

DOCUMENT OF THE INTER-AMERICAN DEVELOPMENT BANK

**COLOMBIA**

**SUPPORT FOR SUBSIDY REFORM PROGRAM**

**(CO-L1163)**

**LOAN PROPOSAL**

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## ABBREVIATIONS

CONPES	Consejo Nacional de Política Económica y Social [National Economic and Social Policy Council]
COPEP	Consejo de Progresividad y Eficiencia Pública [Public Progressivity and Efficiency Council]
DANE	Departamento Administrativo Nacional de Estadística [National Administrative Department of Statistics]
DIA	Development in the Americas
DNP	Departamento Nacional de Planeación [National Planning Department]
DPS	Departamento de Prosperidad Social [Social Prosperity Department]
ECV	Encuesta Nacional de Calidad de Vida [National Survey on Quality of Life]
EE	Exclusion error
FCL	Flexible Credit Line
FINAGRO	Fondo para el Financiamiento del Sector Agropecuario [Agricultural Sector Financing Fund]
IMF	International Monetary Fund
LIBOR	London Interbank Offered Rate
MHCP	Ministry of Finance and Public Credit
NPV	Net present value
OECD	Organization for Economic Co-operation and Development
OEL	Optional electronic link
OVE	Office of Evaluation and Oversight
PBL	Policy-based loan
PCR	Project completion report
PMT	Proxy means test
SGSSS	Sistema General de Seguridad Social en Salud [General Social Security Health Care System]
Sisbén	Sistema de Identificación y Clasificación de Potenciales Beneficiarios de Programas Sociales [System for Identification and Classification of Potential Social Program Beneficiaries]
UIS	Update to the Institutional Strategy
VAT	Value-added tax

**PROJECT SUMMARY**  
**COLOMBIA**  
**SUPPORT FOR SUBSIDY REFORM PROGRAM**  
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Financial Terms and Conditions				
<b>Borrower:</b> Republic of Colombia			<b>Flexible Financing Facility<sup>(a)</sup></b>	
			<b>Amortization period:</b>	Bullet payment on 15 November 2028
<b>Executing agency:</b> Ministry of Finance and Public Credit			<b>Original WAL:</b>	Maximum of 12 years <sup>(b)</sup>
			<b>Disbursement period:</b>	1 year
<b>Source</b>	<b>Amount (US\$)</b>	<b>%</b>	<b>Grace period:</b>	Maximum of 12 years <sup>(b)</sup>
<b>IDB (Ordinary Capital):</b>	400 million	100	<b>Inspection and supervision fee:</b>	<sup>(c)</sup>
<b>Total:</b>	400 million	100	<b>Interest rate:</b>	LIBOR-based
			<b>Credit fee:</b>	<sup>(c)</sup>
			<b>Approval currency:</b>	United States dollars from the Ordinary Capital
Project at a Glance				
<b>Project objective/description:</b> This operation is the first in a programmatic policy-based loan (PBP) series consisting of two loans that are contractually independent but technically linked, in accordance with document CS-3633-1. The objective of this programmatic series is to enhance the equity and efficiency of spending in subsidies financed by the national budget.				
<b>Special contractual conditions precedent to release of the single tranche of the loan:</b> The release of the single tranche will be subject to fulfillment of the policy reform conditions described in the policy matrix ( <a href="#">Annex II</a> ), the policy letter, and the conditions set forth in the loan contract (paragraph 3.3).				
<b>Exceptions to Bank policies:</b> None.				
Strategic Alignment				
<b>Challenges:<sup>(d)</sup></b>	SI	<input checked="" type="checkbox"/>	PI	<input type="checkbox"/>
			EI	<input type="checkbox"/>
<b>Crosscutting themes:<sup>(e)</sup></b>	GD	<input type="checkbox"/>	CC	<input type="checkbox"/>
			IC	<input checked="" type="checkbox"/>

<sup>(a)</sup> Under the terms of 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 reviewing such requests.

<sup>(b)</sup> The original WAL of the loan could be shorter, depending on the actual loan contract signature date.

<sup>(c)</sup> 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 applicable policies.

<sup>(d)</sup> SI (Social Inclusion and Equality); PI (Productivity and Innovation); and EI (Economic Integration).

<sup>(e)</sup> 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 addressed, and rationale

#### 1. Recent economic performance

- 1.1 In recent years, Colombia has had remarkable economic performance and made significant social gains. In the 2010-2014 period, the country's gross domestic product (GDP) grew at a yearly rate of 4.8%, with inflation on the long-term target (3%), a continuous decline in unemployment (from 11.8% to 9.1%), and an increase in foreign direct investment and exports. In addition, the central national government's fiscal deficit fell from 3.9% to 2.3% over this period. In terms of social indicators, the rate of monetary poverty declined from 39.0% to 28.5% over the period, while extreme poverty dropped to the single-digit level, from 12.3% to 8.1%. Over these years, both the emerging middle class and the consolidated middle class exceeded the percentage of the population living in poverty,<sup>1</sup> while the primary measure of inequality, the Gini coefficient, fell from 0.560 to 0.538.
- 1.2 In 2015, the external economic context became unfavorable, creating significant challenges for the Colombian economy. Deteriorating terms of trade have led to a fall in tax revenue from oil production (1.5% of GDP) and grew the current account deficit (6.5% of GDP). In nominal terms, tax revenue from oil production declined to half of the 2014 figure in 2015 and is expected to be zero in 2016. The fall in the price of crude affected the level of economic activity, reducing annual GDP growth to 3.1% in 2015. In response, the exchange rate is acting as an automatic stabilizer, lowering the level of imports and raising tax revenue from foreign trade. In addition, inflation is rising (6.8% per year as of December 2015) due to temporary hikes in the price of foods as a result of El Niño and a transfer of the Colombian peso's depreciation to the prices of tradable goods. In view of this scenario, the Government of Colombia cut spending in 2016 by 2.0% of GDP to comply with the fiscal rule,<sup>2</sup> while Banco de la República [Colombia's central bank] raised the benchmark rate by 225 basis points.
- 1.3 Despite the unfavorable context, the soundness of the country's macroeconomic fundamentals and social policy enabled the main indicators to post a positive performance in 2015.<sup>3</sup> Investment reached 29.4% of GDP, unemployment decreased slightly to 8.9%, and both poverty and extreme poverty continued to decline (by 27.8% and 7.9%, respectively). While foreign direct investment and

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<sup>1</sup> The emerging middle class (also known as the vulnerable class in other countries) is a portion of the population that earns income above the poverty line but is nevertheless vulnerable to falling into poverty. The consolidated middle class is in an income bracket with minimal risk of falling into poverty. According to data from the Departamento Administrativo Nacional de Estadística [National Administrative Department of Statistics] (DANE) published in March 2016, the emerging middle class accounts for 39.3%, and the consolidated middle class for 30.5%, of the Colombian population.

<sup>2</sup> Law 1473 of 2011 establishes the fiscal rule and other provisions. The fiscal rule states that structural spending may not exceed structural revenue by an amount higher than the annual target for the established structural balance. Starting in 2022, the structural deficit of the central national government may not exceed 1% of GDP. In addition, there is a temporary provision in this law requiring the national government to pursue a progressively lower structural fiscal balance deficit, posting a structural deficit of 2.3% of GDP or lower in 2014, 1.9% of GDP or lower in 2018, and 1% of GDP or lower in 2022.

<sup>3</sup> See, for example, the OECD report (2016) OECD Reviews of Labour Market and Social Policies; Colombia.

exports fell and the fiscal deficit rose in 2015, the outlook for the coming years is favorable.

