Colombian Fiscal Policy: A Limited Tool for Long-term Development and Short-term Recovery

OECD &DeFiNe Meeting

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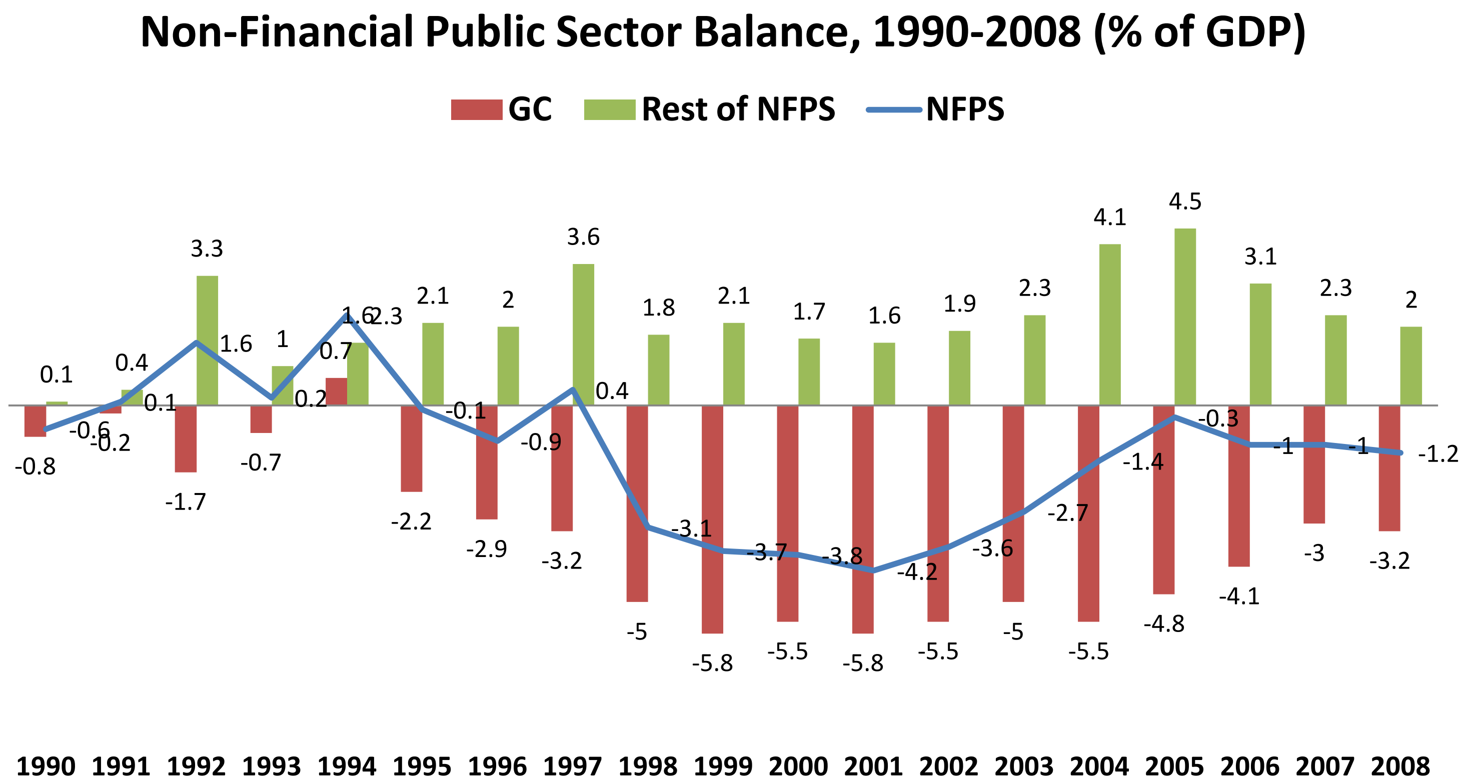
September, 25th, Paris

Main Issues

- Colombia has lacked fiscal discipline
- The fiscal policy has not been a tool for economic stabilization (short-term perspective)
  - Not enough room for anti-cyclical measures
- The social contract
  - The impact of social spending has been limited
  - Infrastructure spending has not been growth-enhancing
  - Taxes: an erratic policy, with narrow effect on income redistribution and growth-enhancing
- Fiscal legitimacy is poor
- It is not a matter of the lack of reforms but of their quality, depth and scope
- Recommendations

- Colombia has lacked fiscal discipline

The fiscal situation has continuously deteriorated over the last 15 years, particularly due to the Central Government imbalance

