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COLOMBIA

PROGRAM TO DEEPEN FISCAL REFORM IN COLOMBIA II

(CO-L1227)

LOAN PROPOSAL

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ABBREVIATIONS

ANCP	Agencia Nacional de Compras Públicas [National Public Procurement Agency]
CHIP	Consolidador de Hacienda e Información Pública [Consolidated Public Financial Information System]
CNG	Central national government
Col$	Colombian pesos
CREE	Contribución empresarial para la equidad [business contribution for equity]
DANE	Departamento Administrativo Nacional de Estadística [National Administrative Department of Statistics]
DIAN	Dirección de Impuestos y Aduanas Nacionales [National Tax and Customs Directorate]
DNP	Departamento Nacional de Planeación [National Planning Department]
ECG	Evaluation Cooperation Group
ECLAC	Economic Commission for Latin America and the Caribbean
FCR	Fondo de Compensación Regional [Regional Compensatory Fund]
FCTI	Fondo de Ciencia, Tecnología e Innovación [Science, Technology, and Innovation Fund]
FDR	Fondo de Desarrollo Regional [Regional Development Fund]
FONPET	Fondo de Ahorro Pensional de las Entidades Territoriales [Pension Savings Fund for Subnational Entities]
IMAN	Impuesto mínimo alternativo nacional [national alternative minimum tax]
IMAS	Impuesto mínimo alternativo simple [simple alternative minimum tax]
MFMP	Marco Fiscal de Mediano Plazo [Medium-term Fiscal Framework]
MHCP	Ministerio de Hacienda y Crédito Público [Ministry of Finance]
NFPS	Nonfinancial public sector
OCAD	Órganos colegiados de administración y decisión [administrative and decision-making bodies]
OECD	Organization for Economic Cooperation and Development
PBL	Policy-based loan
PPP	Public-private partnership
SECO	Swiss State Secretariat for Economic Affairs
SECOP	Sistema Electrónico de Contratación Pública [Electronic Public Contracting System]
SGR	Sistema General de Regalías [General Royalties System]
VAT	Value-added tax

PROJECT SUMMARY

COLOMBIA

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(CO-L1227)

<table>
<tr><th colspan="5">Financial Terms and Conditions</th></tr>
<tr><td colspan="3" rowspan="2">Borrower: Republic of Colombia</td><th colspan="2">Flexible Financing Facility[a]</th></tr>
<tr><td>Amortization period:</td><td>20 years</td></tr>
<tr><td colspan="3" rowspan="2">Executing agency: Ministry of Finance (MHCP)</td><td>Disbursement period:</td><td>12 months</td></tr>
<tr><td>Grace period:</td><td>5.5 years[b]</td></tr>
<tr><th>Source</th><th>Amount (US$)</th><th>%</th><td>Interest rate:</td><td>LIBOR-based</td></tr>
<tr><td rowspan="2">IDB (Ordinary Capital):</td><td rowspan="2">600 million</td><td rowspan="2">100%</td><td>Credit fee:</td><td>[c]</td></tr>
<tr><td>Inspection and supervision fee:</td><td>[c]</td></tr>
<tr><td rowspan="2">Total:</td><td rowspan="2">600 million</td><td rowspan="2">100%</td><td>Weighted average life:</td><td>12.75 years</td></tr>
<tr><td>Currency of approval:</td><td>United States dollars</td></tr>
<tr><th colspan="5">Project at a Glance</th></tr>
<tr><td colspan="5">Project objective: The program's general objective is to contribute to Colombia's fiscal stability through an increase in tax revenue intake, more efficient use of public expenditure, and better management of public debt and liabilities, including contingent liabilities. The specific objectives include the following: (i) strengthen the collection of tax revenue; (ii) improve public expenditure efficiency; and (iii) improve the management of debt and contingent liabilities.
This operation is the second in a series of two operations under the programmatic policy-based loan modality.</td></tr>
<tr><td colspan="5">Special contractual conditions precedent to the first and only disbursement of the loan proceeds: The first and only disbursement under this operation is subject to fulfillment of the policy reform conditions as established in the Policy Matrix (Annex II), the Policy Letter, and the other conditions established in the loan contract (see paragraph 3.3).</td></tr>
<tr><td colspan="5">Exceptions to Bank policy: None.</td></tr>
<tr><th colspan="5">Strategic Alignment</th></tr>
<tr><td colspan="5">Challenges:[d] SI ☐ PI ☑ EI ☐</td></tr>
<tr><td colspan="5">Crosscutting themes:[e] GD ☐ CC ☐ IC ☑</td></tr>
</table>

[a] Under the Flexible Financing Facility (document FN-655-1), the borrower has the option of requesting changes to the amortization schedule, as well as currency and interest rate conversions. The Bank will take operational and risk management considerations into account when considering such requests.

[b] Under the flexible repayment options of the Flexible Financing Facility, changes to the grace period are permitted, provided that they do not entail any extension of the original weighted average life of the loan or the last payment date as documented in the loan contract.

[c] The credit fee and inspection and supervision fee will be established periodically by the Board of Executive Directors as part of its review of the Bank's lending charges, in accordance with the relevant policies.

[d] SI (Social Inclusion and Equality); PI (Productivity and Innovation); and EI (Economic Integration).

[e] GD (Gender Equality and Diversity); CC (Climate Change and Environmental Sustainability); and IC (Institutional Capacity and Rule of Law).

I. DESCRIPTION AND RESULTS MONITORING

A. Background, problem to be addressed, and rationale

1.1 This operation is the second in a programmatic series of two policy-based loans (PBLs). The series began in 2014 (loan 3284/OC-CO) and was undertaken with the Government of Colombia to support structural measures contributing to fiscal stability through an increase in tax revenue intake, more efficient use of public expenditure, and better management of public debt and liabilities, including contingent liabilities.

1.2 This operation maintains support for policy reforms consistent with the objectives laid out in programmatic loan 3284/OC-CO, which was approved in 2014 and disbursed in 2015. This second operation will consolidate the policy reforms adopted by Colombia as part of safeguarding fiscal sustainability within the framework of the peace process and the accession process to the Organization for Economic Cooperation and Development (OECD). The outcomes of the first operation have been highly significant, including: (i) approving two reforms to expand the tax base and control evasion,[1] including the adoption of electronic invoicing and accompanying regulations; (ii) progress in modernizing the customs statute and administration; (iii) institutional capacity-building for the effective operation of the new General Royalties System (SGR);[2] (iv) consolidating the public procurement system; (v) formulating a debt management strategy; (vi) improving the quality of public-private partnership (PPP) projects; and (vii) determining a financial strategy for natural disaster risk management.

1.3 **Macroeconomic conditions.** Colombia's economy deteriorated between 2014 and 2016 due to falling international oil prices. GDP growth took a downward turn, falling from a 4.4% annual rate in 2014 to 2% in 2016. The current account deficit widened to an average of 5.3% of GDP between 2014 and 2016, compared to an average of 3.1% in the period 2010-2013. The central national government (CNG) fiscal deficit rose to 4% of GDP in 2016, versus 2.3% in 2013. Lastly, in 2015 inflation exceeded its target range (2% to 4% per year) as a result of the El Niño phenomenon and exchange rate depreciation, rising to an annual rate of 5.7% in 2016.[3]

1.4 Prudent economic policy management helped to cushion the impact of an external shock associated with the 2014 drop in oil prices through a gradual adjustment in the external and fiscal accounts. The exchange rate buffered falling oil prices, depreciating 56% between 2013 and 2015. This depreciation facilitated a reduction in import levels and an increase in nontraditional exports. Faced with a reduction

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1 The objective of the 2012 reform was to promote employment by replacing parafiscal payroll taxes with a tax on earnings, and to foster equity in taxation by modifying the individual income tax, expanding the tax base, and creating an alternative minimum tax. The 2014 reform was focused on creating and extending taxes that produce crucial revenue for fiscal sustainability. It also made significant advances in terms of combating evasion, with the introduction of a foreign assets declaration and a "normalization tax" for undeclared assets. The 2014 reform also created an Expert Committee on Tax Equity and Competitiveness to study tax regimes and recommend changes to reduce evasion and avoidance and create a more equitable and efficient tax system.

2 The SGR was created as part of the 2011 constitutional reform process and was launched in 2012.

3 Sources: Departamento Administrativo Nacional de Estadística [National Administrative Department of Statistics] (DANE), Banco de la República, and Ministry of Finance (MHCP).

in CNG oil revenue—equivalent to 3.2% of GDP in 2013—the government used a combination of public expenditure cutbacks[4] and a higher deficit to reduce the impact of the adjustment on the real sector of the economy. At the same time, Banco de la República (the central bank) tightened monetary policy, raising the benchmark rate by 400 basis points. This contained inflation, which fell to an annual 3.4% in July 2017.

