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Colombia's Efforts at Achieving Inclusive and Sustainable Growth

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At the end of the 1980s, Colombia confronted a situation of slow economic growth and unsettled domestic security. To address these issues, a comprehensive reform effort was undertaken starting in 1990. The agenda comprised a set of market-driven reforms aimed at enhancing competition and the role of the private sector, as well as a vast array of institutional reforms aimed at strengthening macroeconomic stability, promoting equality of opportunities in the political and judicial arenas, and sharing more broadly the benefits of growth across regions and individuals. In this chapter we show that this ambitious reform drive proved very challenging. Reforms aimed at strengthening some foundations for growth actually weakened others. Restrictions stemming from the local environment and issues of design prevented many of the reforms from fully delivering on their promise. In particular, the benefits of broadened opportunities achieved through fiscal decentralization, increased social expenditure, and expanded access to the judicial system must be contrasted with the fiscal deterioration and macroeconomic vulnerability that accompanied them.

Starting in 1999, a succession of three administrations tackled some of the salient problems. Although this effort, coupled with a supportive external environment and improved security, delivered a favorable economic outcome, chal-

We have received very useful comments from Liliana Rojas-Suárez, Nora Lustig, Ernesto Stein, Felipe Botero, Mauricio Cárdenas, and Mauricio Santamaria and from participants at a September 2007 workshop at the Center for Global Development in Washington.

lenges remain in further strengthening the foundations for growth. This chapter will offer some proposals to that effect, with an emphasis on the need to remove some of the limitations imposed by the local environment, particularly those arising from a highly activist judicial system.

The Road to a Comprehensive Reform Effort

During the late 1960s and 1970s, Colombia's economic performance was strong. Between 1965 and 1979 real GDP growth averaged 5.6 percent a year, and inflation, although seldom in the single digits, never experienced the sharp rises typical of some other Latin American countries. Prudent macroeconomic policies rather than a particularly stable external environment were behind these developments.¹ Growth in output per worker, which averaged 1.8 percent a year during 1965–79, was led by increases in total factor productivity (TFP), which grew at an average rate of 1.1 percent a year (Cárdenas, 2007). The 1960s and 1970s were also a period of political tranquility and of progress in social indicators. A 1958 power sharing agreement between the two historically dominant political parties had brought an end to political violence, and peace and economic prosperity facilitated a decline in poverty and an improvement in the distribution of income.²

Although Colombia was, except for Chile, the only large regional economy not to be devastated by the 1980s debt crisis, performance during that decade was at best mediocre. Average GDP growth declined to 3.4 percent a year, led by a dismal performance of TFP, which contracted at an annual rate of 1 percent during the decade.³ Most social indicators continued to improve, but at a slower pace. The salient feature of the 1980s was the deterioration in security.⁴

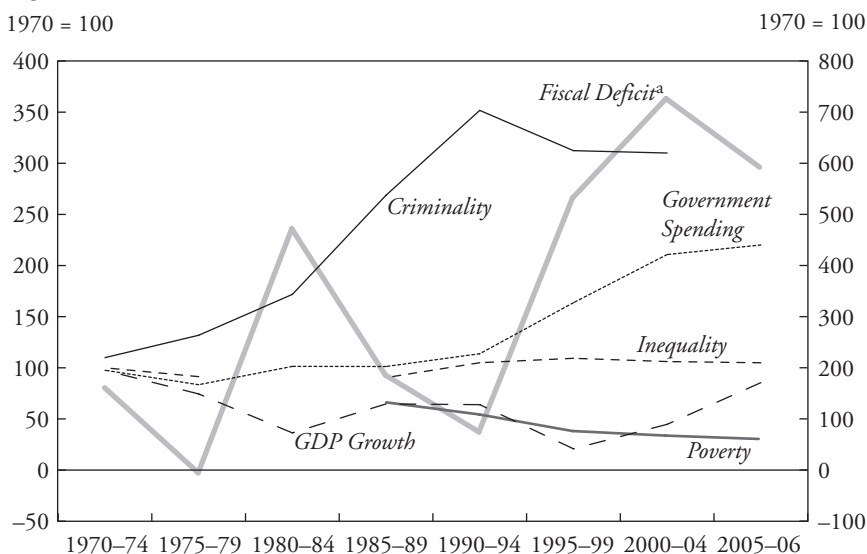
1. A study by the Inter-American Development Bank (1995) characterized Colombia's economic policy as the most stable among twenty-two regional economies. Except during a short period in the early 1980s, the fiscal deficit was always small. Until 1993, public debt had never surpassed 20 percent of GDP.

2. Income inequality declined during the 1960s and 1970s (Londoño, 1995). Recent estimations, although not strictly comparable to the earlier ones, suggest that the distribution of income improved only slightly during the 1980s.

3. As part of the policy package designed to confront the decline in net foreign transfers that followed the Mexican crisis, throughout the 1980s the Colombian economy became increasingly distorted and closed to foreign competition. Whereas in 1980 around a third of imports were prohibited or subject to government approval, by 1984 that share had risen to 99.6 percent. Labor market regulation was inflexible and obsolete. Restrictions and distortions were also prevalent in the financial sector. A vast array of exchange controls supported a crawling peg exchange rate regime, and legislation governing foreign direct investment appeared to be aimed at severing ties with the world economy. The tax system, meanwhile, featured double taxation of distributed earnings and a broad range of exemptions.

4. Drug money emboldened the cartels and Marxist guerrilla movements. In 1982, when the government began to extradite drug traffickers to the United States, the drug mafia declared war. The guerrillas, who had been somewhat active in remote regions in the 1970s, became important actors during the 1980s. It was during the early 1980s that the head of Colombia's main business association memorably said, "even though the economy is doing well, the country is doing poorly." By the end of the decade this decoupling seemed untenable.

Figure 1. *Colombia: Selected Economic and Social Indicators*



Sources: Ministry of Finance, Departamento Nacional de Planeación, Departamento Administrativo Nacional de Estadística, Banco de la República, Defensoría del Pueblo, Cárdenas (2007), Londoño (1995), MERP (2006).

a. Scaled on the right axis; all other variables are scaled on the left axis.

Figure 1 looks at six dimensions of economic and social issues—GDP growth, public spending, the fiscal deficit, poverty, inequality, and criminality—since 1970, a stretch of time that encompasses the pre-reform period, the decade following the first round of reforms, and the period since the second round of reforms. In a nutshell, growth slowed in the 1980s while security, as measured by the homicide rate, deteriorated markedly in the context of a slow but continuous decline in poverty. Following the first wave of reforms in the early 1990s, the fiscal situation sharply worsened as a result of the hike in public expenditure that was mandated in the new constitution, which went into effect in 1991. Although growth failed to recover, poverty continued to decline; criminality meanwhile remained high. Following the second wave of reforms starting in 1999, the fiscal deficit declined sharply. This, coupled with a remarkable improvement in security and a supportive external environment, has delivered much stronger economic growth.

Over a short period during 1990–92, Colombia—which had been a regional beacon of economic and political stability during the 1960s and 1970s, where policy continuity had been the norm—underwent major economic, political, and institutional change (Edwards and Steiner, 2008). The comprehensive reform process was the consequence of two forces. On the economic front, the slowdown in growth and its association with a contraction in productivity paved the way for the introduction of pro-market reforms—including in trade, finance, and the

labor market—during the second half of 1990. On the political-institutional front, in late 1990 a popularly elected Constitutional Assembly was entrusted with rewriting the country’s 100-year-old constitution, with the expectation that the new constitution would enhance governance and facilitate both the containment of the drug cartels and the negotiation of a peace agreement with the guerrilla movements. The new constitution significantly expanded expenditure in health and education and broadened access to the judicial system and to the political process. These measures were aimed at sharing the benefits of growth more broadly, so as to make growth more sustainable.

Several analyses of the new constitution support the following general description of its contents:

- It commits the nation to a welfare state, in contrast to the market-oriented reforms being introduced at the same time.
- It mandates that the central government transfer a large and growing portion of tax revenue to subnational governments (departments and municipalities) in order to finance a meaningful expansion of expenditure in health and education.
- It empowers citizens, particularly by establishing the *acción de tutela*, an expeditious mechanism granting immediate access to the judicial system.
- It shifts the policymaking structure from one characterized by a powerful president to one in which subnational governments, the Constitutional Court, and the central bank are key actors as well. In those areas that are “hard-wired” in the constitution—such as the transfers to subnational governments to fund health and education—the executive saw its discretion significantly reduced.

In terms of the CGD framework (see chapter 2), the early 1990s reform drive sought to affect four of the five foundations: fostering *economic and political competition*, promoting *equality of opportunities*, *broadier sharing of the benefits of growth*, and protecting *macroeconomic stability*, the last of these particularly by granting independence to the central bank and introducing fully funded private pension funds. Progress on the fifth foundation, securing *property rights*, might have occurred as a by-product of the pension reform. The prominence given to competition reflected the fact that lagging productivity was viewed as driving the slowdown in growth during the 1980s. Likewise, promoting competition and equality of opportunities on the economic, political, and judicial fronts was a means of dealing with a much deteriorated political and security situation by broadening the pool of beneficiaries from growth.

During the decade that followed the launch of the reforms, the economy underperformed. The fiscal position weakened, the economy became more vulnerable and volatile, poverty reduction slowed,⁵ and income distribution wors-

5. This statement applies when poverty is defined in terms of unsatisfied basic needs, as in figure 1. When poverty is defined as the percentage of the population living on less than x amount per day, poverty becomes highly pro-cyclical, *increasing* during the second half of the 1990s.

ened. Although several exogenous factors play a role in explaining this turn of events,⁶ elements associated with the reform program also contributed. When the Asian crisis of the late 1990s hit Latin America, Colombia found itself in a particularly weak macroeconomic position. An unprecedented output contraction followed, which hit the poor especially hard. More rapid growth and a new, positive trend in poverty reduction have been achieved only recently, after the fiscal imbalance began to be addressed and the security situation started to improve, in the context of a favorable external environment.

Some stylized facts about the performance of the Colombian economy since the launch of the 1990 reforms include the following:

- Performance went from exemplary in the 1970s, to mediocre in the 1980s, to very poor until recently. In 1999 Colombia saw its first economic contraction in seventy years. Since 2002 GDP growth has accelerated, averaging 5.5 percent a year during 2003–07. Estimates by Cárdenas (2007) show that during the second half of the 1990s, and contrary to what was expected following the pro-market reforms undertaken at the beginning of the decade, TFP growth was a dismal –2.7 percent a year. The recovery in growth that followed the second round of reforms, in a context of enhanced security and a benign international environment, has been accompanied by an improvement in TFP, which rose at an annual rate of 0.8 percent between 2001 and 2005, and by significantly more in 2006–07 according to a preliminary update of Cárdenas (2007) undertaken by Fedesarrollo.⁷

- Colombia is the only large Latin American country in which growth during the decade following the launch of reforms was historically low, the fiscal balance weak, and public expenditure particularly high (Sahay and Goyal, 2006).⁸

- Growth also became increasingly volatile during the 1990s and the first few years of the new century (figure 2).