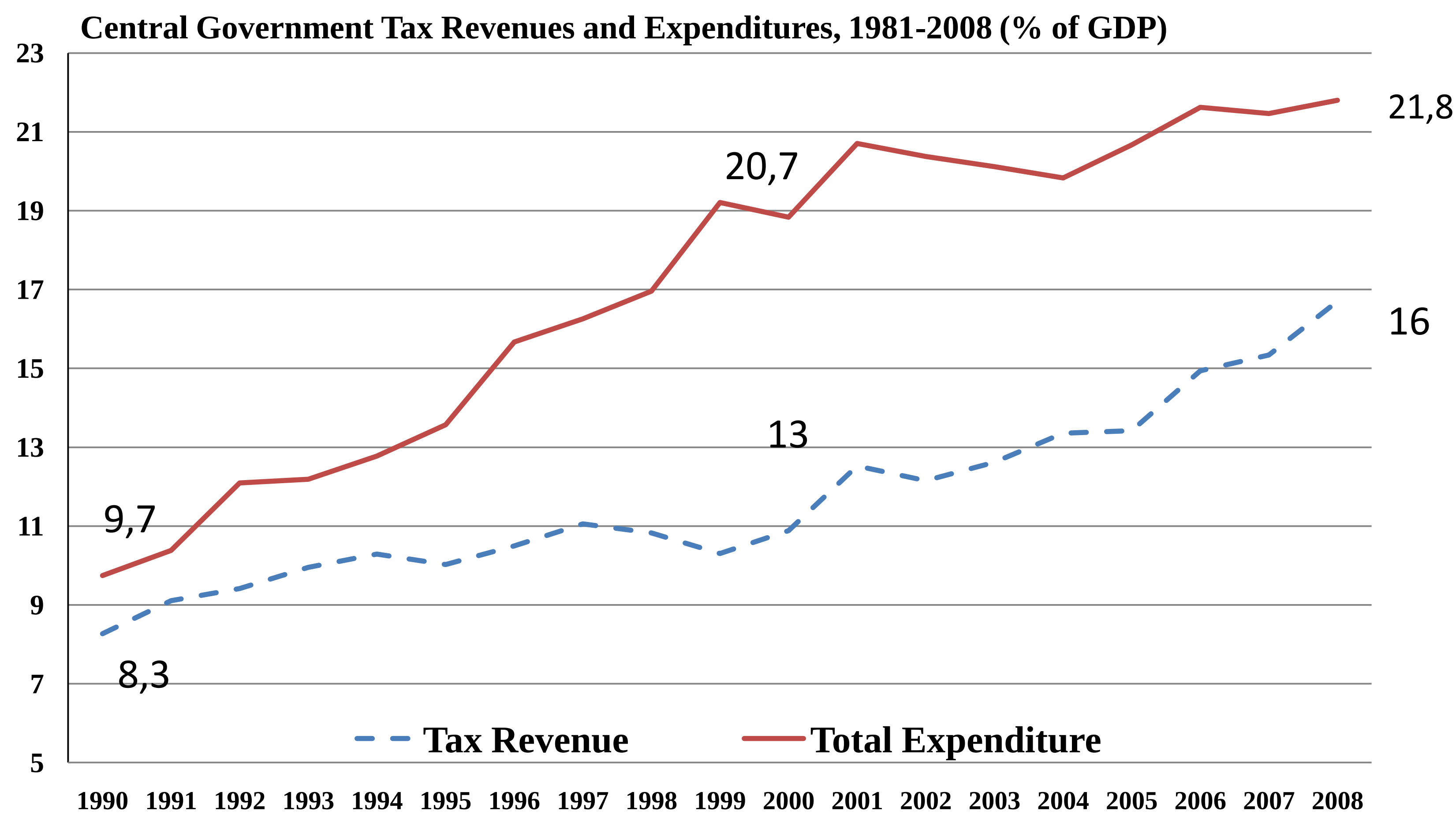


Source: Ministry of Finance and Public Credit and author's calculations

The imbalance was the result of three factors:

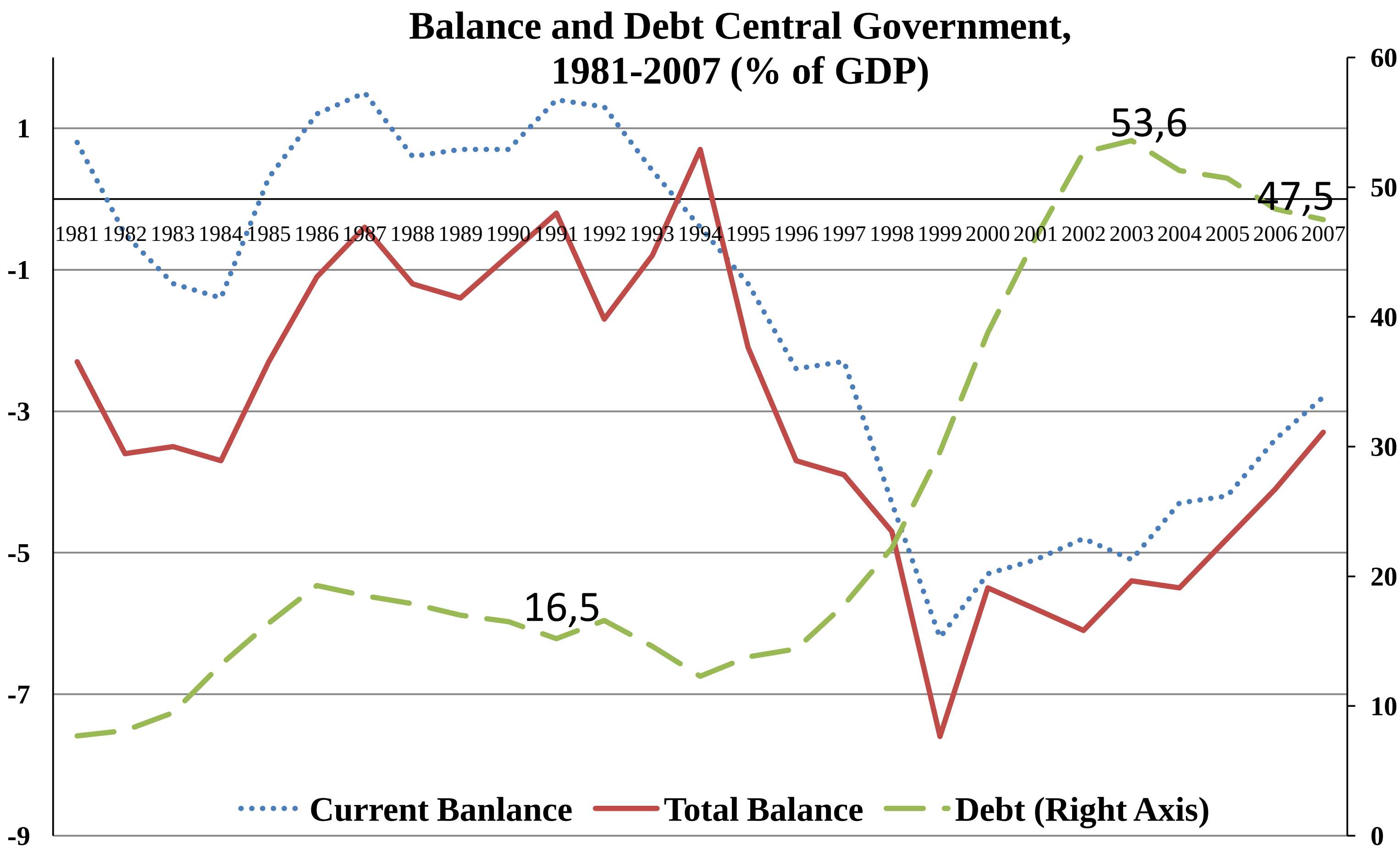
- The Constitutional reform of 1991, by which a percentage of CG current revenues were to be transferred to the regions (decentralization)
- The pension reform
- The increase in military expenditures

Spending grew much faster than revenues



Source: Ministry of Finance and Public Credit and author's calculations

