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Analysis and Reform of the Colombian Tax System

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ABSTRACT

The tax system of Colombia has been under constant study and revision during the past 25 years and has been improved markedly, if not steadily, by these efforts. This paper examines both the recent history of tax reform in Colombia and the major tax reform studies that have influenced such reforms, focusing on the proposals of the Taylor and Musgrave missions and upon the tax reform efforts of 1974 and 1986. (Political sensitivity precludes discussion of the results of a study of inflation adjustment that the author is directing for the Government of Colombia as a result of the 1986 tax reform legislation.) Significant credit for improvement can be traced to the influence of the tax reform studies conducted by foreigners. But the role of Colombian experts should not be understated; the 1974 and 1986 reforms were formulated by local experts, with little or no outside advice.

Primary attention is focussed on structural features of the income and complementary taxes. Only secondary attention is given to domestic indirect taxes levied by the national government, including the national sales tax. Among the important threads of income tax reform traced through the period under study are exemptions and incentives, the taxation of housing, simplification, rate reduction, unification and integration of the taxation of companies and their owners, depreciation allowances, inflation adjustment, presumptive income taxation, and tax administration.

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I. Introduction

The tax system of Colombia has been under almost constant study and revision for at least the past 25 years.[1] As a result Colombian experience provides a fascinating story of the interplay of tax advice and policy reform.

During the early 1960s a Fiscal Survey of Colombia (1965, hereafter the Taylor Report, after Professor Milton Taylor, its mission chief) was prepared as part of the joint program of the Organization of American States and the Inter-American Development Bank. This led to several important administrative innovations, but few concrete reforms of substance. Perhaps as important in its impact on policy was the small volume prepared by Professor Richard Bird (1970) on the basis of his experience as a resident adviser to the government of Colombia on tax and fiscal policy during the two-year period 1964-66.

In 1968 Professor Richard Musgrave was asked by President Carlos Lleras Restrepo to assemble a commission of Colombian and foreign experts to appraise the tax system and make recommendations for reform. The result, Fiscal Reform for Colombia: Final Report and Staff Papers of the Colombian Commission on Tax Reform (Musgrave and Gillis, 1971, hereafter the Musgrave Report), which has become a classic in the field of

tax reform in developing countries, significantly shaped the 1974 tax reform (and subsequent reforms) to be discussed below.

In late 1974 Colombia undertook a major reform of its tax system, drawing heavily on the recommendations of the Musgrave Commission. A consultants' report for the World Bank, translated into Spanish and published as La Reforma Tributaria de 1974 (Gillis and McLure, 1977) provided an early appraisal of these reforms and suggested further improvements in the tax system. A subsequent World Bank Report which received some circulation in English in Colombia (McLure, 1982) analyzed further reforms that followed during the intervening period, as well as examining the 1974 reforms in greater depth.

Finally, in December 1986 the Government of Colombia passed a major reform package that greatly simplified the income tax, lowered income tax rates, and provided further adjustments for inflation in the measurement of income from business and capital. The 1986 act contained an important provision that grants the Government broad powers to alter the system of inflation adjustment during the two years following enactment. To assist the Government in determining how best to use those powers, a comprehensive report on the taxation of income from business and capital (McLure, Mutti, Thuronyi, and Zodrow, forthcoming) has been prepared.

This survey of tax reform in Colombia examines both the recent history of tax reform initiatives and the major tax reform studies that have influenced the course of such reforms. It

concludes that the tax system of Colombia has been improved markedly, if not steadily, by the efforts of the past quarter century. Significant credit for this improvement can probably be traced to the influence of the tax reform studies cited above. But the role of Colombian experts should not be understated; both the 1974 and 1986 reforms were formulated by local experts, with little or no outside advice. In many of the remaining areas where reform is still needed the problem is not that experts have not shown clearly the necessity and benefits of reform; rather those with political influence -- the wealthy (especially those involved in agriculture), politicians, and the military-- continue to enjoy privileged tax status, despite the inequities and inefficiencies inherent in such treatment.

The organizational plan followed in presenting this material is essentially chronological. Section II describes the salient features of the Colombian tax system as the Taylor Mission found it in the early 1960s. Sections III and IV indicate the reforms recommended by the Taylor and Musgrave Missions, respectively. Many of the provisions extant in 1960 and the Taylor and Musgrave proposals for dealing with them have cast long shadows, some extending even to the present; they are described in considerable detail in order to provide a benchmark for the appraisal of the tax reform that has followed. (Where provisions of early law are no longer applicable, or were modified relatively early in the period, such provisions are not described in great detail. By comparison, provisions that remain in effect or that were

reformed only recently are treated in greater detail.)

Section V describes the fundamental reforms of 1974. Section VI describes the changes in the tax law that occurred between the major reforms of 1974 and 1986, and Section VII describes the 1986 reforms. The final section provides an appraisal of the past quarter century of analysis and reform of the tax system of Colombia.

Primary focus in this discussion is on structural features of the so-called income and complementary taxes. Only secondary attention is focussed on domestic indirect taxes levied by the national government, especially the national sales tax. Little attention is devoted to either the politics of tax reform or the importance of macroeconomic conditions, including the need for more or less revenue, in shaping the timing and substance of reform. A wide range of other important fiscal or quasi-fiscal issues, including some in the realm of income taxation, are also ignored; these include import duties and related policies such as quantitative restrictions, import licensing, and advance deposits; the special tax treatment accorded both foreign investment and natural resource industries; the domestic pricing of petroleum products; the use of differential exchange rates and other devices to tax exports of coffee; the taxation of quasi-governmental autonomous agencies; sub-national taxes, including property taxes; and intergovernmental fiscal relations, including earmarking of revenues and the use of valorization to finance local public services.[2]

One of the trends that can be discerned in both tax reform studies and legislation in Colombia is greater appreciation for the importance of tax administration and the role simplification can play in facilitating administration. Another is greater pragmatism -- an increased realization that "things ain't always what they seem." That is, there is greater awareness that what matters for the equity and neutrality of a tax system is not merely what appears on paper in the tax law. Rather, it is important to understand what will result once the taxpayer makes his decisions, particularly if the taxpayer is well advised and perhaps relatively unafraid of the consequences of being found in violation of the law -- a law known not to be well enforced.

II. Colombian Taxes in the 1960s

A. Income and Complementary Taxes

1. Income Tax

Colombia has a long history of income taxation dating from 1821; indeed, it was the first nation in the Western Hemisphere to impose such a tax. For over a century it relied on a system of schedular income taxes, before switching to tax on global income in 1927. Further reforms during the next three decades resulted in an income tax that was progressive and productive, as income tax revenues grew from 3 percent of total tax revenues and barely 0.3 percent of GDP at the beginning of the period to well over one half of tax revenues and roughly 4 percent of GDP at the end.[3]

Space does not permit a detailed survey of developments of the Colombian tax system before the early 1960s. Yet several features of this development must be noted, because they, too, have cast long shadows. First, the modernization and strengthening of the income tax in order to increase the progressivity of the Colombian tax system occurred during two periods of left-of-center government, under the Liberal party during the Great Depression years of 1931-36 and under the rule of military dictator Rojas Pinilla in 1953. Second, this thrust of tax policy was reversed in the 1960 reforms, which, following the advice of the UN Economic Commission for Latin America (ECLA), lowered tax rates and introduced a far-reaching system of tax incentives.[4] This pattern of reform and counter-reform has been a continuing phenomenon in Colombia.

At the time of the Taylor Mission, just after a major reform in 1960, Colombia's system of "income and complementary taxes" consisted of the basic income tax, a net wealth tax, and an excess profits tax. In addition, there were five other taxes on income and wealth, each on a base that was generally different from that for the basic income and net wealth taxes.[5]

In principle, the base of the Colombian income tax in the early 1960s was quite broad, in that it included all "enrichment;" thus it included imputed income from owner-occupied housing, as well as corporate dividends and shares in the earnings of limited liability companies and partnerships. In fact, a wide array of income was tax-exempt for both individuals

and juridical persons (legal entities).

