poverty and other social indicators

PSIA TF: context and main outputs

The main outputs of a PSIA TF (large grant) included:

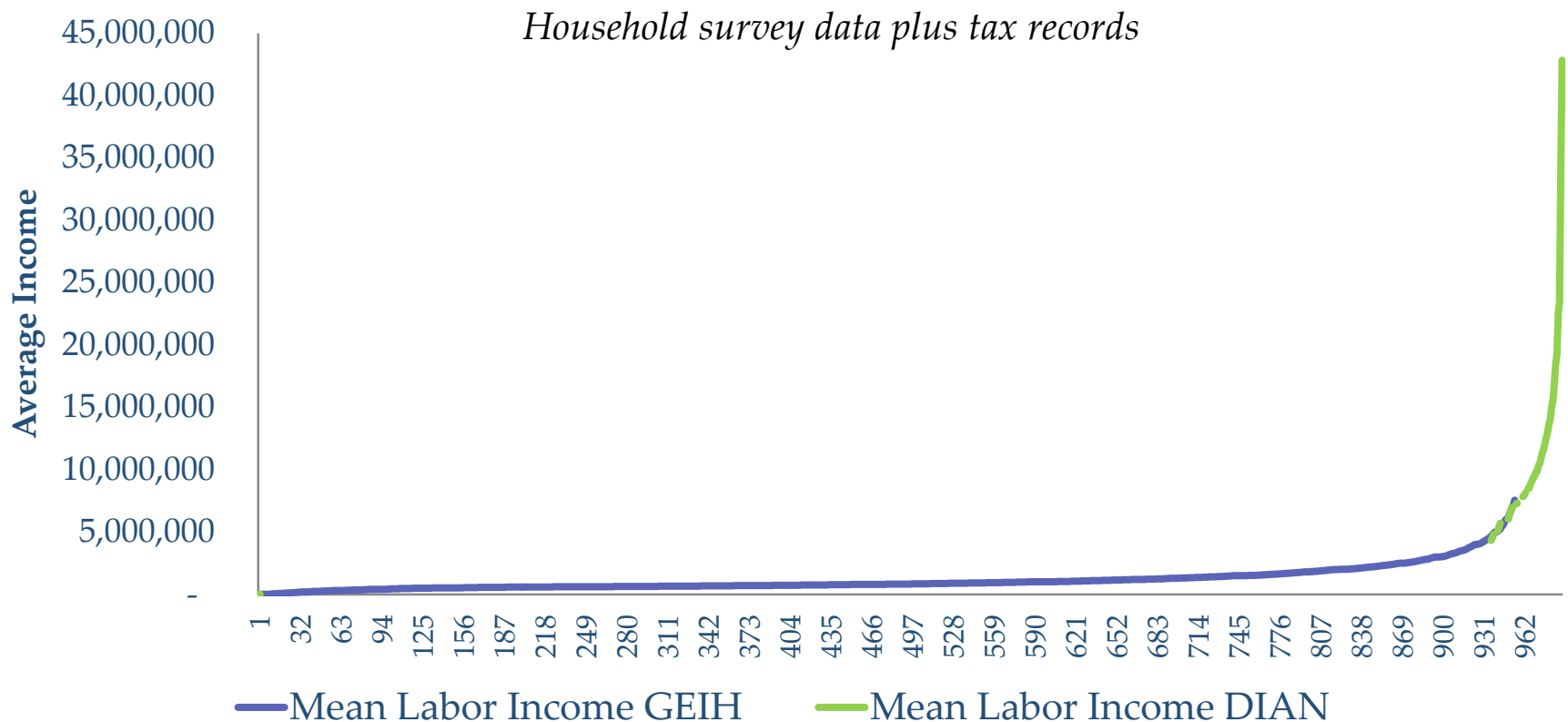
1. A full PSIA report on the distributional effects of the Tax reform (including analysis of IMAN, VAT, Luxury tax and CREE);
2. Two background papers:
 - i. Anton, A. (2014). “The effect of payroll taxes on employment and wages under high labor informality,” *IZA Journal of Labor & Development*, 3(20).
 - ii. Bazan-Diaz, T. (20145). “Measuring Inequality from top to Bottom.” WB PRWP 7232.
3. A CEQ-WB Policy Note (Lustig, Melendez and Rodriguez-Castelan).
4. A set of regular presentations to the GoC.

Summary of main results

The main ex-ante distributional effects of 2012 Colombia's Tax reform are:

1. Changes in the income tax served the intended purpose of reducing income inequality. Using the constructed full income distribution, the Gini coefficient decreases from 0.586 to 0.579.
2. Changes to the VAT code were expected to have practically no impact on inequality and tax revenues. However, assuming some tax evasion, the approved changes to the VAT code were expected to be overall progressive.
3. Introduction of CREE was expected to have a positive impact on the creation of formal jobs and wages. Results suggest a large reallocation of labor across occupations and formality status but small positive impact on total employment (Antón, 2014). Specifically, formal employment would rise between 3.4 and 3.7 percent.

Combining hh survey data and tax records



Source: PSIA report.