- 1.4 In the current context and with the policy framework presently in effect, International Monetary Fund (IMF) and private-sector analysts expect the Colombian economy to recover 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 Colombia's international reserves), doubling the amount of the previous FCL. The IMF analysis acknowledges the country's track record of implementing very sound policy frameworks, which include a set of inflation targets, a flexible exchange rate, adequate financial sector regulation and supervision, and a fiscal structural balance rule, while noting the economy's resilience in the face of declining oil prices.<sup>4</sup> In the short term, the drop in public revenue is creating a funding gap that will be covered in part by the proceeds of this operation.<sup>5</sup>
- 1.5 To ensure medium-term fiscal sustainability and compliance with the fiscal rule, the Government of Colombia is launching substantive fiscal reforms. Thus, the government created an Expert Commission to Support Tax Equity and Competitiveness, and the commission delivered its final report to the Minister of Finance and Public Credit (MHCP) in December 2015. Based on the commission's work, the national government is now initiating a tax reform aimed at increasing tax collection by 1.5% to 2% of GDP to offset the drop in revenue due to lower oil prices, while at the same time creating a simple and efficient tax system.<sup>6</sup> To supplement the tax reform and make strides in boosting equity and efficiency in public spending, the Colombian government has identified a priority reform agenda aimed at making public investment in subsidies more efficient, with a view to maximizing the impact of subsidy expenditure in terms of efficiency and equity.
- 1.6 The tax reform and the reform in public investment in subsidies are in line with the public management principles of the Organization for Economic Co-operation and Development (OECD). These reforms are expected help enhance the economy's efficiency, paving the way for locking in a sustainable and equitable growth process. The present programmatic series focuses on reforming the subsidy system.

## **2. Diagnostic assessment and challenges in the area of subsidies**

- 1.7 Subsidies are defined as transfers of public resources granting an economic benefit to an individual or legal entity in fulfillment of a constitutional duty, particularly the State's authority to intervene in the economy (to correct market failures) and the State's social duties and purposes (redistributive and social inclusion purposes). The Departamento Nacional de Planeación [National Planning Department] (DNP) has spearheaded an analysis of subsidies in

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<sup>4</sup> Colombia's economy was the second hardest hit by the fall in the price of crude, but it grew as much as or more than economies that experienced lesser shocks in their terms of trade.

<sup>5</sup> Paragraph 2.2 sets forth additional details.

<sup>6</sup> In this regard, the bill is expected to include a more progressive and equitable income tax. In addition, the government is examining alternatives to ensure that the value-added tax (VAT) has the lowest possible regressive impact.

Colombia, identifying two broad categories.<sup>7</sup> Redistributive subsidies are aimed at enhancing equity in the distribution of public resources and at social inclusion. This category includes cash transfers and social spending to subsidize basic human capital development and protection services. The second category covers subsidies aimed at boosting economic productivity, supporting the creation of public goods, or reducing market failures that create distortions in the allocation of resources and lead to a loss of efficiency. These flaws notably include the positive externalities occurring, for example, when private returns on investment are lower than social returns.<sup>8</sup> The economic rationale for subsidies—promoting equity and social inclusion or productivity—is consistent with the constitutional support for allocating them. In addition, subsidies may be classified by desired target (individuals-households or producers-firms), how specific they are (targeted or general), or by how they are granted (through a cash transfer or in kind).

- 1.8 According to DNP estimates, the Government of Colombia spends roughly 10% of GDP on subsidies. Social subsidies account for 9% of GDP. They include, *inter alia*, early childhood care, provision of free basic, middle, and secondary education, the cost of the Capitation Payment Unit guaranteeing access to the mandatory health plan provided by the Sistema General de Seguridad Social en Salud [General Social Security Health Care System] (SGSSS), housing subsidies, subsidies for residential public services, antipoverty programs, and closing of social gaps and pension subsidies. Estimates of production-related subsidies are still preliminary, but they are believed to account for roughly 1% of GDP.<sup>9</sup>
- 1.9 The diagnostic assessment performed by the DNP showed that despite accounting for close to 10% of GDP, the current subsidy spending system has some insufficiencies, for example: (i) there are no binding regulations systematically providing guidelines on technical criteria guiding the creation, duration, implementation and evaluation of subsidies; (ii) in the case of some programs, there is no clear rationale or an ex ante impact and cost-benefit analysis; and

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<sup>7</sup> The DNP's definition focuses on direct subsidies, i.e., occurring when there is a transfer of public resources to individuals or legal entities. This does not include so-called implicit subsidies, which occur when the government grants tax exemptions, possibly for the same purposes as in the case of direct subsidies. At the present time, these tools are being considered part of the tax reform.

<sup>8</sup> Other market failures are public goods, information problems, and barriers to entry. Positive externalities also occur when private costs are higher than social costs and, as a result, production that maximizes private benefits is lower than if it were to maximize social benefits. This occurs in investments in research and development of new technologies, which generate greater benefits to society than the profits earned by the companies that make the investments. In these cases, it has theoretically and empirically been shown that subsidies can correct this market failure and increase investment in research and development, closing the gap between private and social benefits and thereby generating productivity gains in the economy. See, for example, Gustavo Crespi, Alessandro Maffioli, and Alejandro Rastelletti (2014). *Investing in Ideas: Policies to Foster Innovation in Rethinking Productive Development: Sound Policies and Institutions for Economic Transformation*. Ed. Eduardo Fernández Arias, Gustavo Crespi, Ernesto Stein. Washington, D.C.

<sup>9</sup> Production-related subsidies include direct subsidies from the Agricultural Sector Financing Fund (FINAGRO), support to companies through the Administrative Department of Science, Technology, and Innovation (COLCIENCIAS) and Procolombia, and support from the Ministry of Technology and Communications. The subsidies directly managed by the Ministry of Agriculture and Rural Development, the currency hedges provided by FINAGRO, and the implicit subsidies from Banco Agrario (in this regard, the OECD estimates that Colombia spends approximately 1.8% of its GDP on agricultural sector subsidies) were initially left out of the analysis. The difficulty in quantifying production-related subsidies shows the need to subject them to closer budgetary monitoring, and this consideration is included in the proposed subsidy reform.



(iii) the institutional arrangement for comprehensive monitoring and evaluation of public spending on subsidies has coordination problems and has not generated an information system sufficiently robust and dynamic to enable timely budgetary monitoring of subsidy spending. For these reasons, several of the programs examined have design and targeting problems, to the detriment of efficiency in the allocation of public resources and ultimately undermining the welfare of the most vulnerable population groups (DNP, 2016).

- 1.10 The objective of the subsidy reform (hereinafter, the “reform”) is to rationalize the allocation of subsidies so that all subsidies are aimed at either fulfilling redistributive and social inclusion purposes or responding to a market failure. In addition, the reform is designed to introduce a standardized procedure that includes: (i) performing an analysis to justify the use of a subsidy instead of other policy instruments; (ii) establishing prioritization and targeting criteria for the allocation of subsidies; (iii) identifying criteria for evaluating the subsidies; and (iv) determining the duration of each subsidy, this being particularly important in the case of specific subsidies. The reform is also designed to introduce a better categorization of subsidies to facilitate their monitoring.
- 1.11 The scope of the reform encompasses the development, approval, and gradual implementation of a general legal framework for the allocation of subsidies funded by the national budget. This framework will have the force of law, with ordinary and organic provisions, and will set forth the governing principles and requirements for subsidy creation and allocation as well as the relevant budgetary provisions. The legal framework will be applicable to all subsidies that meet the definition of the term adopted by the Government of Colombia. A core component of the reform is a set of improvements in the system of redistributive and social inclusion subsidies and a new targeting methodology for allocating such subsidies. The general legal framework will strengthen the specific measures of the targeting system and help to enhance the equity and efficiency of social subsidies.<sup>10</sup>
- 1.12 In 1993, Law 60 established the targeting criteria for social programs. Subsequently, Law 715 of 2001 and Law 1176 of 2007 defined targeting as the “process for ensuring that social spending is allocated to the poorest and most vulnerable population groups.” In parallel, the national government began work on developing a targeting tool for social programs. The initial version of the Sistema de Identificación y Clasificación de Potenciales Beneficiarios de Programas Sociales [System for Identification and Classification of Potential Social Program Beneficiaries] (Sisbén), which is the government’s primary targeting tool, became effective in 1995. Sisbén is a database built through a household survey conducted periodically by the DNP. The survey classifies households by socioeconomic status (the poorest being placed first and the wealthiest last), and the resulting score is used as an input for selecting beneficiaries of the main social programs. As it has evolved, Sisbén has been supported by documents from the Consejo Nacional de Política Económica y Social [National Economic and Social Policy

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<sup>10</sup> The legal framework will pave the way for a review of all subsidies; however, according to the DNP review, social subsidies account for the largest share of subsidy spending. In particular, the legal framework supplements the proposed social subsidy reforms by establishing the governing principles and requirements for the creation and allocation of subsidies, creating a registry of subsidies and beneficiaries for public consultation, setting quality criteria, and creating a technical entity responsible for monitoring the subsidies. In addition, the legal framework will allow a gradual review of all subsidies and will be particularly applicable to the new subsidies.

