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Will Colombia be able to get rid of the Financial Transactions Tax (FTT)?

Catalina Hoyos (Godoy & Hoyos Abogados) · Tuesday, April 7th, 2015

One of the most polemical tax measures in Colombia's recent taxation history has undoubtedly been the introduction of the Financial Transactions Tax (FTT). Loved by the public administration but hated by the taxpayers, this tax highlights the very difficult problem of whether it is possible to combine both a high degree of efficiency and an acceptable level of fairness, in order to achieve an ideal tax system. Absurd though this tax seems to be for some tax experts and probably for all taxpayers, it is highly relevant to the study of the very fundamental principles of taxation.

The regulation of this tax goes back to 1998, the year in which Colombia's financial system crashed. It was at that moment that Colombian policymakers dusted down the Tobin doctrines and introduced the so-called Financial Transactions Tax (Gravamen a los Movimientos Financieros – GMF) as a tax with the specific purpose of saving the financial system. Tobin had developed the idea of a tax levied on financial transactions as an effective measure to discourage certain practices known to be harmful to the economy – such as term capitals – by means of what he described as putting “sand in the wheels of international finance” (Tobin, 1974, 1978). However, the tax decisions taken in Colombia went much further and even beyond the scope of Tobin's ideas, with the result that today, more than 15 years after overcoming the crisis, the tax (which is not a Tobin-like contribution at all) is still in force. It ceased to be a temporary measure, as first presented to the public, and turned out to be a permanent tax in 2000, as ordinary as other regular taxes such as Income Tax or VAT.

Nevertheless, the tax reforms passed over the last few years have again stated that the tax will disappear “soon”. Law 1430 of 2010 envisaged a gradual reduction of the tax rate (which today is 0.4% for virtually any financial transaction) from 2014 to 2018, the year in which the tax was supposed to disappear. Law 1694 of 2013 changed this decision and, in spite of maintaining the criterion of 2018 as the final year of the tax, stated that the gradual reduction would only start in 2015. In contrast, Law 1739 of 2014 stated that the gradual reduction would start in 2019 and that the tax would be abolished in 2022.

Will this distant promise be true this time?

We have several reasons seriously to doubt this, the most powerful of which is the above-mentioned history. However, the Constitutional Court of Colombia has, once again, for around the nineteenth time, the challenge of deciding whether this new delay in the abrogation of the tax might be against the Constitution. As a matter of fact, some citizens have filed a lawsuit against

Law 1739, arguing that it goes against several tax-constitutional principles, including efficiency, good faith and certainty. Just to give an idea of how controversial the FTT has been, the scope of the tax has suffered changes, clarifications and amendments by means of twelve tax reforms since its origins in 1998 and has determined more than eighteen Constitutional Court judgments.

There are several negative things we can say about this tax. In the first place, there is the tax burden that some businesses have to bear. According to recent studies (Paying Taxes, World Bank, 2014), Colombia is one of the most tax-burdensome countries anywhere in the world; although this position cannot exclusively be attributed to the FTT, it is not difficult to see that it worsens the situation. It is a tax which does not take into account the real income of taxpayers and instead opts for taxing the movements of capitals, irrespective of whether or not they represent a real manifestation of wealth. This tax follows the exclusive rule of “if it moves, tax it” (Hoyos, 2012). Moreover, studies show that some economic sectors are more affected by the tax than others, together with the fact there are other – informal – activities which are neither affected by this tax, nor by others (Fedesarrollo, 2005).

Secondly, there are several studies which demonstrate that the FTT, along with the decrease in interest rates, has had the effect of increasing the costs of current and savings accounts and, therefore, promoting the migration to the use of cash. In black and white, the use of cash in Colombia turned from 49.50% to 67.85% of the monetary base between December 1997 and December 2010. The same occurred with the relationship between cash and current accounts, which shifted from 59.93% to 92.11% for the same period (Asociación Bancaria, *Semana Económica* N° 453). An official study suggests that in the years following the establishment of the FTT, the amount of cash increased by 30% annually, while Colombia’s inflation rates in recent years have never gone above 6% (Castillo Benitez, 2002).