For individual taxpayers exempt income included interest on governmental securities, social security benefits, "thirteenth month" service bonuses commonly paid in the private sector and corresponding Christmas bonuses in the public sector, vacation pay, compulsory severance pay equal to one month's salary for each year of service, family subsidies, maternity benefits, death and burial benefits, workmen's compensation, sick pay, income of the Catholic clergy, winnings from gambling, limited amounts of both interest and dividends, and allowances that essentially constituted salary, though ostensibly paid for travel and expenses of representation.[6] Finally, it was possible for high income taxpayers largely to evade the individual income tax on dividends and interest on bearer securities, since a withholding tax of only 12 percent was levied on such income.[7]

Capital gains have been generally taxable only since 1960. Ten percent of such gains were exempt for each year the asset in question had been held. In addition gains on securities and other personal property were exempt from tax, except when realized in the normal course of business.

In addition to personal exemptions for the taxpayer, spouse, and other dependents, there was a complicated system of personal deductions for expenditures on medical, educational, and other professional services; these deductions depended on the income and number of children of the taxpayer. To achieve equity between home-owners and renters the exclusion of a limited amount

of imputed income of the former was matched by a small deduction for residential rent. Moreover, a deduction was allowed for all interest expense, for real estate taxes, and for contributions to social security and pension plans.[8]

Income of individuals was taxed under a graduated schedule consisting of 56 rates, ranging from 0.50 percent to 51 percent. Married persons were required to file separate returns, but within limits could split earned income, in order to mitigate the effects of rate progression.[9]

Straight-line depreciation was allowed, based on useful lives of 20 years for real property, five years for airplanes and motor vehicles, and ten years for all other personal property. There was no provision for inflation-adjustment of depreciation allowances, but deductions were allowed for additions to a tax-free reserve for the replacement of industrial machinery and equipment acquired before June 1, 1957 to compensate for the effect of a large 1957 devaluation of the peso.[10]

As in many developing countries (and consistent with the conventional wisdom in development economics of the day, as indicated by the ECLA recommendations underlying the 1960 reforms), the Colombian tax system of the 1960s was used to subsidize investment in a wide range of activities that were deemed to make an important contribution to economic development or to be worthy of public support for some other reason, as well as to encourage saving. Thus tax incentives were provided for

> a long list of governmental and quasi-governmental financial, developmental, industrial and other

> enterprises. In addition, income tax exemptions, limitations, or reductions are granted as an incentive to oil companies, certain mining companies, large-scale agricultural improvements, cattle-raisers, rural real estate subdivisions, Colombian airlines, certain investment companies, public utility companies, tourist hotels, certain basic industries, manufacturers using products of the Paz del Rio steel plant, and to exporters of products other than coffee, petroleum, bananas, hides, and precious metals. (Fiscal Survey (1965), p. 33.)

Incentives were also provided for investments in agriculture, accruals of an economic development reserve, and reserves for replacement of industrial machinery and equipment.[11]

Juridical persons were subject to graduated rates. Corporate rates (on sociedades anónimas), which applied to all foreign entities, were 12, 24, and 36 percent. By comparison, the rates applied to limited liability companies (sociedades de responsibilidad limitada), the business form used for many of the most important Colombian business ventures, were only 4, 8, and 12 percent, and the income of partnerships was taxed at rates of 3 and 6 percent.[12] Whereas the income of proprietorships was taxed only in the hands of the owner under the individual tax, that of juridical persons was taxed directly to the firm in question. The entire net income of limited liability companies (like that of partnerships) was taxed to the partners, whether or not distributed; by comparison, only dividends were taxed to owners of corporate shares.[13]

The tax system of Colombia suffered from many administrative problems in 1960. Most notably, there was no withholding, even on wages and salaries.

In certain respects administrative problems could be traced to procedural laws that impeded effective tax administration. To the extent this was true, the problems went beyond what is found in most developing countries; more important, such problems could be remedied, at least in principle. For example, a rule which required the filing of returns on which only exempt income was reported, though explicitly exempt, increased the number of exempt returns filed; while intended as an administrative safeguard, this requirement clogged the administrative machinery.[14]

A much more serious problem involved the interplay of an overly short statute of limitations (two years), a system of penalties and interest that encouraged false and delinquent returns, and an over-burdened tax administration. In extreme cases taxpayers could avoid taxation completely by deliberately reporting false information and waiting for the statute of limitations to preclude correction by the fiscal authorities.[15]

2. Net Wealth Tax

Since 1935 Colombia has imposed a tax on net wealth (impuesto complementario de patrimonio), apparently to increase the tax burden related to income from capital and to induce more productive use of land. The tax also offsets to some extent the ability of high-income taxpayers to evade and avoid the income tax. Beginning in 1960 corporations and similar entities were exempted from payment of the tax. Taxable wealth was that held in Colombia, net of indebtedness, whether to local or foreign

creditors. For this purpose, assets were generally valued at cost, less depreciation where applicable. Assessed values derived from property tax assessments were used for real estate, livestock was valued at its current value, and securities were valued at their stock exchange value or other current value.

As under the income tax, there were a large number of exemptions; for the most part these exemptions paralleled those under the income tax. Among exemptions of special interest, either because they were subsequently eliminated or because they have been perennially resistant to reform, are those for securities of governmental agencies, property incapable of producing income, livestock kept for breeding purposes, certain agricultural investments, assets of Colombian airlines, assets of public utility companies, investments in tourist hotels, investments in motor vehicle assembly or manufacturing plants, investments in securities of the Paz del Rio steel plant, and (until 1969) investments in certain basic industries and in certain iron and steel fabricators.[16]

3. Excess Profits Tax

Beginning in 1935 Colombia imposed an excess profits tax. Partnerships were exempt from this tax, which was applied instead to the partners. The calculation of excess profits -- the excess over 12 percent of net wealth when the latter is in excess of a specified figure -- was based on measures of profits and of net wealth that differed from the corresponding definitions under the income and net wealth taxes. A conceptually correct and

important difference was the exclusion of income from personal services from the measure of profits for this purpose. Because the excess profits tax was repealed in 1974, these adjustments are not described in detail.[17]

B. Internal Indirect Taxes

In the early 1960s the national government of Colombia employed only a quite rudimentary system of internal indirect taxes. Such taxes accounted for less than 10 percent of total national tax revenues in all but one year of the decade ending in 1961. There was no broad-based tax on consumption, such as a value-added tax or a retail sales tax. Thus more than half of revenues of the national government from indirect taxes were derived from stamp taxes and sales of stamped paper. Only taxes on distilled liquors also yielded as much as 10 percent of revenues from internal indirect taxes.[18]

III. The Taylor Mission Proposals

A. Income and Complementary Taxes

The Taylor Mission gave the following glowing endorsement to the income and complementary taxes being levied by Colombia in the early 1960s: "The trinity of an income tax, excess profits tax, and net wealth tax represents a development that is essentially ingenious, progressive, and enlightened -- both in terms of the goals of tax policy and administration." Though the Mission made technical proposals for the improvement of the first

two members of the trinity, it noted that "the general pattern should be retained." By comparison, it recommended the repeal of the five surtaxes on income and wealth, characterizing them as nuisance taxes whose primary reason for existence was earmarking of revenues, a practice it described as indefensible.[19]

For the most part the recommendations of the Taylor Mission for the reform of the taxation of income were consistent with the conventional wisdom of the day. The Taylor proposals included suggestions a) that most forms of exempt income should be subject to tax, b) that the itemized deductions for non-business interest expense and property taxes and for contributions to social security and pensions should be eliminated, c) that the special personal exemptions for medical, educational, and other professional expenditures be repealed or limited and made available on equal terms to all taxpayers, d) that the partial exemption for income from owner-occupied housing should be removed, e) that all realized capital gains should be taxed in full as ordinary income without regard to the holding period, and f) that the issuance of bearer shares should be prohibited or made unattractive by the imposition of a higher withholding tax.

In addition, the Taylor Mission noted that both the bottom marginal rate of 0.50 percent and the top rate of 51 percent were too low and that there were far too many rate brackets.[20] It thus proposed that the top marginal rate be raised to 62 percent.[21] A more controversial proposal was the elimination of the option to split earned income.