1.5 Despite the shock at the macroeconomic level, data for unemployment, poverty, and inequality continued to improve. Unemployment fell from 9.6% in 2013 to 9.2% in 2016, while poverty and extreme poverty declined from 30.6% to 28%, and 9.1% to 8.5%, respectively, over the same period. Although inequality remains high compared to other countries in the region, the Gini coefficient fell from 53.9 in 2013 to 51.7 in 2016.[5]

1.6 Under current conditions, and based on the prevailing policy framework, the slowdown in GDP growth is estimated to have bottomed out in the second quarter of 2017 at an annual variation rate of 1.3%. The estimated GDP growth rate for 2017 is 1.8%, with a rate of 2.6% projected for 2018; the annual inflation rate stood at 4.1% in 2017. The external adjustment is also expected to continue, with the current account deficit narrowing to 3.5% of GDP in 2018.

1.7 **Fiscal position.** The Ministry of Finance (MHCP) expects the public finances to begin improving in 2018, after the deterioration associated with the external shock. The nonfinancial public sector (NFPS) deficit is projected to narrow from 3.2% of GDP in 2017 to 2.7% in 2018, while the CNG deficit declines from 3.6% of GDP to 3.1%.

1.8 Net debt as a proportion of GDP has been on an upward path since 2013, reaching 33.7% for the NFPS and 43.6% for the CNG in 2017. CNG net domestic debt stood at 28.9% of GDP the same year, while net external debt was 14.7% of GDP. As explained by the MHCP in the June 2017 Medium-term Fiscal Framework (MFMP), much of the increase in CNG debt occurred from 2014 to 2015 because of exchange rate depreciation. CNG debt is expected to remain at 43.6% of GDP in 2018 and trend downward in the medium term consistent with the reduction in the fiscal deficit.

[4] In July 2015, the government announced a Smart Fiscal Austerity strategy for implementing a fiscal adjustment as required by the Fiscal Rule, prioritizing social spending and making way for the private sector to drive investment.

[5] Source: DANE.

Table 1. Colombia: Macroeconomic and fiscal indicators

Central national government (% of GDP)	2013	2014	2015	2016	2017p	2018e
Ordinary revenue	16.9	16.7	16.1	14.9	15.7	15.4
Total expenditure	19.2	19.1	19.2	18.9	19.3	18.4
Current expenditure	15.9	16.1	16.1	16.9	17.3	16.9
Interest	2.3	2.2	2.6	2.9	2.9	2.9
Investment expenditure	3.3	3.0	3.1	2.0	2.0	1.5
Primary fiscal balance	0.0	-0.2	-0.5	-1.1	-0.7	-0.1
Total fiscal balance	-2.3	-2.4	-3.0	-4.0	-3.6	-3.1
Net public debt	32.6	35.6	41.1	42.6	43.6	43.6
Current account balance	-3.3	-5.2	-6.5	-4.4	-3.6	-3.5
Annual GDP growth (in %)	4.9	4.4	3.1	2.0	1.8	2.6

p: Preliminary; e: Estimated.
Source: MHCP.

1.9 **Public finance challenges.** The decline in oil revenues and resulting expansion of the fiscal deficit put pressure on public expenditure, given the obligation to comply with the Fiscal Rule. The rule set targets for the structural deficit of 1.3% of GDP in 2014, 1.9% of GDP in 2018, and 1% of GDP in 2022, reflecting a downward trend.[6] Despite the gains in fiscal consolidation over the last decade, the external shock demonstrated the need for further deepening of efforts to strengthen tax administration and revenue intake, improve expenditure efficiency, and optimize public debt management, including contingent liabilities. The main challenges are described below.

1.10 **Tax revenue management.** Colombia's CNG tax revenue intake is low (13.6% of GDP) compared to the averages for Latin America (15.8% of GDP) and South America (17.6% of GDP).[7] Subnational tax collection is also low: the departments and municipios currently collect approximately 3.1% of GDP—less than in Argentina and far less than in Brazil, countries which exhibit a similar level of decentralization to Colombia and which collect 5.9% and 9.8% of GDP, respectively.[8] With the decline in oil revenue, the trend in tax revenue in recent years will be insufficient to meet the Fiscal Rule targets in the medium term.

1.11 In its 2015 report, the Expert Commission on Tax Equity and Competitiveness ("Tax Commission") confirmed that the revenue intake of the tax system is low compared to potential levels in an economy of such characteristics,[9] and that temporary taxes introduce high levels of uncertainty surrounding medium-term targets. It also concluded that the system does not improve income distribution, exhibits problems of horizontal equity, is complex and difficult to administer, and lacks sufficient resources to combat evasion, avoidance, and smuggling.[10] The limited tax revenue intake is largely the result of factors relating to: (i) national and

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6 According to the information in annual compliance reports, the government has complied with the Fiscal Rule in terms of both the 2014 target and the downward trend in the structural deficit.

7 Economic Commission for Latin America and the Caribbean (ECLAC), 2017. Fiscal Panorama of Latin America and the Caribbean 2017: Mobilizing resources to finance sustainable development.

8 IDB, 2015. Country strategy with Colombia (2015-2018) (document GN-2832).

9 The country's revenue intake has been lower in comparison, even before the fall in commodity prices.

10 Bonilla, R., Córdoba, R., Lewin, A., Morales, O. D., Montoya, S., Perry, G., and Piza, J. R. (2015). Tax Commission. Final report to the MHCP. December 2015. Fedesarrollo.

subnational government tax policies characterized by low rates, outdated property registries, and exemptions that erode the tax base; and (ii) weak tax and customs administration in terms of both rules and enforceability.

1.12 Taxes levied by the CNG exhibit weaknesses in terms of revenue generation due to: (i) the high level of informality in the economy, which stands at close to 47%;[11] (ii) the high number of exemptions; and (iii) complex rules governing tax payments.[12] In the case of exemptions, tax expenditure is estimated at 4.5% of GDP (2.4% in income tax (ISR) and 2.1% in value-added tax (VAT)), resulting from more than 200 exemptions representing around 30% of tax collections.[13] A key issue with policy instruments aimed at combating tax evasion is that existing rules are still not aligned with international best practices, such as OECD rules governing base erosion and profit shifting (BEPS).[14] Similarly, the Tax Commission concluded that the system exhibited an anti-investment bias that affected prospects for growth and job creation. Firstly, the nominal rate of the income tax and the CREE tax on corporations reached a de facto maximum of over 40%:[15] the highest nominal rate in the region. In addition, no income tax deductions were allowed for value-added tax paid on capital goods purchases in the same year, representing a strong disincentive to saving and private investment. As a result, in addition to the urgent need to offset the decline in oil revenues, this bias against private investment also needed to be reduced.

1.13 At the subnational level, the low level of tax revenue is mainly the result of: (i) low tax rates;[16] (ii) outdated registries;[17] and (iii) poor enforcement.[18]

1.14 The VAT, which accounts for 36% of tax revenue, is subject to a large number of exemptions and benefits while also exhibiting low productivity due to the lack of

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11 DANE, labor informality rates for 13 primate cities, 2016.

12 The 2014 tax reform introduced three income tax declaration systems for individuals (the national alternative minimum tax (IMAN), simple alternative minimum tax (IMAS), and the ordinary system) and the CREE tax on corporations, each with a different tax base, benefits, rates, and withholding arrangements. This increased the complexity of the system and made it more difficult for taxpayers to understand their obligations (Tax Commission, 2015).

13 IDB, 2015.

14 The main weaknesses include a lack of reporting and specified methods for transfer pricing.

15 This nominal rate consisted of a statutory corporate income tax rate of 25%, plus an additional 15% comprising the CREE and a CREE surtax, which were applicable to a wider tax base than the income tax.

16 At the municipal level, effective rates are 5 per 1,000 for the property tax and 2 per 1,000 for the industry and commerce tax (ICA), whereas the potential is 16 per 1,000 and 10 per 1,000, respectively (source: loan 2744/OC-CO). At the departmental level, the cigarette tax generates fiscal pressure of 35% on the final price, which is lower than in the OECD countries, where it is up to 60%; the tax rate on the amount of alcohol in beverages is also below the OECD average (Tax Commission, 2015).

17 A Bank study indicates that properties are undervalued by 40% to 50% on average, and that the property registry is outdated by between 25% and 39% (IDB, 2015).

18 Efficiency in property tax collections—measured as revenue as a proportion of the amount billed—averages 60% for the 15 Colombian cities in the Bank’s Emerging and Sustainable Cities Initiative (ESCI). This phenomenon is associated with the absence of invoicing procedures and systems for tax payment and collection, leading to a high level of arrears (Tax Commission, 2015).

implementation and widespread use of electronic invoicing.[19] The OECD also indicates that most VAT evasion is the result of weak customs administration, particularly the poor regulation and management of border crossings.[20,21] According to data from the Economic Commission for Latin America and the Caribbean (ECLAC), VAT evasion was around 20% in 2015, representing 1.3% of GDP.[22] Although this figure is below average for Latin America (27.8%), other estimates for Colombia put VAT evasion at 40%.[23] Lastly, the Enforcement Unit does not have enough human resources, and the Dirección de Impuestos y Aduanas Nacionales [National Tax and Customs Directorate] does not have the necessary autonomy to manage the hiring process, which limits tax collection and audit operations.[24]

1.15 The first programmatic operation made progress in laying the policy groundwork to improve revenue management, including: (i) issuing regulations tied to certain aspects of international taxation; (ii) approving rules for the use of electronic invoicing; (iii) introducing a bill for new customs regulations; (iv) identifying a customs control system that meets Colombia's needs; and (v) adopting measures to modernize DIAN's organizational structure.

