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FEATURED Q&A

Will Colombia's Tax Reform Improve the Economy?

Colombian President Juan Manuel Santos' government pushed the tax reform, saying it is necessary to ensure investor confidence. // File Photo: Colombian Government.

Q At the beginning of the year, Colombia implemented a controversial tax reform that includes an increase in the national sales tax and other provisions in order to replace lost revenue from the country's chief export, oil. The reforms, which also reduce the overall corporate tax burden, are expected to raise an additional $2 billion for the government this year, and officials hope it will reduce the risk of downgrades to Colombia's credit rating. What effects will the tax reform have on Colombia's economy and on businesses operating there? Which business sectors are best positioned to benefit from the changes, and which may be harmed by it? To what extent does the reform fail to tackle tax evasion, as Colombia's chief prosecutor, Néstor Humberto Martínez, has argued?

A **Wilfredo Rodriguez, CFO at Avenida Capital** "Through the tax reform, the government seems to be taking a strong stance on trying to restore the country's historical consistent economic growth, which has been recently affected by declines in oil and other commodity prices. I believe this tax reform will have a positive impact on Colombia's economy in the midterm and will pave the way for economic stability in the coming years. The tax overhaul focuses in part on broadening the tax base and thus increasing both income and consumption taxes on individuals, especially those individuals who were previously exempt from income tax filing. These changes may lead to a reduction overall consumption. Businesses, however, are seeing an overall decrease in taxes, which will lead firms to continue to support their

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The balloting was the final round of a long-delayed election cycle. Turnout was reportedly light and mainly peaceful.

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Two Florida Ports Cancel Deals With Cuba

The ports of Everglades and Palm Beach canceled deals with Cuba after Republican Governor Rick Scott threatened to revoke funding for ports doing business with "the Cuban dictatorship."

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Batista Arrested After Returning to Brazil

Former billionaire Eike Batista was arrested this morning at Rio de Janeiro's international airport after arriving from New York. Batista is accused in connection with the massive corruption scheme at Brazilian state-run oil company Petrobras.

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Batista // Fie Photo: Brazilian Government.

POLITICAL NEWS

Colombian Gov't, FARC Announce Coca Eradication Plan

Colombia's government and the Revolutionary Armed Forces of Colombia, or FARC, rebels on Friday announced a plan to eradicate vast amounts of coca leaf, the main ingredient of cocaine, as part of the peace agreement they signed last year, Reuters reported. The country manually destroyed 17,642 hectares of coca last year and seized 378 tons of cocaine, a record amount. There are more than 96,000 hectares of coca in the country, according to the United Nations. Planting of the leaf increased by 39 percent in 2015 after President Juan Manuel Santos' government halted aerial spraying of the herbicide glyphosate. The new strategy also includes a crop substitution plan. "The goal is to replace approximately 50,000 hectares of illicit crops during the first year of implementation in more than 40 municipalities in the most affected departments," the government and the FARC said in a joint statement. The two sides agreed to pursue a crop substitution program as part of their peace accord. The government is planning to invest $340 million in the substitution program, which will benefit 50,000 families, said the country's post-conflict minister, Rafael Pardo. Among the new crops to be planted are cacao and fruit trees, Reuters reported.

Batista Arrested After Returning to Brazil

Former billionaire Eike Batista was arrested this morning at Rio de Janeiro's international airport after arriving on a flight from New York, where his lawyer said he away on business, Bloomberg News reported. Batista stands accused of money laundering and corruption, including in the alleged payment of $16.5 million in bribes to former Rio de Janeiro Governor Sérgio Cabral, who was imprisoned in November. Both men are accused in the corruption scandal at state-run oil company Petrobras. "I'm coming back to face justice, as is my duty," Batista told a Globo TV reporter before leaving New York. "It's time to help clear things up."

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ongoing operations. This will likely drive new investments in the country, thus boosting Colombia's economy in the long run. This puts Colombia on a path to achieve a tax balance between personal and corporate income taxes closer to the OECD and Latin America averages. Overall, businesses will now be able to deduct 100 percent of the value-added tax, which will allow them to continue investing in their operations. Firms focused on real estate, health, mining, agriculture and technology will continue to benefit from the reform. In addition, those establishing operations in the regions previously affected by the guerrilla conflicts will see tax benefits. Free-zone firms and those selling products and services will be affected in the short term. It is a move in the right direction to consider VAT evasion as a criminal activity. Moreover, Colombia was the only country of the Pacific Alliance that did not penalize tax evasion."