Note: Source: Based on GEIH (raw) 2011 and data from income tax declarations, DIAN 2010. Estimations correspond to all individuals who report having labor income.

Main findings IMAN

Table 1. Changes in Gini coefficient

Scenarios	Household survey (GEIH)	Tax records (DIAN)	GEIH + DIAN (no overlap)	GEIH + DIAN (overlap)
Gini – status quo	0.51845	0.69277	0.58634	0.61091
Gini – Tax bill	0.51025	0.67390	0.57827	0.60040
Gini – Approved reform	0.51434	0.67580	0.57901	0.60215

Table 2. Tax collection (in billions of COP)

Scenarios	Household survey (GEIH)	Tax records (DIAN)	GEIH + DIAN (no overlap)	GEIH + DIAN (overlap)
Tax collection – status quo	1.4	3.7	4.9	5.1
Tax collection – Tax bill	1.8	3.8	4.8	5.6
Tax collection – Approved reform	1.5	3.6	4.8	5.1

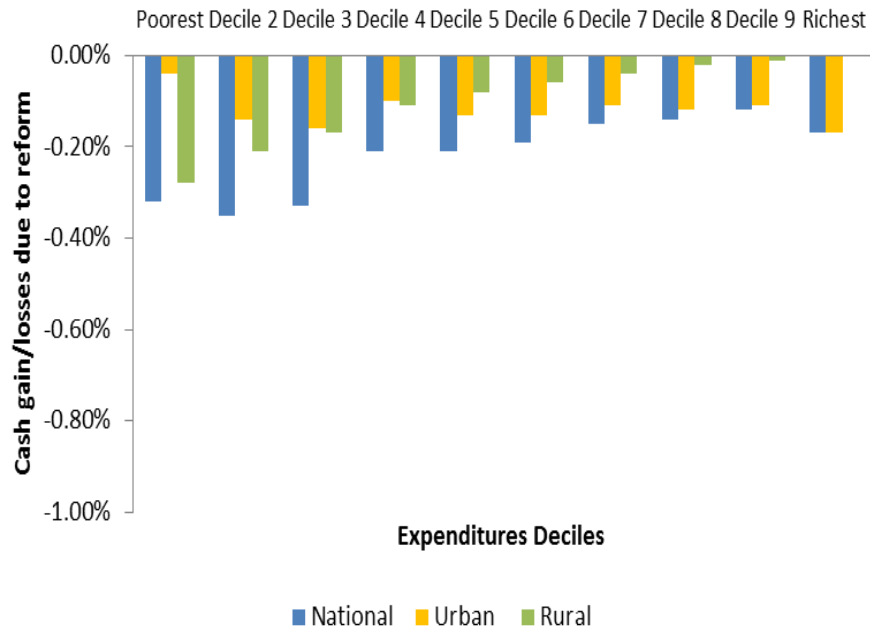
Source: PSIA Report. Calculations based on GEIH 2011 and administrative data 2010.

Note: Coefficient is estimated for all workers reporting labor income.

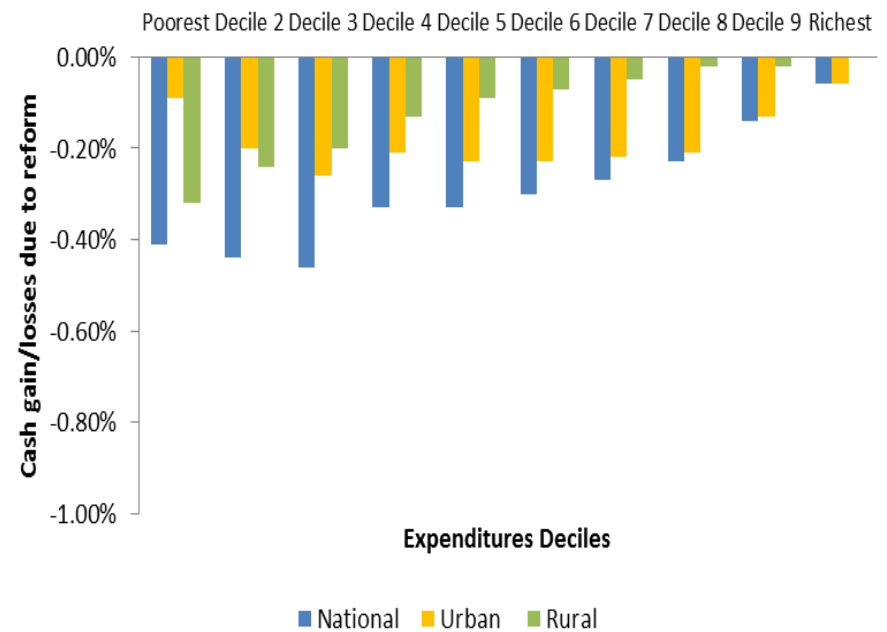
Main findings VAT

The combined effect of the VAT simplification (under the no-tax-evasion scenario) was slightly regressive in relative terms (progressive in absolute terms)