1.16 **Public expenditure management.** Pressure to reduce public spending is created by the need to reduce the fiscal deficit in order to meet targets established under the rule for the structural balance. As highlighted by the Public Expenditure and Investment Commission ("Expenditure Commission"), however, continued reductions in the level of spending are not only difficult due to the high level of budget inflexibility but may also have a negative impact on economic growth.[25] Priority therefore needs to be put on measures to improve expenditure efficiency, effectiveness, and targeting. Key administration and management problems in the budget process include the absence of technical arrangements for the proper prioritization of expenditure allocations; the disconnect between budgeting and evaluation; and weaknesses in expenditure information systems.

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19 Paper invoices limit the tax authorities' ability and effectiveness in combating fraud and evasion. Electronic invoicing facilitates enforcement and audits by allowing information to be analyzed and cross-referenced to detect irregularities. For this to happen, according to ECLAC (2017), the invoicing mechanism needs to be extended and made mandatory, which first requires ensuring that the associated information technology services are accessible and operable. The most effective electronic invoicing models offer real-time reporting that allows prevalidation by the tax administration. Electronic invoicing is currently mandatory in 10 out of 18 countries in Latin America, although not all employ prevalidation or have extended the system to the level of the final consumer.

20 In the Doing Business 2018 report, Colombia ranked 125th on the trading across borders indicator, compared to an overall ranking of 59th.

21 The import process takes 4.7 days in Colombia, including obtaining, preparing, and submitting documentation during port or border handling, customs clearance, and inspection procedures; this compares to an average of 2.6 days for Latin America and the Caribbean (Doing Business 2018).

22 ECLAC, 2017.

23 OECD, 2015. Economic Surveys: Colombia 2015, OECD Publishing.

24 The Tax Commission indicated that DIAN lacks autonomy for determining the number of employees, their qualifications, and contract duration, resulting in one of the highest numbers of citizens per full-time employee (9,215, compared to 4,651 in Mexico and 2,462 in Argentina).

25 The Expenditure Commission was created under the 2016 Tax Reform Law with the objective of strengthening equity, formalization, and inclusion, as well as improving public management efficiency and strengthening the State.

1.17 In terms of spending by subnational entities, the Expenditure Commission indicates that there is room to improve efficiency in the use of royalties. The General Royalties System (SGR) has made progress in terms of distribution, as it allows the resources to be channeled to a greater number of departments.[26] Nonetheless, there are still delays in execution[27] due to the difficulties that subnational entities experience in submitting quality projects in a timely manner.[28] As a result, a number of funds in the system—such as the Science, Technology, and Innovation Fund (FCTI) and the Pension Savings Fund for Subnational Entities (FONPET)—accumulated growing balances that were not being used, leading to inefficiencies in the use of these resources. Many subnational entities lack institutional capacity for using FCTI funds, while others have already covered a significant share of their savings commitments for pension liabilities without having accessed FONPET resources.

1.18 Likewise, the lack of regulations standardizing methodologies for project design and appraisal, together with inadequate training on the part of the CNG, has hindered the structuring and design of investment projects using this source of financing.[29] Difficulties in identifying and structuring projects have led to the fragmentation of resources across small-scale projects with low regional impact.[30]

1.19 Lower oil prices have created pressures to reduced expenditure, which has affected financing for investment projects, in particular. Nonetheless, the 2016 Final Agreement to End the Armed Conflict[31] created additional government spending commitments for investments in the areas most affected by the conflict. This meant that underutilized SGR funds needed to be redirected into investment projects aligned with the agreement, and that agreements were needed between the different levels of government to jointly prioritize and execute investments in these areas. Accordingly, the commitments in the agreement require resources to be utilized more effectively and efficiently, in order to stay within the fiscal constraints established in the Fiscal Rule Law.

1.20 In addition to the weaknesses already discussed, there is room to improve the design and execution of resources in the main SGR funds.[32] An evaluation of the

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[26] An assessment by the Comptroller General's Office estimated that in 2010, 80% of the population received only 20% of royalties. With the launch of the SGR, 80% of the population now receives 70% of royalties.

[27] Execution rates for the Regional Development Fund (FDR) and the Regional Compensatory Fund (FCR) stood at 48% and 50%, respectively, in the two-year period 2015-2016, while the rate for direct royalties (received by producing territories) was 66% (Comptroller General's Office, 2017).

[28] Measurements by the National Planning Department (DNP) indicate that 66% of municipios have low capacity, and only 30% have medium or high capacity (OECD, 2016). These weaknesses mean that projects in the 2015-2016 budget committed only 75% of system resources (Comptroller General's Office, 2017).

[29] As of December 2016, more than 10,000 projects had been approved by the SGR. The approval process for these involves more than 1,000 administrative and decision-making bodies (OCADs), whose procedures exceed the capacities of the subnational entities and the DNP.

[30] As of June 2017, municipal-level initiatives accounted for 73% of approved projects representing just 34% of system funding (DNP). Large-scale projects with high social return are no longer prioritized, and only 5% of approved projects have a regional impact (OECD, 2016).

[31] The seven-point Agreement to End the Armed Conflict and Build a Stable and Lasting Peace was signed by the CNG and the Revolutionary Armed Forces of Colombia—People's Army (FARC) on 24 November 2016.

[32] Bonet et al. (2014) indicates that the distribution system needs to take varying capacities among the territorial entities into account and incorporate incentives to improve fiscal performance.

system's impact was therefore needed to identify specific actions to improve that impact. At the same time, design of the SGR needed to be adjusted to improve its operation, based on the identification of bottlenecks and on the recommendations arising from the institutional and process evaluation of the system.

1.21 With respect to current expenditure, given the importance of goods and services procurement,[33] major progress has been made with the creation of a National Public Procurement Agency (ANCP), through the introduction of a regulatory framework with such features as: (i) a procurement manual; (ii) the development of standard bidding documents; and (iii) pricing framework agreements.[34] Nonetheless, inefficiencies and limited transparency persisted due to the absence of an Electronic Public Contracting System (SECOP) that would allow transactions to be performed online, as well as the limited coverage of the pricing framework agreements available through the Tienda Virtual del Estado [Virtual Store of the State]. Together with persistent problems such as corruption and complex regulations, limited access to real-time information is an issue that needs to be improved in the public procurement process, as indicated by the Expenditure Commission.

1.22 With the support of the first programmatic operation, progress was made in creating institutional mechanisms (such as coordinating groups or networks) to build the capacity of subnational entities to develop investment projects; collecting data to improve SGR design and operation; evaluating the impact of certain funds; and designing demand-aggregation tools.

1.23 **Management of debt and contingent liabilities.** Unexpected events such as macroeconomic shocks, natural disasters, or contingent liabilities becoming actual can lead to a substantial deterioration in the fiscal balance. The most frequent and onerous risks have been associated with external shocks and financial crises, followed by PPP project contingencies and natural disaster-related damage.[35]

1.24 Colombia exhibits strengths in the management of risks associated with macroeconomic shocks, financial crises, and subnational finances.[36] However, the CNG debt remains vulnerable to external shocks, as observed following the oil price drop, when the debt began trending upward to almost 50%. As a result, progress has been made on developing a National Medium-term Debt Management Strategy, which envisions a series of actions related to the size and characteristics of the bond portfolio, aimed at achieving specific objectives in the areas of risk, maturity, cost, currency, and interest rates. Given the reduction in revenue in recent years, induced by the decline in commodity prices, higher

[33] According to the OECD, public procurement accounts for approximately 12.5% of GDP and 35.7% of government spending (OECD, 2016).

[34] The pricing framework agreements set maximum prices for the purchase of specific goods and services, based on which suppliers of those goods and services compete to offer lower prices.

[35] The materialization of these risks has created significant fiscal pressures in Colombia. The 1998-2000 financial crisis had a fiscal cost of 6.3% of GDP (Laeven and Valencia, 2012), while demands related to PPP guarantees in telecommunications, energy, and roads resulted in cumulative fiscal costs of 2% of GDP in the period to 2004 (Cebotari et al., 2009). The 1999 earthquake is estimated to have cost between 1.9% and 2.6% of GDP (International Disasters Database).

[36] After the crisis at the end of the 1990s, the country adopted and consolidated stabilization mechanisms to deal with shocks to the macroeconomic environment, including strengthening financial system regulation and adopting a fiscal rule. At the territorial level, there are rules that limit subnational borrowing.

financing requirements mean that bond issues will need to be consistent with this strategy.