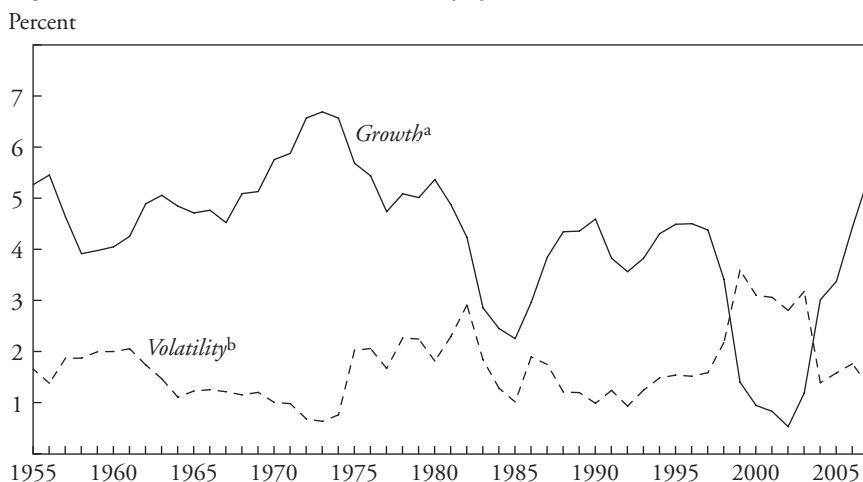
- Inflation declined consistently and now hovers at around 4 to 6 percent a year.

- Colombia strayed from its tradition of a sound fiscal stance. Although the deterioration had a cyclical component, it was to a large extent the result of structural features, in particular the increase in expenditure mandated in the new constitution. In no other large country in the region did social expenditure increase as much, as a percentage of GDP, in the decade following the launch of pro-market reforms, although it remains below that in Argentina, Brazil, and Chile

6. These factors included an unfavorable international environment, a tense security situation, and a profound political crisis in the mid-1990s following allegations that drug money had financed a presidential campaign.

7. Because of a change in 2006 in the employment module of the household survey, the employment index fell considerably, perhaps causing an underestimation of the capital-output ratio.

8. Colombia is one of only three countries—the other two being Paraguay and Venezuela—in the Sahay and Goyal (2006) sample in which the decade with the slowest growth (which can refer to any consecutive ten-year period) happened *after* the early-1990s reform process.

Figure 2. *Colombia: Growth and Volatility of GDP, 1955–2007*

Source: Authors' calculations based on data from the Departamento Administrativo Nacional de Estadística.

a. Average of the past five years.

b. Average standard deviation of growth over the past five years.

(table 1). Since entering into a seven-year agreement with the International Monetary Fund in 1999, three successive administrations have focused on restoring fiscal discipline. Progress notwithstanding, the public debt is still around 40 percent of GDP.

- With regard to income distribution, the progress achieved in the 1970s and the first half of the 1980s was reversed during 1990–2000. Although the distribution has improved lately, in 2005 it was as inequitable as it had been in 1992 (figure 3).

- As measured by the UBN (unsatisfied basic needs) index, poverty declined throughout the 1990s, although at a slower rate than previously. But poverty as measured by the percentage of the population living below the poverty line (a definition that is heavily influenced by the business cycle) increased. Núñez and Espinosa (2005), using data on income per capita from the national household surveys and applying the poverty equivalent growth rate (PEGR) methodology,⁹ show that during the worst period in terms of output expansion, growth was anti-poor (table 2): although economic growth was positive, headcount poverty

9. The PEGR is the growth rate that would have resulted in the same poverty reduction as the observed growth rate if everyone had received the same proportional benefits. If the PEGR is greater than the observed rate, growth is pro-poor. If the PEGR is less than the observed rate but positive, growth is defined as “trickle-down”: although poverty declines, inequality increases. If the PEGR is less than observed growth and negative, growth is defined as anti-poor: although observed growth is positive, poverty increases because the benefits are distributed only among the non-poor.

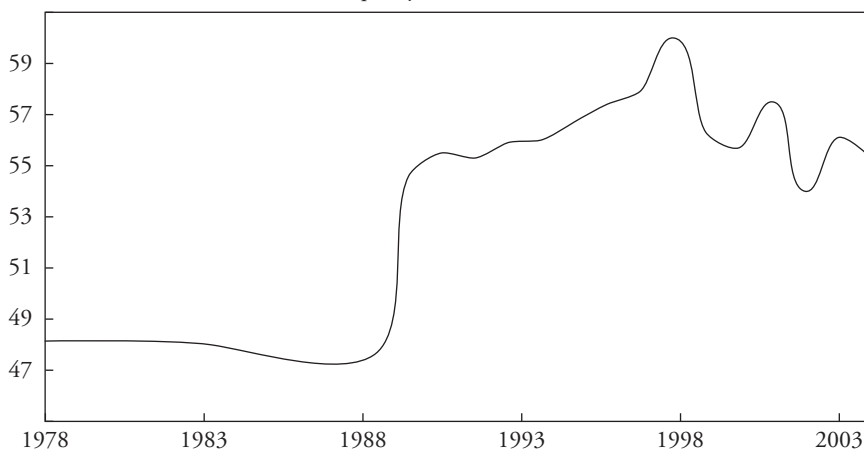
Table 1. *Public Social Expenditure in Selected Latin American Countries*
Percent of GDP

Country	1990–93	1999–2001
Argentina	19.7	21.2
Brazil	17.9	19.1
Chile	12.1	15.4
Colombia	7.5	13.8
Mexico	7.3	9.5
Peru	4.7	7.9
Venezuela	8.7	9.9

Source: Authors' calculations from ECLAC database.

Figure 3. *Colombia: Income Inequality, 1978–2007*

Gini coefficient (100 = maximum inequality)



Source: MERP (2006).

Table 2. *Colombia: GDP Growth and Poverty-Equivalent Growth*
Percent a year (simple averages)

Period	GDP growth rate	Poverty-equivalent growth rate ^a
1997–2000	0.625	–2.625
2000–04	2.875	3.1
1997–2004	1.75	0.2375

Source: Núñez and Espinosa (2005).

a. The growth rate that would result in the same poverty reduction as the observed growth rate if everyone had received the same proportional benefits.

increased; thus the benefits of growth were captured by the nonpoor. During the recovery, growth has been pro-poor, as poverty has declined on account of faster growth and an improved income distribution. During the entire 1997–2004 period, the nonpoor benefited more from growth than the poor (growth “trickled down”): although growth contributed to reducing poverty, higher inequality increased poverty on a yearly basis (except in 2000 and 2003).

Colombia’s attempt at promoting market-driven reforms while at the same time putting in place measures to enhance economic, political, and judicial inclusiveness proved very difficult, as some reforms turned out to include elements that detracted from the effectiveness of others. Although the renewed impetus since the late 1990s, together with a favorable external environment and a much improved security situation, has delivered an economic dividend, important challenges lie ahead.

The next section describes the main reforms undertaken in the early 1990s and the foundations that they were intended to impact. We then highlight some inconsistencies among elements of the reforms that weakened these foundations. In some cases there were design problems; in others the instruments used were insufficient; in most there were institutional constraints, mainly stemming from the active role of the Constitutional Court and from restrictions imposed by the decentralization effort mandated under the new constitution. Although progress has recently been made in addressing some of the inconsistencies, there is room for improvement. We follow this discussion with some proposals aimed at improving the prospects for achieving a sustainable rate of growth, that is, one consistent with macroeconomic stability and social inclusiveness. We not only try to identify “what” needs to be done; we also offer recommendations for “how” specific initiatives stand a better chance of being implemented. And we do not shy away from acknowledging that some constraints imposed by the local environment appear insurmountable, at least in the short to medium term.

The Reforms and Their Intended Impact on the Foundations

The reform effort launched in 1990 was an attempt to affect, to varying degrees, most of the foundations for growth identified in the CGD framework. Table 3 summarizes both the intended and the actual impacts of the most important reforms; in this section we discuss the intended effects, and in the next we analyze the actual results. Reforms in the economic arena—trade, finance, and labor—were geared mainly at enhancing *competition* so as to foster efficiency and reverse the trend decline in TFP. Financial liberalization also aimed at *broader sharing of the benefits of growth*, and capital account liberalization at promoting *equality of opportunities*, by fostering financial deepening and access to credit. Consolidating *macroeconomic stability* was the goal of two institutional reforms—to the central bank and the pension system—and of several tax reforms, although pension

Table 3. Colombia: Intended and Actual Impact of Reforms on the Growth Foundations

Reform	Property rights		Equal opportunities		Competition		Broad sharing of growth benefits		Macroeconomic stability	
	Intended	Actual	Intended	Actual	Intended	Actual	Intended	Actual	Intended	Actual
Trade liberalization					++	++				
Financial reform					++	+				
Capital account liberalization	+	+					+			
Labor reform					++	+				
Tax reform									++	++
Central bank independence									++	++
Pension reform	+	+			+	-	+	+	+	+
Fiscal decentralization								++		-
Health reform					+	-	+	+		-
Education reform								++		-
Political reform								+	+	-
Judicial reform								++	+	--

Source: Authors' evaluations.

Key: +, positive; ++, strongly positive; -, negative; --, strongly negative.

reform had other objectives as well. Broader sharing of the benefits of growth was also the main goal of decentralization, which was undertaken together with a hike in social expenditure. Equality of opportunities, and to a lesser extent the broader sharing of the benefits of growth, was the purpose of reforms in the judicial and political arenas.¹⁰

Enhancing Competition and Lowering Barriers to Entry

The centerpiece of the economic reforms was *trade liberalization*. Launched as a gradual reform in the late 1980s, it was significantly expanded in 1991. The driving force behind this reform was the view that the economy should be exposed to foreign competition as a means of reversing the pattern of declining TFP witnessed throughout the 1980s, which, as noted above, explained most of the growth slowdown. The five-year program that began in early 1990 was geared toward eliminating quantitative restrictions, reducing tariff rates and the number of tariff levels, implementing institutional reforms, and negotiating international trade agreements. In October 1990 a new government issued a three-year liberalization schedule, which included the agricultural sector. But instead of increasing as expected, imports actually declined. Together with an increase in capital inflows, this made monetary management exceedingly difficult. In June 1991 it was decided that the initial liberalization schedule would be carried out by September 1991.

Trade liberalization was accompanied by *financial liberalization*. This reform sought to foster competition and efficiency and to strengthen and deepen the financial sector. It also aimed at a more level playing field in which foreign institutions could compete on an equal footing with local ones, and in which all investors, not only those with connections, could allocate their portfolios across borders.¹¹ With the enforcement of new capitalization standards and stronger regulation and supervision, it was expected that the financial sector would contribute to economic stability. Specific features of the package included removal of barriers to entry, reduction and rationalization of reserve requirements, liberalization of most interest rates, a reduction in forced investments, and the privatization of some banks. Law 9 of 1991 removed all entry restrictions and established national treatment for foreign direct investment. It also eliminated limits on the profits that foreign firms could transfer abroad.

The authorities held the view that for the country to effectively compete in the global economy, a more *flexible labor market* was needed. The 1990 reform made

10. Other than through the introduction of private pension funds, the strengthening of *property rights* does not appear to have been an important goal of the reforms undertaken since the early 1990s.

11. An important component of financial liberalization was the dismantling of capital controls that had been in place for over twenty years. Also, a general amnesty was given to Colombians who had kept foreign exchange abroad.

contracts more flexible and reduced labor costs. Importantly, it attempted to reduce the gap between formal sector workers and those working informally. In order to expand formalization, dismissal costs and nonwage labor costs were reduced and short-term contracts and flexibility in the definition of working hours introduced. At the same time, procedures for establishing a labor union were made simpler, a regulation forbidding them from participating in politics was repealed, and liabilities to workers were granted seniority in the event of their employer's bankruptcy.

