



# **Institutional Reforms in Colombia**

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**Revised version, November 2000**

## **INSTITUTIONAL REFORMS IN COLOMBIA**

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### **Preface and Acknowledgements**

This document summarizes the results of a team effort of Colombian and international economists and political scientists. Members of the group of authors are: Olga Lucia Acosta, Alberto Alesina, Ulpiano Ayala, George Borjas, Alberto Carasquilla, Juan Jose Echavarría, Maurice Kugler, Steven Levitt, Roberto Perotti, Gerald Roland, Mauricio Rubio, Howard Rosenthal, Roberto Steiner, Juan Gonzalo Zapata.

These teams of authors produced the following eight papers:

- O. Acosta and G. Borjas "Public Education in Colombia"
- A. Alesina, A. Carasquilla and J.J. Echavarría "Decentralization in Colombia"
- A. Alesina, A. Carasquilla and R. Steiner "The Central Bank in Colombia"
- U. Ayala and R. Perotti "The Colombian budget process"
- M. Kugler and H. Rosenthal "Checks and Balances: An assessment of the institutional separation of political power in Colombia"
- S. Levitt and M. Rubio "Crime and crime prevention in Colombia"
- R. Perotti "The provision of social services in Colombia"
- G. Roland and J.G. Zapata "Colombia's electoral and party system"

Each paper contains specific proposals and the present document is based upon them. While this overview reflects very closely the spirit of the underlying nine chapters, I do not expect any single author of the background papers to necessarily agree with every line of this final report, nor they bear responsibility for it. The present report is synthetic and compact and meant to summarize the proposals. Readers interested in more justifications of the proposals, data, background material, supporting arguments and references should consult the underlying chapters, which can be obtained as working papers from Fedesarrollo and will be published as a book. These papers are available in both Spanish and English. Sometimes I used sentences taken verbatim from the background chapters. In order to avoid making this document heavy with references, I did not keep referring to the underlying chapter explicitly. It should be understood that the entire credit goes to the authors of the papers.

This project would have not been possible without the full commitment of Fedesarrollo Juan Jose Echavarria believed in the project from the very beginning and took risks to push it forward. In addition to his contribution as one of the authors, his energy, optimism and good spirits were essential. Maria Mercedes Carrasquilla is the «hero» of the project. I have never met somebody so efficient, hard working, committed and enthusiastic. She was perfect. She covered an enormous amount of ground, from fund raising to organizing meetings, to finding data, to helping the authors in any humanly possible way. The entire project would have collapsed without her. I am also very grateful to Mauricio Rubio, Roberto Steiner and Juan Gonzalo Zapata, for very useful comments on a first draft of this introductory chapter. Several individuals helped with comments and data in the individual chapters. We are all very grateful to them; their names are acknowledged in the specific chapters. For financial support we are very grateful to: The Inter American Development Bank (Country Division 5 - Region 3 (RE3/OD5)), The Tinker Foundation, The Trust Fund for Belgian Consultants of the IDB, the Italian Individual Consultant Trust Fund of the IDB, the Central Bank of Colombia, the Ministry of Mines of Colombia, and The National Planning Department of Colombia.

## **I. Introduction**

Colombia faces a critical juncture in its recent history. One road leads to violence, chaos and economic collapse. The other leads to peace, reforms and economic progress. Hoping that the second road will be chosen, this document offers ideas about institutional reforms and governance.

The need for institutional reforms in Colombia is quite self-evident. Violence, crime and terrorism are rampant; the "social contract" is threatened. The Judicial system is incapable of effectively persecuting crime, while at the same time the Constitutional Court is too "pro active" in economic areas better left to the market or policymakers. The parliament is fragmented, subject to a myriad of lobbying pressures and its relationship with the government is strained. The traditional macroeconomic stability of Colombia is threatened by institutional shortcomings. In fact, the process of decentralization has led to large fiscal imbalances and inefficiencies in the central/local government relationship. The budget process is chaotic and non-transparent. Improvements in the development of social services and poverty reduction programs are still lacking because of an inefficient use of limited resources. Monetary and financial stability require a firmer commitment to inflation control.

Many of these problems are common to many developing and industrial countries. However, the combination of all of the above has lead Colombia to the brink of collapse. No one should expect that only with institutional engineering one can enforce good policies and achieve peace and progress: individuals, not institutions, make policy decisions. However, one can ask from institutions to avoid creating obstacles for well-intentioned policymakers to achieve the desired good outcomes, and conversely, to create obstacles to corrupt, self-serving, and short termist policies.

We tried to suggest ideas which were politically feasible and required the minimum amount of legislative transaction costs. A formidable obstacle to this goal is the fact that the 1991 Constitution is very detailed in its prescriptions and the Constitutional Court has been very active in enforcing various constitutional articles. The consequence is that, more than in other countries, many, even relatively small changes of economic institutions or even of economic policy require a Constitutional change.

This document is organized around "political" and "economic" institutions. We begin with the former, with a discussion of the role of the judicial system and of the separation of power followed by the electoral law and structure of parliament; and a discussion of crime prevention and criminal justice system. We then move to economic institutions; we focus on those that have to do with the bureaucracy and provision of social services; monetary and fiscal institutions, namely the Central Bank, the budget process and, especially important, the local/central government relationships.

## **II. Political institutions**

### **A. Introduction**

A student of the political institutions of Colombia is immediately struck by several anomalies. Colombia has two parties which are virtually indistinguishable, that often share government responsibilities; an extremely fragmented parliament composed by innumerable "lists" of candidates; a conflictual relationship between the executive and the parliament; Constitutional Courts that are very active in applying and interpreting a very long, verbose and interventionist Constitution.