1.25 Regarding PPP projects, a law was enacted in 2012 to improve the institutional, economic, and regulatory environment and provide incentives for private-sector involvement in the development of infrastructure projects. This change intensified the fiscal risks associated with PPP contracts, which require effective risk management; as a result, insurance arrangements were introduced through a PPP framework contract. To avoid financial risks that might lead to an increase in financing costs and a possible reduction in real revenue, PPP contracts need to comply with the risk mitigation measures established in the regulations. Likewise, given the more widespread use of this instrument as a source of financing and the workload that this creates, institution-strengthening is required so that quality projects can be prepared and approved in a timely manner.[37]

1.26 To mitigate the significant fiscal costs that arise from natural disasters, in 2014 the Public Credit Directorate designed a strategy to reduce vulnerability in the face of this type of event by enabling the associated risks to be identified, quantified, mitigated, and addressed. To ensure its effective implementation, this strategy needs to be disseminated to different stakeholders and sectors, to incorporate into their contracting instruments.

1.27 As part of Colombia's OECD accession process, risks were identified relating to the government's role as a shareholder in public enterprises.[38] While the publicly traded state enterprises in which the government has a majority stake are profitable, profitability among unlisted state companies is low. Nineteen percent of all state-owned enterprises had negative profitability in the period 2011-2014. Although the social value created by some of these companies is also important, it is worth noting that at 46 companies where the government is a minority shareholder returns on equity and assets have averaged 2.2% and 1.3%, respectively. These returns have been lower than the average inflation rate, meaning that government investments in these companies have lost value in real terms while creating an administrative and operational burden for the government. The companies' independence and decision-making are limited by the absence of clear objectives and coordination and decision arrangements, as well as fragmentation of responsibilities among the different stakeholders.[39] These problems have given rise to a mixed portfolio, with government stakes in a number of low-profitability enterprises that are not sufficiently monitored in terms of the contingencies they may create for the country.

1.28 Regarding debt and contingent liabilities, the first operation made progress on the creation and design of tools for the effective management of contingencies related to debt administration, the mitigation of risks associated with PPP contracts and

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[37] Eighteen concessions were approved for highway projects between 1994 and 2010, equivalent to 1.1 per year. With the approval of the regulatory framework in 2012, the number of highway PPP concessions rose to 30 between 2014 and 2006, with an average of 10 new concessions approved per year, including private initiative PPPs (National Infrastructure Agency).

[38] The value of the CNG's shareholdings in the 111 state-owned enterprises is equivalent to 32% of GDP, while the sum of their earnings is equivalent to 30% of the national investment budget (DNP, based on December 2014 data from the Consolidated Public Financial Information System (CHIP)).

[39] Lehuedé, H. (2013), Colombian SOEs: A review against the OECD guidelines on corporate governance of state-owned enterprises, OECD Corporate Governance Working Papers, No. 12, OECD Publishing, Paris.

the adoption of good practices for their design, and the financial management of natural disaster-related contingencies.

1.29 **The Bank's experience with the country.** This operation builds and expands on the experience gained in fiscal and of public management strengthening operations between the Bank and Colombia, including: Program to Consolidate Subnational Fiscal Responsibility, Phases I (2341/OC-CO) and II (2744/OC-CO); Program to Strengthen the Legal Defense of the State (2755/OC-CO); Program to Strengthen the Public Investment System (2977/OC-CO); Citizen Service Efficiency Project (3154/OC-CO); Disaster Risk Management and Climate Change Adaptation Reform Program (2616/OC-CO); Program to Support Public-Private Partnerships in Infrastructure (3090/OC-CO); Promotion and Expansion of Electronic Invoicing in Colombia (3155/OC-CO); Program to Deepen Fiscal Reform in Colombia I (3284/OC-CO); and the Multisector Conditional Credit Line for Investment Projects for Fiscal and Public Investment Expenditure Strengthening in Subnational Entities (CCLIP CO-X1018).[40]

1.30 The group of operations executed in Colombia in recent years demonstrates the importance of complementarity and synergy among the different lending instruments, where the mix of investment loans, policy-based loans, and technical-cooperation operations to support dialogue with the country helps to build and strengthen institutional modernization. In providing continuity to the programmatic policy-based loan, the team has adopted the recommendations of the Office of Evaluation and Oversight (OVE) in terms of strengthening the design, monitoring, and follow-through of these types of operations, to ensure that development objectives are met in a sustainable manner.[41] Prior experience on Bank operations in the fiscal area also highlight the importance of supplementing tax policy actions with capacity-building for revenue administration, as well as the need to build consensus with different stakeholders to ensure the sustainability of reforms.[42] This program has embedded these experiences by: (i) supplementing this policy-based loan operation with other investment lending and technical cooperation instruments;[43] (ii) adding follow-on tax policy and revenue administration actions; and (iii) sustaining dialogue and building consensus around the reforms since the first operation.

1.31 **Empirical evidence.** The literature offers robust evidence on the effectiveness of the main program measures in middle-income countries. Auerbach and Smetters (2017) and IDB (2015) found that reductions in corporate income tax rates, when financed by reductions in expenditure, are associated with higher levels of

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[40] Summary table of recent operations in the fiscal area in Colombia. See, for example, operations 2341/OC-CO and 2744/OC-CO, as well as the final report on the evaluation of the IDB's Program to Consolidate Subnational Fiscal Responsibility and the system for monitoring, supervision, and control of subnational finances in Colombia.

[41] Country program evaluation: Colombia, 2012-2014, OVE.

[42] For regional experiences, see "*Apresentação consolidada das etapas Proconfis Bahia I e II*" [Presentation on the Fiscal Stability Consolidation Program (PROCONFIS), Stages I and II], prepared by the Government of the State of Bahia, Brazil; optional link 3, which summarizes the fiscal reform programs in Brazil and Mexico; and OVE's "Comparative evaluation: Review of Bank support to tax policy and administration, 2007-2016."

[43] The program complements the following investment and technical cooperation operations: 3155/OC-CO, to support the expansion of electronic invoicing; CO-X1018, to strengthen fiscal management and investment spending in subnational entities; CO-L1164, to strengthen municipal cadastral management; and ATN/OC-15920-CO, to strengthen the management of state-owned enterprises.

investment and economic growth. Similarly, Schwellnus and Arnold (2008) showed that higher corporate tax rates are associated with lower productivity. In terms of measures to increase the productivity of revenue collection, studies have found positive effects from the use of electronic invoicing and organizational reforms in tax administration.[44] In terms of public expenditure reforms aimed at improving efficiency, the empirical literature highlights the importance of the project design, selection, implementation, and evaluation process for determining the final impact of investments (Esfahani and Ramirez, 2003; Haque and Kneller, 2008). Lastly, there are many successful examples in Latin America involving the use of public procurement portals and contracting arrangements similar to those promoted by the program.[45]

1.32 As part of program preparation, the Bank has provided technical assistance to the MHCP in several areas. For the investment loan to expand electronic invoicing (3155/OC-CO), the Bank has conducted ongoing support missions contributing to the design and implementation of the required technological platforms and bringing the best experiences of countries in the region to bear. As part of the Fiscal and Public Investment Expenditure Strengthening Program for Subnational Entities and their Public Utilities, the Bank supported the work of the Tax Commission under technical cooperation operation ATN/KR-14472-CO. To support implementation of the state-owned enterprises policy, which was introduced as part of Colombia's OECD accession process, the Bank contributed via technical cooperation operation ATN/OC-15920-CO to developing tools to establish the value of the portfolio of strategic enterprises, identify the factors that determine their value, and design a methodology for monitoring their operations. In the area of expenditure management, the Bank has supported the strengthening of the public procurement system by implementing SECOP 2 and conducting studies to support the preparation of framework agreements (3154/OC-CO). Lastly, donor funds are being used to support updating of the Medium-term Debt Management Strategy, including revision of both the methodology and the scenarios for future years.

1.33 **Coordination with other donors.** Bank support for the reforms pursued by the Government of Colombia has been coordinated and supplemented by multilaterals and bilaterals such as the IMF, World Bank, OECD, European Union, and the program of the Swiss State Secretariat for Economic Affairs (SECO). With regard to strengthening the management and collection of tax and customs revenues, the Bank joined with the IMF, World Bank, and OECD to support the Tax Commission, whose report was a key input into the bill sent to Congress.[46] Together with the World Bank, European Union, and the SECO program, the Bank contributed to preparation of a Public Expenditure and Financial Accountability (PEFA)

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[44] For electronic invoicing and progress on it in the region, see Barreix et al. (2018). Kahn et al. (2001) found evidence that the introduction of performance-based incentives for tax administration employees increased the detection of irregularities and significantly reduced tax evasion in Brazil. See also Olken et al. (2014) for the case of Pakistan.

[45] There is evidence that demand aggregation mechanisms in public procurement systems lead to significant cost savings, on the order of 1% of GDP (see Bandiera et al., 2009). In the case of Chile, use of the e-Procurement system is estimated to have lowered the price of government purchases by 2.65% on average in 2007, and administrative costs by 0.28% to 0.38% from 2006 to 2007 (Singer et al., 2009). In Paraguay, implementation of the public procurement system yielded average annual savings of US$38 million (Mejía and Garay, 2012).

[46] See the Tax Commission's final report in the Fedesarrollo archive.

assessment, as an input for reforms to improve public expenditure efficiency. Lastly, with a view to improving the management of public debt and contingent liabilities, the Bank coordinated with the World Bank and the OECD in providing support to the government.