Council] (CONPES):<sup>11</sup> CONPES documents 040 of 1997, 055 of 2001, and 117 of 2008. While the Colombian Constitution recognizes the focus on universal rights and social policies, it also recognizes the need to prioritize and target subsidy spending toward the most vulnerable individuals and families.

- 1.13 The Sisbén version currently in use is the third. Its database was completed in 2011 and therefore has some deficiencies by virtue of being out of date. In addition, Sisbén exhibits two basic weaknesses: (i) significant targeting errors that justify redesigning the methodology for calculating the classification score; and (ii) lack of interoperability with the databases of other social programs funded with State resources, making it impossible to determine what benefits reach a given family and how the redistributive subsidies are complemented by the range of social services provided by the State. These issues are discussed in the following paragraphs.
- 1.14 Targeting consists of three phases: identification, selection, and allocation. Identification is done by Sisbén; selection is carried out on a shared basis by Sisbén and the programs that establish cutoff points; and allocation is the responsibility of the social programs that use the Sisbén score as an eligibility criterion. Identification is performed at the household level as part of the periodic sweep of households conducted by the DNP, or whenever an interested individual approaches a municipal Sisbén office with a request to be included in the Sisbén database or have his/her information updated. This request is followed by a household survey conducted by a municipal employee. The municipalities consolidate the information and forward it to the DNP for validation. DNP validates the information through a quality and consistency evaluation process, which, however, provides limited options for comparing the information with other databases for validation purposes. Lastly, the allocation process involves calculating and certifying the score, which is done by the DNP, and feeding the Sisbén database to the social programs so that it may be used as a reference when determining potential beneficiaries.
- 1.15 The use of Sisbén for allocating the redistributive subsidies described in paragraph 1.8 includes the subsidized SGSSS system, the early childhood programs operated by the Instituto Colombiano de Bienestar Familiar [Colombian Family Welfare Institute] (ICBF); the Más Familias en Acción [More Families in Action] conditional cash transfer programs for families living in poverty, the Jóvenes en Acción [Youth in Action] program supporting poor or vulnerable youths so as to enable them to pursue technical, technological, or vocational studies, and the Red Unidos [United Network] family assistance program for families living in extreme poverty, all of them operated by the Departamento de Prosperidad Social [Social Prosperity Department] (DPS); the Colombia Mayor [Senior Colombia] program operated by the Ministry of Labor; and the Ser Pilo Paga [It Pays to Be Smart] program supporting academic achievement in upper secondary school, as well as other educational support programs, through the Instituto Colombiano de Crédito Educativo y Estudios Técnicos en el Exterior [Colombian Institute for Education Loans and Foreign Technical Education] (ICETEX). The total amount spent on these programs in 2015 was approximately 21 billion pesos (US\$7.1 billion); the targeted direct transfer and extreme-poverty reducing programs (Más Familias en Acción, Jóvenes en Acción, Colombia Mayor, and Red Unidos), where the

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<sup>11</sup> Documents approved by CONPES.

implications of potential gains in targeting efficiency due to Sisbén improvements are greater, alone total US\$1.2 billion per year.

- 1.16 The DNP led a comprehensive review of Sisbén III to identify the main challenges and improvement opportunities. In addition to a qualitative study based on focus groups to learn the opinions of people included in the Sisbén database,<sup>12</sup> the Sisbén III evaluation exercise included an evaluation of the classification methodology<sup>13</sup> and an analysis of the technology platform that supports data collection and management of the index.
- 1.17 The technical analysis of Sisbén III considered three aspects: (i) the efficiency of the classification method; (ii) the relevance of the weightings and dimensions; and (iii) the existence of easily manipulated variables. The efficiency analysis was based on a measurement of inclusion and exclusion errors in the Sisbén III index. These errors were calculated using (as a reference) the individuals classified as potential beneficiaries of the conditional cash transfer program, *Más Familias en Acción* program, and health subsidy system based on their score, and comparing these data with their poverty status based on income and multidimensional poverty measurements. The exclusion error refers to people living in poverty who are not classified as potential beneficiaries of the social programs, while the inclusion error refers to those who, not being poor, are classified as potential beneficiaries of these programs. This comparison was used to calculate the horizontal and vertical efficiency of the instrument for different years.<sup>14</sup> The sources of information used for these analyses were the quality of life surveys of the National Administrative Department of Statistics (DANE) from 2008 to 2013 and the Sisbén III national database as of December 2011 and 2013.
- 1.18 The results of these analyses show, in the first place, that Sisbén is inconsistent with poverty measurements. This inconsistency stems from the nature of Sisbén III, which measures quality of life and is not intended to measure poverty. For example, while poverty has declined in all its forms (moderate or extreme monetary poverty, multidimensional poverty), the percentage of the population with a Sisbén score that makes it eligible for the health subsidy system or for the *Más Familias en Acción* program has risen. The efficiency analysis shows that the inclusion errors calculated in household surveys increase during the period under review in all geographic areas, going from 45% to 50% in the case of monetary poverty and reaching even higher levels in the case of extreme monetary poverty. This is partly due to outdated weightings, changes in the living conditions of the population, the methodology used in Sisbén III (which was not intended as a way of predicting monetary poverty), and failure to update the cutoff points to make them consistent with the percentage of the population living in poverty. As a result of the above, there is a decline in vertical efficiency in all areas, with higher inefficiency in the 14 largest cities and lower inefficiency in rural areas. Given the inverse relation between inclusion and exclusion errors, the high levels of inclusion error are associated with relatively low levels of exclusion error. However, according to the 2013 National Survey on Quality of Life (ECV), 23.5% of those living in monetary poverty nationwide fail to qualify for the health subsidy system

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<sup>12</sup> See [OEL #2](#).

<sup>13</sup> See [OEL #2](#), DNP, 2015.

<sup>14</sup> Horizontal efficiency is a complement of the exclusion error (EE) (1-EE), indicating whether all those who should be included in the program are in fact included, and vertical efficiency is a complement of the inclusion error, indicating whether the beneficiaries are those who should have been included.

based on their Sisbén score, and this figure approaches 35% in the Valle del Cauca, Oriental, and Bogotá regions.

- 1.19 In addition, an assessment was performed to determine the relative robustness of the Sisbén III score in the face of changes in the variables used to calculate it. The assessment showed some limitations in the methodology, which assigned a large weight to variables with a smaller number of categories and to the lowest-frequency category. This may have made it possible to identify those variables with a view to manipulating the information reported and obtaining a lower score.<sup>15</sup>
- 1.20 The majority of social programs are designed to target low-income individuals and families, but Sisbén III focuses on quality of life. This has resulted in a disconnect between the information needs of social programs for purposes of allocating benefits on one hand, and Sisbén III as a targeting instrument on the other. In addition, while Sisbén's coverage is very high (approximately 75% of Colombians have a Sisbén score), the updating of the information is limited, with 74% of the records not having been updated since 2011. Furthermore, there is ample room for improvement in data quality and consistency, since the DNP does not have access to all available tools to reduce inconsistencies, there are no effective penalties for fraud, and updating the information is not mandatory. At the present time, updates are the responsibility of the territories, and they are performed through nonautomated processes, with limited sources for verification by means of administrative data cross-checking.
- 1.21 Another fundamental weakness of Sisbén is its lack of interoperability. The fact that the information is fragmented leads to unawareness of overlap in the coverage of the various programs. Thus, there are records for 34 million individuals benefitting from one of the programs targeted through Sisbén, but this actually refers to 19 million beneficiaries. For example, there are 1.15 million individuals covered by four or more social programs (DPS master database, April 2016). In addition, it is worth noting that the social programs that use the Sisbén index as a targeting instrument generally do not take into account other types of information on the characteristics of the population, the territories, or other social programs.
- 1.22 Sisbén's weaknesses have contributed to various problems that affect efficiency in the allocation of subsidies and social programs, such as: (i) lack of coordination at the territorial level between the needs of the population and the supply of social programs; (ii) lack of targeting coordination across sectors, creating duplication of supply and beneficiaries; (iii) information asymmetry between the targeting tool (which focuses on quality of life) and the information needs of the social programs (which are designed to serve low-income population groups); (iv) absence of a system for monitoring the beneficiary population, partly due to a lack of information-sharing between institutions; and (v) lack of incentives for social mobility in the population.