The Taylor Mission produced an impressive analysis of the distortions and inequities that flow from the disparate treatment of individuals, corporations, limited liability companies, and partnerships. But having noted particularly the case for integration of the corporate (or company) and individual income taxes, it concluded that "a policy of integrating corporate and personal income taxes does not appear to be warranted at this time."[22] This apparent inconsistency may have reflected political realism as much as schizophrenic economic reasoning; since the double taxation of dividends had only been introduced in 1953 as part of the reforms of Rojas Pinilla, it may have been unrealistic to expect it to be eliminated so soon. Instead, its policy recommendations for the taxation of corporations focussed heavily on the interplay between the income tax, two of the supplementary taxes on income (which it proposed to eliminate), and the excess profits tax (which it advocated retaining with modifications). It favored an upward adjustment of the tax rates on limited liability companies, which it acknowledged were used "as a tax avoidance device."[23] It is unclear whether the Mission gave any consideration to the possibility of using the combination of limited liability companies and fragmentation of businesses to reduce taxes on the capital and business income of a family.

Beyond this, the Taylor Mission proposed more generous depreciation allowances as a means of spurring investment and economic development and compensating roughly for inflation. It

rejected the need for "replacement cost depreciation" because the inflation rate was not sufficiently high to justify its introduction.[24] Moreover, it decried the structure of the provision intended to compensate for the 1957 devaluation. The Taylor Mission favored introduction of carry-forward of losses; it rejected carry-back, in part because of the administrative problem that would be created by opening past returns.

While favoring such general incentives for investment as accelerated depreciation and the elimination of impediments to development such as the inability to carry losses forward and the discriminatory tax treatment of corporations, the Taylor Mission did not condone the proliferation of incentives for special purposes, especially since those in the government who were responsible for administration of the incentives apparently had no clear idea how effective they were in increasing investment or employment. The Mission did not, however, appear to believe that incentives based on careful appraisal of the potential to make contributions in these areas would be inappropriate.[25]

The Taylor Mission devoted particular attention to the agricultural sector, both because of the potential revenue being lost and the role it saw for tax policy in stimulating efficient use of rural resources. Its most important proposal was for a presumptive calculation of income from agriculture equal to 10 percent of the assessed value of agricultural property. This innovation would prevent artificial losses in agriculture from being used to offset income from other sources, in addition to

causing agriculture to make a positive contribution to the tax base. In order to makes the presumptive income tax effective, as well as to improve the taxation of rural property, the Mission urged that the cadastral survey then underway should be given high priority.[26]

Perhaps as important as these proposals for structural tax reform were the administrative proposals advanced by the Taylor mission. These included withholding for wages, salaries, interest, and dividends, the requirement for advance payments of taxes based on estimated liabilities, self-assessment, extension of the statute of limitations, and rigorous application of penalties.[27]

B. Internal Indirect Taxes

The Taylor mission's recommendations in the area of national internal indirect taxes seem rather modest by today's standards, though at the time they represented an important break with prior policy. They included elimination of all stamp taxes levied only for revenue reasons, rationalization of other stamp taxes, and introduction of "a broad system of excises on semi-luxury and luxury goods." Especially important was the insistence that excises should be levied on domestically produced products, in order to prevent (or reverse) tax-induced incentives for uneconomical import substitution. In addition, it is worth noting that the system of excises was favored over the type of sales tax that had been legislated in 1963 because of the

regressivity of the latter.[28]

IV. The Musgrave Commission's Proposals

At the time Richard Musgrave submitted the Final Report of his Commission in February 1969 the tax system of Colombia was not much changed from that analyzed by the Taylor Mission a few years earlier, except for the introduction of withholding and estimated payments -- an improvement of major importance. Essentially the same types of income were exempt, the same tax incentives existed, income was measured in much the same way, roughly the same special personal exemptions and itemized deductions were allowed, and the rate structure was basically the same as earlier.[29] For the most part the Taylor and Musgrave recommendations for income tax reform were broadly consistent. Thus it will be convenient to focus primarily on important instances in which the recommendations of the two missions differed.

A. Income and Complementary Taxes[30]

The Musgrave Commission did not share the enthusiasm of the Taylor Mission for the trinity of income, net wealth, and excess profits taxes. While it said that "the Colombian income tax is a relatively well-developed and sophisticated statute in comparison with others in Latin America,"[31] and that "the net wealth tax fulfills a valuable role in the Colombian tax structure,"[32] it had little good to say about the excess profits tax and recommended that it be abolished.[33] The Musgrave Commission

shared the Taylor Mission's view that the supplemental taxes on income and wealth and the practice of earmarking revenues should be abolished.[34]

Noting the basic inconsistency between both exempting social security benefits from tax and allowing tax deductions (for the employer) and exemptions (for the employee) for contributions, the Musgrave Commission recommended that such benefits be made taxable.[35] It recommended continuation of a limited exemption for interest and dividends.[36] It also favored continuing the special exemptions for medical and educational expenses and making them more generally available, but eliminating the exemption for other payments to professionals.[37] Some forms of exempt income and the special exemptions would be made subject to a vanishing formula in order to limit the benefits of such provisions; that is, the exempt or deductible amount would decline as income rose above a specific amount. By comparison, it was suggested that a deduction should be allowed for charitable contributions in excess of 3 percent of income, without vanishing (but subject to a limit of 30 percent of income).[38] In order to simplify administration, the Musgrave Commission also proposed introduction of a standard deduction equal to 5 percent of income, subject to a fixed peso limit.[39] In contrast to the Taylor Mission's condemnation of income splitting, the Musgrave Commission thought the provision of limited ability to split earned income to be a reasonable compromise between basing taxation entirely on the income of

individuals and complete income splitting.[40] Like the Taylor Mission, the Musgrave Commission believed that the number of tax rates should be reduced and that personal exemptions and bracket limits should not be adjusted for inflation. It argued that "provision for automatic adjustment tends to remove resistance to inflation and to institutionalize a high inflation rate. These effects are detrimental to sound economic development."[41] It proposed raising the top individual tax rate from 52 percent to 55 percent.[42]

The Musgrave Mission offered two alternatives for the taxation of capital gains. Under one, the basis used for calculating gains would be adjusted for inflation, and gains would be taxed as ordinary income. Under the other, no inflation adjustment would be allowed, but the rate applied to gains would be 5 percentage points below that otherwise applicable. To qualify for capital gains treatment an asset would be subject to a two year holding period. In either event gains on assets held for more than five years would be subject to averaging. The 10 percent per year exclusion based on the length of holding period would be eliminated. Coverage would be extended to essentially all assets; gains on sale of the principal residence of the taxpayer would be partially exempt, subject to the vanishing provision mentioned above. In order to prevent "lock-in" of appreciated assets, gains would be constructively realized at the time of death.[43]

Noting the difficulty of a solution to the problem of taxing

income from owner-occupied housing that simultaneously achieves the economic goals of tax policy and is administratively feasible, the Musgrave Commission offered two alternatives without choosing between them: a) taxation of the imputed income from owner-occupied housing, with full deduction of mortgage interest and property taxes and no special deduction for renters, and b) omitting imputed income, disallowing deductions for mortgage interest and property taxes, and retaining a limited deduction for renters.

The Musgrave Commission noted that the introduction of withholding in 1967, which included a system of current payment for the self-employed, was an important advance. It repeated the call for heavier penalties for tax evasion and added a suggestion for the development of a master tax roll. It also added suggestions for improved taxation of the "hard-to-tax" groups such as small traders, independent professionals, and agriculture.[44]

Like the Taylor Mission, the Musgrave Commission devoted particular scrutiny to the agricultural sector and also proposed introduction of a presumptive measure of income based on assets invested in agriculture. It also proposed that agricultural losses should not be allowed to offset income from other sources.[45]

Integration of the taxes on businesses and on individuals was rejected by the Musgrave Commission, as it had been by the Taylor mission. Instead, the Commission proposed that the income

of corporations and limited-liability companies be subject to a unified system of taxation consisting of taxation at the entity level and taxation at the individual shareholder level only on income that is distributed. Partnerships would be taxed at the entity level at a substantially lower rate, and subject to certain conditions limited-liability companies would be given the option of being taxed like partnerships; the partners' shares in partnership profits would also be subject to individual taxation, whether distributed or not. Only limited relief would be available for small businesses through a preferential rate for small corporations and limited-liability companies; continuation of the existing system of highly graduated rates for such organizations was rejected.