The increasing spending was largely financed with debt



Source: Ministry of Finance and Public Credit and author's calculations

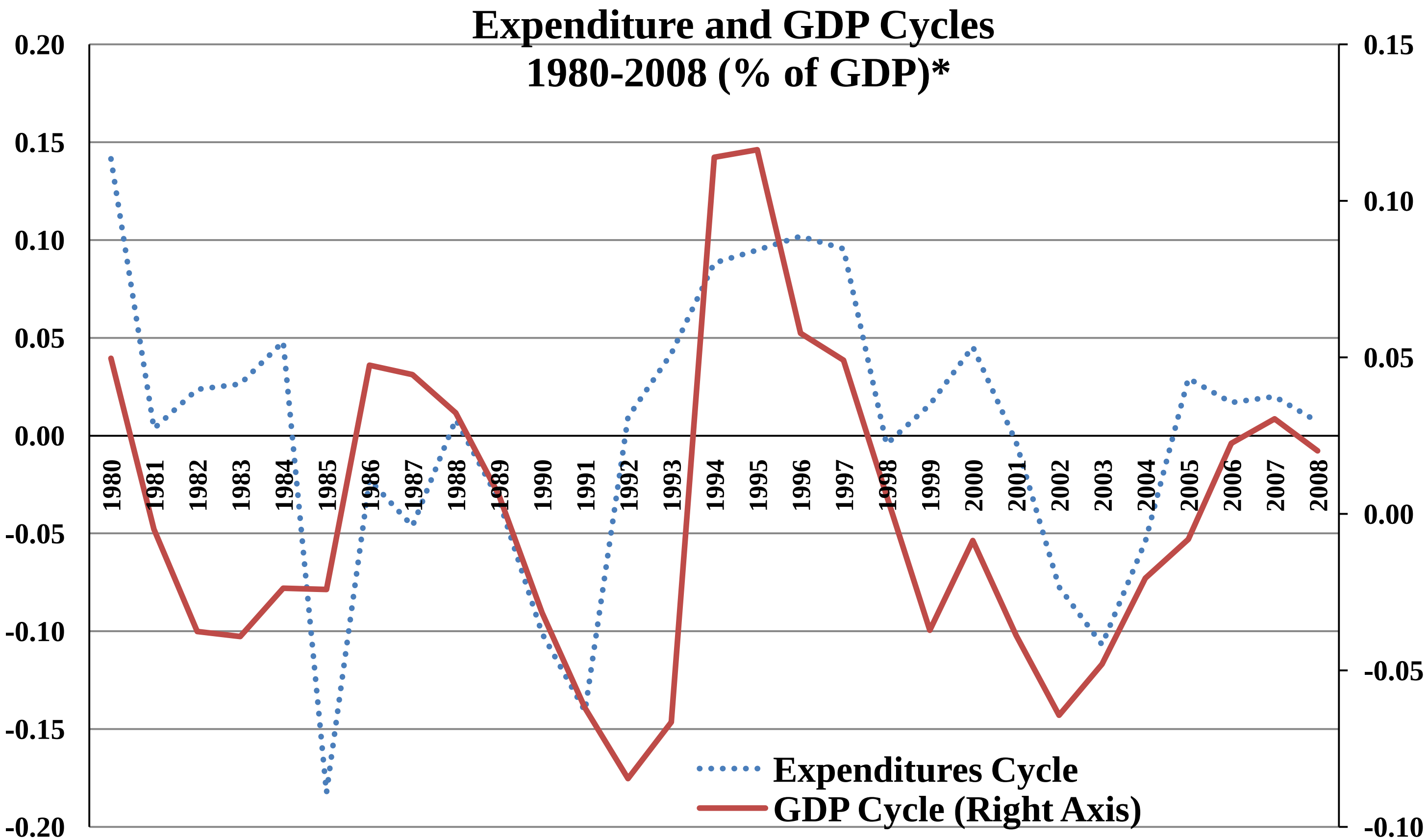
In 2002, Colombia had to start running a permanent primary surplus of at least 1.8% of GDP for public finances to be sustainable. The CG has reached a primary surplus, however still low.