### **3. The subsidy reform agenda**

- 1.23 The Government of Colombia has undertaken to review and organize the delivery of subsidies and has requested the Bank's support in this endeavor. The subsidy

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<sup>15</sup> For example, there are only two categories for measuring types of housing, and one of them (the one most closely associated with poverty and, in principle, the least frequent) is heavily weighted in the index. At the same time, the floor material variable has five categories and the index is not that sensitive to changes in category.

reform has two dimensions. First, it would involve developing a comprehensive legal framework to organize and systematize subsidies, where the Bank has provided strategic support. The DNP is leading this initiative by preparing a legislative bill containing ordinary and organic provisions on subsidies. The aim is to establish organic budgetary and procedural regulations for creating subsidies and thereby set the basic rules that will govern subsidies funded in whole or in part with national budget resources. Second, it seeks to make social subsidy targeting more efficient through a new comprehensive targeting system, Sisbén IV. In this dimension, Bank support has focused on technical and operational elements of the new targeting system.

- 1.24 The subsidy bill provides for creating a Consejo de Progresividad y Eficiencia Pública [Public Progressivity and Efficiency Council] (COPEP) responsible for issuing a binding technical opinion regarding compliance with the bill's principles, criteria, and requirements for each subsidy-granting program. The bill sets forth the following criteria for subsidies: (i) every subsidy must have a clear and explicitly defined purpose, identifying the individual or legal entity intended as the beneficiary; (ii) the specificity of the subsidy, i.e., whether or not it should be targeted, must be indicated; (iii) its duration (which may be strictly time-based—for a certain period—or for as long as a certain condition is met); and (iv) the beneficiary's criteria for graduation (i.e., the requirements or circumstances for ceasing to receive the subsidy). In the case of specific subsidies, the duration and graduation criteria are very important.<sup>16</sup>
- 1.25 In addition, the legislative bill establishes the governing principles that are to guide the national government's subsidy policy. These principles notably include: (i) the principle of legality, which states that every subsidy must be created, authorized, and provided by a legislative act, unless it is envisaged in a public policy forming part of the National Development Plan or designed in response to an economic, social, or environmental emergency; (ii) the principles of transparency and effectiveness, which state that the information as to who is receiving what amount and for what purpose should be public, and that the results of the subsidies should be monitored to ensure compliance with the objectives for which they were created; (iii) the principle of solidarity, which emphasizes the importance of ensuring that those who are able to pay do so and determines the basis for cross-subsidies, by means of which those who are able to make partial or full payment subsidize those who are not; (iv) the principle of progressivity, which requires following the parameters of horizontal equity (equitable treatment for persons with similar circumstances) and vertical equity (equitable treatment based on differences in circumstances; for example, granting higher subsidies to those who have a greater need for it); and (v) the principle of fiscal sustainability, which requires that the definition and allocation of subsidies be linked to the fiscal rule and the medium-term fiscal and expenditure framework.
- 1.26 Based on the aforementioned criteria and governing principles, the legal framework will identify at least the following requirements for creating a subsidy:

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<sup>16</sup> Various studies analyze the principles and practices that should guide a subsidy policy aimed at promoting equity and efficiency and contributing to economic growth. Evidence (international and from the region) is included in the Fiscal Policy and Management Sector Framework Document (document GN-2831-3). In addition, the following documents (quoted in detail in [OEL #3](#)) present elements used in the case of Colombia: Meléndez, 2008; Motta, 2004; Office of Fair Trading, 2009; OECD, 2015; World Trade Organization, 2006; Steenblik & Jones, 2010; Steenblik, 2007.

- (i) observe the principle of legality, preventing a proliferation of subsidies by requiring them to have a solid legal basis; (ii) incorporate quality-related aspects, i.e., an analysis of the expected costs and benefits derived from the suitability of the subsidy as an intervention instrument as opposed to other policy instruments, as well as the priority status of the expenditure needed to fund the subsidy; and (iii) have a basis either in the State's duties to intervene in the economy (to correct market failures, specifically positive externalities) or in the State's social duties and purposes (for redistributive and social inclusion purposes).
- 1.27 Since one of the purposes of the legal framework for subsidies is to rationalize the use of subsidies, it also contains significant budgetary and transparency provisions, notably including the following: (i) establishing a tax spending budget classification to identify subsidy-related items at all national government ministries and entities. This will allow better dimensioning and monitoring of subsidy expenditures; (ii) establishing a registry of subsidies and beneficiaries for consultation by the general public to promote transparency; in addition, this registry will be part of the interoperability arrangements, which are aimed at creating synergies, and both maximizing the impacts and boosting the efficiency of social spending through a system that fosters information and knowledge sharing among organizations, and of the framework for business processes; and (iii) establishing criteria for subsidy reporting, including the effectiveness of subsidies and the results of subsidy monitoring and evaluation, in the form of an annual COPEP report to be sent to Congress.
- 1.28 The implementation of this legal framework envisages a transitional arrangement aimed at gradually reviewing all currently existing subsidies, which COPEP is expected to complete within a period of five years.
- 1.29 In the case of the social subsidies allocated on the basis of Sisbén, the Government of Colombia is proposing a substantive reform through a new, comprehensive targeting system. This proposal will be reflected in the CONPES<sup>17</sup> document on Sisbén IV. In addition to introducing technical improvements in the individual targeting methodology, the new system requires families to update their information at least every two years, provides for periodically re-estimating the statistical model for presumed income, and also provides for exploring alternatives to ensure that the cutoff point for program eligibility is linked to the observed poverty rate. All of this will lead to a more dynamic scoring system that better reflects both the conditions of households and the determining factors and dynamics of poverty. In addition, the new system envisages an interoperability mechanism that will give social programs access not only to the Sisbén score of potential beneficiaries but also to data on the characteristics of the population and the territories, including access to information in the administrative records of other social programs or other entities. To implement the new comprehensive targeting system, the following specific objectives need to be met: (i) estimate a presumed income index as one of the individual targeting tools, based on the updated file on the socioeconomic characterization of households; and (ii) design and implement an interoperable information system. This will allow Sisbén to provide information

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<sup>17</sup> CONPES is the highest national planning authority and operates as a governmental advisory body on all matters related to the country's economic and social development. To fulfill this mission, CONPES coordinates with and advises the national government entities responsible for economic and social policy by studying and approving documents on the development of general policies that are presented at council meetings. For further details, see <https://www.dnp.gov.co/CONPES/Paginas/conpes.aspx>.

on the population, the territories, and the availability of social programs as an input for sector planning and planning across sectors.