The Musgrave Commission considered two types of integration schemes: a dividends-paid credit at the entity level and a dividend-received credit for shareholders. Among the reasons given for rejection were revenue loss, the possibility of shifting of the tax to consumers or wage-earners, the strong Colombian tradition of taxing income from capital more heavily than labor income, the increase in progressivity that results from an unintegrated system, the risk of inducing increased distribution and thus reduced private saving, and the practical difficulties of integration.[46]

Like the Taylor Mission, the Musgrave Commission did not favor allowing depreciation to be placed on a replacement cost basis; nor did it favor introducing general revaluation of assets

to correct balance sheets for inflation. Instead it followed the Taylor approach of suggesting more liberal depreciation allowances. The reasons the Musgrave Commission rejected inflation adjustment for depreciation allowances included the observation that "a general revaluation of assets is extremely difficult to apply, and one may doubt the equity of providing for a depreciation adjustment without considering other items in the balance sheet (such as a reduction in the real value of debt liability) and without applying similar adjustments to taxpayers who do not have depreciable assets."[47]

The Musgrave recommendations for liberalizing depreciation allowances included replacement of the system of straight-line depreciation based on three asset classes with a nine asset system that allowed double declining balance depreciation for assets with useful lives of at least five years. In addition, salvage value would be eliminated, and it was suggested that consideration might be given to permitting increased depreciation allowances for assets used in multiple shift operations.[48] Only new assets would be eligible for most of these changes.

Like the Taylor Mission, the Musgrave Commission found the incentive programs existing in the late 1960s to be "costly, inequitable, and ineffective." Since some of these (those for "basic industries," those for industries complementary with the Paz del Rio steel plant, and the special deduction for a reserve for development investments) were scheduled to expire at the end of 1969, it was simply suggested that they not be renewed. The

Commission urged that direct grants, rather than tax incentives, be used in the future if incentives were thought necessary for the implementation of development policy. But if tax incentives were to be used, it suggested guidelines for incentives in three areas: raising the general level of investment, encouraging particular industries, and stimulating development of backwards regions.[49]

The Musgrave Commission recommended that the net wealth tax should be strengthened by eliminating exemptions for assets that are incapable of producing income, for assets located abroad, and for many assets benefitting from specific exemptions, including those yielding tax-exempt income and those in industries accorded tax-preferred status because of their presumed importance for development. The Commission also argued that debts should be deductible only if incurred in relation to or secured by taxable assets. In order to prevent abuse by non-profit organizations, it was proposed that such organizations should be taxable on their business assets.[50]

The Musgrave Commission repeated (perhaps with modification of approach or details) several other recommendations of the Taylor Mission. These included five-year carryover of losses (and unused depreciation allowances), limitations on deductible salaries (to prevent non-deductible dividends from being paid as deductible salaries), and increased withholding on interest and dividends on bearer bonds and shares. In addition the Musgrave Commission added a recommendation that non-profit organizations

be taxed on any business earnings (but not on interest and dividends received from firms in the for-profit sector).[51]

B. Internal Indirect Taxes

Colombia introduced a national sales tax on January 1, 1965.[52] This was a single-stage manufacturers' tax levied at rates of 3 to 10 percent on "finished" domestic goods and imports. To prevent double taxation of value added, tax was not to be charged on a transaction upon receipt of certification from the buyer that the goods involved would undergo further processing. This system inevitably led to instances of both double taxation and evasion, and in June 1966 it was converted to a crude credit-type value added tax (VAT), but one that extended only through the manufacturing level and allowed no credit for tax paid on capital goods.[53]

Despite explicit recognition of the disadvantages of a manufacturers' level sales tax, the Musgrave Commission offered no recommendations for fundamental changes in the newly enacted sales tax. It did, however, suggest that it might be necessary in the long run to move toward a retail sales tax, perhaps of the "ring" type then being used in several Central American countries.[54] Though recognizing that adoption of a retail sales tax might require elimination of capital goods from the tax base, the Commission did not include a suggestion for such a change in the tax base for revenue and administrative reasons. Beyond that, the Musgrave Commission repeated the call of the Taylor Mission for reduced reliance on stamp taxes and increased

taxation of luxury consumption.[55]

V. The 1974 Reforms

Though the Report of the Musgrave Commission had little immediate impact, its long-term effect was considerable. During the last four months of 1974 the government of newly elected president Alfonso López Michelson employed emergency powers provided by the constitution of Colombia to introduce a far-ranging reform package that included changes in the income and sales taxes, taxes and subsidies on international trade, and the tax treatment of governmental agencies. These reforms bore the distinct stamp of the Musgrave recommendations, which had been considered further and refined by local experts during the intervening half-decade.[56] Besides rationalizing many aspects of the income and net wealth taxes, the 1974 reforms eliminated the tax on excess profits, added a calculation of presumptive income based on net wealth, and further improved the system of internal indirect taxes.

A. Income and Complementary Taxes

1. Income Tax

The 1974 reforms eliminated many exemptions and other forms of preferential treatment for non-labor income; these included the exclusion of interest on public debt, exemptions for automobile producers and private electrical companies, and deductions for reserves for investment. Exemptions or incentives were left intact for a few sectors (e.g., airlines, publishing,

and reforestation) and for various activities in selected regions (primarily "frontier' and other less developed ones). Unfortunately the government was prohibited by the economic emergency provisions of the constitution under which it acted from also eliminating the equally egregious exemptions for labor income.[57]

In 1973 the special personal exemptions for medical and educational expenses, expenditures on other professional services, and rental payments had been made to vanish as income rose above various figures (not the same for all of the allowances), as suggested by the Musgrave Commission. This resulted in an unacceptable complication of tax filing, and the 1974 reforms converted the special deductions, the deduction for charitable contributions, the exemptions for interest and dividends, and the personal exemptions to tax credits. Moreover a "standard credit" analogous to the more commonly employed standard deduction was provided.[58]

The 1974 reforms introduced a novel approach to the taxation of capital gains and other "occasional gains" (ganancias ocasionales). Receipts subject to this new regime included net capital gains on assets held for more than two years, as well as receipts from gambling, 80 percent of inheritances and gifts, the excess over 8 percent per annum of nominal interest on indexed savings accounts issued by financial institutions to fund residential mortgage lending (hereafter called by their Colombian acronym UPACs), and various other lump-sum payments and prizes.

Twenty percent of occasional gains were added to ordinary income; the marginal tax rate to be applied to all occasional gains realized during the year was the marginal rate applicable to this sum under the regular income tax schedule, minus 10 percentage points.[59]

Realized gains on all assets were made subject to this tax; however, the reduction of gains by ten percent per year for each year of ownership was continued for owner-occupied residences. The new law did not provide for constructive realization of gains at death or upon transfer by gift.[60]

The 1974 law gave the taxpayer the option of annually adjusting asset values for inflation (up to 8 percent per year) occurring after enactment of the new law (as well as a one-time revaluation of assets to market values at the end of 1974). Any revaluations of assets had to be employed in calculating net wealth for purposes of the net wealth tax and the presumptive income tax (to be described below), as well as in the calculation of capital gains. Adjustments not made currently could not be made subsequently. Moreover, this revaluation of assets was not allowed to affect the basis of future depreciation deductions.[61]

The structure of taxation applied to business income represented partial movement toward the structure recommended by the Musgrave Commission. Graduated rates were replaced with flat-rate taxes. But the taxation of corporations and limited liability companies was not unified. Instead, the income of corporations was taxed at 40 percent and that of limited

liability companies and partnerships at a rate of 20 percent. As before, shareholders in corporations paid tax only on dividends, whereas owners of limited liability companies and partnerships were required to pay tax currently on the share of the profits of the company imputed to them.