In fact, most of the current political institutions are born in the 1991 Constitution. This document includes many detailed articles and, in addition, leaves room for active interpretation from the

Courts. A particularly egregious example is the article that prescribes «equal treatment» for all. This principle could be seen as a generic statement but has often been interpreted by the Court in a very interventionist and pro active ways that has interfered in economic matters better left for discretionary policymaking. The electoral system has made quite easy for "local" lobbies to find a voice in the parliament, in fact a very small number of strategically placed votes can "buy" a seat. Finally, the relatively small ruling class of policymakers and technocrats in administrative position raises a critical issue of separation of power and checks and balances as well as representation.

Some of these institutional features are "old" and explain some "historical" features of Colombia, such as a difficulty in governability. Others are new, like the 1991 Constitution, and are more directly responsible for the emergence of more recent problems, such as fiscal imbalances.

## **B. Checks and balances<sup>1</sup>**

### **1. The issues**

The 1991 Constitution has vastly rewritten the Colombian institutional structure. One of the goal of a Constitution should be to create a system of institutional checks and balances in order to promote at the same time a chance for the executive to govern, at the same time guaranteeing the rights of the minority and the rule of law. The 1991 Constitution indeed makes progress in this direction, but not enough. Colombia is still governed in a manner that is both unchecked and unbalanced.

The 1991 Constitution resulted from a negotiation to resolve internal conflict. It is a document of rigid micromanagement (such as mandating indexation of pensions, setting specific targets for inflation and the allocation of regional public expenditures) rather than one that establishes basic institutions for democratic decision-making in a dynamic world. In addition, the Constitution promises too much to too many citizens as if Colombia could create the welfare state of an advanced industrial country. For instance, chapter II, Article 1, "Economic, Social and Cultural Rights," creates high expectations for groups in society such as the handicapped, children, and senior citizens. But Colombia, with a per capita income of US\$2600, cannot possibly emulate Sweden or Canada or even the US. For example, the US Constitution asserts only that it seeks to "promote the general welfare," rather than making specific "promises" to various groups. In addition, an overemphasis on egalitarianism can be counterproductive. For example, Article 58, which permits uncompensated expropriation for reasons of "equity", can be a substantial deterrent to foreign investment.

These declarations about the rights to welfare and equality are not only words on paper. In fact, the Constitutional Court has often intervened in these matters with ruling about issues which, in other countries, are left to normal legislation. Furthermore, the Constitution gives private individuals standing to contest legislation directly with the highest courts in the land. As a result, almost all legislation can potentially be challenged in court. The Constitutional Court is free to pick and choose among the complaints and often, some laws are overturned on procedural grounds.

A second issue concerns the executive-legislative interaction. There has been often a tension between these two institutions. Because of its fragmentation, lack of party structure and clientelism, the legislature has often failed to be a channel of grass root representation and a "check" on executive power. As we discuss in the next chapter, the electoral system has contributed to this situation.

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<sup>1</sup> This section is based upon M. Kugler and H. Rosenthal "Checks and Balances: An assessment of the institutional separation of power in Colombia".

Partly as a result of the poor functioning of the legislature, the executive has enjoyed a large amount of discretion and often bypassed the legislature. This has been achieved by repeated declaration of "states of emergency," a situation in which policymaking can be very centralized. In other words, the system of checks and balance between the legislature and the government does not work well. A combination of legislative action and court rulings, often make executive action ineffective. On the other hand, the executive reaction is to infringe legislative perspectives, least temporarily.

Finally, it is worth noting that the institutional structure in Colombia has not been very stable. Since independence in 1810, there has been drastic Constitutional changes in 1821, 1848, 1863, 1886, 1910, and 1991. There have been periods of two-party consensus, as in the National Front, as well as winner take all arrangements, with widespread redistribution of political control from the losing party to the winning party. Moreover, there were periods of military rule and also one-party dominance.

## **2. Proposals**

Successful democracies have adopted very different institutional settings, and the same is true for less successful ones: the «ideal» institutional arrangement does not exist. There is trade-off between alternative goals that can be achieved by different institutions. In addition, how these trade-offs might play out in practice in a specific case, it is often hard to predict ex-ante with absolute precision. Having said that, it is pretty clear that democratic institutions in Colombia do not work well enough and do not provide an appropriate system of checks and balances. The underlying motivation of the following proposal is to suggest improvement on the current system without revolutionizing it.

### **a. Proposals concerning the courts**

- Make the hierarchy of decision-making across the three systems of courts (Constitutional Court, Supreme Court, and Council of State) extremely clear, such that decisions may be appealed upwards in the hierarchy and such that decisions of a higher court in the hierarchy are binding on courts lower in the hierarchy.
- A supermajority vote of 7 of the 9 members should be required for the Constitutional Court to overturn a law passed with the agreement of the President and Congress.
- Modify article 253 of the Constitution to make members of the Constitutional Court, the Supreme Court, and the Council of State life appointees.
- Modify articles 231 and 239 to have judges in the high courts nominated by the executive and confirmed by the Senate. In article 240, eliminate the prohibition of holding another high court judgeship within one year of appointment to the Constitutional Court.
- Within the court hierarchy, create specialized courts for economic matters, such as taxation and bankruptcy.

The motivation for these proposals is to make Constitutional courts more politically independent. At the same time, the second point makes it more difficult for the Courts to be excessively proactive in economic matters. The last point reinforces this idea by creating specialized courts for specific technical economic and financial matters.