- The fiscal policy has not been a tool for economic stabilization (short-term perspective)

Fiscal policy indiscipline has caused macroeconomic conditions for development to deteriorate

- The boost in domestic debt resulted in a deep *crowding out* since the mid nineties, that caused a rising in interest rates and a slump in private investment
- High current spending was partly responsible for real exchange rate revaluation
- The large deficit caused international investors' risk perceptions to deteriorate, which increased spreads
- The boost of the external debt, which reached 25.5% of GDP in 2002, increased the vulnerability of fiscal performance to external shocks and exchange rate changes
- Colombia lost its investment grade in 1999 and has not been able to recover it

Fiscal policy has been pro-cyclical
The CG spent more during booms and less during slumps

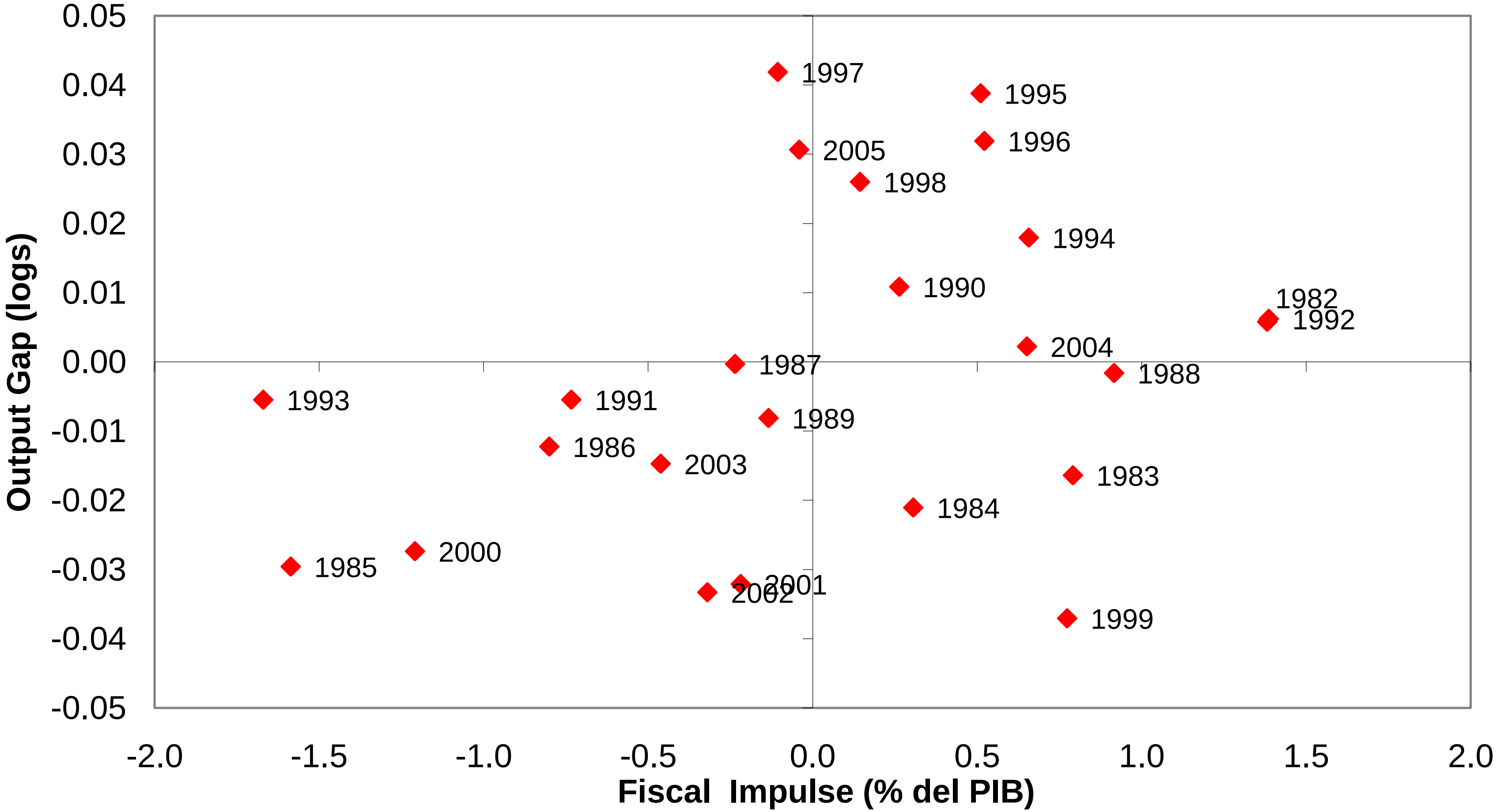


*** Log scale**

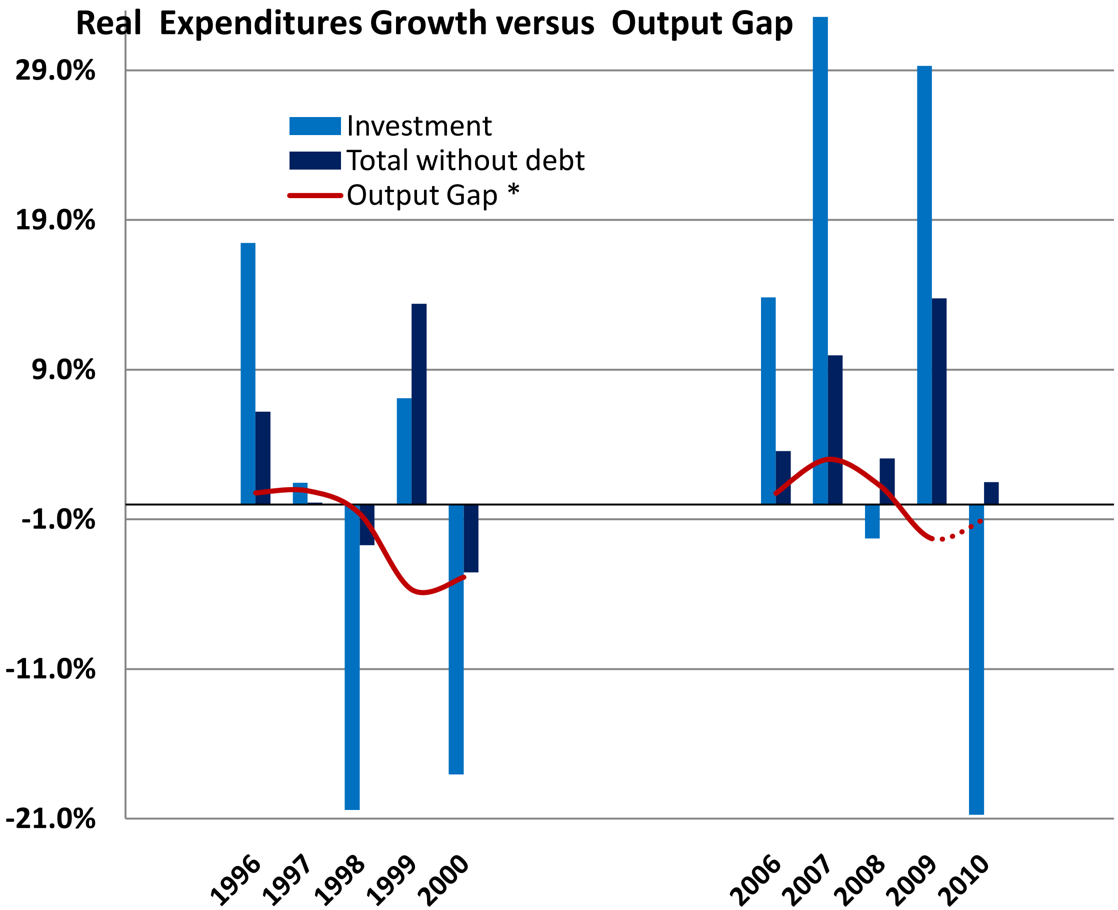
Source: Ministry of Finance and Public Credit and Olivera, Pachón, and Perry (2008)