1.34 **Strategic alignment.** The program is consistent with the Update to the Institutional Strategy 2010-2020 (document AB-3008) and is strategically aligned with the development challenge of productivity and innovation through its implementation of reforms to reduce informality and evasion, and institution-strengthening to raise the quality of expenditure on investment projects. The program is also aligned with the crosscutting issue of institutional capacity and the rule of law through improvements in tax collection and savings from improved efficiency in public procurement. The program will also contribute to the Corporate Results Framework 2016-2019 (document GN-2727-6), particularly the following indicators: (i) percent of GDP collected in taxes; (ii) government agencies benefited by projects that strengthen technological and managerial tools to improve public service delivery; (iii) countries benefited by IDB projects to improve the leveraging of domestic resources; (iv) subnational governments benefited by decentralization, fiscal management, and institutional capacity projects; and (v) public registries strengthened. The program is also consistent with the Sector Strategy: Institutions for Growth and Social Welfare (document GN-2587-2), in that it supports revenue generation, macrofiscal management, and public expenditure management. It is consistent with the Fiscal Policy and Management Sector Framework Document (document GN-2831-3), in that it supports fiscal policies that favor higher growth in a context of macroeconomic and fiscal stability.

1.35 The program is consistent with the country strategy with Colombia (2015-2018) (document GN-2832), which includes the following objectives in the area of public management effectiveness: (i) support a fiscal compact to improve State revenues, through the approval of a comprehensive tax reform, an increase in the number of taxpayers, and an increase in subnational tax collection; and (ii) raise the quality of expenditure and public investment management capacity at all levels of government by continuing the progress made by Colombia under the fiscal responsibility framework introduced more than a decade ago. The program is included in the 2018 Operational Program Report (document GN-2915).

B. Objectives, components, and costs

1.36 The program's general objective is to contribute to Colombia's fiscal stability through an increase in tax revenue intake, more efficient use of public expenditure, and better management of public debt and liabilities, including contingent liabilities. The specific objectives include the following: (i) strengthen the collection of tax revenue; (ii) improve public expenditure efficiency; and (iii) improve the management of debt and contingent liabilities. In strengthening the key pillars of the country's fiscal policy and management, the program is expected to benefit the general population. In particular, it is expected to contribute to lowering the risk of macroeconomic shocks, which have an outsized impact on more vulnerable

households,[47] or to lessening their impact when unavoidable. Likewise, in focusing on policy reforms to improve the quality of public investment at the subnational level, the program will also reach a large beneficiary population.[48]

1.37 This program of support for the fiscal policy actions taken by the government was split into two, technically linked operations. These actions seek to address the most important challenges faced by the country in consolidating its fiscal accounts and accelerating growth. The first operation was aimed at laying some of the policy groundwork for the reform program and establishing the necessary institutional arrangements for subsequent implementation of the policies. This second operation continues the policy development of the reform program, as well as its approval and effective implementation, while making the necessary adjustments to comply with international norms and standards.

1.38 The reforms supported under both the first and second operations represent profound changes to the policy and operational framework of public administration in Colombia. In the area of revenue, the conditions relate to two tax reforms and the adoption of new systems and procedures aimed not only at adjusting rates and tax bases, but also structurally strengthening tax administration capacities. To raise the quality of expenditure and public investment, support has been provided to create coordination mechanisms and institutional strengthening programs that provide an integrated response to the need to create and build capacity in subnational governments, as well as further developing tools such as the public procurement system. Lastly, the creation of mechanisms to prevent or mitigate the impact of contingencies on the public finances has been included, to address the challenges that such events pose for the fiscal position.

1.39 The complete set of reforms included in this second operation were implemented over the period 2015-2017 as part of the preparation for this operation and are included in the Policy Matrix. In this way, the program with its two operations contributed to maintaining fiscal sustainability, in accordance with the Fiscal Rule Law, based on the structural balance. On the revenue side, despite the fact that the oil shock generated a reduction of more than 3% of GDP, the reforms supported by this program made it possible to maintain intake levels. In terms of expenditure, the institutional capacity gap has been closed at the central government level, which will improve the effectiveness of public investment and the efficiency of expenditure. Lastly, the implementation of risk management policies has aligned the management of liabilities, both explicit and contingent, with the international best practices, reducing risk exposure. Consequently, the program has the following components:

1.40 **Component I. Maintain macroeconomic stability.** The objective of this component is to ensure a stable and fiscally sustainable macroeconomic environment conducive to the program objectives, as established in the Policy Letter.

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[47] De Janvry and Sadoulet (2000) found evidence that the rise in poverty in the wake of a macroeconomic shock may be larger than the subsequent reduction resulting from economic growth. One explanation for this phenomenon is that crises have long-term consequences for the poor, such as a shift from schooling to child labor that, if not reversed, erodes the stock of human capital, leading to wage losses in the long term (Hicks and Wodon, 2001). For evidence on the general impact of macroeconomic crises on poverty and inequality, see Lustig (2000).

[48] From 2012 to 2016, 1,052 of Colombia's 1,123 municipios received SGR funds.

1.41 **Component II. Strengthen the management and collection of tax and customs revenues.** The objective of this component is to increase the productivity of the tax base with a view to improving revenue intake. This second operation in the programmatic series maintains the five conditions originally envisioned and adds three new conditions to more fully accomplish the objective of the component. The conditions that remain unaltered are as follows: (i) comply with OECD norms regarding base erosion and profit shifting (BEPS) by establishing requirements and methodologies for the reporting of transfer pricing; (ii) implement the pilot program for the rollout of electronic invoicing; (iii) enact and implement New Customs Regulations ("Customs Statute") aligned with international best practices and agreements; (iv) new information system for strengthening customs controls with the customs clearance module operating at full capacity; and (v) capacity-building of DIAN's Enforcement Unit by hiring additional staff and updating the entity's career structure.[49]

1.42 The first added condition relates to the strengthening of CNG tax revenue consistent with both short- and medium-term targets under the Fiscal Rule through reductions in exemptions, the creation of a simplified regime for small taxpayers ("monotributo") to combat informality, and simplification of the tax filing and payment systems. In line with the recommendations of the Tax Commission and the technical assistance provided by the IDB project team, a comprehensive tax reform was approved to address the decline in oil revenue, while reducing the bias against private investment by lowering the statutory rate of the income tax (ISR) and eliminating the CREE tax on corporations.[50] Similarly, VAT paid on capital goods was recognized as a deductible expense for the purposes of calculating income subject to the income tax, eliminating the bias against private investment. With a view to increasing public revenue, certain exemptions were reduced, new indirect taxes were created (including a number of green taxes),[51] and the VAT rate was raised from 16% to 19%.[52] Taxes of 5% and 10% were created on dividends distributed and paid in excess of 18 million and 29.7 million Colombian pesos, respectively.[53] Lastly, a series of additional measures was introduced to combat evasion in the informal sector, with the creation of a voluntary simplified tax regime

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[49] This last policy condition, which initially envisioned a new organizational structure for DIAN operations, was altered due to the budget restrictions imposed by the Smart Fiscal Austerity policy that precluded the operation of this new structure. Instead, the government took alternative steps that included the expedited hiring of 900 employees and updating of the entity's specific career structure with the aim of ensuring that the right staff were available for the efficient performance of its functions. (The system establishes rules for testing, experience requirements, and the selection process to be followed, and creates bodies such as the School of Advanced Tax, Customs, and Currency Administration Studies).

[50] The statutory maximum income tax rate was reduced to 33%, and the CREE tax on corporations was eliminated from 2018 onwards. The statutory maximum income tax rate for corporations was consequently set at 33% from 2019 onwards, compared to the 40% nominal rate that had applied since 2016.

[51] This includes the tax on carbon emissions from fossil fuels for domestic consumption (15,000 Colombian pesos per ton of CO_2) and the tax on plastic bags.

[52] Of the increase of three percentage points in the VAT rate, 0.5 points will be earmarked for education expenditure, and 0.5 for health expenditure. There is evidence that public spending in Latin America and the Caribbean has a much greater distributional impact than taxes, and that these effects reduce or eliminate the inequitable biases that some taxes—particularly indirect taxes—may exhibit (see Lustig, 2016, and OECD-IDB, 2016).

[53] This measure brings Colombia into line with the approach taken most countries of the region to distributed dividends, which had been fully exempt. As a result, capital gains and distributed dividends are taxed at a substantially lower rate than that of the ISR, so as to reduce double taxation in the ISR and reduce the bias against private savings and investment, while also improving equity in the tax system.

("monotributo voluntario"), and tax filing and payment procedures were simplified, particularly for the individual income tax, with elimination of the national alternative minimum tax (IMAN) and simple alternative minimum tax (IMAS) and standardization of the income tax rate.

1.43 The second added condition relates to the strengthening of subnational tax revenue intake. To this end, the CNG introduced legislative amendments to adjust tax rates on cigarettes and alcoholic beverages, update property registries, and strengthen subnational governments' enforcement mechanisms. Lastly, the third added condition included relates to modification of the electronic invoicing system so that it operates in real time with prevalidation by DIAN, in contrast to the current asynchronous model in which there is no prevalidation. This approach is critical to ensuring much more effective tax audits. This reform brings Colombia into line with the most recent technological advances implemented in the OECD countries and a several countries of Latin America.