Promoting Macroeconomic Stability

To enhance macroeconomic stability, the 1991 constitution granted *independence to the central bank*. Its board of directors is the authority in charge of monetary, exchange rate, and credit policy. The board is composed of seven members: five of these are appointed by the government for concurrent four-year terms, but every four years only two of the five may be replaced;¹² the minister of finance is a member of the board and together with the five appointed members elects the central bank governor for a four-year term that can be renewed twice. The central bank may not extend credit or offer guarantees to the private nonfinancial sector and may extend direct credit to the government only upon unanimous vote by its board. It must strive for a low and stable rate of inflation, in coordination with overall economic policy. In the event that other goals conflict with achieving low and stable inflation, the bank must give priority to the latter.

Another reform undertaken mainly with the purpose of promoting macroeconomic stability was a major transformation of the *pension system* in 1993. The system previously in place exhibited all the limitations of a public pay-as-you-go (PAYGO) scheme: contributions and benefits differed across the various subsystems; the earliest retirees received huge transfers; contributions were weakly linked to benefits; coverage was low; administration was inefficient; and the system lacked adequate reserves and therefore depended on growing fiscal transfers. The reform established a general scheme composed of two subsystems: a public PAYGO regime and a subsidized individual savings scheme using privately managed funds (*administradoras de fondos de pensiones*, or AFPs). Although the subsystems were separate from one another, transfers between them were allowed. The system was made mandatory for employees in the private and public sectors. Until it was reformed again in 2003, participation was optional for the self-employed and for dependents of participants. Although a long transition period was allowed, the reform increased the retirement age,

12. The tenure of the Colombian president is four years, and until 2005 the president could not seek a second term.

raised contribution rates and eligibility requirements, and rationalized benefits. In addition to placing the system in a more sustainable financial position, other objectives of the reform included exposing the public fund to competition, promoting the development of the capital market, and, in the case of the 2003 reform, better targeting of subsidies. A by-product of the reform was greater security of the pension rights of formal sector workers, with rights more clearly defined in individual accounts.

Since the early 1990s Colombia has undergone several *tax reforms*. Unlike the reform of 1986, which brought about a major improvement in the *quality* of the tax code, the reforms undertaken since 1990 have aimed at increasing tax revenue, to finance the increase in public expenditure mandated, for the most part, in the 1991 constitution.

Broader Sharing of the Benefits of Growth and Greater Equality of Opportunities

The second half of the 1980s saw a growing recognition that *decentralization* should play a major role in rebuilding trust in institutions, in the context of a critical security situation. Self-government was seen as a means of consolidating democracy while improving the efficiency of government intervention. The 1991 constitution established the popular election of governors,¹³ as well as the ability to remove them and mayors through popular vote. It increased the amount of resources transferred from the central government to subnational governments—and, implicitly, from wealthier to poorer regions—in order to ensure broad access to *health and education*. The constitution went into great detail regarding the distribution of resources among government levels and expenditure categories; widened the base for calculating transfers and increased them significantly; gave local authorities the power to levy taxes; and established that income from monopolies that are the property of regions may not be appropriated by the central government.

The 1993 reform of the *health care system* was mainly geared toward broader sharing of the benefits of growth, by promoting universal coverage and incorporating elements of solidarity and fairness. It also aimed at fostering competition between private and public providers to enhance quality and efficiency. The reform changed the way public hospitals are financed (through the sale of services rather than through the budget), decentralized their administration, and forced them to compete with private hospitals, so that the efficient public hospitals should thrive and others close. The system uses vouchers to subsidize demand, with the costs distributed between employers and employees when the insured has the ability to pay, and the responsibility of the government otherwise. Cross sub-

13. Mayors had been elected, rather than appointed by the central government, since 1986.

sidies, both among those who can contribute and between them and those who cannot, promote solidarity.¹⁴

In addition to introducing the popular election of governors, the 1991 constitution included a major *political reform* focused on enhancing representation, weakening the two-party system, empowering voters, and shifting power away from the executive.¹⁵ The reform aimed at improving equality of opportunities and may contribute to broader sharing of the benefits of growth as well. It established that the senate would be elected on a nationwide basis, on the premise that candidates of minority groups, all but unelectable in small districts, could gather enough votes from across the different regions to win seats.¹⁶ Also, voting in a national district was expected to place at a disadvantage the small regional movements that had become prevalent during the Frente Nacional period (Botero, 2000).¹⁷ The constitution lowered barriers to entry, empowered citizens to organize political parties, and made it easier for voters to directly submit proposed legislation to Congress and to remove elected officials. The constitution also assigned to Congress additional legislative and control functions. An important provision made it much more complicated for the executive to use extraordinary powers to legislate (Ungar, 2003), and Congress can now override a presidential veto with a simple majority.

The 1991 constitution promoted equality of opportunities by expanding *access to the justice system*. All citizens are now in a better position to claim their constitutional rights, which also promotes the broader sharing of the benefits of growth. The constitution enshrined the concept of an *estado social de derecho*, geared

14. The system operates on the basis of an insurance premium (which is calibrated to reflect gender, age, and regional differences) and offers a standard package to workers and their dependents. For self-employed and formal sector workers there is a contributory regime, funded by a contribution from wages. Health promotion firms affiliate individuals and receive contributions. Contributors may choose their own health promotion firm as well as their own service provider. Each firm transfers the contributions it collects in excess of entitled capitation payments to a public fund and is compensated by the fund when contributions fall short of entitled capitation payments. Individuals wishing to enroll in the subsidized regime must come from a household at level 1 or 2 of Sisben (a proxy means test index stratifying households into six levels). One-twelfth of contributions are transferred to the subsidized regime, and those eligible for coverage who remain uninsured (*vinculados*) receive services from public hospitals or from private ones that enter into contracts with subnational governments.

15. Cárdenas, Junguito, and Pachón (2006) provide a good description of how the 1991 constitution redistributed power away from the executive and toward the legislative, the subnational governments, the judiciary, and the central bank.

16. Two of the 102 Senate seats were reserved to those elected in a district reserved for indigenous groups.

17. The Frente Nacional (FN) was a 1958 compromise to end civil unrest between the two historically dominant parties. Although the compromise formally ended in 1974, many of its provisions lasted longer. During the FN, 50 percent of seats in Congress were reserved for each party, excluding all others. Elections thus became a personal contest *within* parties rather than an ideological contest between them. When the FN formally ended, provisions allowing parties to present multiple lists in an election were preserved.

toward ensuring not only those rights labeled as “first generation” (that is, civil liberties, which are ensured through government restraint) but also “second generation” rights (access to certain services that require positive action by the state). Although the constitution defines first-generation rights as “fundamental” and second-generation rights as “social and economic,”¹⁸ it also established a mechanism (the *tutela*) by which any citizen who feels his or her rights have been disregarded may go before any judge and seek restitution, which, if the judge rules in favor, must be provided immediately.¹⁹ The country’s highest court, the Constitutional Court, has developed the principle of connectivity (*principio de conexidad*), according to which many rights not deemed “fundamental” in the constitution are to be treated as such. For example, a connection has been established between access to health care (a second-generation right) and the fundamental right to life.

The Reforms in Practice

Table 3 shows that many of the expected effects of the early-1990s reforms on the foundations of growth were indeed achieved. However, in several cases—particularly with respect to decentralization of health and education expenditure, and political and judicial reform—there were also unintended consequences. Several inconsistencies had become evident by the late 1990s, including the following:

- Some policies proved fiscally unsustainable; notable among these was the major expansion of expenditure in the social sectors by subnational governments.
- Some social policies, financed through taxes on labor, fostered the movement of workers to the informal sector.
- Reforms in the political arena geared at broadening representation also fostered party fragmentation and increased political transaction costs.
- Reforms aimed at facilitating access to the justice system also empowered judges and made the Constitutional Court a veto player in economic policy.

This section highlights some of the problems that characterized the reform effort and reports on corrective measures undertaken since. Reference will be made to limitations stemming from the local environment, issues of design, and inconsistencies among elements of different reforms. The picture that emerges is one of tension between policies aimed at enhancing competition and promoting macro-

18. Chapter 1 of Title II is “On Fundamental Rights”: the right to life (article 11), to religious freedom (article 19), to free speech (article 20), and to due process (article 29). Chapter 2 is “On Social, Economic and Cultural Rights,” which include social security (article 48), health (article 49), dignified housing (article 51), and property (articles 58–61).

19. *Tutelas* need not be in writing, and the judge must rule within ten days. Appeals have to be decided within twenty days. All decisions are sent to the Constitutional Court, which chooses those it will review.

economic stability, on the one hand, and institutional arrangements geared toward fostering equality of opportunities and promoting a broad sharing of the benefits of growth, on the other.

The Judicial System: Greater Access to Justice, but at a High Fiscal Cost

Although the growing number of *tutelas* suggests that this new mechanism has broadened access to the legal system, it also raises issues of abuse and inefficiency.²⁰ The resulting judicial rulings, for example on the indexing of minimum salaries, have redistributed income and thus contributed to the broader sharing of growth. But the added cost to the government of higher salaries and benefits, together with other judicial decisions that forced a lowering of taxes, threatens fiscal balance and thus macroeconomic stability, and much higher minimum salaries tend to make labor markets less flexible, reducing economic competition. An activist judicial system, basing its decisions on a rather simplistic interpretation of the concepts of equality and dignity, has had a profound influence on economic reform and has prevented some reforms from delivering on their promise. The Constitutional Court has gone beyond “legislating in the negative”; it often modifies legislation in an attempt to ensure that the law, as the court sees it, complies with the constitution. It has extended its decisions to apply beyond the regulation in question to others that had not been challenged. In so doing the court has imposed peremptory deadlines on Congress to legislate in accordance with its rulings.²¹

Some of the most important interventions by the Constitutional Court in economic matters include the following:

- *Wages.* The task of establishing the monthly minimum salary is undertaken by a commission on which government, labor, and business are represented. If no agreement is reached, the government sets the minimum salary. Until 1998 it was standard practice to increase the minimum salary periodically in line with *expected* inflation plus some allowance for productivity growth. In 1999, however, the court determined that this procedure violated workers’ right to a minimum “vital and mobile” remuneration and determined that “the adjustment must never be lower than the previous year’s inflation.” In 2000 the court extended this rationale to most public sector wages and determined that “any savings achieved from limiting wage hikes has to go to social investment,” even though the constitution establishes that in time of peace only elected bodies may mandate public expenditure.

20. Between 1999 and April 2007, 1.6 million *tutelas* were filed, one-third of them in reference to health care. The judiciary upheld 87 percent of the total (*El Tiempo*, August 31, 2007).

21. The court’s activism generates uncertainty and encourages the use of lawsuits to produce changes that politically disadvantaged groups are unable to accomplish through the legislative process, and which may deter many from participating in the political process (Kalmanovitz, 2003; Uprimny, 2001). Politicians might, as a result, find it rational to defer to the Constitutional Court on topical issues, transferring to it the political costs involved.

- *Pensions.* The court struck down a provision in the 2003 pension reform shortening the transition period. It opined that the reform affected not just workers' expectations, but also their acquired rights. In upholding a *tutela* by teachers claiming their right to a fourteenth monthly pension payment each year, the court justified its decision on equity grounds. This payment had been established in 1993 to compensate *some* retirees whose pensions had not been fully adjusted for inflation; the court extended the benefit to *all* pensioners, at a cost of around 12.5 percent of GDP (Cadena, 2006).

- *Taxes.* Stating that it deemed the graduation of VAT rates across different goods to be insufficient, the court overturned a provision in a tax reform that extended the VAT to previously excluded items, but at a very low rate.

- *Health care.* Although the health care law defines the manner in which citizens may exercise their health care rights, judges and the Constitutional Court have allowed citizens to claim much broader rights, at public expense, on grounds of protecting the "right to life."