- 1.30 The new method of calculating the Sisbén score will seek to approximate household income. This is a change in approach from a quality-of-life perspective to an income generation approach, which the evidence from the region has shown to be a good practice for targeting programs that grant redistributive subsidies.<sup>18</sup> Since the purpose of the new model is to approximate monetary poverty, work was done with the Major Comprehensive Household Survey (GEIH) for 2012 and 2013 (the survey used by DANE to derive official measurements of monetary poverty) and a comparison was made among several estimation methods based on the following criteria: better approximation of observed income and incidence of poverty; behavior of inclusion and exclusion errors under each alternative with respect to observed poverty; and correlation between observed income and estimated income. Based on the results of the comparison under these criteria, one method was selected as the best-performing model in approximating a classification of households based on the criterion of monetary poverty. The preliminary results of the model show inclusion errors of 11.8% and exclusion errors of 29.8% in municipal capitals (urban areas), while the inclusion and exclusion errors in rural areas are shown to be respectively 20.8% and 23.9%, when comparing observed poverty and estimated poverty. These values are consistent with those obtained through other systems for targeting by income and lower than those documented in the evaluation of Sisbén III.<sup>19</sup> In addition, while the Sisbén III and Sisbén IV scores are difficult to compare because their population classification systems are based on different criteria (quality of life measurement and monetary income estimate, respectively), the new system has clearly superior performance in terms of correlation with the classification by observed income, which will be the basis for eligibility for social programs (based on the 2013 ECV, the correlation of the Sisbén III classification to the classification by observed income is 0.41 in rural areas and 0.50 in urban areas, while in the case of Sisbén IV the correlation is 0.62 and 0.75, respectively).
- 1.31 To complete the targeting system, work will be done on the interoperability of Sisbén with the administrative records of other social programs.<sup>20</sup> The interoperability mechanism will coordinate the various data sources (administrative

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<sup>18</sup> As indicated in the Social Protection and Poverty Sector Framework Document (document GN-2784-3), the use of targeting by income approximation has allowed the conditional cash transfer programs in the region (including Colombia) to have higher targeting levels than all previous programs that use other targeting models. See, for example, Levy, 2006; Lindert et al., 2006; Grosh et al., 2008; Stampini and Merino-Juárez, 2012 (full references are available in [OEL #3](#)). For global evidence of the advantages of targeting through proxy means tests (PMTs), see Banerjee et al., 2010.

<sup>19</sup> It is worth noting the significance of taking into account not only percentages but also absolute numbers. The 29.8% exclusion error is over the poor population, and the 11.8% inclusion error is over the non-poor population. This means that 5.9 million poor people are classified as not poor and 3.15 million non-poor people are classified as poor. Furthermore, reducing the exclusion error requires adopting a higher cutoff point, being willing to tolerate a higher inclusion error, and assuming a higher estimated poverty percentage than the observed poverty percentage. As discussed in [Veinte años de PTMC: buenas prácticas en su implementación en América Latina y el Caribe](#), a publication prepared by the Social Protection and Health Division (SPH), [expanding coverage among the extremely poor requires supplementing PMT-based targeting with active search work \(an area in which the Bank will work with DNP in the form of technical cooperation\)](#).

<sup>20</sup> For a general description of the national government's interoperability project, see [https://www.sisben.gov.co/Portals/0/Presentacion%20Interoperabilidad%201%20Foro%20\\_1.1.pdf](https://www.sisben.gov.co/Portals/0/Presentacion%20Interoperabilidad%201%20Foro%20_1.1.pdf).

- program databases and individual files) under a service integrator that will group them according to the predetermined classification in order to generate reports and visualizations, depending on user type and access level (for example, program operators, DNP, DPS). This will also make it possible to perform a comprehensive analysis of the supply of and demand for social programs.
- 1.32 To this end, a decree will be issued to regulate the interoperability of the government's administrative databases so as to facilitate information sharing, which currently takes place pursuant to agreements. The goal is to: (i) reduce red tape and the time it takes to obtain information; (ii) regulate information management (habeas data), allowing governmental entities to use the information they need to perform their mission; and (iii) determine the governing authority for system interoperability. Sisbén, with access to a larger number of administrative databases, will be able to verify and update its information on a regular basis, thus enhancing the accuracy and quality of its records. In addition, other entities will be able to use other administrative databases, including Sisbén. This will improve their planning process and enable the tracing of families that participate in one or more social programs. Sisbén's interoperability will give rise to an integrated database, and this has proven to be a good practice in allocating social programs in Latin America and the Caribbean.<sup>21</sup>
- 1.33 Lastly, to improve the quality of Sisbén's information, the reform would introduce effective penalties for both citizens and government employees for fraudulently providing or recording information, including removal from Sisbén and loss of benefits for the former and loss of employment, disqualification, or even criminal penalties for the latter. It will also promote a new verification model for Sisbén based on community oversight performed by national entities with the support of control agencies. In addition, a comprehensive information updating strategy will be developed, making updates mandatory, allowing updates through the administrative records, and launching an awareness campaign on the importance of reliable data. The participation of Sisbén's user institutions and entities will be essential for this purpose. To this end, the proposal calls for using multiple sources of information to perform any updates.
- 1.34 To implement the expected reforms in terms of enhancing the accuracy, quality, and timeliness of Sisbén records, there will be an amendment to Decree 1082 of 2015 (Sole Regulatory Decree for the National Administrative Planning Sector), title eight of which regulates the targeting tools for social services. The aforementioned amendment is expected to: (i) reinforce the articles dealing with suspension and removal of records from the Sisbén database in the event of fraud, and provide penalties for citizens and government employees involved in fraudulent conduct; and (ii) modify the articles that describe the responsibilities of the DNP and the municipios in managing the databases, reducing the responsibilities of territorial bodies and centralizing them in the DNP with a view to enhancing the accuracy of the records and reducing manipulation of the records for political purposes.

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<sup>21</sup> See the section on targeting on the Bank's web page on conditional cash transfers, and the book *Buenas Prácticas en la Implementación de los Programas de Transferencias Monetarias Condicionadas*.



#### **4. Relation to other Bank operations and lessons learned**

- 1.35 The Bank has extensive experience in conditional cash transfer programs and in rationalizing social protection systems in the region. This experience shows the importance of creating modern beneficiary records and information management systems to boost efficiency in managing redistributive subsidy expenditure. This is the direction in which the present operation is headed by providing interoperability for Sisbén. In Colombia, the Bank has assisted Más Familias en Acción since its design stage by means of three operations: Social Safety Net Program (CO0247; 1280/OC-CO) in 2000; Multiphase Program to Support the Second Stage of Expansion of the Familias en Acción Conditional Cash Transfer Program. Phase I (CO-L1021; 1947/OC-CO) in 2007; and Multiphase Program to Support the Second Stage of Expansion of the Familias en Acción Conditional Cash Transfer Program. Phase II (CO-L1059, 2356/OC-CO) in 2010. The first operation supported the design of the program and its expansion to cover 340,000 families living in extreme poverty in municipios with fewer than 100,000 inhabitants. The second and third operations supported expanding the program to 1.5 million families living in extreme poverty, including in medium-sized and large urban centers. At the same time, the Bank accompanied the process of improvement in the targeting of social programs through dialogue and technical assistance in designing and collecting data for Sisbén II and in developing data collection tools for Sisbén III.
- 1.36 In short, the Bank has been assisting Colombia over the past 16 years, both in the design and implementation of strategies to lift people out of extreme poverty and in making adjustments to the targeting instruments for those programs. The lessons learned over these years and reflected in the design of the present operation include: (i) the need to periodically update the information in the beneficiary records in view of the level of social mobility in the country; (ii) the limitations of social program beneficiary records based on multidimensional poverty, which fail to consider the impact of the income variable on poverty (Sisbén III); and (iii) the need for the various social programs to coordinate their targeting and have reciprocal access to strategic administrative records through interoperability mechanisms, so as to ensure the synergy needed to support the process of overcoming poverty and prevent unnecessary duplication of benefits. In addition, and in line with the conclusions of the OVE Annual Report 2015 Technical Note: Design and Use of Policy-based Loans at the IDB (document RE-485-6), it was decided to include a limited number of policy measures that reflect substantive aspects of the subsidy reform supported through this operation. Another aspect emphasized by OVE is the importance of carrying out parallel technical cooperation operations to accompany the reforms. In the present case, this will be done through the operation "Support for preparation of the subsidy reform program" (CO-T1418).
- 1.37 Based on the diagnostic assessment, the government proposal, and the Bank's experience in the design and implementation of improvements in subsidy allocation, a programmatic series is being proposed to support the reform and make public investment in subsidies more equitable and efficient. To this end, the initial stage will consist of supporting the development of a legal framework to establish and systematize the governing principles of the subsidy policy and lay out the institutional framework and processes for implementing it, as well as to develop tools and strategies to boost the efficiency of social subsidies. A second

stage will consist of supporting approval of the developed instruments in order to pave the way for moving forward on implementing the principles for subsidy allocation and the comprehensive targeting system for social subsidies. In this process, the Bank's contribution will be based on its technical expertise on the political economy of applying the principles of subsidy reform,<sup>22</sup> as well as on its experience in designing and implementing reforms of targeting systems for the allocation of social subsidies.<sup>23</sup>

