The costs and benefits of Peace

Interview with MAURICIO CÁRDENAS and SIMÓN GAVIRIA

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The rejection by a narrow margin in the October 2 referendum of some of the terms of the peace accord is an undoubted setback and will require a return to the negotiating table, but nobody in Colombia believes the delay will derail four years of economic reforms and ambitious development plans that are taking the country to the next level. During this time, Colombia has been able to move away from oil dependency and begin laying the foundations for economic diversification: there is a clear sense of direction of travel that requires the government stay focused on meeting the challenge of financing the peace.

Under the terms of the accord, the government has set up a fund to compensate the estimated eight million victims, undertake much-needed land reform, stimulate the agricultural sector, provide for coca substitution plans, remove landmines and take measures to help drug-prevention, along with a series of initiatives to improve infrastructure, healthcare, education, food security, housing, and to further reduce poverty.

"We have to keep in mind the fundamental goals of these reforms, which are essentially to strengthen our fiscal management, build credibility, preserve our credit rating which is BBB now, and that will be a source of confidence," says Colombian Finance Minister Mauricio Cárdenas.

How much will the next stage of Colombia's reforms cost? Mr Cárdenas estimates US$30 billion in the long term. Global Risk Insights, an analyst group at the London School of Economics, has put the price tag at US$90 billion over the next decade. London-based Capital Economics has offered another range, with the high end coming somewhere in the middle.

How will this be paid for? Colombia has been earmarking post-conflict programmes into its budgets over the last two years. In late 2015, some US$3.4 billion was reserved for victims, those displaced by the war, and to fund land restitution. The 2017 national budget proposal that Mr Cárdenas sent to congress in late July included a slight increase, to around US$3.9 billion, in direct post-conflict funds. "But if the post-conflict period requires additional resources, we will also have to generate additional income and we will have to find more in the budget," he warns, raising the spectre of higher taxes.

In the meantime, the international community has already offered financial support, with the biggest sum, at least US$450 million, coming from the United States. Canada will throw US$57 million into the pot over the next five years, and the United Kingdom has said it will contribute some £30 million.

Global financial institutions are also onboard. The Development Bank of Latin America has issued a US$450 million loan for general development goals. The World Bank has created a "multi-donor" fund that will guarantee at least US$6.5 million. And the International Monetary Fund approved a US$11.5 billion line of credit in June. The IMF measure is intended to assure foreign investors rather than fund post-conflict programmes. But given that the IMF more than doubled its previous US$5.4 billion limit, Mr Cárdenas says there is now a larger 'rainy day' line of credit if the government needs some extra breathing room.

At the same time, the Colombian government is also banking on a significant peace dividend: "A portion of the peace process pays for itself," says Mr Cárdenas.

"What's interesting about post-conflict economies generally, is that there are two types of dividend: There's an increase in income per capita over the following decade of around 50 per cent. This is usually the result of formalising of those economies," says Simón Gaviria, director of the government's National Planning Department and son of former president César Gaviria.

His department, which has a budget of $250 million for 2016, conducted research into similar conflicts worldwide to determine the appropriate strategies for development and projects. Among their findings: they expect GDP to grow up to an additional 1.9 per cent annually in the post-conflict era. Moreover, says Mr Gaviria, increased formality will lead income per capita to grow 10 to 15 per cent over a ten-year period, and foreign direct investment is expected to triple.

"There's a second dividend as well, which is to do with investment-to-GDP ratios: a lot of new investment comes into post-conflict economies. Foreign direct investment increases threefold over those next ten years," he says.

"In 2010 the figure for investment as a percentage of GDP was 24 per cent, which was very important. By 2014, it had increased to 29 per cent, a historic high for Colombia, and we are now leaders in the region in terms of rate of investment as a percentage of GDP," explains Mr Gaviria.

"This is best illustrated by the 4G infrastructure programme, which is going to enable us to create

a revolution in infrastructure and logistics in Colombia and to continue attracting investments, especially in high-growth sectors of the Colombian economy like industry, agriculture, tourism and construction," he adds.

