

**COLOMBIA**  
**SECTOR PROGRAM FOR SUBNATIONAL FISCAL REFORM**  
**(CO-0240)**

**ABSTRACT**

**Objective**

*General objective.* To support a deepening of the decentralization process by enhancing the institutional arrangements in place and promoting a culture of fiscal responsibility.

*Specific objectives:* (i) Establish and implement mechanisms for the fiscal rehabilitation of subnational entities; (ii) clarify the division of powers so as to minimize duplication in spending on health and education among different levels of government; (iii) create regulations that facilitate the fiscal viability of subnational entities by introducing hard budget constraints on subnational finances, to be complemented by the development of reliable information systems; and (iv) launch institutional strengthening programs for subnational entities.

**Design**

The operation fulfills a dual role. First, it is an instrument that *supports the rehabilitation of public finances*, in that it promotes control of the fiscal situation in subnational entities by means of two types of reforms: (i) in the short term, measures to allow subnational entities with financial problems to restore their solvency; and (ii) in the medium term, by establishing rules, institutions, and incentives that minimize the likelihood of recurrence of a subnational fiscal crisis.

Second, it *supports the decentralization process*, whereby Colombia has sought to bring about greater local participation throughout the country in defining the concept and content of a development strategy. The operation supports a deepening of decentralization in three areas: (i) division of powers, (ii) laying of foundation for making subnational entities financially sustainable; and (iii) improving management of subnational resources.

**Description**

The program actions are grouped as follows: (i) **macroeconomic stability** (component A); (ii) **fiscal rehabilitation** (component B), aimed at providing a systematic solution to the problem of liabilities accumulated by subnational entities; (iii) **subnational fiscal viability** (component C), to introduce hard budget constraints in subnational entities and reduce excessive current expenditures, along with measures to ensure transparency in the production and dissemination of reliable, timely subnational fiscal information that will facilitate financial monitoring; (iv) **division of powers** (component D), to divide powers and responsibilities more transparently among the different levels of government, providing for greater consistency in the organization and management of subnational finances, thus eliminating duplication in efforts and expenditures at various levels of

government, especially in the health and education sectors; and (v) **institutional strengthening** (component E), so that subnational entities that have been fiscally rehabilitated have the tools and capacity to manage their resources efficiently, thereby ensuring sustainability in the decentralization process and subnational fiscal stability.

The proposed financing consists of a quick-disbursing loan in the amount of up to US\$400 million, to be disbursed in two tranches of up to US\$200 million each.

### **1. Macroeconomic stability (Component A)**

To strengthen the macroeconomic program and rebuild confidence in the economy, Colombia signed an Extended Fund Facility (EFF) with the International Monetary Fund in December 1999. The Facility, which extends over the three-year period 2000-2002 and provides access to US\$2.7 billion, is aimed principally at restoring fiscal stability, consolidating the financial system, and reactivating the economy. In the medium term, the fiscal plan seeks to bring about a sharp reduction in the consolidated public-sector deficit: 3.6% of GDP in 2000, 2.6% in 2001, and 1.8% in 2002. Fiscal adjustment will be achieved by broadening the tax base, improving tax collection, paring back public spending (excluding interest payments), strengthening public-sector pension systems, and gaining greater control over funds under the fiscal decentralization system.

### **2. Fiscal rehabilitation (Component B)**

#### **a) Restructuring of financial liabilities and financing of labor liabilities**

The government will establish mechanisms to facilitate a restructuring of the subnational entities' liabilities through a process of negotiation between creditors and the subnational entities, mediated by a party designated by the Ministry of Finance. To provide an incentive for participation and agreement between banks and subnational entities, the national government will—for a very limited time—grant guarantees conditional on debt relief by creditors. No guarantee will be given to the subnational entity concerned unless: all of its financial creditors participate; there is a plan for fiscal rehabilitation; and a strategy has been agreed upon with the Ministry of Finance for the comprehensive institutional strengthening of the subnational entity (see Component E).

Even with debt restructuring, subnational entities may require additional resources in order to recover fiscal viability, for which purpose participating banks will be obligated to provide new loans to the entities, when required. New funds for fiscal rehabilitation will temporarily be covered by guarantees of up to 100% from the central government. These funds will be provided to pay for the settlements, obligations, close-outs of contracts for the delivery of personal services, and staff liabilities that need to be uncoupled in the process of restructuring the subnational entities. This guarantee will only cover the needs arising from the Subnational Economic Reform Program, based on an opinion issued by the Fiscal Support Division and the documentation submitted by the respective subnational entity. During the period that the regulations supporting the financial mechanism and the guarantee system described above are in force, the central government will not issue any other type of guarantee for debt restructuring.

b) Financing of pension liabilities

With the passage of Law 100/93, it was established that starting in 1995 employees of subnational entities would contribute directly to an individual account to finance their pensions. Nevertheless, the great majority of subnational entities do not have the reserves needed to cover contingent pension obligations predating 1995. With Law 549 of 1999, the government created the National Pension Fund for Subnational Entities (FONPET) to collect the funds needed from the central government and the subnational entities to ensure future coverage of pension liabilities. For this purpose, stable and permanent funding sources are to be established, such as, for example, a percentage of the registry tax or of the national stamp tax, a portion of revenue-shareouts to municipios and royalties, as well as revenue from the national lottery. FONPET funds will be managed by private managers chosen through competitive bidding; with the candidates being companies managing pension and unemployment funds, trust companies, or life insurance companies, subject to inspection and supervision by the Superintendency of Banking.