A Richard Francis, director of sovereign ratings at Fitch Ratings: "The tax reform should help addresses the large and growing central government deficits, which reached an estimated 4 percent of GDP last year. Most of the key elements of the tax reform passed, such as an increase in the VAT, preservation of the financial transaction tax and the introduction of a tax on dividends. The government estimates the tax plan will raise revenues by 0.7 percent of GDP in 2017, rising to 3.1 percent in 2022. The reforms will clearly yield revenues. However, the impact of some of the measures, such as anti-evasion tools and efforts to boost formalization, is more difficult to quantify.

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NEWS BRIEFS

Haitians Vote in Local, Legislative Elections

Haitians went to the polls Sunday in local and legislative elections that were mainly peaceful and marked by low turnout, the Associated Press reported. The balloting was the final round of a long-delayed election cycle that began in 2015. There were no results yet in the elections, in which voters were choosing 5,500 district authorities. There were also eight legislative runoffs, in which President-elect Jovenel Moïse, who takes office Feb. 7, and his allies were hoping to increase their parliamentary majority.

Death Toll Increases to 11 in Chile Wildfires

The death toll increased to 11 on Friday as the worst wildfires in Chile's history spread to threaten the city of Concepción and the country's wine industry, a day after the fires destroyed the town of Santa Olga about 200 miles from the nation's capital, the Los Angeles Times reported. President Michelle Bachelet's office said that in addition to the 11 deaths, more than 5,000 people have been evacuated.

U.S. State Legislators Invite Peña Nieto to New Mexico

Mexican President Enrique Peña Nieto on Friday received an invitation to visit the U.S. state of New Mexico from three Democratic state lawmakers there, the Associated Press reported. The invitation came days after Peña Nieto canceled his trip to Washington after U.S. President Donald Trump advanced plans to build a multi-billion-dollar wall along the countries' border and repeated his assertion that he will force Mexico to pay for it. One of the legislators, Rep. Javier Martínez of Albuquerque, said the feud is a threat to the centuries-old tradition of economic and cultural ties between his state and Mexico.

ECONOMIC NEWS

Two Florida Ports Cancel Planned Deals With Cuba

Two Florida ports pulled out of plans to sign cooperation agreements with Cuba after Republican Governor Rick Scott threatened to revoke funding for the ports if they did business with the "Cuban dictatorship," Reuters reported Friday. "I will recommend restricting state funds for ports that work with Cuba in my budget," Scott tweeted last week. U.S. President Donald Trump has threatened to reverse the normalization of ties between the two countries, which his predecessor, Barack Obama, began two years ago. The ports of Everglades and Palm Beach had been planning to sign agreements with Cuba during a Cuban trade delegation's visit this week. Port of Everglades spokeswoman Ellen Kennedy said the decision would not affect trade with Cuba, which is conducted by port clients, rather than by the ports themselves.

BUSINESS NEWS

Venezuela's Maduro Names New Top Executives at PDVSA

Venezuelan President Nicolás Maduro on Sunday created an executive vice president position for PDVSA and named new vice presidents to the state oil company in what he said was an effort to fight corruption, Reuters reported. Eulogio Del Pino will remain in his position as PDVSA's president, but new vice presidents were named, including in the areas of finance and exploration. "We have to clean out the corruption that has incubated in [the oil industry]; I call on the oil workers to forcefully defeat corruption," Maduro said. For years, the country's main industry has been plagued by graft, ranging from smuggling to kickbacks and bribery that led to the prosecution of some U.S.-based contractors who had done business with the company. Previous attempts to shake up the company's leadership have not led to significant changes in its management style, which is known for heavy social spending, low crude output and payment disputes with suppliers. The newly appointed executive vice president is Maribel Parra, who is a rear admiral in the armed forces. Also, Simón Zerpa will serve as the new finance vice president. Zerpa previously led a bilateral Venezuela-China fund, through which the South American country borrowed billions of dollars from Beijing, to be repaid in oil and fuel shipments.

THE DIALOGUE CONTINUES

Will a New Team Turn Argentina's Economy Around?

Q Since taking over as Argentina's president a year ago, Mauricio Macri has implemented free-market measures in an effort to spur the economy and attract foreign investment. However, the country's economy contracted for the fourth consecutive time in last year's third quarter, and Macri in December dismissed his finance minister, Alfonso Prat-Gay, and split his ministry of treasury and finance into two cabinet departments. What kinds of economic policies can be expected of new Treasury Minister Nicolás Dujovne and new Finance Minister Luis Caputo? What policies should the Macri administration push in order to restore the country to growth? To what extent will midterm legislative elections in October complicate efforts to reduce the country's fiscal deficit and pass other needed reforms?