The depreciation rules contained in the 1974 reforms followed closely the recommendations of the Musgrave Commission: elimination of the 10 percent salvage value rule, availability of the double declining balance method for assets with useful lives of more than five years, and the increase of regular depreciation allowances by 25 percent for each extra shift. Asset lives were to be specified by regulation. As noted above, the basis of depreciable assets could not be revalued to reflect domestic inflation for purposes of calculating depreciation allowances. But depreciable basis could be adjusted for increases in the peso value of debt incurred to finance acquisition of such assets that is either denominated in foreign currencies or represented by securities of constant purchasing power.

The 1974 reforms also included the five-year carry-forward of losses suggested by the Musgrave Commission. In an apparent attempt to induce greater disclosure of financial information by limited liability companies, loss carry-forward was made available only to juridical entities subject to the supervision of the Superintendent of Corporations. Juridical entities were allowed to offset agricultural losses against income from any source; by comparison, agricultural losses of individuals could

be offset only against agricultural income. If the presumptive income of a corporation exceeded its income as regularly determined, any loss carried over had to be used to offset this excess.

As initially promulgated, the 1974 reforms contained important procedural and administrative provisions that would have increased the ability of the tax administration to prevent the type of willful evasion that had concerned the Taylor Mission.[62] Unfortunately, the Counsel of State declared these procedural provisions to be outside the scope of reforms allowable under the emergency powers, and therefore unconstitutional. As a result, many of the administrative "teeth" of the 1974 reform were effectively extracted.

2. Net Wealth Tax

The 1974 reforms of the net wealth tax adopted many of the reforms recommended by the Musgrave Commission, and indeed went beyond them in some ways. Among the most important exemptions ended by the reform were those for mortgages and securities issued by governmental and quasi-governmental agencies after September 30, 1974, investments in non-profit enterprises, assets yielding exempt income, investments in activities previously deemed to deserve exemptions as being especially important for the economic development of the country, assets not capable of producing income, limited amounts invested in stocks of Colombian corporations or in savings accounts, books and works of art, and personal effects.[63]

3. Presumptive Income Tax

In 1973 Colombia introduced a presumptive income tax on the agricultural sector, following the recommendations of the Taylor and Musgrave missions. Because the problem of tax evasion was thought to be troublesome outside of agriculture, and to avoid having a schedular tax that applied only to one sector, the 1974 reforms extended the concept of presumptive income to the economy as a whole. Under this important new addition to the fiscal arsenal of Colombia -- arguably the most important of the 1974 reforms, income (whether from labor or capital) was presumed to be no less than 8 percent of net wealth, defined generally in the same way as for the net wealth tax.[64] In addition, any increase in net wealth from year to year that could not be explained to result from exempt income or income that had been taxed would be subject to tax as current income.

B. Internal Indirect Taxes

The 1974 reforms continued the movement of the national sales tax toward a full-fledged value added tax, by eliminating the possibility of buying otherwise taxed items on an exempt basis simply by certifying to the seller that they were to be processed further; under the new law the tax credit (invoice) system was extended to all such transactions. This created administrative headaches because of the many claims for refunds that had to be processed.[65]

In order to reduce the regressivity of the VAT at the upper end of the income scale, the law expanded the base of the tax,

especially by applying it to many services, including parking lots, insurance, international air fares, photographic developing and photocopying, telegraphic and telephone services, and fees of social clubs. For the same reason the degree of progressivity of the rate schedule applied to various goods, ranging from "wage" goods (6 percent) to luxuries (35 percent), was increased. The 1974 reforms also provided more widespread exemptions, for example, for almost all food and for selected agricultural machinery. For the most part these changes were consistent with the recommendations of the Musgrave Commission.

As under prior law, no credit was allowed on capital goods, in part to compensate for underpricing of capital resulting from various non-tax policies, including an undervalued exchange rate. On the other hand, the law contained anomalous provision that exempted imports of capital goods destined for "basic" industries. The combination of these policies placed domestic producers of capital goods at a competitive disadvantage, relative to foreign producers of imported capital goods.[66]

VI. The 1974-86 Period

The period from 1974 to 1986 can perhaps best be characterized as one of continued tinkering with the tax system of Colombia. Though some of the changes clearly represented improvements, some of the more important ones lacked justification in sound public policy; they represented retrogression, having been made in large part in response to the

pleadings of politically powerful economic groups. Indeed, the 1977 and 1979 laws have been characterized as "counter-reforms."[67] Moreover, many of the provisions identified by the Taylor and Musgrave Missions (and by subsequent analysts) as being inappropriate (especially exemptions of certain types of labor income) survived. Finally, weaknesses of administration persisted, since little was done to eliminate them, and stymied efforts to improve implementation. As a result, the equity, neutrality, and revenue potential of the system suffered.[68] The following are among the most important of these reforms and deforms.[69]

Since 1979 values fixed in nominal (monetary) terms, including personal allowances and bracket limits, have been fully indexed for inflation, following a period of partial indexing from 1975 to 1978. Beginning in 1983, 60 percent of the monetary correction for UPACs (40 percent in the case of other indexed debt) is exempt from tax. Withholding on interest payments was raised to 6 percent of the nominal amount.

In 1976 depreciation was liberalized by providing that flexible rates of the taxpayer's choosing could be used for all personal property (that is, all depreciable assets except real estate), as long as no more than 40 percent of the cost of an asset was deducted in one year. With the 25 percent augmentation for extra shifts, as much as 50 or 60 percent of cost could thus be written off in the year of acquisition in some cases; in any case such assets could be fully depreciated in three years.

In a world of stable prices this change would clearly be inappropriate; since such highly accelerated depreciation would not be required for the accurate measurement of income, it would reduce both the equity and the neutrality of the tax system. Given that Colombia experiences a substantial amount of inflation and yet allows no adjustment of depreciation allowances for price increases, the acceleration of depreciation allowances can be cast in a more favorable light. At an inflation rate of 25 percent the real present value of the depreciation allowances provided as an option in the 1976 legislation is roughly equal to that of indexed economic depreciation.[70] But at any other inflation rate these allowance are either too generous or not generous enough; moreover, they automatically produce an understatement of the depreciable asset component of the net wealth tax base. Thus they are likely to be a poor substitute for explicit inflation adjustment of depreciation allowances.

Law 20 of 1979 reintroduced substantial holes in the measurement of taxable income, partially reversing the progress that had been made in 1974. It effectively exempted income from cattle raising from income tax (by exempting income from the sale of calves in the year of their birth and artificially restating the cost basis of cattle sold during a given year to the value at the end of the previous year) and arbitrarily reduced the value of breeding stock and dairy cattle for net wealth and presumptive income tax purposes by 50 percent.[71]

For the complex calculation of tax on occasional gains of

individuals provided by the 1974 reforms, Law 20 substituted a provision that such income should be taxed at one half the average rate applied to ordinary income, but no less than 10 percent. For high-income taxpayers, this represented a substantial reduction in the rate applied to capital gains. The same law provided that no tax would be due on capital gains on fixed assets if 80 percent or more of the gain (plus the original inflation-adjusted cost of the asset) were invested in specified assets. Since there was no requirement that the qualifying investment had to be held for any particular length of time, this provision served as a vehicle for the effective exemption of capital gains and for the evasion of tax on other income that could be converted to capital gains.[72]

In law 9 of 1983 a tax credit of 10 percent of dividends received was provided as a means of reducing double taxation of dividends.[73] More generous credits were provided for dividends by "open" corporations and for small amounts of dividends, and other incentives were also given in the effort to widen ownership of corporations.

The same law instituted a measure of presumptive income equal to two percent of receipts to supplement the measure based on net wealth. In addition, it extended the presumptive income tax to limited liability companies.

The 1983 cadastral reform has the potential of improving the measurement of the value of real estate; this is important for both the net wealth tax and the calculation of presumptive

income. But, in a major reversal of tax reform, the value of real estate for purpose of the presumptive income tax was limited to 75 percent of its cadastral value. In addition, several more unjustified exemptions and deductions were granted the agricultural sector. On the other hand, a rule was introduced prohibiting the use of losses in agriculture to offset labor income.