This effect of “unbanking” the economy means nothing less than obstructing one of the very important challenges of the last decades – the global migration to a modern banking system which avoids the use of cash – and leaving Colombia back in the era when the use of cash was necessary for any form of commerce. Our system rewards the use of cash and, with it, rewards the informal economy, the evasion of taxes and money laundering (Klein, 2011; Cárdenas, 2005). The informal economy in Colombia has been estimated as accounting for almost 60% (Misas, et.al., 2005) of the economy, while the banking system only covers 58%, making it very difficult for us to arrive at a full and comprehensive financial system without the necessity for cash. However, the FTT does not help to change this situation; more worryingly, it worsens it.

Thirdly, and closely linked to the second point above, some studies show that the FTT has resulted in higher levels of evasion as a result of people and businesses being reluctant to use the banking access. Without the benefit of the information that the financial system can provide to the tax administration, this latter also loses the relevant data to control the appropriate collection of other taxes such as Income Tax and VAT. On top of that, there are studies which demonstrate that, particularly before the last few tax reforms, it was the small savers and businesses which were paying for the tax. This was due to the long list of exemptions that ended up being applied to the complex operations only possible by the big businesses and enterprises (Arbeláez, et.al. 2005).

The fourth consideration is the higher costs of the financial system and reduction in financial intermediation. Some studies reveal that the worst effects of the FTT on financial variables are those on the demand for cash, the volume of compensated cheques and the size of the foreign currency, banking, financial and securities markets (Suescún, 2001). Needless to say, such markets

are extremely important for any economy. A tax like the FTT makes the financial system costly and there is evidence for this. Transactions using cheques declined by almost 44% with the establishment of the tax (due to the use of the endorsement as an effective way of avoiding the tax) and other financial operations such as short-term deposits were also discouraged. In addition, studies demonstrate that the tax has been accompanied by a deviation of resources to international banks and instruments (Cárdenas, 2005).

Finally, we can talk a lot about tax arbitrages and competition among financial institutions. Because of the effects of the tax, financial institutions have entered into a fight to create new FTT-exempted products in order to keep their existing clients and to attract new ones. The reality is that inside such institutions, whole departments have been created at great cost which are dedicated to the “administration” of the tax, particularly to prevent it being a deterrent to their clients and operations. The Tax Administration has put these practices centre stage both by challenging huge financial operations before the Tribunals and by trying to create a public debate which calls into question the ethics of avoiding this particular tax. However, this debate appears nonsensical, as it is very difficult to apply any related “substance over form” theory to a tax which has no substance at all. It would probably be more productive to question the decision to maintain the tax despite the evidence of its damaging effects. On the other hand, these new FTT-exempted products also have their costs for users. These kinds of tax arbitrages show, once more, that the FTT is far beyond the neutrality principle, probably one of the most important economic rules when talking about tax policies.

In general, the FTT is a bad tax. As we have seen, it puts “sand in the wheels” of the whole economy (Castillo, 2002), discourages saving, distorts productive activity, affects the income of taxpayers, makes credit more expensive, promotes the use of cash, favours the informal economy (and, with it, tax evasion and money laundering) and is highly unfair. The tax has negative effects on investments, foreign trade and the cost of assets. The impact on the economy, therefore, is dramatic.

We sincerely hope that this time the Constitutional Court takes a strong position towards the elimination of this hideous tax.

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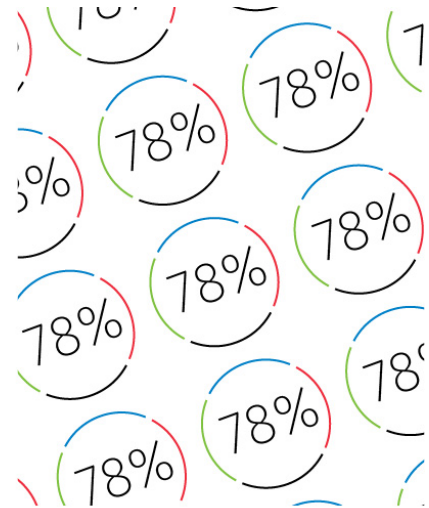
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