1.44 **Component III. Improve public expenditure efficiency.** The objective of this component is to strengthen the quality of public expenditure. This component maintains the six policy conditions initially envisioned, which focus on consolidating the operations of the SGR and the public procurement system. Only one condition has been added, to address the obligations arising from the Final Agreement to End the Armed Conflict. The conditions for this component are as follows: (i) consolidate SGR coordination and operational activities by creating an SGR Directorate at the DNP, issuing regulations, developing tools, and strengthening the DNP's technical team for the structuring and management of SGR-financed projects for subnational entities; (ii) operationalize the "Red de Estructuradores" [Structurers' Network] for SGR-financed investment projects by creating a group of experts within the SGR office at the DNP, responsible for helping subnational governments structure and design SGR-financed investment projects; (iii) build the capacity of subnational entities to design and execute investment projects at the regional level, through new policy instruments to prioritize and coordinate efforts and resources;[54] (iv) set baseline for assessing the impact of the SGR on the Regional Development Fund (FDR), Regional Compensatory Fund (FCR), and Science, Technology, and Innovation Fund (FCTI); (v) based on the results of the SGR institutional and process evaluation, adjust the SGR to include a scoring system for project appraisal and redefine time frames and responsibilities within the project cycle; and (vi) launch the Electronic Public Contracting System 2 (SECOP 2) and sign five new framework pricing agreements linking major stores to the Tienda Virtual del Estado [Virtual Store of the State] (the platform for the framework agreements).

1.45 Given the need to meet government commitments and target resources toward the areas most affected by the conflict, modification of the SGR is included as an added condition, to redirect resources of the Science, Technology, and Innovation Fund (FCTI) and the Pension Savings Fund for Subnational Entities (FONPET) into investment projects as part of the Final Agreement to End the Armed Conflict. This condition seeks to contribute to the objective of improving efficiency in the use of resources and finance the commitment to fund priority projects that require

[54] This policy action initially envisioned the operation of a National Roundtable for Regional Strengthening, which was never launched. Instead, the government created a strengthening program and adopted Plan for Peace Contracts as capacity-building mechanisms for subnational entities at the regional level.

coordination among different sources of financing and levels of government.[55] At the same time, this policy includes the use of part of the system's financial returns and future revenues to ensure continuity in financing for these investments in the medium term.

1.46 **Component IV. Improve the management of public debt and contingent liabilities.** The objective of this component is to reduce the vulnerability of the public finances. The four policy conditions envisioned for the fourth component remain unchanged, to further pursue the actions in the first operation. These conditions include the following: (i) implement the new debt management strategy aimed at increasing average life, reducing cost, and minimizing risk exposure; (ii) PPP contracts signed subsequent to the adoption of the framework contract contain the mandated risk mitigation measures; (iii) fully operationalize a PPP division at the MHCP to strengthen the PPP preparation and approval process;[56] and (vi) implement a public financial management policy that includes risk identification, the design of financial instruments, and insurance for public assets, to mitigate fiscal risks linked to natural disasters.

1.47 As part of Colombia's OECD accession process, an added policy condition relates to the approval and implementation of a policy to strengthen the management of CNG state-owned enterprises, including an asset management strategy and arrangements for evaluating business performance. This condition seeks to mitigate the risks associated with the government's role as a shareholder in public enterprises, which can generate fiscal costs stemming from unidentified contingencies.

1.48 The adjustments to the three indicative conditions for the second disbursement (points 2.8, 3.3, and 4.3 in Annex II), with respect to those agreed under the first operation, were in largely response to the oil price shock and the commitments under the Final Agreement to End the Armed Conflict, which were not foreseen at the time the first operation was approved. In response to these events, the government reinforced policy measures to improve revenue intake and took alternative steps to improve the efficiency and allocation of public expenditure. These changes ensure that the program development objectives will be met (for more detail, see the Comparative Policy Matrix).

C. Key results indicators

1.49 To measure the expected impact of the reform measures in the medium term, a Results Matrix was prepared jointly with the borrower, indicating the impacts, outcomes, and outputs of the program. The policy actions included in the operation are expected to have a positive impact, reflected in a stable macroeconomic environment and a sustainable fiscal balance.

1.50 The expected impact of the program is a stable macroeconomic environment and a sustainable fiscal balance, as measured by (i) a reduction in the CNG fiscal deficit;

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55 As part of the peace process and the post-conflict period, the DNP's Plan Contracts were renamed by the administration in May 2017, becoming the Plan for Peace Contracts. This transformed them into an effective tool for managing public investment, as it allowed the different levels of government to come together and target efforts toward rebuilding areas where violence had destroyed public institutions, delaying economic and social development (DNP website).

56 The indicative policy action established under the first operation involved the creation of an interagency committee. Instead, and with the objective of strengthening the PPP preparation and approval process, the government created a PPP division at the MHCP that is stronger than the originally planned committee.

and (ii) a reduction in the CNG's net public debt, both as a proportion of GDP. The expected outcomes of the program are: (i) improvement in tax revenue intake, while eliminating disincentives to private investment; (ii) efficiency gains from improvements in the customs system; (iii) improved quality of SGR-financed investment projects presented by local governments; (iv) savings from efficiency improvements in public procurement; (v) improvement in the public debt profile; and (vi) improved management of CNG state-owned companies. The following table presents the expected outcomes and key indicators (for more detail, see the Results Matrix).

Table 2. Summary of expected outcomes

Indicators	Unit	Baseline		Targets	
		Value	Year	Value	Year
Expected impact: Stable macroeconomic environment and sustainable fiscal balance					
CNG fiscal balance	% of GDP	-4.0	2016	-2.4	2019
CNG net public debt[a]	% of GDP	42.5	2016	42.2	2019
Expected outcome 1: Improvement in tax revenue intake and efficiency					
Total tax revenues	% of GDP	14.7	2016	14.1	2019
Tax collected through effective enforcement	% of GDP	0.6	2016	1.0	2019
Expected outcome 2: Efficiency gains from improvements in the customs system					
Import clearance times	Hours	21	2016	20	2019
Expected outcome 3: Improved quality of SGR-financed investment projects presented by local governments					
Amount approved in SGR investment projects / SGR available budget	%	74	2015-2016	78	2019-2020
SGR projects in execution / Total projects approved by OCADs	%	86	2016	89	2019
Expected outcome 4: Savings from efficiency improvements in public procurement					
Difference between the maximum price set in the framework agreements and the price actually paid for government purchases through the "Colombia Compra Eficiente" virtual store	%	5.93	2017	5.23	2019
Value of public purchases conducted by SECOP 2	% of GDP	0.5	2017	0.7	2019
Expected outcome 5: Improvement in the public debt profile					
Average life of domestic debt	Years	6.2	2016	6.4	2019
Average life of external debt	Years	11.9	2016	11.1	2019
Foreign-currency denominated share of public debt	% of total	33.9	2016	32	2019
Expected outcome 6: Improved management of CNG state-owned companies					
Mixed public-private enterprises with identified assets keeping or generating value	Number	0	2016	30	2019

[a] Debt net of financial assets, not excluding other accounts payable.

1.51 **Economic analysis.** Based on the recommendations of the Office of Evaluation and Oversight (OVE) in its 2011 Evaluability Review of Bank Projects[57] and the findings

[57] Document RE-397-1: "Currently, the economic analysis section is computed as the maximum between the cost-benefit analysis and the cost-effectiveness analysis. Yet neither a cost-benefit analysis nor a cost-effectiveness analysis is applicable to PBLs."

of the review of evaluation practices and standards for policy-based loans, conducted by the Evaluation Cooperation Group (ECG) of the independent evaluation offices of the multilateral development banks,[58] as established in paragraph 1.3 of the Review of the Development Effectiveness Matrix for Sovereign Guaranteed and Non-sovereign Guaranteed Operations (document GN-2489-5), which provides that an analysis of efficiency in the use of financial resources would be unnecessary,[59] it was determined and reported to the Bank's Board of Executive Directors that no economic analysis will be performed for this type of loan. Accordingly, this loan operation does not include an economic analysis, and the economic analysis has therefore not been considered for measuring the evaluability score in the Development Effectiveness Matrix for this program.

1.52 **Economic and fiscal impacts.** The set of policies implemented by the government in recent years, and designed and implemented with support from this program, has been instrumental in addressing the decline in oil revenues while keeping growth from contracting in a context of financial and price stability. The economic growth rate and tax system productivity are expected to increase as a result of higher tax revenue and a reduction in the tax system's bias against private investment and savings.[60] Together with improved efficiency in the use of SGR resources for public investment, the Smart Fiscal Austerity policy implemented by the government to contain public spending in the face of the external shock will also enable the country to meet the commitments contained in the Final Agreement to End the Armed Conflict, in terms of recovery in the areas affected by the conflict. At the same time, it will allow a return to the fiscal balance path established in the Fiscal Rule Law, as reflected in the Medium-term Fiscal Framework (MFMP) presented by the MHCP in June 2017.[61] Figure 1 shows the contribution of the reforms supported by the proposed operation to narrowing the fiscal deficit, with the aim of continued compliance with the structural balance rule.