Several times during the period measures were taken to reduce the number of taxpayers required to file income and net wealth tax returns. Returns were not required if 80 percent of income was from labor subject to withholding, if the remaining 20 percent was also subject to withholding, if the taxpayer was not an owner of shares in a limited liability company (ownership of corporate shares was allowed), if net wealth fell below a certain level, and if the taxpayer was not liable for sales tax. For such taxpayers withholding fully discharged income tax liability, there was no liability for net wealth tax, and tax on sales of assets was withhold by the notary.

In 1983 the value added tax was extended to the retail level, with a "simplified system" being made available to small retailers in the effort to ease compliance costs and administrative burden. Additional services (e.g., hotels, computing services, maintenance, and rental of goods and fixtures) were brought within the scope of the tax. Moreover, because of the difficulties of dealing with differential rates at the retail level, there was some unification of rates; this led

to an increase in the rate of (non-creditable) tax applied to domestically produced capital goods. Imported capital goods used in basic industries continued to be exempt from tax. In 1984 exemptions for agricultural machinery, transportation equipment, and certain other goods were eliminated.[74]

VII. The 1986 Reforms

In 1986 the government of Colombia undertook another major reform of the income tax. The avowed purpose of these reforms was equity, economic neutrality, and simplification.[75]

These reforms contained several distinct and important components.[76] While some of these changes continued in the tradition of the Musgrave proposals, others seem to have been influenced more by the thinking that lay behind the U.S. tax reform of 1986.[77] Moreover, the 1986 reforms exhibited a heavy-- and healthy -- dose of pragmatism.

The government attempted yet another assault on the citadel of tax preferences. It was successful in eliminating the exemptions for severance pay and pensions (but only for those in excess of rather high floors), for the thirteenth month and Christmas bonuses, for many travel and representation allowances of public and private employees, and for vacation pay.[78] The exemptions for severance pay and pensions below monthly ceilings, representation allowances for high-level government officials, judges, and teachers, and income of the military in excess of the basic amount were retained.[79] The 1986 reforms eliminated

the tax exemption for reinvested capital gains contained in Law 20 of 1979.[80] It left some sectors favored; these include cattle raising, forestry, commercial airlines, and navigation. Only 60 percent of the cadastral value of real estate is to be included in the calculation of net wealth.[81]

The 1986 reform reduced tax rates dramatically. The top tax rate applied to individual income was reduced from 49 percent to 30 percent; the same rate is applied to the income of corporations and limited liability companies. At the same time the application of a preferential tax rate to occasional gains was eliminated.[82] Though the same rate schedule is applied to occasional gains as to ordinary income, it is applied separately to the two types of income, instead of to the aggregate of ordinary income and occasional gains.

Withholding taxes were made final taxes for a large portion of the taxpaying population. Filing may not be necessary, and is not allowed, depending inter alia on the size and composition of income (at least 80 percent from wages and salaries), the application of withholding to all income, and the size of net wealth.[83] The benefits of income splitting were abolished; thus the Colombian income tax is now based entirely on the income of individuals, rather than on that of married couples. Credits for personal exemptions and special credits for rent and expenses of health and education have also been abolished. These changes make much more accurate withholding possible and the three tables required previously were replaced with a single table.[84]

The provisions for taxing the imputed income from owner-occupied homes and allowing a limited credit for residential rent were eliminated.[85] Though mortgage interest remains deductible, deductions are subject to annual limits.[86]

Deductions for joint expenses of earning both taxable and exempt income are allowed in the proportion of taxable to total income. Moreover, no deduction is allowed for payments to non-taxable organizations related to the taxpayer.[87] Expense deductions of independent professionals were limited to 50 percent of income in an effort to curtail a major source of abuse and further the achievement of "rough justice."[88]

Taxation of decentralized agencies of the government, mixed enterprises (those with a combination of public and private ownership), and business enterprises and financial income of non-profit organizations was increased in order to achieve parity with the for-profit private sector.[89]

The 1986 reforms unified the taxation of corporations and limited liability companies by taxing both at a rate of 30 percent. It "integrated" the taxation of companies and individuals by exempting corporate dividends and participation in profits of limited liability companies from tax at the individual shareholder/owner level.[90] Consistent with this treatment, losses, exempt income, and tax credits of companies cannot be used to offset income of their owners.[91] To prevent the provision of relief from double taxation of dividends where no double taxation exists, tax-free distributions are limited to 7/3

of the amount of tax paid by the entity.[92] To be consistent, shares of corporations and limited liability corporations were excluded from the figure for net wealth used in the calculation of presumptive income.[93]

Inflation adjustment was extended to all interest income and expense. (Inflation adjustment will be fully effective only after a ten-year transition period, except in the case of interest income of individuals, for which full inflation adjustment was allowed beginning in 1986).[94] The values of capital assets are to be adjusted for inflation for the purpose of calculating gains on dispositions.[95] Indexation was not applied to depreciable assets or to inventories. (Last-in, first-out inventory accounting is allowed, however.) The Government was also granted power to make potentially far-reaching changes in the part of the law dealing with inflation adjustment during the two years following enactment.[96]

VIII. Appraisal

Tax policy in Colombia has generally improved over the past quarter century, though not without important episodes of retrogression or "counter-reform." To a large degree the basic improvements made early in the period reviewed here reflect the recommendations of highly visible foreign tax missions, especially the Musgrave Commission (and, to a lesser degree, the Taylor Mission). Interestingly enough, many of these reforms undid mischief advocated by earlier foreign missions, especially

the interventionist incentive policies proposed by ECLA.[97] But as a cadre of local experts trained in policy analysis and experienced in tax administration has emerged, the recommendations of foreigners have been modified and extended in important ways by Colombian nationals, especially in the 1974 reforms.

More recently reforms have been essentially "home-grown," the products of local expertise, with only minimal foreign input; this is especially true of the 1986 reforms. As this has occurred, foreign influences of a different sort can be discerned. These include greater attention to the policy goals that underlay the 1984 proposals for tax reform offered by the U.S. Treasury Department: economic neutrality, equity, simplicity, and lower rates.

It seems reasonable to say that throughout the period Colombian tax reform has to a remarkable extent been aiming at the target of an ideal tax system specified by the conventional wisdom imported from more advanced countries. One of the reasons reform proposals have changed over time and that reforms recently implemented often reverse reforms undertaken earlier is that the conventional wisdom has not remained static. Of course, the pattern of reform and counter-reform seen over the last half century has also often reflected the ebb and flow of political power of interest groups.

A. Patterns of Change

It is useful to examine briefly the changes that have been

made in various aspects of the tax system of Colombia since the early 1960s. Space does not, however, allow adequate discussion and appraisal of the many reforms that have occurred over the past quarter century.[98]

Exemptions and incentives have been substantially curtailed. As a result most elements of the inequitable and distortionary interventionist policies incorporated in the 1960 reforms have been eliminated. Even so, progress has not been uninterrupted, and egregious gaps remain in the income tax base. Exemptions for labor income include many fringe benefits provided by employers, income of the military, and representation allowances of high-level government officials. Income from agriculture, especially cattle raising, and forestry are among the sectors still benefitting from the most outrageously favorable tax treatment.

The taxation of housing has undergone an interesting evolution in Colombia. Twenty-five years ago imputed income from owner-occupied housing in excess of a specified figure was taxed, as the normative theory of tax policy says is proper; to be consistent there was a limited deduction for residential rent, and the deduction of mortgage interest was allowed. By 1986 it was realized that the taxation of imputed income could not be enforced effectively, so this provision and the limited credit for residential rent were repealed. Though mortgage interest continues to be deductible, the deduction is limited. This seems to be a movement in the right direction, given administrative realities in Colombia, especially if the interest deduction can

be reduced further.

Simplification has been furthered by the recent changes that eliminate the requirement to file income and net wealth tax returns for many whose income is primarily from labor and subject to withholding. Elimination of the taxation of imputed income on owner-occupied housing, income splitting, personal exemptions, and special exemptions, while otherwise questionable on policy grounds, facilitates this important reform. On balance the "rough justice" that these reforms make possible is preferable to the attempt to implement a more sophisticated and complex provisions of prior law; the latter approach may have been preferable from a theoretical standpoint, but it often could not actually be achieved.