## **5. Strategic alignment**

- 1.38 The program's strategic alignment.** The program is consistent with the Update to the Institutional Strategy (UIS) 2010-2020: Partnering with Latin America and the Caribbean to Improve Lives (document AB-3008) and is directly aligned with the development challenge of social inclusion and equality by: (i) boosting targeting efficiency in capacity-building programs for the population living in extreme poverty; and (ii) developing a legal framework for subsidy allocation that will promote a more redistributive fiscal policy. This program is also aligned with the UIS's crosscutting area of institutions and the rule of law by strengthening the strategic planning and monitoring capacity of fiscal policy, particularly with regard to public expenditure on subsidies, and by making social subsidies more efficient. In addition, the program will contribute to the Corporate Results Framework 2016-2019 (CRF) (document GN-2727-6), specifically through the regional context indicator on the poverty incidence rate included in the results matrix. This operation contributes to the objectives of improving public management effectiveness and fostering greater social mobility set forth in the Bank's Country Strategy with Colombia 2015-2018 (document GN-2832) and is aligned with the strategic objective of continuing to reduce poverty and eliminating extreme poverty, by improving the targeting and coverage of capacity-building programs for the population living in extreme poverty. In addition, this operation contributes to the Strategy on Social Policy for Equity and Productivity (document GN-2588-4) and is consistent with the Social Protection and Poverty Sector Framework Document (document GN-2784-3), particularly with regard to the use of efficient redistributive instruments.

## **B. Objectives, components, and cost**

- 1.39 Objective and expected outcomes.** This operation is the first in a programmatic policy-based loan (PBP) series consisting of two loans that are contractually independent but technically linked, in accordance with document CS-3633-1. The objective of this programmatic series is to enhance the equity and efficiency of spending in subsidies financed by the national budget. The first operation will support the preparation of a law containing ordinary and organic provisions that set subsidy policy and will design mechanisms to optimize the management of social subsidies. The second operation will move forward on reorganizing

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<sup>22</sup> See, for example, the 2016 Development in the Americas (DIA) report (Saving for Development), the 2013 DIA (More than Revenue: Taxation as a Development Tool), and the publication *¿Quiénes deciden la Política Social? Economía Política de los Programas Sociales en América Latina*, Bonvecchi et al., 2015; as well as the evidence presented in the Social Protection and Poverty Sector Framework Document (document GN-2784-3) and the Fiscal Policy and Management Sector Framework Document (document GN-2831-3).

<sup>23</sup> As documented in the Social Protection and Poverty Sector Framework Document (document GN-2784-3), the Bank has participated in the design, implementation, and evaluation of social subsidy targeting and allocation systems in countries such as Colombia, Honduras, Dominican Republic, Panama, and Mexico.

subsidies based on the principles of the legal framework through the approval and implementation of this framework, and on creating the necessary processes and implementing the new comprehensive targeting system for social subsidies.

- 1.40 **Component 1. Macroeconomic framework.** The objective of this component is to ensure the maintenance of a macroeconomic context consistent with the program objectives as set forth in the policy matrix and sector policy letter.
- 1.41 **Component 2. Legal framework for the allocation of subsidies.** The objective of this component is to make subsidies more equitable and efficient by preparing a legislative bill with ordinary and organic provisions that establishes the principles, criteria, and requirements that are to govern investment in subsidies by the Colombian government. The legal framework will determine the appropriate circumstances for subsidies that address positive externalities and for subsidies that have redistributive or social inclusion purposes.
- 1.42 The first operation will support the rationalization and optimization of subsidies<sup>24</sup> by specifying their design, form of implementation, and monitoring through a legislative bill approved by the DNP Director that indicates, *inter alia*, the purposes, duration, and governing principles of subsidies as well as the criteria for receiving them. The second operation will support the approval of this bill by the National Congress as well as the gradual application of its principles in the allocation of subsidies, rationalizing and optimizing subsidies by allocating at least 25% of subsidy spending in accordance with the principles and criteria provided in the legal framework.
- 1.43 **Component 3. Social subsidies.** The objective of this component is to make expenditure on social subsidies more equitable and efficient in line with the principles of the aforementioned legal framework, and specifically to: (i) reduce inclusion and exclusion errors among social program beneficiaries, with a particular emphasis on inclusion errors, taking into account the country's current fiscal situation; (ii) improve planning by various State entities for the supply of social programs; and (iii) allow for the traceability of families that participate in a social program. This will be achieved by supporting the design and implementation of Sisbén IV, which will introduce the following innovations over Sisbén III: (i) facilitate interagency access to the records of the State's administrative databases (system interoperability) in order to dynamically update and periodically review the accuracy of Sisbén records; (ii) include additional information on household income and household georeferencing; (iii) review the formula for calculating the eligibility score so as to include variables predicting per capita income; and (iv) effectively and severely penalize fraudulent records.
- 1.44 In the first operation, this component will support the following policy measures: (i) improve the quality of the Sisbén database by establishing instruments that enable better data collection and database validation, to be achieved through a proposed amendment to Decree 1082 of 2015 aimed at building quality control capacity at the central level and setting penalties against individuals and government employees involved in fraudulent conduct; (ii) increase the targeting efficiency of social programs by developing a new household classification model; and (iii) improve the social programs used by Sisbén to select beneficiaries,

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<sup>24</sup> Rationalization means establishing the criteria, requirements, and principles that will govern subsidy allocation in Colombia, while optimization means allocating subsidies based on a proper economic justification and on more efficient targeting systems (i.e., having fewer inclusion / exclusion errors).

making it easier to consult the administrative records of other programs in order to optimize planning, improve the quality of the available information (verification, validation, and updating processes), and enable the traceability of families that participate in a social program by developing an interoperable system of administrative records. These measures will make it possible to improve management and quality control of the Sisbén database through the use of information technologies to capture, validate, and georeference data, as well as by creating protocols for cross-checking administrative records, for purposes of checking for survey inconsistencies and facilitating the reporting of irregularities and penalizing fraud.

- 1.45 The second operation will support the following policy measures: (i) improve the quality of the Sisbén database by creating instruments that enable better data collection and database validation, achieved by building quality control capacity at the central level and setting penalties against individuals and government employees involved in fraudulent conduct, through approval of the amendment to Decree 1082 of 2015 and implementation of the measures provided in this amendment; (ii) increase the targeting efficiency of social programs by approving a new household classification model by means of a CONPES document on Sisbén IV and its implementation and setting cutoff points for eligibility for such programs, and updating information on the socioeconomic characteristics of households by moving forward on implementing Sisbén IV, achieving household data collection in municipios that account for at least 25% of Colombia's population; and (iii) improve the planning capacity of social programs and the quality of their administrative information and facilitate the traceability of families that participate in social programs, as well as the updating and verification of Sisbén records, by creating an interoperability system (through approval of the interoperability decree) and implementing it.