Proposed Reform



Approved Reform

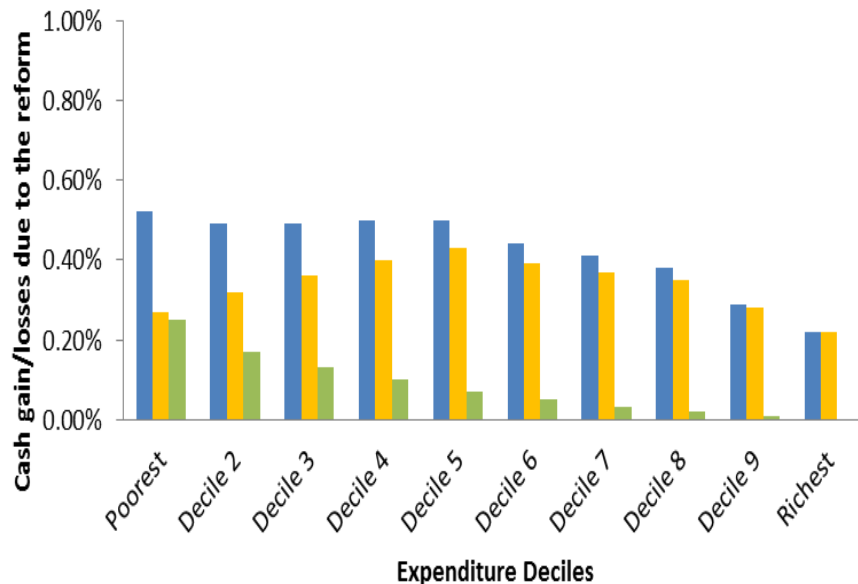


Source: PSIA Report. Calculations based LATAx simulator and ECV 2011.

Main findings VAT (2)

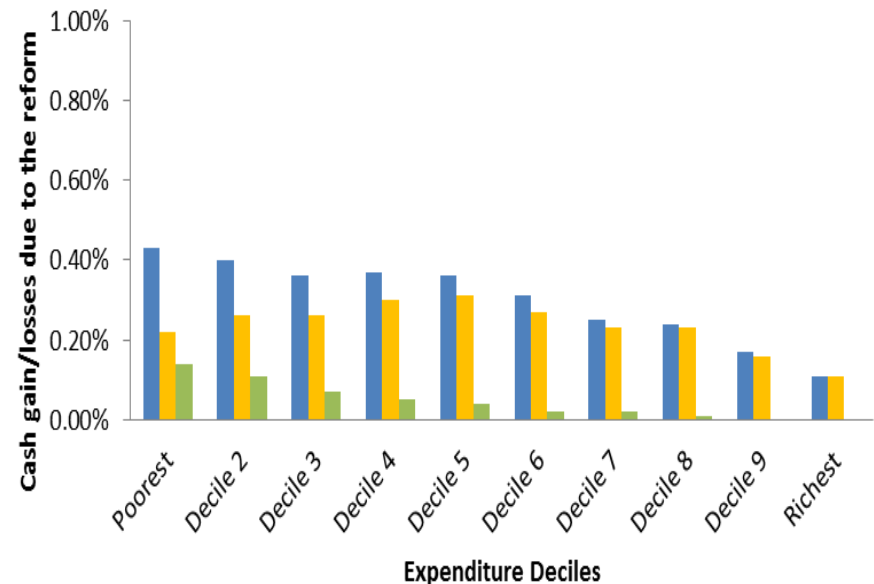
Results for **processed food** both the proposed and the approved changes to the VAT were expected to have a generally progressive distributional impact

Proposed Reform



■ National ■ Urban ■ Rural

Approved Reform



■ National ■ Urban ■ Rural

Source: PSIA Report. Calculations based LATAx simulator and ECV 2011.

Main findings CREE

Based on a General Equilibrium model, a background paper concluded that the implementation of CREE was expected to increase formal employment

	Changes with respect to baseline
Employment	
Total employment	0.3
Salaried formal	3.7
Salaried informal	0.9
Own-account	-4.3
Real Earnings	
Formal net wage (net of taxes/subsidies)	4.9
Informal net wage (net of taxes/subsidies)	3.0
After-tax average earnings, own account	2.8
After-tax average earnings, employers	4.0

Source: PSIA Report based on Anton (2014).

Conclusions

- The main ex-ante distributional effects of 2012 Colombia's Tax reform were confirmed by recent data collected by DIAN and DANE (DPL ICR).
- Although it is still too early to determine the impact of these reforms, post-reform actual trends in the creation of formal jobs are highly encouraging and consistent with the anticipated impact.
- Since the adoption of the tax reform, employment and formal employment have exhibited a clear upward trend (no causality).
- However, a ruling against IMAN that lowered the effective tax rate for top earners partially counterbalanced its potential effects on reducing income inequality.

What is Next?

Due to the “new normal” of lower growth driven partly by low commodity prices, and dependency of tax collection on extractives, Colombia needs a comprehensive tax reform focusing on:

- Increasing the relatively low levels of tax collection, and;
- Reviewing efficiency and quality of public expenditures.

In order to sustain its recently observed social gains in terms of poverty and inequality reduction, the tax reform currently under discussion in Colombia should also consider its potential distributional effects.

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