**b. *Proposals concerning the executive-legislative interaction***

- Modify articles 154 and 163 to give the president "fast-track" powers to submit unamendable propositions for urgent matters of economic policy to the Congress.
- Eliminate secret voting in both Congress and the three high courts except on matters relating to organized crime and guerrillas activity.
- Revise Article 171 such that the size of the Senate is reduced from 102 to 51 members.
- Revise Article 176 such that the size of the Chamber of Representative does not increase from its present size of 165.

These proposals, coupled with those discussed below on the electoral law have two objectives. On the one hand they attribute to the executive a Constitutional way of having «fast track.» This should avoid the declaration unchecked «state of emergency.» The reduction in size and elimination of secret ballot in the legislature may help reducing the clientelism and fragmentation which is rampant in this institution. Reinforcing the party structure would also go a long way in this direction. This is a main objective of the proposals for reforms of the electoral law discussed in the next section.

**c. *Referendum***

- Private citizens collecting signatures of 5% of the electorate can propose national referenda on legislation and Constitutional changes (at present, article 375 allows citizens only to propose changes to Congress).

**C. Electoral law and the parliament<sup>2</sup>**

**1. The issues**

The Colombia bi-cameral legislature is characterized by an extreme degree of fragmentation. Although only two parties exist, various lobby groups compete within each party and, as a result, it is often difficult for the legislature to produce laws which pursue the general interest, rather than a compromise between competing lobbies. To be fair, many legislatures have this problem, but the Colombian case has some peculiarities. In Colombia, parties do not have control over their party labels, and different lists can compete within the same party. Needless to say, the party organization has virtually no control and ways of disciplining or coordinating the activities and behavior of party members in the legislature.

The proliferation of lists both in the house and in the senate and the ability of even quite small groups to elect a representative follows from the electoral system. Colombia has a LR (largest remainder) Hare system, which works as follows. In each district, seat quotas are calculated by dividing the number of votes by the number of seats. Seats are first allocated to parties according to integer multiples of quota's. The remaining seats are then allocated in order of the largest remainders. In practice, this system has worked in such a way that most seats are allocated by largest remainders, instead of

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<sup>2</sup> This section is based upon G. Roland and J.G. Zapata "Colombia's electoral and party system".

the quota, because of the fragmentation of lists. In fact, the larger the number of lists the lower the number of votes necessary to win a seat.

The 1991 Constitutional reform tried to tackle this problem by instituting a single national electoral district for the Senate. The purpose was (correctly) to encourage candidates to broaden their electoral platform and to rally voters in a nation-wide fashion, based on national issues, and to «include» minorities scattered around the country. However, that reform has failed. In the 1991 election in the Senate, the first to be held based on the nation-wide district, showed a decrease in the number of lists, decreased only slightly and the number of lists has steadily increased in 1994 and 1998.

Senators learned quickly that the old clientelistic equilibrium could be replicated even in the national district. Indeed, no representation thresholds were put in place to discourage small lists and the LR-Hare system remained in place encouraging fragmentation and election by largest remainders. The number of seats allocated by quota has steadily decreased and in 1998, only 5 out of 100 senators were elected by quota, all the others by remainder. The marginal price of a seat, calculated as the minimum remainder for which a seat was allocated represents roughly only 40% of the number of votes specified by the quota and was lower in 1998 compared to 1991 and 1994. Instead of trying to gather votes across districts as initially intended by the reform, seats are gained mostly by getting regionally concentrated votes.

The negative consequence of this fragmentation and of the low "price" (in terms of votes) for a candidate to win has been twofold. First a loss of legitimacy of many members of the House and of the Senate. Second, the emergency of a difficult executive-legislative relationship. In fact, because of the fragmentation in the legislature, the perception is that the only way govern effectively is to "bypass" the legislature. While a strong executive is essential in a well functioning democracy, and executive-legislature conflicts are common (even in the US), the situation in Colombia has vastly deteriorated, as discussed in the previous chapter.

## **2. Proposals**

The purpose of the following proposals is to reduce fragmentation in the legislature, increase party cohesion and increase legitimacy. However, when thinking about electoral reforms, it is important to keep in mind "feasibility" in two senses. One in terms of transaction costs and history. For example, it would be quite a task to transform the US into a parliamentary democracy given its tradition, history and institutional status quo. The second is that existing legislature would have to vote on a reform. Any electoral reform that would make current legislators unlikely to be reelected is likely to be defeated. The following proposal is relatively simple to implement but may have important consequences.

### **a. *A two-tier district system***

The idea is to keep the current electoral formula (LR-Hare) for the election of the Lower Chamber (House) but to transfer the above-quota residual votes of local district lists to a national "district". Those residual votes would be pooled together and allocated to the national party with which the list is associated. National parties would have control over the order of candidates in the upper-tier district. In other words, seats not attributed by local quota would be allocated proportionally to the national district lists. A threshold rule (as a percentage of the residuals) would determine what those national parties are.

The threshold limit is important, in order to avoid the same failure of the 1991 Senate reform. Even relatively low quotas would create a strong incentive for local politicians to "group" and severely

reduce the number of parties represented in the House. In addition to the electoral system, other reforms may improve the functioning of Congress, and make parties more cohesive.

***b. Move the presidential election to same month before the legislative election***

This reform may make the newly elected President less depended on local barons and the newly elected President may create a national "focal point" in the ensuing legislative elections.

***c. Reduction of a host of special privileges to congressmen***

This is of course, one of those changes that many legislatures would oppose, but it would increase legitimacy and voters' participation.