"Colombia is a highly competitive country, with a good growth and dynamic and attractive investment conditions," explains Mr Cárdenas, pointing out that in early January 2015 Colombia raised $2.5 billion in a 30-year bond issue. "This was remarkable because it showed that, even with the dramatic drop in commodity prices investors' confidence in the Colombian economy was not affected. We are certain that foreign investors will maintain their confidence in the country based on its fiscal stability."

Tax reform

The OECD has highlighted some of the structural issues facing the Colombian tax system, saying it has been unable to raise revenues to fund necessary investment in infrastructure, education and innovation, or to reduce poverty and expand the social safety net.

While tax revenues grew by an amount equivalent to almost 3 per cent of GDP between 2000 and 2010, since then it has moved up to around 16 per cent, which is still well below the OECD average of 34.4 per cent and below that of countries with a per capita income similar to Colombia's.

Oil earnings have fallen by 70 per cent since 2013, a sizeable hit, since oil money has come to represent up to 20 per cent of government revenue in recent years. Revenue for this year is expected to be as little as US$1.1 billion, a sharp drop from last year's US$6.7 billion.

Over the last two years, this changing scenario has required measures to reduce public spending while ramping up taxes. In 2015 a looming deficit led the government to ram a hasty tax reform package through Congress that dramatically increased taxes on entrepreneurs. The result has been a newfound polarisation with many in the business community and the middle classes who believe they are shouldering the lion's share of the downturn.

At present, the corporate tax burden is extremely high, with companies paying corporate income tax (CIT), a wealth tax on net assets and non-refundable VAT on fixed assets. Here, too, a series of exemptions generate distortions between different types of companies.

The combination of different corporate taxes, plus other levies and the wealth tax, has made the tax burden on some companies as high as 60 per cent of net revenue, one of the highest corporate tax rates in the region and a disincentive to local investment, say many in the business community, pointing out that many large corporations have upped sticks over the last year.

Colombia's tax system also relies heavily on VAT, which tends to be regressive and is complicated by a multitude of exemptions and special rates. VAT tends to hit the poorest hardest. In contrast, Personal income tax (PIT) has a high tax-free allowance and a series of exemptions that disproportionately benefit the wealthy.

The government says it intends to get a major overhaul of the tax system approved by Congress before year's end. Some significant changes have already been made to the tax system: package of tax reforms approved in 2012 reduced payroll taxes, simplified VAT, increased PIT on high-income earners and eliminated some tax exemptions for fuels.

"Tax reform is central both to financing the cost of the peace, as well as to creating a better business environment for domestic and international players," says Mr Cárdenas, noting that in the medium to long term there is broad agreement in Colombia on the need for structural tax reform aimed at generating higher and more sustainable government revenues. "This need had been apparent even before the oil price shock pushed it higher up the political and policymaking agenda."

"We still face great challenges in reducing tax evasion and economic informality, but we're optimistic," explains Mr Cárdenas. But he says from 2012 onwards, the repeal of taxes on company payrolls has considerably reduced informality, and the new jobs that this created are well within the legal framework.

Colombia has also made progress in reducing tax evasion through the integration of 500,000 new taxpayers into the tax base over the last year.

Mr Cárdenas points out that the tax reforms will involve structural changes to allow Colombia to not only raise more revenue, but also in a way that enhances the competitiveness of the economy: "because our system today relies too heavily on a few corporations that pay their taxes according to the law, that have high effective rates of taxation, while at the same time there

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Colombia's Finance Minister, Mauricio Cárdenas, in conversation with FIRST Editor Alastair Harris

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is a lot of tax evasion and there is a lot of informality." In Colombia, traditionally, personal income taxes generate only a fraction of total revenue.