Interventions by the Constitutional Court in the *financial sector* have been by far the most controversial. In 1998, at a time when the country's mortgage banks were in crisis, the administration declared an economic emergency and issued decrees with the (temporary) force of law. Their review opened the door for the Constitutional Court to play a very active role in a range of financial matters:

- The government introduced a financial transactions tax (FTT) but exempted interbank operations. The court overturned this provision on grounds that it violated the principle of equality. Until a much lower tariff was introduced, the interbank market, including the market for foreign exchange operations, dried up.

- A government proposal, upheld by the court, forced banks to accept, during a twelve-month period, properties returned by mortgage holders in exchange for the complete write-off of their mortgage. The government intended to target this provision to low-income owners, but again citing the principle of equality, the court extended it to all debtors.

- The administrative court ruled that the central bank could not continue linking the *corrección monetaria* to interest rates, but the Constitutional Court ordered that it be fully linked to inflation.²² It opined that if indexed debts increased faster than inflation, citizens' right to housing would be affected. As a result, a 1999 law established that the real rate of interest (that is, the premium

22. Mortgages were defined in terms of a unit of account (UPAC), originally intended to remain constant in terms of the consumer price index. The periodic adjustment of this unit was known as *corrección monetaria*. All assets and liabilities in mortgage banks were indexed to the UPAC. At the insistence of the mortgage banks, the *corrección monetaria* began to incorporate interest rates in addition to inflation. Eventually, the UPAC became fully indexed to interest rates.

Table 4. *Colombia: Proliferation of Political Parties and Electoral Lists*

Year	Parties seeking seats in the senate	Electoral lists offered	
		Senate	House
1978	n.a.	210	308
1982	n.a.	225	343
1986	n.a.	202	330
1990	8	213	351
1991	21	143	486
1994	54	251	628
1998	80	319	692
2002	63	322	883

Sources: Roland and Zapata (2005); Botero and Rodríguez (2007).

n.a. = not available.

over the *corrección monetaria*)²³ would be capped and held constant, and that interest payments could no longer be capitalized. The court then determined that all existing mortgages should be re-priced in terms of the new unit of account, and it ordered banks to issue refunds to debtors who had “overpaid.”

Political Reform: More Participation, but Little or No Improvement in Policy Outcomes

To facilitate the emergence of new political parties, the 1991 constitution determined that “the law cannot establish conditions for the organization of parties and movements, nor make affiliation in one of them a condition for participating in elections.” Lowering barriers to entry and introducing a national senate district ended the monopoly of the two traditional parties: their combined representation in the senate fell from close to 100 percent to around 75 percent. Promoting entry and competition, however, came at a price: an explosion in the number of parties and movements and a sharp increase in registered lists of candidates during elections (table 4). Although the number of lists had already begun to grow before 1991, it shot up during the 1990s. In the 2002 senate, fifty-two parties, movements, and coalitions were represented (Ungar, 2003). Whereas in the 1991 senate the two dominant lists together had held one-third of the 102 seats, in each of the next three elections the top three lists each elected only two senators each. In 2002 the three lists receiving the most votes each received slightly less than 2 percent of the total.

Despite the move to a national district for senatorial elections, politicians did not change their way of doing business, and competition in the political arena was

23. This premium has to be lower than the lowest real rate of interest prevalent in the market, and even lower for low-income housing. The central bank, entrusted in 2000 with periodically setting the rate, is thus forced to negate the principle according to which interest rates reflect expected risks.

not enhanced. Most incumbents managed to obtain enough votes in their traditional regions to retain a seat. Botero (2000) estimates a “regional concentration index” as the percentage of votes raised in their “preferred” department by all elected candidates. The average index value for 1991, 1994, and 1998 was a startling 66.7. Politicians were elected without having to compete beyond their traditional areas of influence, and with no support from a party organization.²⁴ Problems also emerged with regard to representation. Although the 1991 constitution did away with the practice of voting for alternates, it provided that permanent vacancies would be filled by unelected candidates on the same list as the elected candidate. Of the 263 seats in the 1998 Congress, by the end of 2001 some 247 were held by someone other than the person elected. These were legislators for whom nobody had voted; indeed, their names did not even appear on the ballot, which identifies only the head of the list. Also, assigning seats using the LR-Hare system in the context of list proliferation can lead to huge reallocations of votes. Botero (2000) estimates an index of deviations from proportionality to measure the extent of reassignment. This index, which averaged 23 in 1986 and 1990, reached 60 in 2002.²⁵ The D’Hondt system, introduced in 2003, brought about a sharp change; the four most voted lists in 2006 received 62.5 percent of the vote and won 68.6 percent of the seats.²⁶

The emphasis given to providing equality of opportunities by lowering barriers to entry helped deliver a fragmented political system. This in turn raised transaction costs, probably facilitated capture by interest groups, and undermined the political system’s ability to undertake sound long-term policies, which among other things endangers macroeconomic stability. When parties have almost no control over who may run under the party’s banner, the result is to promote *intra-party* rather than *interparty* competition, leading to clientelism: those at the top of the list differentiate themselves from other candidates by catering to narrow local interests (Roland and Zapata, 2005). The rules in place until 2003 for allocating seats in Congress appear to have in fact lowered the quality of legislative work. The average number of bills introduced each year rose from 142 during 1982–91 to 215 during 1992–2003, and around 80 percent of bills in the latter period were introduced by legislators with a clear regional orientation. This kind of legislative

24. Besides the flawed electoral rules, other factors that explain this outcome include the increase in fiscal resources at the local level due to decentralization; the influx of drug money into politics; public campaign financing through reimbursements to candidates rather than to parties; and new voting procedures that reduced the value of the logistical capabilities provided by a party organization (Cárdenas et al., 2006).

25. The index is calculated as 0.5 times the sum of the absolute value of the difference, for each list, between the percentage of votes received and the percentage of seats gained. The index value is zero under perfect proportional representation. In 2002 some 60 percent of votes were reassigned among lists in the process of translating electoral results into congressional seats.

26. See Roland and Zapata (2005) for an explanation of alternative electoral allocation systems in a Colombian context.

“inflation” suggests party weakness: when there is no quality control, the bills submitted by legislators lack financial and judicial rigor. Unsurprisingly, the approval rate for legislation submitted by the executive is much higher.

After several failed attempts, a new reform was approved by Congress in 2003. The new electoral rules maintained a system of proportional representation but shifted to a D’Hondt rule with minimum thresholds: a 2 percent threshold in the senate and 50 percent of the quota in the house, in the case of departments electing more than two representatives, and 30 percent in the few departments that elect only two. Parties may present only one list for each chamber, there can be no more candidates on the list than seats to be filled, and voters may not register with more than one party. As a compromise, each party decides for itself whether voters may choose the order of candidates within the list. In 2005 Congress passed a *ley de bancadas* with several new provisions: it established that members of Congress elected from the same list must constitute a group; delegated to the parties the responsibility of issuing rules to ensure that groups act in conformity with the law; and established procedures to enhance the efficiency of legislative proceedings.

The 2003 reform was put to the test at the congressional level in 2006. The introduction of a threshold induced consolidation: only 20 lists contested for the senate, down from 322 in 2002;²⁷ 10 surpassed the threshold. Although the reform brought order to a situation that some had labeled chaotic, the fate of the 2006 tax reform, perhaps the most important economic issue that Congress has dealt with since, suggests that the greater electoral cohesion has yet to translate into a more structured legislative process, one less prone to capture and better able to deliver sound public policies.

Labor and Tax Reform

Although trade liberalization in Colombia has proceeded almost without interruption, the country’s integration into the global economy has been hampered by two factors that should have enhanced it. First, labor reform failed to deliver on its promise of making the labor market more flexible. Second, in order to finance a much higher level of public expenditure, the tax burden has increased quite markedly, to a level deemed at odds with greater private sector competitiveness. Meanwhile, for a host of reasons, financial liberalization has proved to be a more complex and protracted process than originally envisioned.

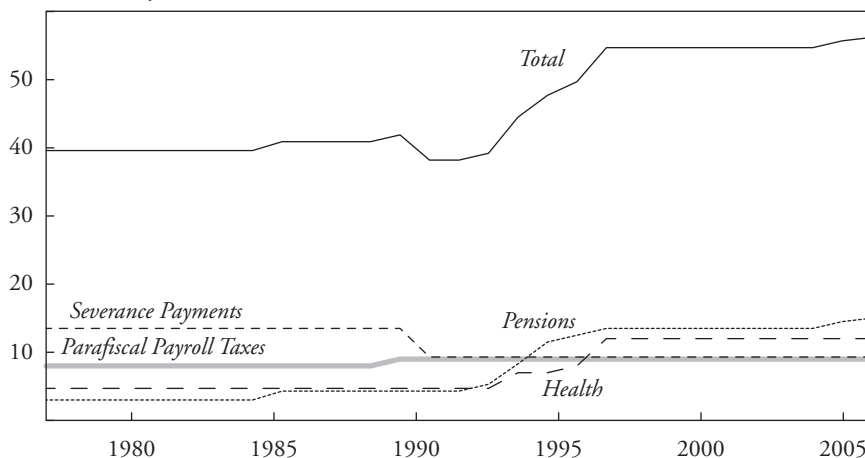
LABOR REFORM: MEASURES TO ENHANCE COMPETITION NEUTRALIZED BY REFORMS ELSEWHERE

The main goal of the 1990 labor reform was to support trade liberalization by enhancing the flexibility and formalization of the labor force, thus making

27. More precisely, in the 2002 elections 63 parties and movements presented 322 lists, whereas four years later 20 parties or movements presented 20 lists.

Figure 4. *Colombia: Nonwage Labor Costs, 1977–2005*^a

Percent of salary



Sources: Cárdenas and Mercer-Blackman (2006); Bernal and Cárdenas (2003).

a. Includes parafiscal payroll taxes (contributions to ICBF, SENA, and CCFs), contributions to social security (health, pensions, severance payments, and professional risks), paid vacations, and mandatory bonuses.

Colombian producers more competitive. The observed reduction in nonwage labor costs would soon be overtaken, however, by the rise in social security contributions stemming from the 1993 social security reform, undertaken for the purpose of promoting macroeconomic stability by placing pensions and health care on a sounder financial footing, and by the rigidity of wages (figure 4). Nonwage costs increased from around 40 percent of payrolls in the 1980s to 56 percent in 2004 (Cárdenas and Meicer-Blackman, 2006; Bernal Cárdenas, 2003).²⁸ By 1999 Colombia had the second-highest nonwage labor costs in the region. A study by the World Bank (2005) shows that the rise in nonwage costs has constrained the demand for labor while increasing supply. The share of workers in the informal

28. Nonwage costs are composed of the following: parafiscal contributions, which sum to 9 percent of payroll, consisting of 2 percent for SENA (Servicio Nacional de Aprendizaje, the vocational training program), 4 percent for ICBF (Instituto Colombiano de Bienestar Familiar, the family welfare program), and 3 percent for the CCFs (*cajas de compensación familiar*, or family compensation funds), which are private funds involved in a host of activities including cash subsidies, recreation and cultural activities, and unemployment insurance; contributions to severance funds and paid vacations; health contributions, which rose from 7 percent in 1993 to 12 percent in 2007; and contributions to pensions, which rose from 6.5 percent to 13.5 percent in 1993 and to 15.5 percent in 2002, with an additional 1-percentage-point contribution for those with high salaries. Other sources have estimated these percentages to be slightly different. These nonwage labor costs are calculated using author-specific definitions of payroll taxes, mandatory bonuses, and so on. For example, according to the World Bank (2005), total nonwage costs were about 47 percent in the late 1980s and rose to around 60 percent in 2004.

sector, at 58 percent, was higher in 2004, when the economy was in a recovery, than it had been in 1992 (54 percent).