***d. Introduce automatic registration of voters***

Anything that increases voters' participation has the potential of reducing the extent of clientelism.

***e. Better definition of the relationship between the house and the senate***

Currently the impression is that the two legislative bodies essentially duplicate their functions. An extreme solution to this problem is to move to a unicameral system. This is probably a rather complex, costly and unlikely to pass reform. An alternative is to better define rules and division of responsibilities.

## **D. The judicial system and crime prevention<sup>3</sup>**

### **1. The issues**

Crime and violence is a major problem (perhaps "the" major problem) in Colombia. However, contrary to common beliefs, not every type of crime is uniformly high. In fact, the number of Colombians who are victimized by crime is high by international standards, but not out of line, if compared with other Latin American countries. This fact, however, hides important differences amongst different type of crime. Homicide rates in Colombia are among the highest in the world. At the peak in 1991, almost one in a thousand Colombians were murdered each year. The homicide rate in Colombia is three times higher than Brazil or Mexico, and ten times higher than Argentina, Uruguay, or the United States. Homicide rates reached a peak in the early nineties and then substantially declined. Today the number of people killed every year is about 60 per 100,000 as compared to 90 in 1991. While the homicide rate is extremely high by international standards, property crimes are not.

What are the possible explanations for the exceptionally high homicide rate? The first, obvious one, is the drug trade. There is overwhelming evidence that the drug trade encourages violence. Participants in the drug market, unable to legally enforce contracts and property rights, turn to violence and intimidation to accomplish these tasks. The illegality of drugs makes traditional forms of industrial competition like advertising and price cutting more difficult. In addition, the presence of this lawless sector erodes respect for the law among those outside the drug trade.

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<sup>3</sup> This section is based upon Steven Levitt and Mauricio Rubio "Crime and Crime Prevention in Colombia".

The period of sharply increasing homicide matches the time period in which the export market for cocaine was rapidly expanding and drug cartels were fighting for control of the markets. The two departments of the country with the highest rates are Valle and Antioquia, in which Cali and Medellin are respectively located. The homicide rates in these departments were four times higher than the median department over the 1990s. Another indication of the link between the drug market and homicides is that much of the drop in homicides since 1991 is due to reductions in Cali and Medellin, as a result of the dismantling of the traditional drug cartels<sup>4</sup>.

The second explanation is the lack of punishment of criminals. Colombia has both one of the highest homicide rates in the world and one of the lowest punishment rate. In the United States, an arrest is made and the defendant is brought to trial in 65 percent of murders, and a conviction occurs in more than half of all homicides. In Colombia, investigations are done in only 38 percent of homicides, and only 11 percent of homicide lead to trials. Convictions occur in less than seven percent of homicides in Colombia, only one-seventh of the rate in the United States. Average sentence length for those convicted of murder in the United States is about twenty years, of which about one-third of the time is actually be served. In Colombia, average sentence length is 14 years. There is no good information on the fraction of the sentence actually served. If one assumes that the fraction is about one-third, (which is probably an overestimate) combining the information on probability of conviction with average time served yields to a calculation of the expected time served behind bars per murder. In the United States, this number is 3.8 years, compared to 0.32 years - less than four months - in Colombia! Thus, effective punishment in Colombia is less than one-tenth that of the United States.

The best empirical estimate of the responsiveness of crime to punishment is that a 10 percent increase in punishment lowers crime by 2 percent. If this estimate is correct, then raising Colombian punishment to United States levels (which are similar to most European countries), would reduce Colombian crime rates by more than 50 percent. That would mean eliminating over 10,000 murders annually in Colombia.

The third factor often mentioned to explain homicides is the guerrilla activity. In fact, the link between the guerrilla activity on the homicide rate is weak. Looking across municipalities, areas with a guerrilla presence are no worse than the others, in terms of homicides. Those that did not have guerrillas in the early 1990s, but had guerrillas in 1997, actually see the greatest declines in homicide over the 1990s. Municipalities that never had guerrillas, or those that had guerillas both in early 1990s and in 1997, see smaller declines in homicides. On the contrary, there is, almost by definition, a very strong connection between guerrilla presence and terrorism and kidnappings, the latter used to finance the former.

An additional explanation often mentioned is that poverty and income inequality foster crime. This is not convincing. Concerning poverty, international evidence suggests that crime is actually higher in richer countries, even though this effect is due to higher reporting rates. As for income inequality, there is indeed a strong relationship between inequality and crime. However, income distribution is not especially unequal in Colombia relative to other Latin American countries. So, the exceptionally high homicide rate of Colombia cannot be explained by income inequality or poverty.

As the previous discussion suggests, the malfunctioning of the criminal justice system has a critical influence on the crime rate in Colombia. There is a large and growing discrepancy between crimes that citizens say they reported and those crimes officially recorded by the police. The number of cri-

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<sup>4</sup> The evolution of violence in Bogota is harder to explain even though public officials optimistically explain this fall with various "successful policies" that were undertaken from 1994 a careful time series analysis of weekly data suggests that this is not the case. See Paz Publica, "Homicidios en la Ciudad de Bogota" forthcoming.

mes which citizens say they reported to the police rose substantially between 1985 and 1995, from 941 to 1,296 per 100,000. Official police records, however, show fewer crimes (661 per 100,000 in 1985) than citizens say they report. Moreover, the official data actually shows a ten-percent decline in crime between 1985 and 1994. There appears to be little relationship between official police records and either victimization, or citizen claims of reported crime. Police records include less than half of the crimes that citizens claim to have reported.