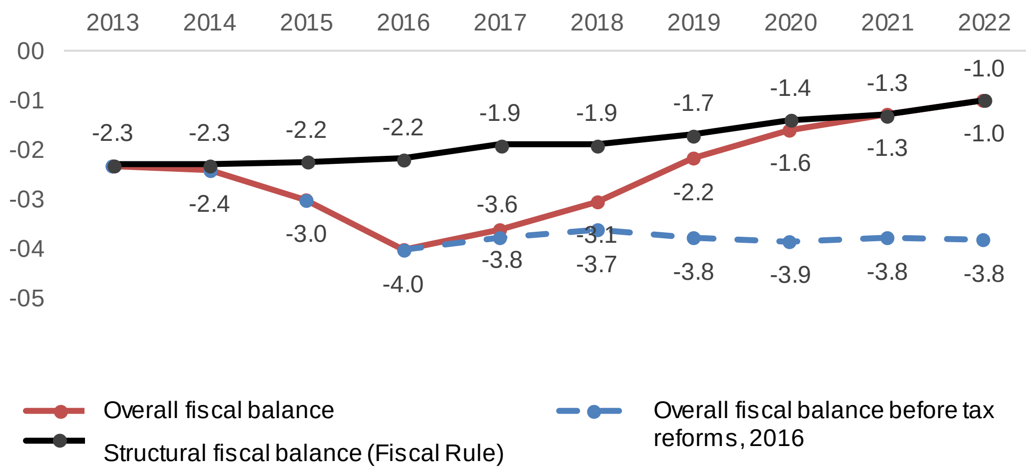
[58] Good Practice Standards for the Evaluation of Public Sector Operations. Evaluation Cooperation Group, Working Group on Public Sector Evaluation, 2012 Revised Edition. February 2012.

[59] According to the ECG, PBLs should be evaluated according to relevance, effectiveness, and sustainability. Efficiency was not included as a criterion, since the dimensioning of PBLs is linked to the financing gap of a country, independent of the benefits of the project.

[60] The change in the electronic invoicing model will play a key role in enhancing the productivity of the VAT by reducing tax evasion. Colombia has adopted an operational model of electronic invoicing that is very similar to the one in Mexico, which facilitated an increase in VAT collections of 1.4 percentage points of GDP over a period of four years. See Fuentes Castro (2016).

[61] Failure to adopt the series of measures supported under this program to return to the fiscal balance path mandated by the Fiscal Rule Law would have jeopardized the investment grade rating attained by the country in 2011 for its public debt.

Figure 1. CNG fiscal balance (% of GDP)



Source: MHCP, MFMP, June 2017, and project team estimates.

II. Financing Structure and Main Risks

A. Financial instruments, amount, and currency

2.1 This operation is structured under the programmatic modality (the second in a series of two operations), based on the guidelines and directives established in the New Lending Framework (document GN-2200-13) and in the guidelines for preparation and implementation of policy-based loans (document CS-3633-1). The programmatic modality is justified by: (i) the complex nature of the reforms; (ii) the different timelines for the implementation of each reform; (iii) the coordination of reforms between different institutions; (iv) support for policy dialogue in the country; and (v) the supervision required for implementation of the reforms, in order to monitor and provide feedback on outcomes.

2.2 **Dimensioning of the operation.** As established in paragraph 3.27(b) of Policy-based Loans: Guidelines for Preparation and Implementation. New version (document CS-3633-1), the size of the operation was based on the country's fiscal resource needs. The government's financing requirements for 2018 are 7.4% of GDP. The amount of this operation—US$600 million—will cover part of this amount, representing 2.6% of total financing requirements and 23% of financing from multilateral sources. This second programmatic operation will be through the Flexible Financing Facility in U.S. dollars from the Bank's Ordinary Capital.

B. Environmental and social safeguard risks

2.3 Given the nature of the program, which involves institutional strengthening activities, there are no associated environmental or social risks. In accordance with directive B.13 of the Environment and Safeguards Compliance Policy (Operational Policy OP-703), this program does not require classification.

C. Key project issues

2.4 **Sustainability.** The policies supported by this operation are fully consistent with the strategy for the modernization of fiscal institutions adopted in recent years, as well as the actions planned under the June 2017 MFMP and the Good Governance

policy pillar of the National Development Plan 2014-2018. The commitment to fiscal sustainability and the Fiscal Rule has become government policy, incorporated into both law and legislative discussions; for this reason, there was political support during the legislative process for the set of reforms supported by the program. Given that the reforms have been incorporated into the country's legal and institutional framework, the advances supported under this programmatic operation are therefore expected to be maintained in the medium term, even subsequent to the changeover to a new administration.

III. IMPLEMENTATION AND MANAGEMENT PLAN

A. Summary of implementation arrangements

3.1 **Borrower and executing agency.** The borrower will be the Republic of Colombia. The Ministry of Finance (MHCP) will be the executing agency. An important factor ensuring success in implementation of the reforms is that program coordination is under the responsibility of the MHCP's Office of the Deputy Director for Financing with Multilateral Agencies and Governments.

3.2 The executing agency is responsible for: (i) holding regular analysis and monitoring meetings to ensure coordination among the different institutions responsible for actions or technical execution of activities (MHCP, DNP, DIAN, and ANCP); (ii) supervising and seeing that the activities planned under the operation are completed; (iii) maintaining official communication with the Bank; (iv) preparing the necessary reports within the established time frames agreed upon with the Bank; and (v) anticipating and effectively addressing any risks or problems in program execution. While the foregoing will be reflected in the loan contract as responsibilities of the executing agency, the MHCP has provided evidence that all program conditionalities have been satisfied.

3.3 **Special contractual conditions precedent to the first and only disbursement of the loan proceeds: The first and only disbursement under this operation is subject to fulfillment of the policy reform conditions as established in the Policy Matrix (Annex II), the Policy Letter, and the other conditions established in the loan contract**.

B. Summary of arrangements for monitoring results

3.4 Once the operation has been declared eligible, the MHCP will supply the information required to determine whether the progress indicators for the operation have been reached, and the agreed reforms have been fully implemented. Most of the targets in the Results Matrix will be monitored using the national government's Sistema Nacional de Evaluación de Gestión y Resultados [National System for the Evaluation of Management and Results] (SINERGIA), which contains and facilitates access to data on the main indicators.

3.5 To support program implementation, the Bank's project team has followed a strategy of: (i) providing required technical assistance in areas already identified; (ii) organizing special missions to coincide with key stages of the operation's design and implementation; and (iii) together with the government, monitoring closely to anticipate and effectively address strategic, technical, and coordination risks and difficulties associated with program execution. An evaluation will be conducted of both compliance with the measures and the administration's

performance, identifying corrective action and good management practices where necessary (monitoring and evaluation plan).

3.6 **Evaluation.** The project team proposes to conduct an evaluation of program impacts after 2019, based on the Results Matrix, which sets targets for that year. The objective of this ex post evaluation is to verify the impact of the policy actions implemented by the Government of Colombia with Bank support. This exercise will seek to evaluate, firstly, the two macroeconomic impacts of the program (overall fiscal balance and net public debt, both for the central national government (CNG) as a percentage of GDP) and secondly, program expected outcome 1 (CNG total tax revenues as a percentage of GDP). A dynamic general equilibrium model, already calibrated for Colombia, will be used to evaluate these two macroeconomic impacts. The synthetic control method will be used to evaluate the expected outcome for tax revenues. The policy related to the rollout of electronic invoicing, which seeks to raise VAT revenue through more efficient and effective tax control technologies, has been chosen for this purpose.[62]

IV. POLICY LETTER

4.1 The Policy Letter reiterates the national government's commitment to the objectives and actions contemplated for the programmatic operation as a whole. The Bank and the Government of Colombia have also agreed on a Policy Matrix that describes the policy actions under this programmatic operation.

[62] For a detailed description of the two methodologies, see optional link 5 and optional link 6.