Actions with regard to wages have also stood in the way of enhancing labor flexibility and formalization. Provisions in the law and interpretations by the Constitutional Court have determined that the minimum monthly salary and wage schedules affecting most civil servants must be indexed to inflation. When, after 1999, the central bank's inflation targeting framework started to deliver consistently lower inflation, backward indexation resulted in a continuous rise in real terms in the minimum salary, an increase in the ratio of the minimum to the average salary, and a rise in the proportion of self-employed workers earning less than the minimum. Between 1996 and 2002 the real wages of the self-employed declined, indicating that this sector had adjusted better to the business cycle than the formal sector, where wages increased even as the economy entered a severe recession. World Bank (2005) estimates of Okun equations show that cyclical variations in output have affected unemployment more strongly since 1998 (that is, the labor market increasingly adjusts through quantities rather than wages); this is hardly consistent with the objective of making labor markets more flexible and supportive of an open trade regime.

A new reform was passed in 2002. Its provisions fall into two categories: formalization of employment, and social protection and enhancement of opportunities for hard-to-hire groups. It reduced overtime pay and made the workday and the workweek more flexible; amended apprenticeship contracts, which no longer involve parafiscal contributions or severance payments and are not subject to the minimum salary; further reduced firing costs; and introduced an unemployment insurance scheme. Gaviria (2004) estimates that the reduction in firing costs and overtime pay barely compensates for the increase in pension contributions enacted at the same time. He also reports positive effects on the hiring of apprentices and on underemployment, minor effects on employment generation and formalization, and no impact from the new unemployment insurance scheme. The 2002 reform seems to have marginally enhanced flexibility. However, by failing to address the two critical issues—high nonwage labor costs and inflexible wages—it has done little to promote labor market formalization.

TAX REFORM: STRONG REVENUE GROWTH, BUT AT THE EXPENSE OF COMPETITIVENESS AND EFFICIENCY

At 15 percent of GDP, Colombia's tax burden is not high, given the country's level of income and the well-established tendency of tax burdens to increase with income. However, the present level of taxation reflects the fact that the tax burden has risen faster in Colombia than in any other country in the region, having almost doubled since 1990. Given the upward pressures on spending described elsewhere, the resulting higher revenue has proved vital to keeping the fiscal deficit under control and the macroeconomy stable. On the other hand, taxation remains

a source of uncertainty for businesses and workers, with no fewer than ten national tax reforms in the last seventeen years and ample discretion exercised by municipal authorities. The tax regime is also extremely inefficient, combining a shallow base (fewer than 2 percent of the active labor force paid income taxes in 2004, according to Cárdenas and Mercer-Blackman, 2006) with high marginal tax rates on both income (the top marginal rate was 38.5 percent until 2007 and is now 35 percent) and consumption (the VAT). Moreover, the tax system is complicated to administer, and the existence of multiple rates (eight in the case of the VAT, ranging from 2 to 45 percent) and an ever-increasing list of exemptions likely foster avoidance and evasion. Finally, all this is complemented by the second-highest tax rate on the wage bill in the region, the highest FTT, a technically flawed local tax on business turnover, and a distortionary tax on net wealth. Successive tax reforms, aimed at supporting fiscal and macroeconomic stability in the context of an ever-rising level of public expenditure, have had a negative effect on competition and efficiency.

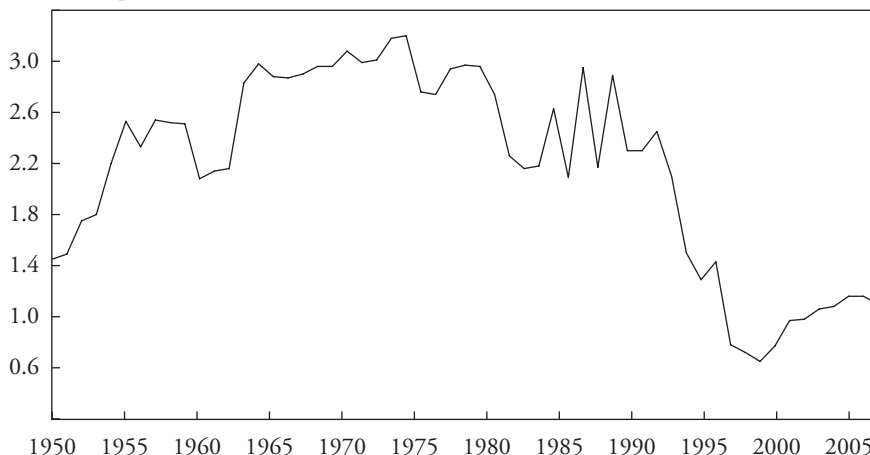
Colombia's business-unfriendly tax regime has its root cause in the fact that the tax burden has had to be raised frequently just to keep pace with growth in public expenditure—throughout the 1990s to comply with mandates in the 1991 constitution, more recently to fund the costs of enhanced security. Although Congress has generally accommodated the executive's need for additional resources, the latter has always found itself at the mercy of the legislature, and therefore of interest groups, regarding the quality of tax changes. A good example has been the fate of the highly distortionary FTT, introduced as a temporary provision at a rate of 0.2 percent in 1999. In each tax reform that the executive has submitted since then, it has requested the phasing out of this tax and its replacement with less distortionary taxes. The results have been dismal: the FTT is now permanent, at a rate of 0.4 percent. Even when Congress has supported attempts to improve the tax code—as in 2002, when it agreed to impose a VAT, at a low rate, on all food-stuffs—the Constitutional Court has ruled that such a move ran counter to any concept of fairness. The administration itself, for example in the failed 2006 reform, has not shied away from making explicit its intention to maintain certain exemptions in order to promote private sector investment. This posture soon led to numerous suggestions for additional exemptions and differential tariff rates, eventually leading the administration to withdraw its reform proposal altogether.

Financial Sector Reform: More Competition and Greater Efficiency, but Access Is Limited and Restrictions Remain

We present several approaches to assessing progress in the financial sector during the reform process to date: a financial repression index, a model gauging the development of competition, and the literature on financial efficiency all suggest room for improvement. An update of Salazar's (2005) repression index suggests that a period of continuous liberalization that began in the late 1980s was inter-

Figure 5. *Colombia: Financial Repression Index, 1960–2006*^a

5 = most repressed



Source: Authors' calculations.

a. Principal components analysis was applied to a set of financial repression indicators. A single indicator was estimated, with the weights of its components set equal to their participation in the variance of the information set. Seven indicators were considered: mandatory investments; reserve requirements; interest rate controls; the difference between the usury interest rate and the average loan rate; revenue from the financial transfers tax; assets of public banks; and assets of foreign banks (the last two measured as a percentage of total assets). The first component was taken as the indicator of repression, as it explains 70 percent of the variance of the information set. The variables most highly correlated with the first component are the importance of public banks, foreign participation, and mandatory investments.

rupted during the crisis affecting both mortgage and public banks in the late 1990s, when an FTT and forced investment were introduced and foreign ownership fell (figure 5).

Although the number of financial institutions increased after the initial reform effort, as a consequence of easier entry, it declined following the crisis that engulfed the mortgage and public banks. The percentage of assets in the largest banks shows a similar pattern. In a contestable market, concentration does not necessarily imply lack of competition. Barajas, Steiner, and Salazar (2000) applied the Panzar–Rosse test for 1985–98 and found that liberalization enhanced competition. In similar estimations for 1990–2007 (results available on request), we found evidence that in spite of a higher concentration of assets, competition has increased but still falls short of being optimal.

There is evidence that efficiency in the banking industry, although still lagging, has increased as well. Labor costs have been on a declining trend, from 4.1 percent of assets in 1991 to 2.3 percent in 2007. Intermediation spreads—which reflect efficiency as well as risk, market structure, and cost of regulation—have likewise fallen, from around 20 percent in the early 1990s to 7 percent recently.

Recent estimates report high levels of cost inefficiency, at anywhere between 30 and 73 percent of total costs.²⁹

Progress with regard to credit expansion (a factor potentially affecting the broad sharing of the benefits of growth) has been modest. Bank credit is only 35 percent of GDP, and credit to the private sector barely 24 percent. Results of a vector autoregression (available upon request) show that once capital flows are included, our repression index does not affect financial deepening. These results suggest that in a small, open economy, capital flows play a critical role, and that although quite complex, our index fails to capture aspects that might be critical in fostering financial deepening and access, such as the role of credit bureaus, an efficient guarantee system, and protection of creditor rights.

Although in the regional context Colombia apparently does not fare poorly with regard to access, as of June 2007 only 35 percent of Colombians held at least one financial product. On the other hand, credit to small and medium-size enterprises has grown, but from a low base. Providing banking services to the poor is costly for financial institutions and taxing on the poor themselves. Information requirements can overburden potential customers, particularly if they work in the informal sector. In 2006 the government launched a program, called Banca de las Oportunidades, aimed at enhancing poor Colombians' access to financial services. At the margin, the program has lessened some of the severe constraints that the poor have faced.³⁰

Just as macroeconomic stability was compromised by constitutional mandates geared toward broadening the pool of beneficiaries from growth, so the concern for macroeconomic stability in the context of insufficient policy instruments has hampered financial liberalization and might have prevented financial reform from meaningfully affecting the foundations as had been expected (see table 3). First, in response to a sharp rise in capital inflows, the central bank has established reserve requirements on foreign borrowing and increased overall reserve requirements. This curtailed competition and efficiency in the financial sector and increased financing costs. Second, limited budgetary flexibility played a role in the decision to finance public intervention in the crisis engulfing mortgage and public banks through an FTT, a tax that retards financial deepening and access by the poor to financial services. Third, unable to resort to the budget to promote specific sectors, in 1999 the government reintroduced some forced investments, this time in favor of low-income housing.

The expansion of bank credit has also been hampered by a deeply engrained cultural bias favoring debtors over creditors, a bias that is evident in the minds of those who write the laws and of those in charge of upholding them; this arguably

29. See Asociación Nacional de Instituciones Financieras (2005) and the references therein.

30. In addition to allowing the creation of nonbanking correspondents, the program established different usury rates for different sectors, increased allowable commissions on microcredit, and expanded FTT exemptions for withdrawals from savings accounts.

amounts to a populist interpretation of property rights by the legislative and judicial branches. We have already mentioned the Constitutional Court's decisions with regard to forcing mortgage banks to bail out debtors. In addition, Law 550 of 1999 attempted to provide lenders and borrowers with incentives and mechanisms to negotiate restructuring programs that would allow businesses under stress to normalize their activities. The bias against creditors became evident, however, and only a few deals were finalized. A major hurdle faced by financial institutions in their attempts at recovering collateral has been the extreme complexity of the judicial process. In addition, the legal system does not allow for the expeditious creation of guarantees, and the existing guarantee registries are technologically obsolete. A 2006 law improves matters but does not fully solve the main problems.

The expansion of credit in general, and to smaller borrowers in particular, is constrained by caps on interest rates. We have already mentioned the decisions by the Constitutional Court that forced banks to decouple interest rates on mortgages from any assessment of risk. In addition, credit operations are subjected to limits imposed by the usury rate of interest, which lately might have become binding for certain operations. Interpretations by the bank supervisory agency have determined that limits shall apply throughout the loan's life span; in other words, if market conditions change and the usury rate falls, the contract has to be renegotiated. Besides producing uncertainty, this inhibits the market for securitized assets.³¹ In the case of microcredit, banks may charge fixed commissions on top of the usury rate. In practice, however, this flexibility is not significant. The system in place does not foster the expansion of microenterprises and does not allow banks to cover the operational costs and risks associated with small transactions with agents in the informal sector.