The investigation of crime is also very poor. A striking figure is that the percentage of reported crime investigated is about 40 percent for each type of crime. In most countries, instead, this percentage is much higher for more serious crime, like homicide or kidnapping. Colombian authorities shy away from investigating the most serious crime. Crimes that are easy to solve, are investigated, the others are not.

## **2. Proposals**

### **a. *Informational gathering***

- Reporting/Statistical duties should be taken away from the agencies involved in the criminal procedures. This will include (1) the Police, (2) the Fiscalía, (3) the Juzgados and (4) the Prisons.
- There should be a regular (every 3 years) victimization survey representing the whole country, not just some urban areas.
- Much more information is needed about prisons. It is currently not possible to accurately determine the composition of the prisons by type of crime committed or the actual time served by inmates.

### **b. *Fight against corruption***

- Anti-corruption investigation/purge of the military like there was of the police a few years ago, with some external supervision.
- An externally supervised corruption/infiltration investigation in the Fiscalía. Since the fiscales are the critical link in bringing criminals to justice, progress in fighting crime cannot be made until improvements are seen here. Moreover, this is a basic preliminary step for reducing what, for some people, looks like a Fiscalía-military confrontation.

### **c. *Investigation and persecution***

- Establishment of a separate anti-kidnapping task force, made up of an elite group of fiscales who have proven themselves effective and non-corrupt. This group would devote 100 percent of their attention to investigating kidnapping incidents.
- The establishment of an elite anti-homicide task force, similar to that proposed for kidnapping. This task force would be charged with carrying out a serious investigation of every homicide that occurs. If the task force contained 1,000 fiscales, then there would be roughly 20 cases annually for each fiscal to investigate. Kidnapping and homicide task forces, whatever their size, should be completely isolated from congestion in other areas.
- Establish mandatory sentences to lessen the scope for corruption of judges and also to lessen the ability of judges to be intimidated by narcos or guerrillas.
- The safety of judges and prosecutors must be guaranteed. The government should provide twenty-four hour a day protection to judges and prosecutors working on cases dealing with

narcos or guerrillas. Extremely harsh mandatory sentences should be introduced for intimidation and crime against judges.

- Violent crime, especially murder and kidnapping, should receive an increased share of the police, fiscalia, and prison resources, even if this means devoting less resources to property crime
- Substantial increases in Colombia's prison capacity. It would not be unreasonable to build enough prison cells to hold 100,000 prisoners (compared to the current prison capacity of 28,000, and actual prison population of 40,000). Even with a prison population of 100,000, the number of prisoners per crime committed will still be very low by international and even South American standards.
- Steps must be taken to put the government - not the prisoners - in control of the prisons.
- Prisoners should be separated according to the seriousness of the crimes. Especially, guerrilla and paramilitary should be separated from the rest of the prisoners to avoid the spreading of conflict within prisons.

### **III. Economic institutions**

#### **A. Introduction**

By Latin American standard, Colombia has traditionally enjoyed macroeconomic stability, avoiding hyperinflation and the very large deficits common to the region. With long periods of moderate inflation and a relative fiscal balance, Colombia is (or was) considered a model of macroeconomic management for Latin America. Recently, with the much improved macroeconomic situation in the region, Colombia is becoming a "problem case". The appearance of budget deficits and of financial fragility has led to IMF intervention and international concerns.

Macroeconomic stability is only one pillar for economic development. The others are good infrastructures, well functioning markets, and an efficient bureaucracy. In addition, economic growth has to benefit the entire population and not a minority. Poverty reduction and, as much as possible, equal opportunities to all has to be a primary policy objective. In fact, income inequality is very high in many Latin American countries, even though Colombia is not the worst case, in this respect. However, in Colombia poverty reduction and better provision of social services remain a priority. In fact, there is no trade off between growth, poverty reduction, and macroeconomic stability. They are all part of the same virtuous circle. In addition, growth and poverty reduction are also the critical ingredient to bring the peace process to a success. In the next five chapters, we examine the institutional aspects of economic policymaking.

#### **B. Decentralization and fiscal federalism<sup>5</sup>**

##### **1. The issues**

The relationship between different levels of governments, (which levels should do what, which types of fiscal relationships should link them) is one of the most hotly debated issues in many countries and international organizations.

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<sup>5</sup> This section is based upon Alberto Alesina, Alberto Carasquilla, and Juan Jose Echavarria "Decentralization in Colombia".

According to some measures, Colombia has become the most decentralized Latin American country, amongst the non-federal ones (i.e. Argentina and Brazil); while the process of decentralization had started earlier, the 1991 Constitution has vastly accelerated the process. Tax collection remains vastly centralized, but spending is decentralized. This arrangement create risks of fiscal imbalance, since the level of government that spends, does not fully internalize the costs of its spending. However, in a country at the level of development of Colombia, many localities, especially in rural areas lack the ability to efficiently collect revenues. Thus, centralizing tax collection is a necessity. On the other hand, concentration of spending is rejected because localities should be able to allocate spending in ways closer to the population's needs and preferences. However, given the little discretion on how localities can allocate spending, it is not clear that this goal of the decentralization process has been reached. For example, about 80% of the fiscal allocation to departments and municipalities have to be spent on health and education. In addition, since (as discussed below) teacher's salaries (which are 80 percent of total spending in education) are decided nationally, localities have very little discretion. An additional argument in favor of centralization of revenues is that it allows for the redistributions of the tax burden across localities.