### **C. Key indicators in the results matrix and economic analysis**

- 1.46 The [results matrix](#) for the programmatic series identifies the expected outputs and outcomes following the implementation of policy measures aimed at enhancing the equity and efficiency of subsidies. The outputs notably include the legal framework for rationalization of subsidies, which will establish the criteria, requirements, and principles that will govern subsidy allocation in Colombia, as well as a new comprehensive targeting system for social subsidies allocated through individual targeting, and the implementation of the strategy for interoperability of social programs. The expected outcomes associated with these outputs notably include a gradual allocation of subsidies based on the principles of the legal framework; a rationalization of subsidies, which will make it possible to identify and track the subsidy spending; a decrease in inclusion and exclusion errors by the socioeconomic classification instrument; and a concomitant improvement in the targeting of social subsidies allocated through Sisbén.
- 1.47 An economic analysis was performed on the expected costs and benefits of the most emblematic policy measures included in this reform ([OEL #1](#)). The analysis was based on the social benefits to be generated through the new Sisbén IV comprehensive targeting system, which will create savings by reducing inclusion errors and create efficiency gains in social program investments thanks to the interoperability system. The economic analysis also considered the benefits that the new legal framework would have by rationalizing and optimizing subsidies, which would help to enhance the benefits of social subsidies. In both cases, for the

base scenario, the analysis calculated the present value of the savings generated by implementing policy measures for subsidy allocation, using a discount rate of 12% and various savings scenarios. In this case, the net present value (NPV) of the benefits (for a period of five years) of social subsidy reform implementation is approximately US\$650 million.<sup>25</sup> In addition, the analysis examined the benefits of reallocating part of those funds toward subsidies that have been shown to have a high social return.<sup>26</sup> In this case, the estimates also show a high potential for generating additional benefits. For example, in the case of social subsidies targeted through Sisbén, improving the coverage of households living in extreme poverty under the Más Familias en Acción program could yield a NPV of up to US\$500 million from improvements in human capital accumulation (nutrition, health, and education). These calculations took into account the benefits that will be created based on currently existing subsidies over a period of five years following implementation of the policy measures. Gains made in subsequent years or associated with new subsidies were not considered.<sup>27</sup> Consequently, the data reported in the economic analysis provide a conservative estimate of the benefits of the reforms.<sup>28</sup>

## **II. FINANCING STRUCTURE AND MAIN RISKS**

### **A. Financing instruments**

- 2.1 This operation is the first in a programmatic policy-based loan (PBP) series consisting of two loans that are contractually independent but technically linked, in accordance with document CS-3633-1. This modality is appropriate for supporting the strategy of legislative reform of subsidy use, which will set criteria for the rationality, structure, purpose, and duration of the subsidies granted by the national government, and for assisting in the design and deployment of the new comprehensive targeting system for social subsidies. This reform has technical and coordination components that justify opting for a programmatic instrument to support its implementation. The amount of this initial operation in the programmatic series is US\$400 million, to be financed with resources from the Bank's Ordinary Capital. The amount for the second operation is expected to be US\$400 million but will be determined at the appropriate time based on the country's financial needs and the Bank's programming exercise.

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<sup>25</sup> This figure refers only to the estimated benefits attributable to implementation of the social subsidy reforms included in Component 3 of the operation. These benefits could increase to an estimated US\$1.050 billion if the social subsidy reforms are reinforced through the approval and implementation of the legal framework for subsidies. Furthermore, such approval would generate additional benefits stemming from the review of other subsidies. These benefits could be in the range of US\$500 million to US\$1 billion.

<sup>26</sup> In this case, a 5% discount rate was used for social subsidies and a 12% discount rate was used for other subsidies. As discussed in the annex (footnote 13), agencies such as the World Health Organization and the United Nations Educational, Scientific, and Cultural Organization suggest using discount rates of 2% to 7% for social projects (health, education, early childhood development), particularly those yielding benefits in the medium and long term.

<sup>27</sup> The analysis does not include some social subsidies that are not expected to be modified in the short or medium term (such as those associated with higher education or health); similarly, it does not include all other subsidies. This means that the estimated benefits are the lower limit of the benefits the reforms are expected to generate. For example, approval and implementation of the legal framework will have a greater effect on new subsidies.

<sup>28</sup> In addition, the annex shows that the outcomes are robust to the sensitivity analysis (including changes in the exchange rate, discount rate, pace of reform implementation, and implementation costs).

- 2.2 **Size of the operation.** In accordance with 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 determined on the basis of the country's needs for fiscal resources. The central government's financing needs are equivalent to 7.7% of GDP. The amount of this operation is designed to cover a portion of this, accounting for 1.9% of total financing needs and 13.3% of multilateral financing. According to Bank and IMF analyses, the macroeconomic outlook for Colombia is stable, while debt sustainability analyses show that total public debt as a percentage of GDP will decline in the medium term and remain manageable even in the event of severe external shocks.

**B. Environmental and social risks**

- 2.3 Based on Directive B.13 of the Environment and Safeguards Compliance Policy (document GN-2208-20 and policy OP-703), this operation does not require classification. The social impact of the program's policy measures is expected to be positive (see [OEL #4](#)).

**C. Other project risks**

- 2.4 There is the risk of delays in approval of the legal framework for subsidy allocation. This risk is classified as medium. While the benefits indicated in paragraph 1.47 are attributable to the social subsidy reform (where the risk of approval delay is very low), approval and implementation of the legal framework would strengthen the impacts of the improvements on social subsidies. As a mitigation measure, in view of the sector's political economy and the country's current political situation, the government will promote the legal framework as part of the long-term fiscal strategy and plans to apply the principles of the legal framework by means of measures that can be implemented through administrative acts that have a legal basis under current legislation. In the case of social subsidies, they will start to be optimized through the measures included in the Sisbén IV technical document and other measures in the reforms under Component 3. For other subsidies, the CONPES documents on productive development and on science, technology, and innovation currently being prepared will include criteria for allocating subsidies aligned with and complementary to those described in the legal framework. Another risk classified as medium is that associated with the scoring model transition and the implementation of Sisbén IV in a period of elections and change in government administration. This risk has been mitigated through scheduling and budgetary provisions to suspend data collection during the election period; furthermore, plans call for gradually rolling out by department the transition from Sisbén III to Sisbén IV. In addition, the Bank will work with the DNP on designing and implementing communication strategies regarding the nature and scope of Sisbén IV. Lastly, there is a risk of noncompliance with the measures that provide penalties for fraudulent conduct and records in managing the Sisbén databases. To mitigate this risk, in 2016 the DNP began purging the Sisbén database and building quality control capacities at the central level. This will facilitate the implementation of the policy measures provided under the present operation.
- 2.5 Sustainability of the reform process. The Colombian government is committed to structural solutions aimed at complying with the fiscal rule, notably including the subsidy reform to be supported by this operation, and is similarly committed to boosting the efficiency of public expenditure, particularly investment in subsidies. The reform includes the establishment of principles to systematize and optimize

the use of subsidies, and the development and approval of a legal framework and of processes for implementing it. The government has demonstrated its commitment to implementing this reform by promoting and adopting the subsidy reform principles on a consistent and complementary basis in various policy areas.<sup>29</sup> In the area of social subsidies, Sisbén has established itself as an objective instrument for targeting resources toward the neediest population groups and enjoys legitimacy as a policy tool. In addition, Sisbén has undergone improvements on two occasions, and these processes were carried out satisfactorily both times. Thus, the conditions are present for sustainability of reforms in this area.

### III. IMPLEMENTATION AND MANAGEMENT PLAN

#### A. Summary of implementation arrangements

- 3.1 The borrower is the Republic of Colombia. The borrower will carry out the program and use the Bank's loan proceeds through the Ministry of Finance and Public Credit, which will act as executing agency. The executing agency will carry out the program in coordination with the DNP, which will be responsible for ensuring compliance with the policy conditions.
- 3.2 The responsibilities for each condition are broken down as follows: The Ministry of Finance and Public Credit is responsible for presenting to Congress the bill prepared by the DNP, providing for a legal framework to organize the allocation of subsidies.<sup>30</sup> The DNP is also required to prepare: the proposed amendment to Decree 1082 of 2015, which builds data quality control capacity at the central level; the technical document to develop the CONPES document on Sisbén IV, aimed at boosting targeting efficiency; and the proposed interoperability decree.
- 3.3 Special contractual conditions precedent to release of the single tranche of the loan: The release of the single tranche will be subject to fulfillment of the policy reform conditions described in the program components (paragraphs 1.40 to 1.45, in accordance with the provisions of the policy matrix ([Annex II](#)), the policy letter, and the conditions set forth in the loan contract.**

#### B. Summary of arrangements for monitoring results

- 3.4 Program monitoring consists of verifying the policy measures agreed upon as disbursement conditions and described in the [results matrix](#) and [means of verification matrix](#). In addition, the outcomes of the reforms will be monitored through the indicators described in the results matrix ([see OEL #3](#)).
- 3.5 Program evaluation will consist of the following: (i) an evaluation of improvement in the efficiency of the Sisbén targeting instrument, comparing the level of inclusion and exclusion errors under the current model and the new model; and (ii) an evaluation of the targeting and coverage changes in the Más Familias en Acción program to determine the effect of the change on Sisbén with a view to making investment in the aforementioned program more efficient, which is one of the pillars of the Colombian government's social inclusion strategy. The first of these

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<sup>29</sup> For example, in the case of the social protection system for social mobility, the productive development policy, and the science, technology, and innovation policy.