There were no fiscal savings during either the mid-nineties or the recent boom of 2004-2007 (in 2007 the economy grew 7.5%)

Smaller fiscal impulse when output gap is negative



During the recent downturn there has been more room for counter-cyclical policy, in contrast to the crisis of 1999



Source: Ministry of Finance and Public Credit and Fedesarrollo's calculations

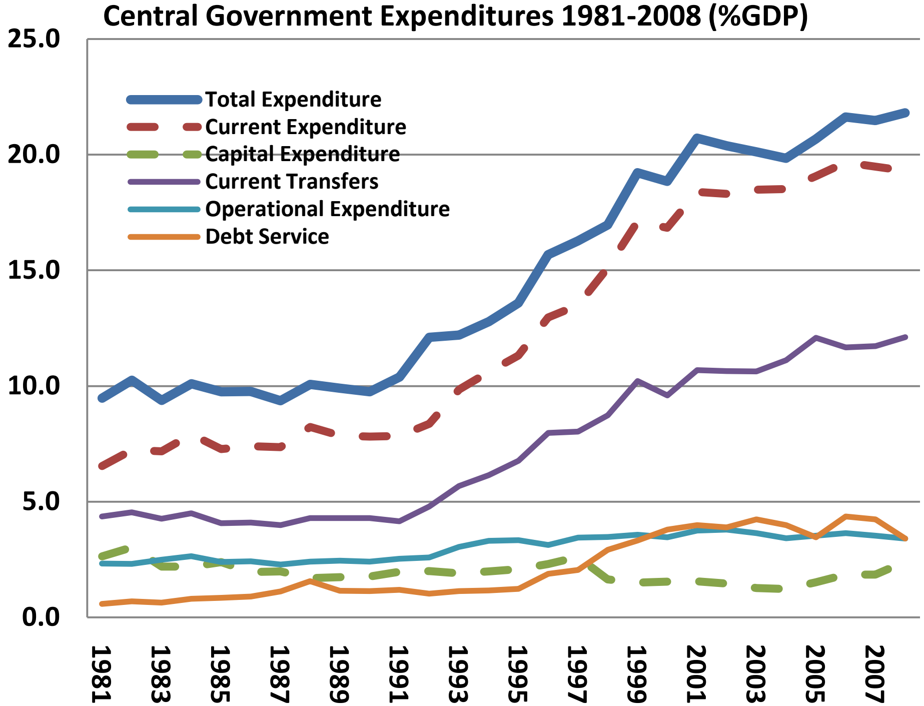
- Current Account deficit was large (around 4-5% of GDP in 1998), so it was necessary to adjust spending, while it was 2.5% in 2008
- Central Government deficit was around 5-6% of GDP in 2000, while it was less than 4% in 2008
-External public debt was around 20% of GDP in 1999-2000, while it was 15% in 2007-2008.
- Between 2008 and 2009, public spending (excluding debt service) rose from 18% to 20.2% of GDP, and investment from 4.6% to 5.9% of GDP

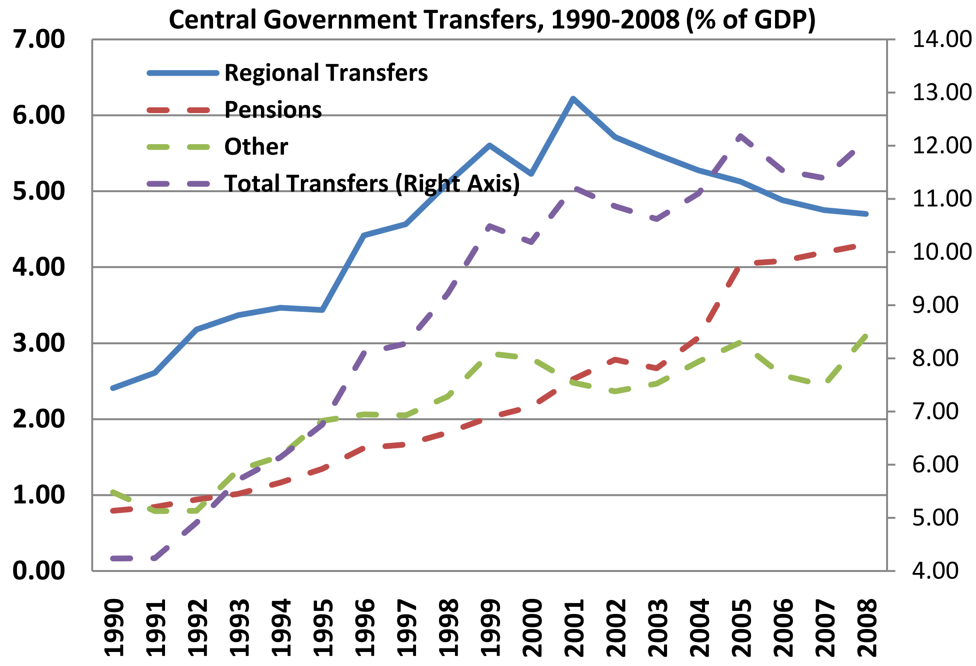
- In the downturn (2008 and 2009), fiscal policy has been counter-cyclical
  - To compensate for the fall in demand, expenditures have been expanded through the acquisition of new debt (instead of the decumulation of assets, e.g., through stabilization funds)
  - Expenditure stimuli are oriented toward infrastructure, Social Protection (strengthening social programs and coverage such as *Familias en Acción, Red Juntos*), and subsidized financial credit lines and housing (*Bancoldex, Fondo Nacional de Garantías, Microcéditos, Finagro*).
- However, the level of debt, still high and needs to remain on a sustainable path, does not allow for maintaining the increased pace of expenditures in 2010