The separation of taxation and spending between different levels of government has indeed fueled severe problems of fiscal imbalance. A large fraction of departments and municipalities has accumulated large debts and operating deficits, and, as a result, the Central government has already intervened to bail out localities, with more bailouts still in the making. Certainly, Colombia is not the only country with this problem. The fiscal deficits originating the localities is an important issue for many industrial and developing countries in general and Latin America in particular. An additional problem stems from the fact that localities can borrow from banks, thus creating dangerous links between fiscal imbalances and financial stability of the banking system.

Given that the bulk of tax revenues is collected by the Central government, an important and politically charged issue is the allocation rule of these tax revenues to department and municipalities. The current rules are relatively complex (especially those for the municipalities). They take into account several parameters and indicators of relative income, the number of users of certain services, the composition of the population etc. These allocation rules leave no room for incentive schemes that may increase the fiscal responsibility of localities and their efficiency in the delivery of public services. In addition, how equitable these rules are is unclear.

Finally, the short horizons of mayors that cannot be reappointed for two consecutive terms make it difficult to implement long-term policies. Mayors have the incentive to spend, knowing that the tax burden is spread over the entire country and, also, will be felt after they leave the office.

## **2. Proposals**

The academic literature on fiscal federalism often suggests, amongst others, two general principles for enforcing fiscal responsibility and efficient use of resources for localities. One is to increase the ratio of local spending financed by taxes collected locally. The coincidence of taxation and spending for the same level of government obviously creates the "correct" incentives. The second is to link transfers from a higher level of government to the achievement of certain objectives, in terms of delivery of social services. In theory, these are two impeccable principles. In practice, their implementation in a middle income country is highly problematic. For a start, many municipalities and departments (especially the poorest ones) lack the technical competence to effectively raise revenues effectively. Second, problems of measurement of efficiency in the "delivery" of social services are quite difficult, and are likely to foster corruption and arbitrariness.

For these reasons we shy away from making these two rather "radical" proposals, because of difficulties of implementation. Nevertheless, we do think that several significant changes are necessary and feasible.

**a. *No local borrowing***

Department and municipalities should not be allowed to borrow, neither from the public by issuing bonds, or from private or public financial institutions, domestic or foreign. The only way in which a department or municipality should be able to spend can, in one year, more than its revenues (local taxes plus transfers from the central government) is to borrow from the following year transfers from the Central Government. The government should set a limit (say 5% of yearly transfers) for the borrowing against the following year allocation, and has the right to refuse "lending" even within this limit.

The motivation of this proposal is self-evident. The inevitability of Central Government bail outs creates incorrect incentives if localities can borrow from the market. An important caveat concerns public investment. Large investment projects may require multi-year financing. If the preceding budget balance rule left out investment from the rule, the main result would be a reclassification of many non investment spending items into investment. The discussion below on the budget process which follows below makes it clear how that has happened at the Central Government level, and it is a common phenomenon internationally. Large investment projects, particularly those involving several departments and municipalities should be financed and controlled by the Central Government.

**b. *Simplification of allocation rules***

Since it is infeasible that localities can raise their own revenues, a large fraction of fiscal transfers from the Central Government to the localities will continue to exist. The allocation rule of these flows must include some system of "weights" to different objectives. We do not want to choose these weights, a decision which is political and to be taken by the government and the legislature. However, we stress that the allocation rule has to be simple and transparent. These two features (clarity and transparency) will make it clear which are the weights given to different objectives and will make it more difficult to achieve "political deals" behind the scene.

An ideal rule should achieve three goals: return to the localities a certain fraction of the tax revenues generated by the region (the remaining fraction is kept by the central government); generate some redistributive flow from richer to poorer regions; allow for some reward for tax collection effort. We propose an allocation rule based upon the three principles above. The details of this scheme and computation of examples are described in the background paper.

**c. *Allow more flexibility in spending decisions***

If one of the goals of the decentralization process is to make public spending closer to the public's needs, increasing the freedom of choice of localities seem reasonable. In fact, a cynical observer may argue that the current arrangement allows localities to write "checks" but does not allow them to make any relevant policy decisions.

The increase in flexibility coupled with the balanced budget rule described above should not make the budget of localities less sound. In practice, this proposal implies reducing the shares of the budget allocated by law to certain use, and increases the "discretionary" share. Even with more discretion, the bulk of spending of local government will remain on health and education. See, however, the

discussion on social services below, which suggests that these two sectors are overextended, relative to other social services.

***d. Clarification of spending responsibilities***

Spending responsibilities between different levels of government need to be better specified to avoid duplication, waste, mismanagement and confusion. Lack of clarity often breeds corruption and rewards for individuals with better connection than can "navigate" the system. As we discuss below, the education sector is a prime example of this confusion. Currently, the same school may be financed partly by the central government, in part by a department and in part by a municipality. This creates confusion, duplications, and unfair allocation. It is imperative that spending responsibilities are redesigned in a coherent way. More discussions of this is in Chapter III. D.

***e. Allow reelection of mayors for two consecutive terms of four years each***

The current combination of a very short electoral cycle (3 years) and the "one term" rule, makes it for an exceptionally short horizon for mayors. The proposed changes appears more in line with international standards. It creates a sufficiently long political horizon for mayors and, at the same time, it avoids that excessively long tenures of office create entrenched interests and "local connections".

**C. The budget institutions<sup>6</sup>**

Budget institutions are all the law and regulations according to which budgets are drafted, by the government, approved by the legislature and then implemented by the bureaucracy. Before proceeding, it should be clear that there is little defense, procedural or otherwise, against a government that is determined to run a "bad" fiscal policy without opposition from Congress. Nevertheless, a well structured budget process can fulfill an important role in fiscal policy.