Rate reduction of the type seen in 1986 (a top individual rate of 30 percent, to be applied to income of companies as well) is quite remarkable, considering the recommendations of the Taylor and Musgrave missions to raise the top individual rate to 62 percent or to 55 percent, respectively. This is one aspect of reform that appears to show the effect of U.S. thinking on the matter in the 1980s. Of course, alternative explanations can also be given, such as a resurgence of the political power of the right in Colombia and response to the same influences that led to rate reduction in developed countries, including the United Kingdom.

The unification and integration of the taxation of companies and their owners contained in the 1986 reforms is at the same

time consistent and inconsistent with the recommendations of the Musgrave Commission. There is little doubt that the unification of rates, one of the recommendations of the Musgrave Commission, is appropriate; given the economic importance of limited liability companies, unification was necessary to achieve equity and neutrality with corporations. Responding to fears of decapitalization of the Colombian economy, the government chose to exclude dividends from the taxable income of individual shareholders. This "rough justice" form of integration also seems appropriate for Colombia, despite its variance from standard practice and advice; given administrative realities it would have made little sense to attempt one of the approaches that are correct conceptually, but much more demanding of scarce resources for compliance and administration. By comparison, the Musgrave Commission thought integration to be unnecessary.

Depreciation allowances are much faster than would be justified in a world of no inflation or in an indexed income tax system. By coincidence, the present pattern of depreciation allowances is roughly equivalent in real present value to indexed economic depreciation. Yet acceleration of allowances is a poor substitute for explicit inflation adjustment of asset values, both because the rate of inflation may change and because it produces an understated measure of the net wealth tax base.

Inflation adjustment has become increasingly sophisticated. The 1986 provisions for adjustment of interest income and expense and of the basis used in calculating capital gains constitutes a

major improvement in the tax system of Colombia. It would be appropriate to extend inflation adjustment to depreciable assets and to inventories, while adopting more realistic (longer) useful lives.[99] Of course, if that is done, the inflation-adjusted values of assets should be used for purpose of calculating net wealth and presumptive income.

Presumptive income taxation is an important and useful addition to the fiscal arsenal of Colombia. It could be improved, however, by comparing presumptive income (based on net wealth) only to non-labor income in the calculation of total income. Moreover, the limitation of the value of real estate to only 75 percent of its cadastral value should be eliminated. Finally, the use of receipts to calculate presumptive income does not make economic sense.

The excess profits tax was appropriately eliminated. Similarly, it was proper to abolish the supplementary taxes that were levied on income and wealth at the beginning of the period under examination.

Tax administration has not been improved as much as might be desired. However, recent changes in the tax law that relieve large numbers of taxpayers subject to withholding of the obligation of filing returns should assist in freeing up administrative resources for more productive tasks. This trend of tailoring the tax system to the capabilities of the tax administration is a healthy development, as long as revenue, equity, and neutrality are not needlessly sacrificed.[100]

Sales tax reform has improved greatly the implementation of this relatively recent addition to the Colombian tax system. In particular, conversion to a more-or-less standard credit method VAT improves the administration of the tax. It appears that extension of the tax to the retail level may have been premature, especially since the simplified system for small retailers does not provide appreciable administrative benefits.[101] Continuation of the practice of allowing no credit for capital goods is also highly questionable; it is reasonable only if it is thought that the price of capital remains artificially low. Important progress has been made in reducing the reliance on stamp taxes, but more remains to be done in this area.

B. A Final Observation

During the remainder of 1988 the Government of Colombia will presumably be considering ways to improve the system of inflation adjustment, as provided by the 1986 statute. Among obvious issues to be discussed are the indexing of depreciable assets and inventories.[102] Any changes made for the income tax should also carry over into the measurement of net wealth and the calculation of presumptive income.

Because of the complexities involved in inflation adjustment, not to mention those that arise under the income tax, even in a world without inflation, another question naturally arises. That is whether Colombia should switch to a system of direct taxation based on consumption, rather than income. Under such a system expensing would be allowed for all business

purchases, neither interest expense nor dividends would be deductible, and neither interest nor dividends would be taxable.[103]

The movement to such a system would actually be relatively small, given the changes already under way as a result of the 1986 act. Depreciation is so accelerated that movement to expensing would involve little change. Dividends are already exempt and non-deductible. Following the ten-year transition period provided by the 1986 act, the majority of interest will also be exempt and non-deductible.[104]

Adopting a system of this type would greatly simplify compliance and administration of the "income" tax, since no inflation adjustment is required and timing issues (such as depreciation) do not arise. Adopting such a tax would, however, raise important issues of equity, taxation of foreign capital, and transition.[105] Moreover, a consumption-based direct tax would not dovetail with the net wealth tax, in the way that the income tax does. Finally, no matter what further reforms are undertaken, it is important to focus on tax administration, for a tax system cannot be truly satisfactory if it is not administered effectively.

FOOTNOTES

*The author is a Senior Fellow at the Hoover Institution at Stanford University. He has benefitted from valuable comments on an earlier draft of this paper from Richard Bird, Wayne Thirsk, and George Zodrow. The views expressed here are, however, solely his own.

[1]Moreover, the history of analysis and reform has been well documented. For analyses of the Colombian tax system by external advisers and consultants, see Fiscal Survey of Colombia (1965), Bird (1970), Musgrave and Gillis (1971), Gillis and McLure (1977), McLure (1982), and McLure, Mutti, Thuronyi, and Zodrow (forthcoming). Of course, there have also been numerous studies by Colombian authors of particular reform issues; for example, Carrizosa (1986) deals with taxation and the revitalization of Colombian capital markets. For a thorough review and analysis of tax policy in Colombia, especially during the period from the fundamental reforms of 1974 until 1985, as well as a brief overview of pre-1974 tax policy and an extensive list of references on tax reform in Colombia, see Perry and Cárdenas (1986). (It is worth noting that Perry, as Director General of Internal Taxes, was intimately involved in the formulation of the 1974 reforms.) Rojas (1983) describes several aspects of the tax reforms of 1960, 1967, 1974, and 1982-83. This last source,

which Richard Bird brought to the attention of the author only after the paper was essentially in final form, has not been consulted adequately.

[2]Many of these topics have, however, been the subject of analyses by tax reform groups. See, for example, Fiscal Survey (1965), chapters 7 (urban real property), 8 (revenues from foreign commerce), 9 (tariffs and development), 10 (internal indirect taxes of sub-national governments), and 12 (autonomous agencies); Bird (1970), chapter 5 (local government finance); Musgrave and Gillis (1971), pp. 648-69 (municipal indirect taxes), pp. 692-719 (automotive tax reform, including the pricing of petroleum products), and pp. 723-805 (sub-national taxes and intergovernmental relations); Gillis and McLure (1977), chapter 5 (taxes and subsidies on the external sector); Ascher (political economy of reform); and Perry and Cárdenas (1986), chapters IV-VI (macroeconomic conditions and revenues) and XIII-XV (political economy of reform). Intergovernmental relations in Colombia have been the subject of a special commission: see Bird (1984), which also discusses earmarking of revenues, as well as other issues. Subnational taxation has been the subject of considerable reform during the 1980s.

[3]See Perry and Cárdenas (1986), pp. 16,19-20.

[4]See Perry and Cárdenas (1986), pp. 15-18, Bird (1970), pp. 191-

203, and Rojas (1983), pp. 40-41.

[5]This discussion draws heavily on Fiscal Survey (1965), pp. 26-27. For a further brief history of income tax reform in Colombia, see Perry and Cárdenas (1986), pp. 15-21, or Hernández (1987), pp. 1-8, which also reproduces many of the documents explaining the rationale for the 1986 reforms.

[6]Fiscal Survey (1965), pp. 30, 68-69. Neither Fiscal Survey (1965) nor Musgrave and Gillis (1971) mentions the allowances for travel and representation, perhaps through oversight.

[7]Fiscal Survey (1965), p. 35.

[8]Fiscal Survey (1965), pp. 65-68.

[9]Fiscal Survey (1965), pp. 27-32.

[10]Fiscal Survey (1965), pp. 82-83. The law provided for the use of declining balance methods of depreciation, but since the factor to be applied to the declining balance could be no greater that 100 percent, this alternative would not be attractive. Bird (1970), p. 253 notes that machinery used more than ten hours per day could legally be depreciated more rapidly than under a 10-year straight-line schedule, but the provision was apparently never put into practice.