The fact that credit bureaus are underdeveloped also helps explain the low level of access to the financial sector. It was only recently that a "habeas data" law was approved, establishing a four-year permanence for all negative information. This law is now under review by the Constitutional Court. Before the law was passed, the court had ruled favorably on numerous demands from citizens arguing that their rights (to privacy and reputation) had been violated by credit bureaus—another example of a judicial intervention that has impeded the development of the financial sector. The negative view that many have regarding the financial sector, together with widespread lack of knowledge about how information systems work, allowed the notion that "the less information, the greater the access to credit" to flourish.

Fiscal and Budget Reform

During the decade following the launch of the reform program, Colombia strayed from its tradition of prudent fiscal policy and relative macroeconomic stability.

31. The authorities have attempted to introduce some flexibility into this restrictive regime. Recently, the government decided to establish the usury rate by type of credit and at a higher time frequency.

Although having granted independence to the central bank would eventually prove to be a wise move—Colombia now enjoys historically low rates of inflation—the lack of a supportive fiscal policy stance during the 1990s determined that when international financial conditions tightened after 1997, the central bank had to adopt an extremely tight monetary policy stance in order to pursue its mandate of low inflation. To support the currency, during 1998 and 1999 the central bank raised interest rates to unprecedented levels. This proved very costly for economic activity in general and for the mortgage industry in particular. The fiscal deterioration that engulfed Colombia in the second half of the 1990s resulted from a confluence of factors, of which we highlight two: overestimation of the fiscal benefits of the 1993 pension reform, and the rise in expenditure, particularly in the social sectors at the subnational level, mandated in the new constitution. In both cases the Constitutional Court played a critical role in making a difficult situation even worse. In late 1999, for the first time ever, Colombia entered into a financial arrangement with the International Monetary Fund. This IMF program involved some important reforms, mostly geared toward restoring macroeconomic stability.

PENSION REFORM: RECENT ADJUSTMENTS PROMISE A SOUNDER, FAIRER SYSTEM

The 1993 reform adjusted the parameters of the pension system to put it on a sustainable footing more in accordance with demographic trends. The reform, however, provided for a long transition period: workers retiring before 2014 would not be affected.³² Members of the armed forces, the police, the teacher's union pension fund, and the state-owned oil company were exempted from the general system. It soon became evident that the reform had not achieved the goal of placing public pension liabilities on a sustainable path. After some failed attempts, important changes were introduced in 2003–05 to address this issue, while also improving equity and enhancing fairness:

- Subsidies now benefit only those unable to save enough to fund a minimum pension. Guaranteed minimum pensions in the AFPs are now fully funded.
- Contributions were raised, benefits were capped, and some degree of progressivity was introduced in the determination of the replacement rate.
- The fourteenth monthly payment—an extra benefit for a few public employees that, on grounds of equality, the Constitutional Court had extended to all—was eliminated for those earning more than three times the minimum salary, and for all persons retiring after 2011; all privileged regimes (except for the military)

32. The reform involved a twenty-year transition and an increase in the retirement age of just two years, even though life expectancy had increased from 61 years at the beginning of the 1970s to 70 at the end of the 1990s, and the conditional life expectancy of a 60-year-old had surpassed 80 (Cadena, 2006).

were eliminated starting in 2010; and collective agreements may no longer establish more favorable conditions than in the general system.

- The transition was brought forward to 2010 except for those very close to retirement. Congress approved bringing it forward to 2008, but, as noted above, this provision was watered down by the Constitutional Court on grounds that those affected had not only an “expectation” of receiving certain benefits but an “acquired right.”

The 2003–05 reforms reduced the unfunded liabilities of the PAYGO regime from over 200 percent of GDP to 140 percent in net present value terms. Yet pension payments will continue to be a drag on the budget. Transfers from the central government are peaking in 2007–08 at slightly less than 5 percent of GDP and are expected to remain close to 4 percent of GDP until 2015 (Ministerio de Hacienda, 2005). The pension regime is not only expensive; it has also proved to be an inequitable use of taxpayer money. The system has involved huge subsidies for many beneficiaries, ranging from those who never contributed but were entitled to a modest pension, to those whose contributions were not enough to cover their pension, to some egregious cases where no contributions were made but where benefits were nevertheless huge.³³ Before the 2003 reform the government subsidized two-thirds of the benefits of those receiving a minimum pension of one monthly minimum salary, and around half of all others (Montenegro and Rivas, 2005). Since coverage is low and biased in favor of the better off, the distribution of the subsidies has been appalling, with the lowest income quintile receiving no subsidy and the highest capturing 80 percent of the total (Lasso, 2006). Notwithstanding the prolonged transition period, the 2003–05 reforms had a major impact on equity by doing away with most of the privileged regimes, the main source of inequality. Solidarity was also enhanced. At the margin, pension subsidies are now well targeted.

FISCAL DECENTRALIZATION: A BROADER SHARING OF WEALTH, BUT AT THE EXPENSE OF BUDGET BALANCE

Since the entry into force of the 1991 constitution, there has been a significant transfer of resources from rich regions to poor ones, and the bulk of the resources transferred from the central government to subnational governments has been used to fund expenditures in health and education, thereby broadening the pool of beneficiaries of growth. Transfers rose from around 5 percent of GDP in 1990 to over 12 percent recently. In the initial stages, however, some subnational

33. For example, before the 2003 reform, public school teachers did not contribute to the pension fund, could retire much earlier, and received significantly higher benefits. Borjas and Acosta (2000) estimated that in 2000 this program, benefiting 303,000 active teachers, had generated a liability to the government equivalent to 30 percent of GDP. This was similar to the pension liability generated by 2.3 million nonteachers.

governments began running deficits and accumulating debt, thus compromising macroeconomic stability. Notwithstanding the rise in transfers, expenditure increased even faster.³⁴ The scheme put in place did not provide enough incentives for local tax effort and allowed for full discretion with regard to indebtedness.³⁵ Although views differ as to whether there has been “fiscal apathy,” tax collection was clearly more dynamic at the national level.³⁶ Because they were linked to current central government revenue, transfers became highly procyclical, making macroeconomic policy less flexible while tying expenditure on health and education to tax revenue that was sensitive to the business cycle. Distribution formulas were complicated, and few subnational governments could reasonably predict their income flows. The rigidity of the formulas fostered overprovision of certain services in some areas and underprovision in others.

A second round of reforms was driven by the need to make the scheme sustainable, while introducing flexibility into the distribution of transfers so as to produce a better match between the supply of fiscal resources and the effective demand for them. In 1997 borrowing by subnational governments was made contingent on their meeting certain solvency and liquidity criteria. A 2000 law classified these governments into categories and established differing limits on operational expenses, up to a given percentage of revenue (excluding transfers). Legislative Act 01 of 2000 created the Sistema General de Participaciones (SGP), which combined the three existing transfer mechanisms. The SGP will grow with inflation plus a mark-up, which has recently been raised.³⁷ Law 715 in 2000 made the allocation of transfers more flexible—without a regional dimension, and taking into account potential users as well as standardized costs—and introduced incentives for local taxation. A 2003 fiscal responsibility law affecting all levels of government establishes that the primary surplus must be at least equal to debt service. Even if deficits at the subnational level have been averted, the central government still faces imbalances on account of decentralization. Overlapping functions, a confusing distribution of responsibilities, and weak links between expenditure and financing decisions abound. How expenditures are to be assigned by level of government has never been made entirely clear. Although the 1991 constitution called for Congress to pass a territorial organization law

34. There is evidence of a “flypaper effect,” according to which “money sticks where it hits,” the most interesting example being the education compensation fund.

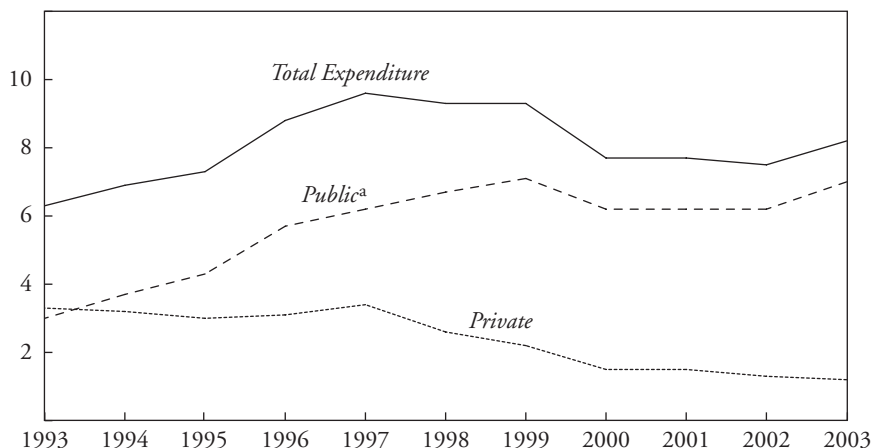
35. Local governments with negative current saving were allowed to borrow by pledging transfer receipts, and provisioning rules gave banks incentives to lend to them.

36. A revealing case has to do with the surcharge on gasoline. This 20 percent tax was first established in Bogotá, and later in Medellín. It was expected that these success stories would be replicated throughout the country. Local authorities, however, balked and instead lobbied their congressional delegations to pass national legislation—whose political costs fell mainly on the central government—making the surcharge mandatory.

37. Because of political pressure from FECODE, the powerful teachers’ union, transfers to education will receive an additional mark-up on top of the general mark-up.

Figure 6. *Colombia: Health Care Expenditure, 1993–2003*

Percent of GDP



Source: Authors' calculations based on Barón (2007).

a. Includes spending by ISS (Instituto de Seguros Sociales) and all other public sector social security entities.

distributing assignments, this has not happened, and the central government continues to pay for many responsibilities that presumably had already been devolved to subnational governments.³⁸

HEALTH CARE: WIDER COVERAGE, BUT COSTS ARE RISING AND QUALITY IS DOUBTFUL

Although the goal of universal health care coverage, originally set for 2001, has yet to be achieved, there has been huge progress: coverage has risen from 47 percent of the population in 1996 to 74 percent in 2005. The 1993 reform (enacted in Law 100) implied a rise in public resources devoted to health care, accompanied by a (smaller) reduction in private expenditure (figure 6). Early evaluations gave Law 100 high marks. Consumer satisfaction was high, and the World Health Organization ranked Colombia first among 191 countries with regard to fairness of contributions and financial risk protection (World Bank, 2003). The system's progressivity is also evident in the estimates of Lasso (2006).

This early success notwithstanding, it soon became evident that the health care system was costly and universal coverage elusive, and that further expansion of coverage would require a curtailment in the quality of service. Law 100 mandated

38. Notwithstanding the macro and financial problems associated with the decentralization process, it is important to recognize some important non-economic payoffs to the greater discretion granted mayors and localities in terms of security. For example, recent youth programs and anti-gang policies have contributed to the transformation of Bogotá. Similarly, resource transfers to localities may have helped in restoring greater social peace.

the shifting of subsidies from suppliers to consumers and established a precise schedule by which this should happen.³⁹ But the schedule was not met. The process of transforming the subsidies into demand subsidies gave rise to a vicious cycle, since payments to suppliers had to be maintained in order to assist the poor and the uninsured. This reduced the resources available to subsidize demand, which in turn hindered the enrollment of new members and consequently prevented a reduction in supply subsidies (World Bank, 2003; Gaviria, Medina, and Mejía, 2006). Although the number of potential users of supply subsidies fell by 54 percent from 1994 to 2000, resources devoted to subsidizing supply increased by 155 percent (Departamento Nacional de Planeación, 2002). These inconsistencies were compounded by the fact that closing an underutilized public facility is always a challenging endeavor.⁴⁰ With resources devoted to health care declining after 1997, and coverage increasing, expenditure per capita fell.