Central Government Balance, 2009-2010 (COP Billon)		
	2009 (% PIB)	**2010 (% PIB)**
Total Revenues	**16.1**	**14.5**
Tax revenues	13.6	13.0
Nontax revenues	0.1	0.1
Capital Ressources	2.2	1.2
Others	0.2	0.2
Total Expenditures	**19.8**	**18.8**
Interest	3.2	3.3
Operation	14.5	13.9
Investment	2.1	1.6
Net Loan	0.1	0.1
Deficit	-3.7	-4.3
CRSF	0.2	0.1
Deficit to finance	**-4.0**	**-4.4**

- The social contract (long term impact on development)
  - The impact of social spending has been limited
  - Infrastructure spending has not been growth-enhancing
  - Taxes: an erratic policy, with narrow effect on income redistribution and growth-enhancing

Spending composition: Capital expenditures represent around 7% of total expenditures, Current Transfers 55%, Operational Expenditures 18% and Debt Service 20%





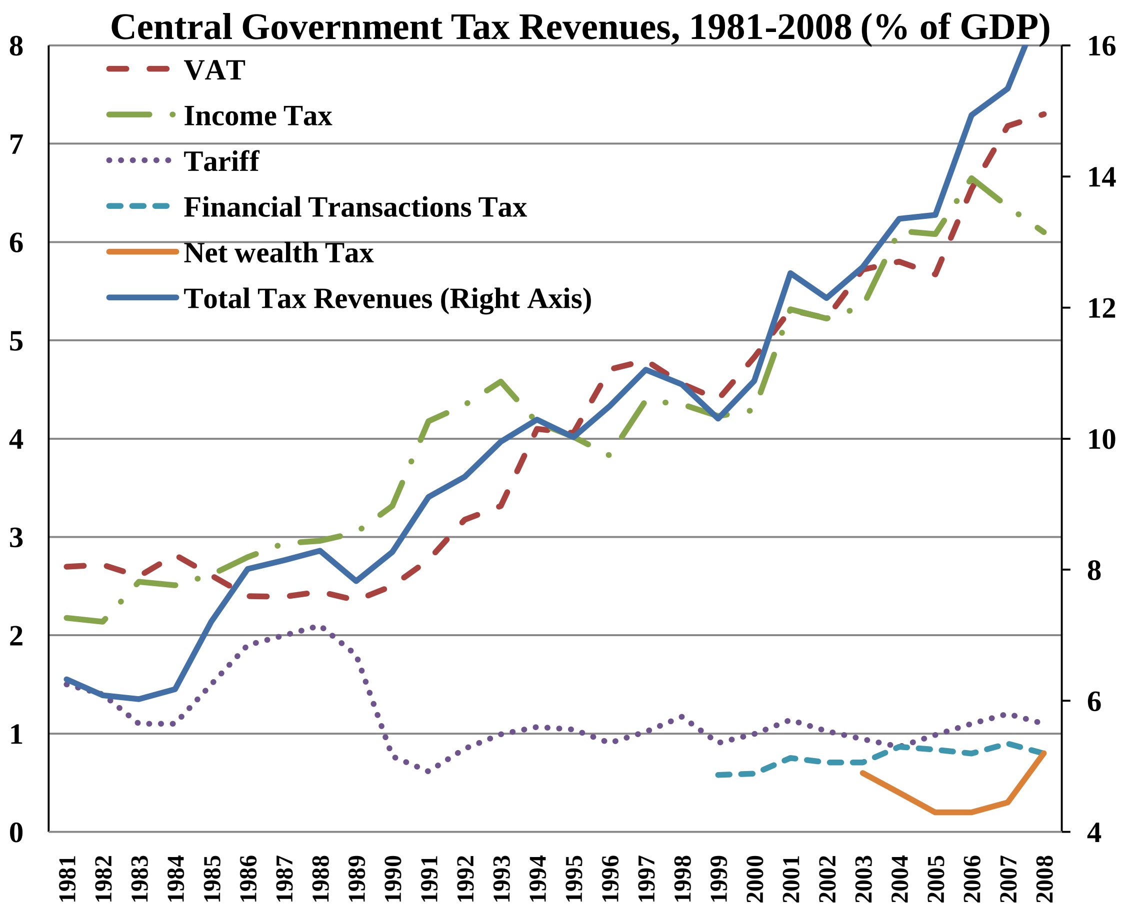
Source: Ministry of Finance and Public Credit and Olivera, *et al*, 2008