The rules governing the formation of and the dissemination of information on fiscal policy should achieve as least three goals:

- allow a government to run a "good" fiscal policy in a transparent manner;
- make sure that fiscal policy does not get out of control in the presence of shocks of moderate to large dimensions;
- allow a person with a moderate knowledge of economics and accounting to understand the main thrust of the fiscal policy package proposed by the government, and to compare it with previous years.

The last condition is especially important. Since there is no enforcement mechanism that can prevent a government from running a "bad" fiscal policy, only the market, and the public opinion can exert pressure on that government. Thus, the public should have a clear and transparent view of the fiscal policy run by the government. In Colombia instead, the preparation, discussion and implementation of the budget is not transparent. As a result, the average citizen, journalist and even a trained economist would have a hard time understanding the Colombian budget documents. In recent years, international

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<sup>6</sup> This section is based upon Ulpiano Ayala and Roberto Perotti "Budget Institutions in Colombia".

organizations have put a lot of emphasis on improving transparency: Colombia has a long way to go.

Several factors greatly contribute to a lack of transparency. First, is the multiplication of the budget documents. Several budget documents can be useful if they fulfill clearly differentiated functions, and if it is easy to go from one document to the other. Neither condition is satisfied in the Colombian budget process. For instance by art 13 EOP, the Budget must be consistent with the Plan Nacional de Desarrollo, the Plan Nacional de Inversiones, the Plan Financiero, and the plan Operativo Annual de Inversiones. A careful examination of these documents reveals that the requirement of consistency can be easily circumvented de facto, and, in some cases, even de iure. The proliferation of these documents (many of which have a multi-year horizon, coupled with a very loose enforcement of consistency) makes it fairly easy to find something for everybody in the budget. In addition, even though the Colombian Constitution attributes a strong role to the Finance Minister in the preparation of the budget, the multiplication of documents and agencies involved tends to obfuscate and reduce his role.

Second, is the definition and classification of investment spending. Investment is a magic word in the Colombian budget process (and it becomes even more magical when combined with "social"). This is largely a reflection of the emphasis on planning, of which investment is the key instrument, and of the populist bend of the 1991 Constitution. The assumption underlying all the budget documents is that only investment has any social value, all other expenditures are necessary evils. This, together with the prohibition to cut the share of social investment spending in the budget, is an open invitation to use a very liberal notion of investment, and one that is at odds with any conventional usage of the term in the macroeconomic and accounting professions. The Manual de Programacion de la Inversion Publica of DNP give such a loose definition of investment that very little exists that could not fit into it. Thus, the most important notion in the budget process becomes extremely difficult to interpret. Why is this latitude in the definition of investment dangerous? First, it prevents an understanding of the budget. Very little of macroeconomic significance can be inferred with the current use of the term "investment" in Colombian budget documents. Second, it undermines the comparability of different figures and budget documents: one is never quite sure what definition a budget document is using, amongst the many possible. Third, it invites creating accounting.

Third, the frequent use of non-standard accounting practices. Particularly troublesome is the inclusion of gross debt issues (both amortization and new) and of proceeds from asset sales and amortization as a "recurso de capital" (art 31 EOP), hence above the line. That is, the structure of the Budget presentation is:

Revenue = Current revenues + new emission of debt + proceeds for asset sales and privatization + other capital spending + other revenues

Spending = Current spending + capital spending + interest + amortization of debt

This classification hides the deficit. Properly speaking, the most common definition of the deficit is (see IMF 1999): New emission of debt - Amortization of existing debt + Proceeds from asset sales and privatization (plus some quasi-fiscal operations, of limited size).

Without a long and detailed analysis of both the revenue and spending sides of the budget it is impossible to form an idea of the deficit. In addition, without that, it is difficult to form an idea of the budget.

A fourth source of lack of transparency is the incomplete coverage of the budget. Ideally, the budget should cover the entire public sector, as prescribed by international standards, enforced, for instance, by the OECD. This is far from what happens in Colombia. Particularly troublesome is that not even the entire amounts of public pensions are covered in the budget.

Finally, two additional sources of confusion has to do with imperfect macroeconomic forecasts, and with the intertemporal links between budgets, namely arrears. Most governments have a tendency to manipulate forecast to "predict" the best fiscal outcome with the minimum effort. For instance,

GNP growth has been systematically overpredicted in the nineties. The treatment of the "quite large" areas needs to be improved.

In addition to the lack of transparency, the second major problem in the Colombian budget process is the excessive emphasis on planning. The fact that in a market economy there exists an important and powerful agency called the "Planning Department" is quite telling. There are several reasons why the emphasis on planning is counterproductive. First of all, the PND itself is a hodge-pot of good intentions, to which virtually all institutions and interest groups in the country contribute with their own preferred investment projects. According to the Constitution, the PND is elaborated by the Government with the "active participation of the planning authorities, the territorial entities, and the Government with the "active participation of the planning authorities, the territorial entities, and the Consejo Superior de la Judicatura". The Draft Plan must be submitted to the Consejo Nacional de Planeacion, which is formed by "representatives of the territorial entities, and the economic, social, ecological, community, and cultural sectors" (art. 320 Const.). To all this, one must add the Departmental Consejos de Planeacion, each of which elaborates their own Plan de Desarrollo. The separation of the investment part of the budget, controlled by the DNP and the rest of the budget reduces the centralization of the budget itself as a whole.

