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INTER-AMERICAN DEVELOPMENT BANK

COLOMBIA

PROGRAM TO SUPPORT THE SUBSIDIES REFORM

(CO-L1163)

PROJECT SUMMARY

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Project Summary[1]

I. General Description

A. The Problem

In recent years, Colombia has had a remarkable macroeconomic performance and has made significant achievements in social matters. During 2010-2014 Gross Domestic Product (GDP) grew 4.8% annually, the inflation rate was 3% (which met the long-term inflationary target), there was a continuous reduction in unemployment (which fell from 11.8% to 9.1 %), and an increase in foreign direct investment and exports. Also, the fiscal deficit of the central government fell from 3.9% to 2.3% between 2010 and 2014. For the same period, regarding social indicators, the monetary poverty rate fell from 39.0% to 28.5%, while extreme poverty fell below one digit: it decreased from 12.3% to 8.1%. During these years the percentage of people of middle class exceeded the percentage of the population living in poverty, and there was a slight reduction in inequality.

In 2015, the external economic environment became unfavorable and created significant challenges for the Colombian economy. The deterioration of the terms of trade has led to a drop in tax revenues derived from oil revenues (1.5% of GDP) and worsening the current account deficit (6.5% of GDP). Given this, the exchange rate is acting as an automatic stabilizer, reducing the level of imports and increasing the tax collection of foreign trade. Also, increases are observed in the inflation rate (6.8% for 2015) due to the rises in food prices as a result of EL NIÑO phenomenon (long and intense summer) and an increase in the price of the imported goods due to the depreciation of the Colombian peso. Against this background, the central government made expenditure cuts in 2016 of 2.0% of GDP to meet the fiscal rule, while the Central Bank raised the benchmark rate by 225 basis points.

Despite the unfavorable context, the stability of the country's main macroeconomic principles and social policy, allowed the main economic indicators to have a positive performance in 2015. Investment reached 29.4% of the GDP, unemployment declined slightly to 8.9% and both poverty and extreme poverty continued to decrease (27.8% and 7.9% respectively). Although in 2015 foreign direct investment and exports declined and the fiscal deficit increased, the outlook for the upcoming years is favorable.

In the current context and the given policy framework, both the International Monetary Fund (IMF) and private analysts are forecasting a recovery of the Colombian economy in the medium term (2018). In June 2016 the IMF approved a new Flexible Credit Line (FCL) for approximately US $ 11.5 billion (equivalent to 20% of international reserves), doubling the amount of the previous FCL. The analysis made by the IMF recognizes the Colombian history of having a strong policy framework. In particular, Colombia has: (i) an inflation target regime with a flexible exchange rate, (ii) adequate regulation and supervision of the

[1] In agreement with the Banks information access policy (GN-1831-28), more specifically in the exceptions of disclosure "country-specific information" referred to in paragraph 4.1, and by request of the borrowing country, the loan proposal will not be disclosed. This document is a summary of the Loan Proposal.

financial sector, (iii) structural balance rule-based fiscal policy and, (iv) economic resilience to cope with the fall of oil prices. In the short term, the drop in public revenue creates a financing gap to be covered, in part, with the resources of this operation.

To ensure fiscal sustainability in the medium term and to meet the Fiscal Rule, the Government of Colombia is promoting significant fiscal reforms. For that matter, the government established a commission of experts to produce a fiscal reform proposal that assures tax equity and competitiveness, which delivered its final report to the Minister of Finance and Public Credit (MHCP) in December 2015. Based on the work of the commission of experts, the government is promoting a tax reform that seeks to increase revenues between 1.5% and 2% of GDP to compensate for the drop in revenue by the decline in oil prices, while generating an efficient and simple system. To complement the tax reform, the Government has identified as a priority a reform that increases the efficiency of public investment in subsidies to maximize its impacts regarding efficiency and equity.

The tax reform and the reform of public investment in subsidies are in accordance with the principles of good governance of the Organization for Economic Co-operation and Development (OECD). These reforms are expected to help improve the economy efficiency, as they constitute the foundation for consolidating a process of sustainable and equitable growth. This programmatic series focuses on the reform of the subsidy system.

Based on the joint work of the Government of Colombia and the Bank, a programmatic series is proposed to support the subsidy reform and to increase equity and efficiency of public investment in subsidies. To this end, the Bank will support the development of a regulatory framework that will define and systematize the guiding principles of subsidiary policy including the institutional framework and processes for its implementation, as well as the developing tools and strategies to increase efficiency in social subsidies. Second, the Bank will support the approval of the instruments to start the implementation of the principles for the allocation of subsidies and the integral system for targeting social subsidies.

B. Objective

This operation is the first of two individual operations of a programmatic-policy based loan (PBP). The objective of this programmatic series is to improve equity and efficiency in the spending of subsidies that are financed with the national budget.

C. Components

To achieve this objective, the program includes policy measures in the following components:

Component 1. Macroeconomic framework. The objective of this component is to ensure the maintenance of a macroeconomic environment in accordance with the program objectives.

Component 2. Regulatory framework for the assignation of subsidies. The objective of this component is to improve the equity and efficiency of subsidies by developing a regulatory framework defining the principles, criteria and requirements that should rule the investment in subsidies by the National Government.

Component 3. Social subsidies. The objective of this component is to improve equity and efficiency of subsidy spending, consistent with the principles of the abovementioned regulatory framework.

II. FINANCING STRUCTURE AND MAIN RISKS

A. Financing Instruments

This operation is the first operation of a programmatic-policy based loan (PBP), of two individual operations. This type of operation is appropriate because it allows the Bank to support the regulatory reform for subsidies, which will define criteria on rationality, structure, purpose and duration of benefits granted by the National Government. Also, it will allow the Bank to accompany the new integrated system for targeting social beneficiaries. This reform has coordination challenges and technical aspects that justify the choice of a programmatic series for this operation. The amount of funding for this first operation in the programmatic series is of US $400 million that will be drawn from ordinary capital resources (OC).

B. Environmental and Social Safeguard Risks

In response to the Operational Policy Directive (B.13) of the Environment and Safeguards Compliance Policy (GN-2208-20 and OP-703) the loan does not require classification. The social impacts of the policy measures of the program are expected to be positive.

III. IMPLEMENTATION AND MANAGEMENT PLAN

A. Implementation Arrangements

The borrower is the Republic of Colombia. The program implementation and use of the Ban's financing will be carried out by the borrower, through the Ministry of Finance and Public Credit, which will be called the executing agency. Also, the executing agency will implement the program in coordination with the National Planning Department (DNP), which is in charge of assuring the fulfillment of the policy conditions.

B. Arrangements summary for Monitoring Results

The Ministry of Finance and Public Credit, the National Planning Department and the Bank will monitor the agreed policy measures, as well as the results and fulfillment of the program's objectives.