<sup>30</sup> Legislative initiatives are the exclusive province of ministries; administrative departments, such as the DNP, are not authorized to present bills to Congress.

evaluations addresses the statistical efficiency of the classification system, based on household survey data and evaluates the quality of the algorithm in isolation from the operational challenges of targeting in the field. The second evaluation captures the quality of implementation of the new Sisbén. There are also plans to evaluate the impact of the improvements in social subsidy targeting on the rate and intensity of poverty by using microsimulations under various coverage scenarios for the major social programs, based on the National Survey on Quality of Life (ECV) and the Major Comprehensive Household Survey (GEIH). The results of these evaluations will be reported in the Project Completion Report to be produced at the conclusion of the programmatic series.

#### **IV. POLICY LETTER**

- 4.1 The Bank received from the [Government of Colombia](#) the policy letter describing the macro and sector-specific policy actions the country is implementing or plans to carry out. These actions are consistent with the program's objectives.



Development Effectiveness Matrix				
Summary				
I. Strategic Alignment				
1. IDB Strategic Development Objectives		Aligned		
Development Challenges & Cross-cutting Themes		-Social Inclusion and Equality -Institutional Capacity and the Rule of Law		
Regional Context Indicators		-Poverty headcount ratio (US \$4 per day PPP) (%)		
Country Development Results Indicators				
2. Country Strategy Development Objectives		Aligned		
Country Strategy Results Matrix		GN-2832	Increase the quality of expenditure and public investment management capacity at all levels of government. Continue to reduce poverty and eliminate extreme poverty. Increase equitable access to quality basic services.	
Country Program Results Matrix			The intervention is not included in the 2016 Operational Program.	
Relevance of this project to country development challenges (If not aligned to country strategy or country program)				
II. Development Outcomes - Evaluability		Highly Evaluable	Weight	Maximum Score
		9.0		10
3. Evidence-based Assessment & Solution		10.0	33.33%	10
3.1 Program Diagnosis		3.0		
3.2 Proposed Interventions or Solutions		4.0		
3.3 Results Matrix Quality		3.0		
4. Ex ante Economic Analysis		8.5	33.33%	10
4.1 The program has an ERR/NPV, a Cost-Effectiveness Analysis or a General Economic Analysis		4.0		
4.2 Identified and Quantified Benefits		1.5		
4.3 Identified and Quantified Costs		0.0		
4.4 Reasonable Assumptions		1.5		
4.5 Sensitivity Analysis		1.5		
5. Monitoring and Evaluation		8.6	33.33%	10
5.1 Monitoring Mechanisms		1.5		
5.2 Evaluation Plan		7.1		
III. Risks & Mitigation Monitoring Matrix				
Overall risks rate = magnitude of risks*likelihood		Medium		
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)				
Non-Fiduciary		Yes	Strategic Planning National System, Monitoring and Evaluation National System, Statistics National System.	
The IDB's involvement promotes additional improvements of the intended beneficiaries and/or public sector entity in the following dimensions:				
Gender Equality				
Labor				
Environment				
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				
The ex-post impact evaluation of the project will produce evidence to close knowledge gaps in the sector that were identified in the project document and/or in the evaluation plan				

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

The loan proposal presents an adequate diagnosis that identifies significant weaknesses in the current subsidy scheme in Colombia. The document demonstrates that, despite the fact that subsidies granted by the government constitute about 10% of the national GDP, there is no regulation governing its design or implementation according to technical criteria. In addition, the targeting instrument for social subsidies, SISBEN, is out of date with inclusion errors reaching 50%.

To resolve these problems, the document proposes supporting the government's reform agenda on subsidies, which considers two main efforts: i) the development of a regulatory framework to rationalize the allocation of subsidies; and ii) the design of a comprehensive new targeting system. The proposal presents evidence on the importance of these reforms, as well as on their effectiveness.

The project's results matrix is adequate. It includes impact indicators related to poverty measurements, which corresponds to the final objective of the reforms. It also includes relevant outcome indicators regarding the successful application of the reforms. Output indicators are suitable as well, and consistent with the conditions in the policy matrix.

The economic analysis annex estimates the expected benefits from the reform based on the savings that would occur as a result of a better targeting of social subsidies and of an efficient allocation of productive subsidies. The analysis only considers the costs of implementing the reforms to the government, taking into account the new SISBEN, the interoperability processes and the Council of Public Effectiveness and Efficiency. Clear and reasonable assumptions are carried out and sensitivity analysis performed with key variables.

The project monitoring plan is adequate. The evaluation plan proposes a study based on micro-simulations to measure the impact of improvements in the targeting instrument on the incidence and intensity of poverty.

The risk matrix is adequate.

## POLICY MATRIX

	Programmatic I (2016)	Programmatic II
	Policy conditions	Policy conditions
Macroeconomic stability	(1.1) Maintenance of an economic framework consistent with the program's objectives and with the guidelines set forth in the sector policy letter.	(1.1) Economic framework consistent with the program's objectives and with the guidelines set forth in the sector policy letter.
Legal framework for subsidy allocation	(2.1) Rationalization and optimization of subsidies by specifying their design, form of implementation, and monitoring through a legislative bill approved by the DNP Director that indicates, <i>inter alia</i> , the purposes, duration, and governing principles of subsidies as well as the criteria for receiving them.	Rationalization and optimization of subsidies by: (2.1a) Specifying their design, form of establishment, implementation, and monitoring through Congressional approval of a law that indicates, <i>inter alia</i> , the purposes, duration, and governing principles of subsidies as well as the criteria for receiving them. (2.1b) Allocating at least 25% of subsidies in accordance with the principles and criteria set forth in the legal framework for organizing subsidy allocation.
Social subsidies	(3.1) Improvement in the quality of the Sisbén (System for Identification and Classification of Potential Social Program Beneficiaries) database through a proposed amendment to Decree 1082 of 2015 that identifies instruments aimed at improving the quality of the Sisbén data collection and database validation.	Improvement in the quality of the Sisbén database by: (3.1a) Creating instruments aimed at improving the quality of the Sisbén data collection and database validation through the approval of an amendment to Decree 1082 of 2015. (3.1b) Reinforcing the quality of the Sisbén data collection and database validation through the implementation of the measures included in the amendment to Decree 1082/15.
	(3.2) Increase in the targeting efficiency of social programs by developing a new household classification model.	Increase in the targeting efficiency of social programs by: (3.2a) Approving a new household classification model through a CONPES document on Sisbén IV and implementing it. (3.2b) Updating information on the socioeconomic characteristics of households through advances in implementing Sisbén IV, achieving household data collection in municipios that account for at least 25% of Colombia's population.

	<b>Programmatic I (2016)</b>	<b>Programmatic II</b>
	<b>Policy conditions</b>	<b>Policy conditions</b>
	<p>(3.3) Improvement of the social programs that use Sisbén to select beneficiaries, making it easier to consult the administrative records of other programs in order to optimize planning, improve the quality of the available information (verification, validation, and updating processes), and allow for the traceability of families that participate in a social program by developing an interoperable administrative records system.</p>	<p>Improvement in the planning capacity of social programs and the quality of their administrative information, facilitating the traceability of families that participate in social programs as well as the updating and verification of Sisbén records, by:</p> <p>(3.3a) creating an interoperable administrative records system through the approval of an interoperability decree.</p> <p>(3.3b) implementing the interoperability system.</p>

DOCUMENT OF THE INTER-AMERICAN DEVELOPMENT BANK

PROPOSED RESOLUTION DE-\_\_\_/16

Colombia. Loan \_\_\_\_/OC-CO to the Republic of Colombia  
Support for Subsidy Reform Program

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 a support for subsidy reform program. Such financing will be for the amount of up to US\$400,000,000 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 \_\_ \_\_\_\_ 2016)