[11]Fiscal Survey (1965), p. 33, 87-90.

[12]See Fiscal Survey (1965), pp.27-30, which also describes the characteristics of these organizational forms, as well as those of several economically less important ones.

[13]Fiscal Survey (1965), p.55.

[14]Fiscal Survey (1965), pp. 63.

[15]Fiscal Survey (1965), pp. 97-98.

[16]Fiscal Survey (1965), pp. 37-40.

[17]See, however, Fiscal Survey (1965), pp. 35-37.

[18]Fiscal Survey (1965), p. 210-11. Figures on revenue patterns during that period may be distorted by the high yield of taxes on foreign commerce, since those years were characterized by high imports; see Bird (1970), pp. 3-7.

[19]Fiscal Survey (1965), p. 54.

[20]Fiscal Survey, pp. 60-61. It might be noted that the Taylor mission also thought that the personal exemptions then being

allowed were too high, but did not propose reducing them since their real value was being eroded by inflation.

[21]Fiscal Survey, 1965, p. 98.

[22]Fiscal Survey (1965), pp. 54-58 and pp. 244-68; the quotation is from p. 58.

[23]Fiscal Survey (1965), pp. 70-77.

[24]The consumer price index for Bogotá had risen by 76.4 percent during the period 1954-55 to 1962, or at an annual rate of about 8 percent. The official exchange rate of pesos for U.S. dollars had changed from 2.51 in 1952-56 to 9.09 in 1962. Fiscal Survey (1965), pp. 82-85 and 263-67. The discussion of inflation adjustment is quite inadequate in several respects, though not atypical for its day; in particular, it fails to distinguish between basing depreciation on replacement costs and allowing price-level adjustments of the historical-cost basis of depreciable assets.

[25]Fiscal Survey (1965), pp. 21, 90-91. For a more complete discussion that reaches much the same conclusions, but is more skeptical about the usefulness of special incentives, see Bird (1970), pp. 132-46.

[26]Fiscal Survey (1965), chapter 6, especially pp. 121-25 and 129-33. Bird (1970), p. 89, and Perry and Junguito (1978), p. 33, note that proposals for the presumptive taxation of income from agriculture had been made several times before the Taylor Report. Hirschman (1963), pp. 116-141 describes the early history of proposals to use tax policy to improve the productivity of Colombian agriculture.

[27]Fiscal Survey (1965), pp. 96-98.

[28]Fiscal Survey (1965), p. 217, 220. Bird (1970), pp. 112-114, also favors increased use of selective excises, rather than a broad-based sales tax, but for administrative reasons. He also favors a wholesale level tax over a manufacturers' tax.

[29]The form of the subsidy for non-traditional exports had been changed in 1967 from an income tax exemption (with export profits presumed to be 40 percent of the value of exports) to a system of negotiable and tax-exempt tax-credit certificates based on the value of exports. Although the credit was equal to 15 percent of exports, it could not be utilized to pay taxes until one year after issue. Bird (1970), p. 143 notes that at the end of 1967 the certificates were trading at a discount of 30 percent, and thus were worth about 10 percent of exports.

[30]References provided in the footnotes to this section relate

primarily to the Final Report of the Musgrave Commission in Part I of Musgrave and Gillis (1971). Important background for the recommendations reported here are contained in the Staff Papers, which also appear in Musgrave and Gillis (1971). On the income tax, see especially White and Quale (1971) and Slitor (1971).

[31]Musgrave and Gillis (1971), p. 35

[32]Musgrave and Gillis (1971), p. 98.

[33]"The excess profits tax is a major contributor to the high and erratic marginal rate structure. It...has no place in a peacetime economy....Even inflation at continuous moderate rates inevitably warps the significance and intertaxpayer comparability of historic investment costs (by which net wealth is largely measured for Colombian excess profits purposes)....Any function the excess profits tax may have served in the past is now outweighed by its evident inequities, distortions, incentives to waste "cheap tax pesos," and disincentives to growth and efficiency." Musgrave and Gillis (1971), p. 77. For another negative appraisal of the excess profits tax, see Bird (1970), pp. 83-84.

[34]For a more thorough analysis of earmarking, see Bird (1984).

[35]Musgrave and Gillis (1971), pp. 38-40

[36]Musgrave and Gillis (1971), pp. 41-42

[37]Musgrave and Gillis (1971), pp.43-44.

[38]Musgrave and Gillis (1971), pp. 44-45. The Taylor report makes no mention of the deduction for contributions; this was presumably an oversight.

[39]Musgrave and Gillis (1971), pp. 44-45.

[40]Musgrave and Gillis (1971), pp. 50-51.

[41]Musgrave and Gillis (1971), pp. 51-53.

[42]Musgrave and Gillis (1971), p. 62.

[43]Musgrave and Gillis (1971), pp. 46-50

[44]Musgrave and Gillis (1971), pp. 63-69. For further discussions of the taxation of "hard-to-tax" sectors in Colombia, see also Bird (1970), pp. 96-102.

[45]Musgrave and Gillis (1971), pp. 66-67.

[46]Musgrave and Gillis (1971), pp. 78-81. Of course, the heavier

taxation of capital may be more apparent than real.

[47]Musgrave and Gillis (1971), pp. 82. It also offered the counsel that "the proper solution for Colombia lies in a well-designed stabilization policy." While one can hardly disagree with the accuracy of this statement, one can question the propriety of deliberately choosing not to modify the tax system in order to avoid the inequities and distortions that otherwise result in a world in which this prescription is not followed.

[48]Bird (1970), pp. 85-86 favors similar provisions.

[49]Among these guidelines were relatively greater emphasis on increasing saving than on increasing investment, avoidance of interference with decisions on factor proportions, general availability of credits with less administrative discretion, and carryforward of unused credits, Musgrave and Gillis (1971), pp. 91-94. The Musgrave Commission also discussed trade-related incentives; these are not reviewed here, as they are beyond the scope of this paper. But see Musgrave and Gillis (1971), pp. 94-96.

[50]Musgrave and Gillis (1971), pp. 98-105.

[51]Musgrave and Gillis, (1971), pp. 84-89.

[52]Though the tax was established in 1963, it was not actually applied until 1965.

[53]See Gillis (1971), pp. 594-97 for a description of the early evolution of the sales tax. Perry (forthcoming) provides greater detail on the development of the tax (especially on post-1968 developments), including efforts to free business inputs from tax, and describes both economic and administrative difficulties with the tax.

[54]See Due (1972) for a description of ring systems of sales taxation.

[55]Musgrave and Gillis (1971), pp. 115-119.

[56]Perry and Cárdenas (1986), p. 12, indicates that these reforms were prepared by a team that was 100 percent Colombian. See also Gillis and McLure (1977), chapter I. (Page numbers are to the version of this report published in Spanish. Chapter numbers correspond to section numbers in the xeroxed English version.)

[57]Perry and Cárdenas (1986) pp. 24-25 and Gillis and McLure (1977), chap. II. For full details of the 1974 reforms, see Impuesto sobre la Renta en Colombia (1984).

[58]Perry and Cárdenas (1986), pp. 23-25; Gillis and McLure (1977),

chapter II.

[59]Perry and Cárdenas (1986), pp. 25-26.

[60]Gillis and McLure (1977), chap. II.

[61]Perry and Cárdenas (1986), pp. 26-27.

[62]Gillis and McLure (1977), chapter III, p. 103-4, provide examples of how taxpayers could benefit from intentional "errors" and delays.

[63]Gillis and McLure (1977), chapter II, p. 68-69.

[64]Perry and Cárdenas (1986), pp. 27-28; Perry and Junguito (1978), pp. 34-36.

[65]Perry (forthcoming). Under prior law no tax would have been collected on inputs to zero-rated sales or exports. Under the credit system, tax would be collected on all purchases; this could necessitate refunds in the above cases.

[66]Gillis and McLure (1977), chapter IV and Perry (forthcoming). Bird (1970), pp. 119-21 argues in favor of taxing capital goods, but notes that discrimination against imported capital goods might be appropriate.