A Gabrielle Trebat, director for Brazil and the Southern Cone at McLarty Associates: "The dual appointments are intended to signal to investors that there is a clear road map to tackle both the deficit and inflation. With the split of the ministry, Dujovne is expected to focus on an accelerated reduction of the deficit, while Caputo will be charged with raising financing on international capital markets to cover a gap of about $40 billion. A known fiscal hawk, Dujovne has cautioned that markets will not continue funding Argentina's deficit indefinitely; he has pledged greater efficiency in spending and a reform of the tax code. The announcement comes after Argentina's underwhelming year-end 2016 economic results—despite the government's economic adjustment plan—where the economy contracted by 1.8 percent, inflation stands at approximately 40 percent and the 2017 projected budget deficit is 4.2 percent of GDP. Although the Macri government has taken important steps to improve the investment environment and restore relations with the IMF, including resolving the default, liberalizing Argentina's exchange rate controls and normalizing statistics reporting, the government's policies have not yet translated into economic growth nor a measurable reduction of the deficit. Argentina's economic performance continues to be a key concern ahead of the October mid-term elections. While there is an acknowledged need to restore fiscal sustainability, introducing sharp adjustments in an election year is proving to be politically challenging. The fate of Macri's Cambiemos coalition in the October election will greatly influence how much political room he has to continue with his economic reform agenda. Over the long run, however, growth can be expected to recover, owing to lower inflation, higher wages and investments in infrastructure spending."

EDITOR'S NOTE: The comment above is a continuation of the Q&A published in the Jan. 24 issue of the Advisor.

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Furthermore, on the external side, Fitch estimates that the current account deficit fell to below 5 percent of GDP in 2016 (from a previous forecast of 5.7 percent of GDP). Much of the adjustment came from the sharp fall in imports. Fitch believes that further adjustment in the current account balance needed to stabilize the rise in external debt will depend on a pick-up in exports as imports are not expected to drop further.

> **"We think the tax reform will benefit business as a result of the corporate tax cut...."**
>
> **— Daniel Velandia**

Amid rising interest rate costs, the government has adjusted to the revenue decline of recent years by reducing capital spending and containing current spending, although compressing expenditures on a sustained basis was going to be challenging. As such, the tax measures show the government's commitment to addressing the sovereign's loss of oil revenues, rebuilding the tax base and supporting the economy's formalization and investment recovery. In addition, the passage of the tax reform increases confidence in the government's capacity to meet the 3.3 percent of GDP fiscal target for 2017. Successful implementation of the reform, continued expenditure restraint and prioritization (partly to meet the commitments of the peace deal) will be required to meet the medium-term fiscal targets. In our view, successful achievement of fiscal targets and improvement in government debt dynamics as well as further adjustment in the current account deficit will depend on continued fiscal restraint as well as the outlook for exports and economic growth."

A **Daniel Velandia, head of research and chief economist for Colombia at Credicorp Capital in Bogotá:** "We estimate that the approved tax reform will increase inflation by 0.5-0.7 percentage points this year, with the risks balance biased to the lower end of the range amid the current weak domestic demand, which implies that producers and sellers should absorb part of the VAT increase. It is also likely to reduce this year's GDP growth by 0.3-0.5 percentage points. The reform will also provide further room for the central bank's easing cycle to continue. Accordingly, we expect GDP growth this year of 2.1 percent, an inflation of 4.3 percent by December and a repo rate of 5.75 percent in the next 12 months. We think the tax reform will benefit business as a result of the corporate tax cut, which would become more evident by year-end and during 2018 through higher earnings, investment and employment. For instance, we estimate that companies listed in the Colombian stock market could improve valuations by 10 percent on a weighted-average basis (that is, considering the weights in the local index) versus the scenario based on the previous corporate tax regime. However, we think Colombia is likely to preserve its current sovereign rating as the tax reform should allow the compliance of the fiscal rule in the upcoming years. In fact, S&P just affirmed its BBB rating, although the outlook remained negative, providing 18 months to get the results of the tax reform implementation."

The Advisor welcomes comments on its Q&A section. Readers can write editor Gene Kuleta at **gkuleta@thedialogue.org**.

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