To address some of these issues, Congress in 2001 approved Law 715, which more clearly defined responsibilities and rationalized the distribution of transfers. Resources for insurance coverage are now distributed across regions, taking into account the number of beneficiaries and the estimated cost of providing the service. Resources for hospitals are estimated based on each department's number of uninsured. Departments are in charge of executing national policies, running the hospitals, and inspecting and regulating insurers; municipalities are entrusted with running the contributory and subsidized regimes, including selecting the beneficiaries of the latter.⁴¹

Compounding the problems stemming from poor design, there is ample evidence of system abuse. Being poor is not the only reason for being classified as Sisben 1 or 2 and eligible to participate in the subsidized regime. Individuals classified in levels 4 to 6 have also joined,⁴² and political patronage seems to have played a role (Gaviria et al., 2006). Sisben fails to expeditiously capture changes in a household's true condition. A 2000 review found that type I errors (failure to classify a poor household as such) happened 15 percent of the time, but type II

39. However, under the decentralization law (Law 60 of 1993), transfers to subnational governments to fund health care were conceived as supply subsidies, with departments entrusted with administering hospitals.

40. Law 100 had internal consistency problems. Although the idea was that there would be three main actors acting independently from one another (the insured, the insurer, and the service provider), in many instances the same entity acted as both insurer and provider, even though the integration was hardly justified on efficiency grounds. Departments, which own the public hospitals, have been involved in insurance activities. This has given rise to conflicts of interest, reduced competition, and impaired accountability, and has generated demand for providers that otherwise would have been redundant and should have been shut down.

41. In fact, only "certified municipalities" (those with 100,000 or more inhabitants) and smaller ones with a proven track record play this role.

42. Gaviria et al. (2006) estimate that in 2003 more than half of individuals classified as Sisben 1 or 2 were not affiliated with the system, whereas some 20 percent of those classified as Sisben 3 and 4 were.

Table 5. *Public Expenditure on Education in Selected Latin American countries, 1990–2004 Average*

<i>Country</i>	<i>Spending per pupil as percent of GDP per capita</i>	<i>Total spending as percent of GDP</i>
Argentina ^a	13.8	4.3
Brazil ^b	13.8	4.2
Chile	15.3	4.0
Colombia	18.4	4.7
Mexico ^a	17.5	5.1
Peru ^b	8.6	3.1

Source: Authors' calculations based on UNESCO data.

a. Data are for 1990–2003.

b. Data are for 1990–2002.

errors (erroneously classifying a nonpoor household as poor) occurred 25 percent of the time. Unfortunately, the changes that were introduced went in the wrong direction: although type I error was reduced, type II error increased (Peña and Glassman, 2004). The new methodology increased the share of people classified as Sisben 1 or 2 from 21 percent to 56 percent; the number of potential beneficiaries of the system—and other social programs—rose by 15.3 million. Not only is this fiscally costly, but resources will have to be shared among a larger pool of beneficiaries at the expense of the neediest, and perverse incentives to join the formal sector might have been introduced.

In addition, and although the health care law defined in precise terms how citizens may exercise their right to health care, judges have allowed citizens to claim that right under broader terms, and the Constitutional Court has upheld most of these interventions. Sotelo (2000) provides a long and astonishing list of the services that health providers have been forced to make available to patients.⁴³ In some cases the legal ruling explicitly states that the provider should be reimbursed by the government; in others the provider is left in the dark as to who will bear the costs of these expensive services.

EDUCATION: ENROLLMENT IS UP, BUT COSTS ARE UP EVEN MORE

Colombia now spends more per capita on public education than any other large country in the region (table 5). Public expenditure on education rose from 2.4 percent of GDP to 4.5 percent between 1990 and 2005.⁴⁴ There has also been a large increase in coverage, although following the 1999 recession, enrollment stalled at

43. One judge ordered a provider to perform a kidney transplant within forty-eight hours. There are instances of judges expanding the contents of the standard health plan by mandating payment for experimental treatments abroad. Recently, a provider was ordered to pay for dental care, a service not covered in the standard health care program.

44. Private expenditure on education amounts to 4.3 percent of GDP (World Bank, 2003).

Table 6. *Colombia: School Enrollment Rates, Selected Years*
Percent

<i>Year</i>	<i>Pre-primary, gross^a</i>	<i>Primary, net^b</i>	<i>Secondary, net</i>	<i>Tertiary, gross</i>
1991	13	69	34	14
1999	36	88	54	22
2002	37	87	55	24
2004	38	83	55	27
Average for Latin America and the Caribbean, 2004	61	95	67	28

Source: UNESCO.

a. Enrollees of all ages as a percent of the population aged 7 to 11.

b. Enrollees aged 7 to 11 as a percent of the population in that age range.

least until 2004 and is still low in comparative terms (table 6). A stock measure of educational attainment (years of schooling completed) also supports the view that Colombia has advanced but remains below the regional average.

Expanded expenditure and coverage have had good results in terms of equity. Data from the World Bank show that:

- Primary school enrollment increased somewhat between 1995 and 2000, but declined afterward. As a result, enrollment in 2005 was roughly similar to that in 1995. Interestingly, it was higher for the lowest quintiles in the income distribution.
- Secondary school enrollment increased throughout the period, and by far the most notable improvement was in the lowest quintiles.
- The bulk of the improvement in enrollment and attainment happened in rural areas and was biased in favor of girls.
- Lasso's (2006) study on targeting supports this favorable assessment: the two lowest quintiles receive two-thirds of public expenditure on primary education; the three lowest quintiles receive three-quarters of expenditure on secondary education. At the tertiary level the situation is reversed: over 70 percent of public expenditure benefits the two highest quintiles.

Enhanced education coverage constitutes progress toward a broader sharing of the benefits of reform. Yet the increase in public school attendance has not kept pace with the resources spent. In constant terms, public expenditure increased by 72 percent between 1996 and 2005, but the number of students enrolled rose by only 43 percent.⁴⁵ Furthermore, the quality of education is generally low, particularly in the public schools. Among schools reporting average results on the ICFES (a standardized test for high school seniors), the share with "low" results

45. These rates of increase in expenditure are almost twice as large if one takes the year before adoption of the 1991 constitution as the basis for comparison. Unfortunately, we lack access to reliable data on the number of students attending public institutions before 1996.

rose from 40 percent in 1986 to over 60 percent in 1999 (Fundación Corona, 2003). The 2005 SABER test portrays a similarly worrisome picture in language and math, nationally and across regions, for fifth and ninth graders.⁴⁶ Colombian students have not fared well on international tests either.⁴⁷ In 2003, 97 percent of students in the lowest income quintile who enrolled in primary school attended public institutions, while only 38 percent of children in the highest quintile did so. There is strong evidence suggesting that the quality of public education is lower than that offered by private schools, even after controlling for socioeconomic differences (Núñez et al., 2002).

Public school teachers are part of the problem. The bulk of the rise in education expenditure following the 1991 boost to decentralization has gone to paying wages.⁴⁸ Although there are three types of teachers—municipal, departmental, and national (some 80 percent of public sector teachers were employed by the central government in 2000)—the wages of all are centrally determined. Given that most resources come in the form of transfers from the central government, the level of government that administers the teacher roster is not the same level that negotiates wages and pays for them. Moreover, Law 60 determined that transfers should be based on the number of students and teachers *as of 1993*. This has perpetuated inefficiencies and kept in place whatever inequalities may have existed then. In 2001 Law 715 brought about a major change, making transfers a function of the number of students, with actual costs taken into consideration. Still, with wages set through centralized bargaining and with transfers paying for most of the wage bill, the incentives for a governor to transfer teachers to places where they are most needed do not seem particularly strong.

Until 2002, teaching activities were governed by a 1979 statute that created a ranking of categories in which time in grade and skill upgrading were the main determinants of promotions, together with other incentives that were prone to abuse. Although the 1994 General Education Law established a system to develop procedures to evaluate teachers, it was only in 2002 that a new statute, applicable to those hired *after 2002*, was enacted. It introduced teacher evaluations both for those entering the system and for those remaining and being promoted. Some 274,000 teachers out of a total of around 426,000—295,000 of them in the public schools—were evaluated in 2005.

46. Scatterplots (available upon request) with data for all thirty-one departments and special districts suggest no discernible association between the 2005 SABER test results and regional GDP.

47. In the 1995 math and science TIMSS exam, eighth and ninth graders ranked next-to-last among forty-one countries assessed. Colombian students ranked twenty-ninth out of thirty-five countries participating in the 2001 PIRLS reading literacy test. On a positive note, students now routinely participate in international evaluations, including the 2005 PISA exam administered by the Organization for Economic Cooperation and Development and in the 2006–07 versions of TIMSS.

48. Current expenditure (mainly wages) represented 92 percent of total expenditure on education in 1990–94 and 97 percent in 2000–05. Public teachers not only enjoyed a privileged pension regime; they also received some of the most generous wage adjustments.

Regional and national authorities have embarked on efforts with the private sector to enhance enrollment and increase the quality of public education. Because of supply limitations in the public sector, using public resources to take advantage of private sector installed capacity has been a wise move. Recent initiatives include the PACES program at the national level (1991–97), in which poor children were randomly given vouchers to attend private schools; ongoing concession schools in Bogotá and other major cities; and the Escuela Nueva program in rural areas. All have received positive evaluations.⁴⁹

Some Proposals for Further Strengthening the Foundations for Growth

We have attempted to show throughout this chapter that although several of the reforms undertaken since 1990 strengthened some of the foundations for growth, other reforms had unintended consequences (see table 3). One of the most salient examples is fiscal decentralization, particularly of expenditure on health and education, which had adverse effects on macroeconomic stability, even if it contributed to broader sharing of the benefits of growth. A similar judgment can be made with regard to judicial reform, where the welcome expansion of access to the justice system came with a high fiscal price tag. Likewise, several reforms—to health care and pensions, for example—as well as restrictions from the local environment emanating from the political system and the justice system have been conducive to high and distortionary taxes on business and labor, which have weakened competitiveness.

The past eight years have been devoted to making many of the reforms consistent with the goal of restoring fiscal sustainability, which is now widely understood to be a prerequisite for sustainable growth, and to avoid the spikes in poverty associated with sharp economic contractions. The fine tuning of the reforms to make them fiscally sustainable has included elements geared toward correcting design flaws that might have prevented the reforms from fully delivering on their objectives. But much remains to be done. In what follows we offer several recommendations for enhancing the quality of certain reforms, giving particular attention to identifying the political and institutional constraints that have to be dealt with to make the suggested changes feasible.

Removing Constraints from the Local Environment

THE JUSTICE SYSTEM

No other single reform seems as important as a fundamental review of certain aspects of the *acción de tutela* and of the way the Constitutional Court operates. Although citizens' right of access to the justice system must be upheld, it is also of

49. Angrist, Bettinger, and Kremer (2006) evaluate PACES, and Barrera (2006) the Bogotá concession schools.

paramount importance to curtail the system's ability to tamper with economic policy matters in general and with macroeconomic stability in particular. Yet it is difficult to envision a more complicated task, as these are two enormously popular institutions, and the Constitutional Court is itself the final arbiter of any proposed change. The challenge is to creatively provide incentives for the highest court to entertain some of these proposals.