Development Effectiveness Matrix		
Summary		
I. Corporate and Country Priorities		
1. IDB Development Objectives	**Yes**	
Development Challenges & Cross-cutting Themes	**-Productivity and Innovation -Institutional Capacity and the Rule of Law**	
Country Development Results Indicators	**-Percent of GDP collected in taxes (%) -Government agencies benefited by projects that strengthen technological and managerial tools to improve public service delivery (#)* -Countries benefited by IDB's projects aimed at improving domestic resource mobilization (#)* -Subnational governments benefited by decentralization, fiscal management and institutional capacity projects (#)* -Public registries strengthened (#)***	
2. Country Development Objectives	**Yes**	
Country Strategy Results Matrix	**GN-2832**	**(i) Support a fiscal compact to improve State revenues; and (ii) Increase the quality of expenditure and public investment management capacity at all levels of government.**
Country Program Results Matrix	**GN-2915**	**The intervention is included in the 2018 Operational Program.**
Relevance of this project to country development challenges (If not aligned to country strategy or country program)		
II. Development Outcomes - Evaluability		**Evaluable**
3. Evidence-based Assessment & Solution	**9.3**	
3.1 Program Diagnosis	**3.0**	
3.2 Proposed Interventions or Solutions	**3.6**	
3.3 Results Matrix Quality	**2.7**	
4. Ex ante Economic Analysis	**N/A**	
5. Monitoring and Evaluation	**6.3**	
5.1 Monitoring Mechanisms	**0.4**	
5.2 Evaluation Plan	**6.0**	
III. Risks & Mitigation Monitoring Matrix		
Overall risks rate = magnitude of risks*likelihood	**Low**	
Identified risks have been rated for magnitude and likelihood	**Yes**	
Mitigation measures have been identified for major risks	**Yes**	
Mitigation measures have indicators for tracking their implementation	**Yes**	
Environmental & social risk classification	**B.13**	
IV. IDB´s Role - Additionality		
The project relies on the use of country systems		
Fiduciary (VPC/FMP Criteria)	**Yes**	**Financial Management: Budget, Treasury, Accounting and Reporting.**
Non-Fiduciary	**Yes**	**Monitoring and Evaluation National System.**
The IDB's involvement promotes additional improvements of the intended beneficiaries and/or public sector entity in the following dimensions:		
Additional (to project preparation) technical assistance was provided to the public sector entity prior to approval to increase the likelihood of success of the project		

Note: (*) Indicates contribution to the corresponding CRF's Country Development Results Indicator.

This operation is the second of a series of two operations under the modality of Programmatic Loan to Support Policy Reforms (PBP).

The general objective is to contribute to Colombia's fiscal stability through: (i) the increase in tax collection (ii) the efficient use of public spending and (iii) improvement in the management of public debt and liabilities (including contingents).

The specific objectives include: (i) strengthening tax collection, (ii) improve the efficiency of public spending and (iii) improve the management of debt and contingent liabilities.

The diagnosis indicates as the main problem the widening of the fiscal deficit due to the decrease in oil revenues. The specific problems are associated with weaknesses in: (i) tax management and collection, (ii) efficiency of spending and (iii) optimization of public debt management (including contingent liabilities).

The main causes associated with limited tax collection are: (i) national and subnational tax policy with low rates, (ii) outdated cadastres, (iii) deficient tax and customs administration, (iv) high informality of the economy, (iv) high level of exemptions and (v) complexity in the regulations for taxpayers payment.

The causes associated with budget management are: (i) absence of technical mechanisms for an adequate prioritization in the allocation of expenditure, (ii) disconnection between budgeting and evaluation and (iii) weakness in spending information systems.

The PBP presents adequate evidence of internal (but not external) validity for the proposed solutions. The vertical logic is clear and well specified. The results matrix, in general, is adequately constructed.

The PBP proposes a general equilibrium model for the program evaluation. This model presents a well-specified methodology.

The general risk classification of the PBP is low

POLICY MATRIX

Objective	Policy conditions First programmatic operation	Policy conditions Second programmatic operation
Component I. Maintain macroeconomic stability		
Maintain an appropriate and fiscally sustainable macroeconomic environment.	1.1 The macroeconomic policy framework is consistent with program objectives and the parameters set out in the policy letter.	1.1 Maintain an appropriate and fiscally sustainable macroeconomic environment.
Component II. Strengthen the management and collection of tax and customs revenues		
Increase the productivity of the tax base and improve collections.	2.1 Strengthen the tax framework by issuing regulations tied to aspects of international taxation that have been affected by the recent reform and are compatible with OECD standards. .	2.1 Strengthen CNG tax revenue consistent with both short- and medium-term targets under the Fiscal Rule Law (Law 1437) through reductions in exemptions, the creation of a simplified regime for small taxpayers ("monotributo") to combat informality, and simplification of the tax filing and payment systems. 2.2 Comply with OECD norms regarding base erosion and profit shifting (BEPS) by establishing requirements and methodologies for the reporting of transfer pricing. 2.3 Strengthen subnational tax revenue intake by adjusting public utility rates, updating property registries, and strengthening enforcement mechanisms.
	2.2 Strengthen management of the value-added tax by laying the legislative foundation for the rollout of electronic invoicing.	2.4 Implement the pilot program for the rollout of electronic invoicing. 2.5 Modify the electronic invoicing system so that it operates in real time with prevalidation by the DIAN, instead of the current asynchronous model in which there is no prevalidation.
	2.3 Modernize customs through the adoption of new customs processes and procedures consistent with both current international practices and targets included in trade agreements.	2.6 Enact and implement New Customs Regulations (Customs Statute) aligned with international best practices and agreements.
	2.4 Strengthen customs through the identification of solutions to facilitate the implementation of	2.7 New information system for strengthening customs controls with the customs clearance module

Objective	Policy conditions First programmatic operation	Policy conditions Second programmatic operation
	improvements in administration, based on international best practices.	operating at full capacity.
	2.5 Modernize the DIAN's organizational structure to improve efficiency.	2.8 Capacity-building of DIAN's Enforcement Unit by hiring additional staff and updating the entity's career structure.
Component III. Improve public expenditure efficiency		
Strengthen the quality of public expenditure.	3.1 Strengthen the DNP through the creation of a new institutional structure for implementation of the SGR.	3.1 Consolidate SGR coordination and operation by: (i) Creating an SGR directorate at the DNP; (ii) Issuing regulations, developing tools, and strengthening the DNP's technical team for the structuring and management of SGR-financed projects for subnational entities.
	3.2 Strengthen the capacity of subnational entities to structure SGR-financed investment projects through the creation of a "Red de Estructuradores" [Structurers' Network] (private sector). .	3.2 Operationalize the Structurers' Network for SGR-financed investment projects by creating a group of experts within the SGR office at the DNP, responsible for helping subnational governments structure and design SGR-financed investment projects.
	3.3 Strengthen the capacity of subnational entities to design and execute SGR-financed projects at the regional level, through the creation of a National Roundtable for Regional Strengthening.	3.3 Strengthen the capacity of subnational entities to design and execute investment projects at the regional level, through new policy instruments to prioritize and coordinate efforts and resources. 3.4 Modify the SGR to redirect resources of the Science, Technology, and Innovation Fund (FCTI) and the Pension Savings Fund for Subnational Entities (FONPET) into investment projects as part of the Final Agreement to End the Armed Conflict.
	3.4 Assess SGR impact to set baselines for the Regional Development Fund (FDR), Regional Compensatory Fund (FCR), and Science, Technology, and Innovation Fund (FCTI).	3.5 Set baseline for assessing the impact of the SGR on the FDR, FCR, and FCTI.
	3.5 Identify the main bottlenecks to SGR functioning through an evaluation of institutional arrangements and processes.	3.6 Based on the results of the SGR institutional and process evaluation, adjust the SGR to include a scoring system for project appraisal and redefine time frames and responsibilities within the project cycle.
	3.6 Strengthen public contracting and purchasing	3.7 Launch the Electronic Public Contracting System 2

Objective	Policy conditions First programmatic operation	Policy conditions Second programmatic operation
	processes to improve efficiency, through the creation of a regulatory framework for demand aggregation.	(SECOP 2) and sign five new framework pricing agreements linking major stores to the Tienda Virtual del Estado [Virtual Store of the State] (the platform for the framework agreements).
Component IV. Improve the management of public debt and contingent liabilities		
Reduce the vulnerability of the public finances.	4.1 Improve the profile of the public debt by developing a model for the monitoring of the new debt management strategy.	4.1 Implement the new debt management strategy aimed at increasing average life, reducing cost, and minimizing risk exposure.
	4.2 Mitigation of PPP-related contingent risk by means of insurance arrangements.	4.2 PPP contracts signed subsequent to the adoption of the framework contract contain the mandated risk mitigation measures.
	4.3 Improve the quality of PPP projects presented by subnational governments through the adoption of measures to improve the institutional, economic, and regulatory framework for PPPs in Colombia.	4.3 Fully operationalize a PPP division to strengthen the PPP preparation and approval process.
	4.4 Mitigate the fiscal risks associated with natural disasters throughdesign of a strategy for public financial management policy inresponse to natural disaster risk	4.4 Implement a public financial management policy that includes risk identification, the design of financial instruments, and insurance for public assets, to mitigate fiscal risks linked to natural disasters.
		4.5 Approve and implement a policy to strengthen the management of CNG state-owned enterprises, including an asset management strategy and arrangements for evaluating business performance.

DOCUMENT OF THE INTER-AMERICAN DEVELOPMENT BANK

PROPOSED RESOLUTION DE-__/18

Colombia. Loan ____/OC-CO to the Republic of Colombia
Program to Deepen Fiscal Reform in Colombia II

The Board of Executive Directors

RESOLVES:

That the President of the Bank, or such representative as he shall designate, is authorized, in the name and on behalf of the Bank, to enter into such contract or contracts as may be necessary with the Republic of Colombia, as Borrower, for the purpose of granting it a financing to cooperate in the execution of the Program to Deepen Fiscal Reform in Colombia II. Such financing will be for the amount of up to US$600,000,000 from the resources of the Bank's Ordinary Capital, and will be subject to the Financial Terms and Conditions and the Special Contractual Conditions of the Project Summary of the Loan Proposal.

(Adopted on _________ 2018)

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