Current Transfers and Debt Service exhibited the largest increase.
Current transfers grew due to regional transfers and pensions

The provision of high-quality public expenditures has been limited

- Social expenditures have increased, but the effectiveness has been partial
  - Social spending grew during the nineties above the region's average: 11.2% of GDP in 1994 to 14.7% in 2006
  - Education has had the greatest increase, but the rate of coverage has increased more slowly than expenditures
  - Some social indicators have improved slightly and poverty has shrunk, but less than proportional to social spending efforts
  - Income distribution inequality remains practically unaltered
- Public policy has not been growth-enhancing in key areas, such as infrastructure
  - Public investment in public works and transportation is low, and decreasing over the last fifteen years. Fiscal adjustments have been made at the expense of such investment
  - Around 3% of GDP in the mid-nineties, 1% in 2003, has recovered in the recent years mainly due to investments in the oil sector. The most pronounced decline has been in public works and transportation (road works)
  - Some indicators show that the quality of infrastructure in Colombia is still very poor

Taxes: an erratic policy (not as redistributive and not growth-enhancing)



- Relies more on indirect taxes (VAT, tariffs and transaction taxes) than on direct taxes (income taxes and wealth taxes)
- Income tax and VAT have the largest shares. Financial transaction taxes and wealth taxes together have the same participation as tariffs.
- Since 1990, there have not been any structural reforms, but only reforms aimed at increasing revenues in the short

Source: Ministry of Finance and Public Credit and Olivera, et al, 2008

- Fiscal legitimacy is limited

Fiscal legitimacy is limited

Budget Transparency Index, components, 2007

	2003	2005	2007
Budget participation			
Civil Society Participation	15	35	13
Functions and powers of the legislative body	40	45	38
Budget Drafting			
Information about macroeconomic criteria	43	60	45
Changes on the Budget	37	47	44
Budget Allocation	31	33	31
Budgetary Control			
Budgetary Overseeing	40	52	38
Capacities of the external control body	40	57	41
Evaluation of the treasury inspector's office	4	21	25
Accountability			
Reporting	24	36	26
Control over public officials	36	48	29
Responsibilities at different levels of the government	34	25	34

Source: Índice Latinoamericano de Transparencia Presupuestaria, 2007

- It is not a matter of the lack of reforms but of their quality, depth and scope

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Fiscal Reforms

1990-2008				
	Tax Reforms	Expenditure Reforms	Decentralization Reforms	Pension Reforms
Decrees	3	3	0	0
Laws	12	3	6	3
Constitutional Reforms	0	0	3	0
Tolal	15	6	9	3

Source: Olivera, Pachón and Perry, 2008

1. Tax laws approved were of the “quick fixes” or “piece meal” type (increases in tax rates, establishment of new distortionary taxes on financial transactions and net wealth). Most Government initiatives were dominated by revenue objectives and disregarded efficiency considerations. Overall, tax revenues increased, but by much less than the increase in expenditures
2. Decentralization-related reforms – indebtedness and expenditure controls and regional transfers for subnational entities – were quite successful, as they achieved a significant reduction in transfers/GDP ratios after 2001 and led to aggregate surpluses in sub-national balances during the boom period
3. Only one expenditure reform (the Fiscal Responsibility Law of 2003) was approved by Congress during the period. This reform required the use of medium expenditure frameworks, though it did not include enforcement instruments

- Recommendations

Long-term perspective

- Improve the institutional framework and arrangements in order to:
  - improve fiscal discipline and the consistency of spending and revenue policies with macroeconomic stability
  - budget allocations according to policy priorities (by sector, regions)
  - and efficiency and evaluation of expenditures (see, Olivera, 2008)
- Adopt *structural tax reforms* aimed at:
  - reducing tax exemptions and carefully reviewing their impact and the source of financing
  - making the income tax more progressive and increasing the taxable base (reducing the rate for corporations)
  - increasing the scope in terms of goods subject to the VAT and reducing the number of rates
  - eliminating distortionary taxes that were transitory and have became permanent (Transaction Tax, Wealth Tax)
  - and improving the tax administration (see Fiscal Reform in Colombia: Problems and Prospects, 2005)

Short-term stabilizer

- Design institutional mechanisms to improve its capacity to implement counter-cyclical fiscal policies
  - rules that guarantee that spending will evolve in line with long-term fiscal revenues, encouraging fiscal savings when revenues increase beyond their long-term trend, and de-saving when they grow below their long-term path
- Fiscal authorities should improve the automatic stabilizers
  - the adoption of social support programs with clearly defined entry and exit clauses (unemployment insurance instead of programs such as *Familias en Acción*),
  - the definition of budget expenditures based on permanent, not transitory, revenues
- Stabilize mining and energy income
  - by strengthening the existing funds such as the FAEP
- Projections of long-term growth and oil prices, for example, should be made by experts who are independent from the government

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