- *Appointments to the Constitutional Court.* Given how the court is organized and how its justices are chosen, the latter face much the same incentives as politicians. There are nine justices on the court, each elected by the senate for a period of eight years, without the possibility of reelection. The senate chooses from groups of three candidates proposed by the executive, the Supreme Court, and the Consejo de Estado.⁵⁰ After their term, justices face almost no restrictions on their involvement in politics, and indeed several have launched political careers. Some commentators have proposed that the justices be given life tenure and be nominated by the executive and confirmed by the senate (Kugler and Rosenthal, 2005). We believe a less ambitious proposal would stand a better chance of passage: there should be a "cool-off" period of, say, five years before a justice may run for elected office; in exchange for this concession, tenure on the court could be extended to, say, twelve years.

- *The tutela and "fundamental rights."* In the current debate, economists generally argue that justices should interpret and uphold the constitution rather than rewrite it, whereas the legal profession believes justices may proclaim any right as "fundamental." Common ground on this issue has yet to be found. An avenue worth exploring, therefore, is one put forward by former associate justice Uprimny (2001), who believes that Colombia's level of development should inform Constitutional Court rulings. In his view, some rights should be achieved progressively, over time, rather than immediately. He proposes a consensual definition by all powers of what should constitute an adequate health care plan, so that judges will no longer uphold *tutelas* demanding services beyond what the plan includes. The content of such a program should be enhanced as the country becomes wealthier.

- *Prior constitutional review.* There is evidence that the existing political process routinely produces low-quality legislation. Breaches of procedure often occur, which then become grounds for the Constitutional Court to overturn a law. The court should review laws as soon as they are approved, so that if they are to be overturned on procedural grounds, this is done before they become operational.

THE POLITICAL SYSTEM

Additional work is needed to ensure that the goal of political inclusion is made compatible with a legislature that can deliver high-quality public policies in such a manner that one foundation for growth is not strengthened at the expense of

50. Although terms are not concurrent, in 2001 seven out of nine justices were replaced at the same time.

others. Although 20 parties is a much more reasonable number than 322, it is still too many. To be sure, the biggest challenge is to translate the decline in electoral fragmentation into effective cohesion *within* Congress. We offer the following recommendations:

- *Foster additional electoral consolidation.* An obvious step is to gradually increase the threshold for winning representation, from 2 percent up to perhaps 5 percent.

- *Promote stronger political parties.* Campaign finance reform should identify ways to strengthen the links between a member of Congress and his or her party. Public and private funds should go to the party rather than to the candidate. Also, a *ley de bancadas* with more teeth should be enacted, particularly to ensure that the law rather than the party determines the proper sanctions for free-riding members of Congress.

- *Enhance legislative efficiency and transparency.* Kugler and Rosenthal (2005) argue in favor of granting fast-track authority, whereby the president could submit to Congress nonamendable propositions on urgent economic matters for an up-or-down vote. This might be a good mechanism to avoid the watering down of legislation, a recurrent problem in the case of laws related to taxes. The proposal's feasibility would be enhanced by a "sunset clause," so that the authority expires after a set number of years if Congress chooses not to renew it. Transparency would be enhanced if congressional voting were made by roll call and public, except perhaps on issues related to objections of conscience.

Enhancing Labor Flexibility, Promoting Formalization, and Increasing Pension Coverage

Colombia must persist in the elusive goal of enhancing labor market formalization, so as to *enhance competition* and ensure that all workers, not just those currently in the formal sector, *share in the benefits of growth*.⁵¹ Here two constraints seem insurmountable, at least in the short term: high contributions to the funding of health and pensions, and full indexation of the minimum monthly salary. It is therefore essential to reduce nonwage labor costs other than social security contributions (contributions to ICBF, SENA, and CCFs). This is no easy task, given that together these programs administer resources that amount to 1 percent of GDP. In all three, unionization is prevalent, and they are backed by powerful political actors and provide employment to some 25,000 people (Echeverry and Santamaria, 2004). At first glance the solution seems simple: finance ICBF and SENA through user fees or the budget, and end the public funding of CCFs. In fact, this was one of the recommendations of a recent task force on public spend-

51. Bustamante (2006) estimates that 21 percent of the Colombian labor force was affiliated with the pension system in 2002, with 89 percent of affiliates coming from urban areas and a similar percentage from the top three deciles of the income distribution.

ing. The government, however, caved in to pressure from interest groups, who argued that if ICBF and SENA were to be funded out of general taxation, their existence would be a matter of debate during each budget cycle. Therefore second-best options have to be considered. We propose the following:

- *Earmark revenue from general taxation to ICBF and SENA.* Funding would preferably come from the VAT, rather than surcharges on formal sector wages. Although revenue earmarking is generally a questionable practice for several reasons, when it is unavoidable it should at least apply to less distortionary taxes.

- *CCFs should be financed through user fees,* particularly given that informal sector workers do not benefit from them. The move away from a tax on labor would be gradually phased in. The reduction in public financing of the CCFs should start by relieving them of the public policy tasks they now administer, such as the unemployment insurance program, which should be run by the government if it is indeed maintained at all.⁵²

Promoting Financial Sector Deepening and Access and Further Developing the Capital Market

The following reforms of the financial system and the capital market would contribute to a *broader sharing of the benefits of growth* throughout the economy:

- *Adopt a more liberal policy with regard to the usury interest rate and a less restrictive definition of microcredit.* Although it is politically impractical to try to eliminate the usury rate, the executive has ample room to make it less restrictive.

- *Strike a better balance between creditor and debtor rights.* The legal system should facilitate the structuring of guarantees by removing restrictions on the assets that can serve as collateral, and foster the unification and updating of registries. Expedient legal and paralegal procedures that speed the execution of guarantees should be put in place.

- *Provide incentives that promote the expansion of data bases,* once the Constitutional Court upholds the “habeas data” law. Utility companies should be allowed to report to credit bureaus the (generally favorable) information they have on their subscribers.

- *Better regulate AFP investments.* Regulations have skewed investments toward public debt. As proposed by Laserna (2007), AFPs could be required to maintain a minimum degree of diversification. Given the long-term nature of their liabilities, they should be matched to long-term assets such as investments in infrastructure (Asociación Nacional de Instituciones Financieras, 2007). A plausible way forward is a scheme in which each AFP defines a reference portfolio against which its performance can be assessed.

52. The World Bank (2005) raised concerns with regard to conflicts of interest involved in CCFs administering the unemployment insurance program, and it questioned the merit of focusing this insurance on workers previously employed in the formal sector.

Designing a More Business-Friendly Tax Code

On no other topic does there seem to be greater consensus than with regard to taxes, and this is not the place to repeat the specifics of what a “good” tax system should look like. The problem is not with the “what,” but rather the “how.” To be sure, a less fragmented Congress should be of much help, as it would allow the executive to negotiate the reform with a few strong parties rather than with each member of Congress individually. Also, the administration has to negotiate from a position of strength. In our view a structural tax reform should be submitted only in the context of a buoyant fiscal situation, so that the executive can propose *improving* the tax code while at the same time *reducing* the overall tax burden. A fairer and more business-friendly tax system would contribute to *strengthening competition* in the economy.

Clarifying the Distribution of Responsibilities among Levels of Government

Putting in place a decentralized political system in a country with a long tradition of political and fiscal centralization has proved to be a challenge, and any further effort in that direction is bound to confront risks and costs. The changes introduced in 1997–2003 have addressed many of the problems that followed the 1991–93 reforms. One key issue, however, remains unresolved, namely, the delegation of responsibilities. Given the lack of a well-developed framework on territorial organization—Congress has never passed a territorial organization law—efforts to devolve responsibilities have become bogged down in details.⁵³ Behind the label “public expenditure” stand all the intricacies of the business of providing public goods, particularly in the areas of health and education. There are many actors, among whom teachers are the most visible, who benefit from duplicate expenditures and from ill-defined responsibilities.⁵⁴ Without such a framework, full devolution will take a long time, and many of the benefits of decentralization for the *broader sharing of growth* and *equality of opportunities* will be delayed, and *macroeconomic stability* will continue to be undermined. Inasmuch

53. The lack of a well-defined framework for devolution of resources and responsibilities has also made it all but impossible to entertain the possibility of sharing tax bases among levels of government, thus establishing a constraint on allowing subnational governments to have an important say on tax issues.

54. An influential senator recently argued that “. . . a Congress with regional and national representation is in no position to approve a substantive law that affects regional interest with regard to territory, financial resources and responsibilities” (Pérez, 2006, p. 76, our translation). Soon after Congress approved Law 715, in 2001, the secretary general of FECODE wrote an interesting piece objecting to the new framework for decentralization (Arroyave, 2002). What emerges clearly from this document is the opposition of teachers to the decentralization of education. The document complains that “the [central government] will no longer administer nor provide educational services”; that “headmasters will be made responsible for the quality of education”; and that “the regional reallocation of teachers is now at the discretion of each [subnational government].” The conclusion that we reach is that FECODE opposes decentralization because the union stands to obtain better working conditions under a centralized decision-making process.

as many local public goods are provided by the central government, subnational governments do not face a hard budget constraint; to instill discipline, therefore, the central government must have an important say in how expenditure is undertaken. Local governments are more accountable to the central government than to their constituents, and voters hold the central government accountable for problems with the provision of public goods, and they react by demanding more resources from it.

Attempts at correcting the health care system's structural flaws should address three issues: generating adequate incentives at the subnational level, improving targeting, and setting limits on the health care rights of individuals (as discussed above in reference to the Constitutional Court):

- *Increased accountability at the local level is a must.* With the central government providing most of the resources, local authorities face weak incentives to enhance the efficiency of their health care institutions. Instead of being driven out of the market, inefficient providers are kept in operation and become a fiscal burden. In the end, the question boils down to enforcing responsibilities acquired by the governors. Public hospitals must be placed under close supervision to pinpoint and correct efficiency problems and to avoid capture by elites through corruption.

- *Improving targeting systems is key for the sustainability and effectiveness of the subsidized regime.* Aside from creating a fiscal burden, flawed targeting is detrimental to the quality of the assistance provided. Although it would be costly and technically demanding, an upgrade to the Sisben targeting system that allows households who have overcome poverty to be removed from the system should be a priority. The long-run cost of doing so will be far less than that of subsidizing the nonpoor.

- *Strengthen incentives to improve the quality of public education.* Recent notable efforts to this effect—including with regard to the evaluation, training, and promotion of teachers; a better formula for distributing transfers; and the involvement of private schools in the provision of public education—can be constrained by the fact that most teachers are paid at the national level, thus limiting the extent of devolution and enhancement of responsibilities and accountability at the local level.

Concluding Remarks

In 1990 Colombia embarked on a comprehensive reform program that should have had a positive impact on the foundations for growth, making economic growth both fiscally as well as politically sustainable. We have shown that the initial drive for reform failed to deliver on many of its expected promises, and a number of reforms actually weakened some of the foundations, in particular Colombia's long-held adherence to macroeconomic stability. The 1990s were thus

a decade of unfulfilled promises. Starting in 1999, the reform agenda was reinvigorated, and many of the design problems of the initial reform drive have been addressed. This process, coupled with a benign external environment and a much-improved security situation, has of late produced enormous benefits in terms of economic growth and a renewed decline in poverty. The job is far from complete, however, and in many areas additional reforms need to be undertaken in order to make growth sustainable and even more inclusive. In this chapter we have offered policy recommendations along many dimensions, taking care to acknowledge that what is technically advisable is not always politically or institutionally feasible.

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