With the creation of FONPET and the advent of private management of its funds, the creation of reserves to cover pension obligations predating 1995 will be ensured, contributing to the fiscal rehabilitation and financial sustainability of the subnational entities.

### **3. Subnational fiscal viability (Component C)**

The reforms proposed under this component are indispensable to making the decentralization process financially sustainable, once fiscal rehabilitation has been achieved. The component will give greater fiscal autonomy and responsibility to the subnational entities by creating an incentive structure to minimize the likelihood of the central government having to bail them out.

a) Revenue

One of the national government's key concerns has been to provide subnational entities with the legal and financial tools necessary for them to have a reasonable chance of successfully dealing with the challenges of decentralization. One of the main obstacles to modernization is the incoherent collection of regulations and procedures under subnational legislation, especially in regard to taxation.

The significant difference in taxes at the subnational level led many subnational entities to retain their fiscal laws, which are distinctly different from national legislation in terms of procedure and sanctions. This makes subnational tax legislation extremely complicated, acting as a disincentive for taxpayers to comply with the law, and drastically affecting the development of the productive sector. To address this, the central government has prepared a set of regulations to modernize and standardize the tax system of the subnational entities. The basic objective of the regulations is to create a single, substantive system of procedures and sanctions for the subnational entities to overcome

the splintering, regulatory confusion, and vacuums that directly affect the country's departments and municipios in the area of subnational taxation.

b) Spending

Spending for subnational operations has increased substantially in recent years. The Subnational Fiscal Responsibility Act (LRFT) will set severe restrictions on this type of spending by linking it to freely available current revenue and separating it into the categories of municipios and departments. Specifically, depending on the subnational entity's size, its operating costs should not exceed between 55% and 85% of its unearmarked current revenue. This legislation also mandates that subnational entities carry out significant current savings of between 15% and 50%, depending on the category of the subnational entity. This will eliminate the common past practice of financing current spending with borrowing. A transition period will be established for implementing these limits, in order to allow the subnational entities to reorganize their structures in an orderly way. The adoption of these measures will yield substantial savings for subnational entities, enabling them to design and implement their development plans in an appropriate manner.

c) Transfers

Despite the fact that, by linking the amount of the funds to be transferred to the current revenue of the central government, as stipulated in the 1991 Constitution, it was possible to overcome discretionary treatment of transfers, the mechanism produced two undesired effects: (i) it institutionalized the discrepancy between the amounts transferred and the absolute cost of providing services, since transfers were made first on a geographic, then on a sector basis; and (ii) it introduced an unwanted cyclic element in the transfers, which were used partly to finance certain types of current spending that are difficult to reduce during periods of economic contraction.

By constitutional mandate, changes in transfers from the central government's current revenue in 2001 are set at a maximum of 22% to the municipios (municipal revenue-sharing) and 24.5% to the departments (federal revenue-sharing). Legislation has been proposed to provide stability to subnational entities' revenue and expenditures. With this measure, departments and municipios would no longer be affected by fluctuations in revenue and economic cycles, ensuring real growth and thus facilitating subnational fiscal planning. It would also give priority to sector-based—rather than geographically-based—distribution of resources.

d) Intergovernmental loans and borrowing

The LRFT is expected to significantly decrease the need for financing on the part of subnational entities by reducing subnational deficits. However, the government intends to strengthen Law 358/97 (the “red light law”), which controls borrowing by subnational entities in order to remedy some persistent deficiencies.

e) Information and transparency

To make the subnational-debt market more transparent, the Ministry of Finance will launch a streamlined, mandatory central registry (the Registry of Loans and Guarantees, or REG), to provide public access to information on loans and guarantees for subnational entities. In view of its scope, the registry would initially cover a sample of the most heavily indebted subnational entities.

#### **4. Division of powers (Component D)**

At the sector level, the central government will move forward with its review of health and education sector regulations with an eye to improving the regulatory conditions necessary for the State to more effectively meet its constitutional mandate of honoring the right to education and health care.

To this end, modifications in the powers of subnational entities and of the central government will be proposed, along with a review of criteria for distributing resources that finance these sectors. Also, mechanisms will be introduced that provide for strong participation by affected communities, in an effort to increase transparency and accountability for the provision of these services. This effort is designed to improve the division of powers and to establish criteria for the allocation of resources among subnational entities, in a manner consistent with the organization and cost of providing services for basic education and social security for health care. In addition, the intention is to correct existing subnational inequities.

#### **5. Institutional strengthening (Component E)**

Given the low level of institutional capacity of many subnational entities, fiscal rehabilitation must be accompanied by a mandatory program of institutional strengthening in order to improve financial management, increase subnational entities' own collections, and optimize the use of financial, physical, and human resources. The preparation of the PRETs under Component B will include a comprehensive program for institutional strengthening to ensure that the adjustment plan is sustainable. The institutional strengthening programs will involve five basic types of intervention: (i) consulting services; (ii) training; (iii) information systems and equipment; (iv) support teams; and (v) modification of physical space.

In addition to monitoring missions by the project team and support missions by the Country Office in Colombia, the Bank will establish procedures to ensure proper monitoring and supervision for satisfactory execution of the program.

In accordance with Bank policy, the borrower was consulted as to its willingness to conduct an ex post evaluation of the program. The borrower expressed interest in conducting an evaluation of the impact on equity, efficiency, and the sustainability of the reforms to be implemented under this operation. The Government of Colombia has agreed with the Bank that it would share the findings of the evaluation so that the Bank may carry out any additional studies it feels are called for.