"What we are forecasting for the next four years – and has already been approved by law – is the dismantlement of the wealth tax and its substitution with a tax based on profits," explains Mr Cárdenas. He adds that the government's primary consideration is to "provide crystal clear rules for the private sector to ensure a certain amount of state income through higher compliance under the tax reform."

The aim of the tax reform, says Mr Cárdenas, is to raise overall revenue by between one and two percentage points of GDP, as well as freeing up at least 0.3 per cent of GDP every year for infrastructure investment.

Colombia is also pressing ahead with double taxation treaties, and is expected to sign a deal with the United Kingdom in the coming months, says Mr Cárdenas.

OECD accession

The accession process to the OECD, underway since early 2011, should be complete by next year, when Colombia will become only the second South American country to join the organisation.

Readying to join the OECD has spurred many of the reforms underway over the last four years, leading to higher levels of efficiency in the public sector and increased economic productivity, as well as guiding tax reform. Measures to eradicate corruption have also been implemented through the accession process.

"The accession process should foster economic growth in Colombia, help to reduce inequalities, improve education and increase transparency and efficiency in government," says Mr Gaviria, adding: The beneficiaries of these changes and of OECD membership will be the country and its citizens."

The OECD initiative is part of a strategy to give the country more relevance on the international stage. The network of free trade agreements that Colombia has signed in recent years (most notably with the United States and the European Union), the Pacific Alliance initiative, and Colombia's willingness to participate in Asia-Pacific Economic Cooperation are all examples of this. "It is definitely better to be involved in drafting the future economic rules of the world than to just let others do it," notes Mr Cárdenas.

Agricultural reform

A root-and-branch reform of the agricultural sector is one of the six main points of the peace accord with the FARC. As a result of the conflict, agriculture has been neglected for decades. In essence, the problems stem from uneven distribution: around 1 per cent of landowners hold close to half of all agricultural land; while two thirds of small holders share less than five per cent.

More than six million farmers were displaced during the half century of conflict. The result is an agricultural sector producing well below its potential. Only 50 per cent of available agricultural land is being used, and around 30 per cent of land currently employed for livestock is better suited for cultivation purposes, according to the United Nations' Food and Agriculture Organisation (FAO).

Mr Gaviria explains that to create better opportunities for farmers and to begin to fulfil Colombia's agricultural potential: "The government aims to create a land fund that returns land to people whose properties were illegally appropriated and to support farmers financially and technically so that they can become more competitive in national and international markets."

If reforms to the agricultural sector are successful, the FAO estimates that the agriculture sector alone could boost Colombian GDP by 0.6 per cent from 2017 to 2026. It particularly highlights the potential of the vast Cauca Valley to meet a huge percentage of the world's food needs.

Looking to a diversified future

Colombia faces many challenges, not least establishing a viable peace. But it has seen much worse – and has found its way to favourable outcomes. Continued progress will require refocusing the political centre around important policies that are difficult to implement but critical for continued progress. The requirements of OECD accession are providing politicians of the right and the left with some convenient political cover to make the hard choices that will enable change and transformation.

For example, the government will need to press ahead with removing obstacles to innovation, industrial production and exports, while enacting new FTAs. This will be required to open more markets to Colombian goods and services. In particular, Colombia should play a leading role in the Pacific Alliance to help it better compete in the global marketplace.

Colombia is also the only one of the four Pacific Alliance countries that is not yet a part of the Trans-Pacific Partnership (TPP), which was finalised in October 2015 and is awaiting signature and ratification by the twelve Pacific Rim signatories. The TPP provides a good pretext for Colombia to synchronise its laws with TPP standards, once the agreement's terms are made public and it is ratified, with the possibility of future accession.

Colombia is at a critical crossroads. Continued reforms at the institutional level, political consensus and widespread popular support, along with less dependence on oil revenue will all help it achieve an income per capita similar to that of Spain. But while continued political conflict remains a threat, Colombia cannot afford to be distracted and lose its direction of travel: now is the time to cement a lasting peace, and build on it. F