## **1. Proposals**

### ***a. Reduction of the number and consolidation of budget documents***

Ideally, the whole budget process should consist of just one document. But at the moment, there are large differences between the semi-accrual figures of the Budget and the cash figures imposed by reality, and it would not be realistic to impose a move to an exclusively accrual or cash basis. Hence, two documents are required: the Budget and a Plan Financero. The two documents should have exactly the same structure, and should provide a table of reconciliation. The Development Plan should be abolished.

### ***b. Colombia should adopt accounting standards strictly in line with international practice, such as those prescribed by the IMF***

One can also think about an "auditing" system, especially important in the transitional period, where an internationally respected private firms checks the accounting standards of the budget.

### ***c. The Budget should have as wide coverage as possible***

Ideally, one would like to include all the Territorial Entities and the rest of the Non-Financial Public Sector. There are obvious legal obstacles preventing this, but, unfortunately, the Colombian Budget does not even provide a complete picture of the Central Government. The budget covers only the fraction of public pensions: It should cover them all.

### ***d. The government should outsource its forecasting operation to internationally reputable private companies.***

### ***e. The budget for a given fiscal year must deal with appropriations that, for several reasons, straddle over different fiscal years.***

In recent years, these items have created considered problems to the management of fiscal policy. Improvements in accounting may help. The IMF Code of Good Practice on Fiscal Transparency

provides accounting procedures to provide reliable information on arrears, in order to improve transparency and to control them. Such data does not result from simple cash accounting and must be supplemented with modified accrual statements, such as developed by the International Federation of Accountants, IFAC.

## **D. The bureaucracy, civil servants and teachers<sup>7</sup>**

### **1. The issues**

Public spending in Colombia places a great emphasis on education. Teachers are the largest components of the public employee; currently in Colombia there are about 310,000 teachers equal to 26 percent of the total number of public employees. The public sector spends about 4.5 percent of GDP in education and about 70 percent of all teachers are in the public sector.

Despite this emphasis on public spending on teachers, several problems negatively influence the outcome of the education sector. The first one is a fair amount of confusion and overlap between different levels of government. The reorganization of the education system was developed in the context of a general decentralization of public administration. However, there has been confusion as to which level of government is best suited to administer the public education system. Law 29 of 1989 favored the municipalization of public education, but the 1991 Constitution emphasized the role of the departmental level. Similarly, Law 60 of 1993, which regulates the system of transfers of central funds to departments and municipalities, enhances the role of municipalities in the administration of public funds for education. In contrast, Law 115 of 1994, the General Education Law, responded to pressure from the teachers' union and assigned a greater role to the departments. As a result, there are three different types of public school teachers in Colombia: those funded by the central government, those funded by departmental governments, and those funded by municipalities.

The second problem is that teachers, thanks to a very powerful union, are on overly protected category that, by and large, receives a very favorable treatment both in terms of salaries and, especially, in terms of pensions. Note that the favorable position of teachers within the public sector is on top of a favorable treatment (by international standard) of public sector employees. Colombia has the highest public sector wage premium amongst Latin American countries.

The current regulations of the teaching profession in Colombia have their origin in an education statute (Estatuto Docente) promulgated in 1979, which specifies the norms that regulate the recruitment, labor stability, promotion, and retirement teachers. The statute, and particularly the way it has been administered, has introduced several inefficiencies into public education:

- Too much centralization: Teacher salaries are set by the central government, with little input from the regional government agencies that end up paying the bill.
- Inefficient appointment process: The Departments and the Municipalities can create temporary teaching positions. The provisions of the Estatuto Docente imply that these short-term positions eventually become permanent positions, putting additional pressure on the central government to increase its monetary transfers.

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<sup>7</sup> This sector is based upon: Olga Acosta and George Borjas: "Public Education in Colombia" See also the Appendix on the paper on decentralization.

- Ineffective disciplinary regime: The directives (rectors) do not exercise any disciplinary control over the teachers. The Estatuto Docente orders that promotions be determined internally within the magistrery, using a set of rules that are not always related to teaching activities.

The pension system of teachers is very generous, by comparisons with other categories. First, public teachers do not have to contribute to the funding of the system in order to receive a pension. Most non-teachers contribute 25% (13.5% is obligatory). Second, teachers qualify to receive the special pension (pension de gracia) at 50 years of age. Under the pay-as-you-go system set up by Law 100 of 1993 for non-teachers, the retirement age is 55 for women and 60 for men. Third, a different base salary is used to calculate the pension for teachers and non-teachers. The special pension is based on the basic monthly salary that the teacher had at the time of retirement, including bonuses and other benefits. In addition, the teacher's retirement pension is based on the average salary of the last year employed. In contrast, the pension benefits for non-teachers are based on the average salary in the last 10 years of the entire career if more than 1,250 weeks have been contributed. Finally, the pension regime grants teachers the right to receive several of these pensions simultaneously.

A third problem concerns the geographical distribution and allocation of teachers. The centralized seating of wages makes it difficult to let wages adjust to needs. In addition, teachers have a very low degree of mobility compared to other workers, in parts because they are, on average, relatively old.

During the nineties, the Colombia implemented major reforms in the education sector and substantially increased the amount of resources invested (from 3.1 percent of GDP in 1991 to 4.5. percent in 1997). What has been the outcome in terms of quantity and quality of education? It is still quite early to have a clear answer: the returns on human capital investment take decades to fully materialize in terms of more productivity and growth. Thus, it may be premature to cast judgement on this effort, but the initial results are mixed. Enrollment ratios in primary school have increased substantially in the nineties, even though they were increasing even before. Enrollment ratios in secondary schools have increased much less.

Measuring the quality of education is very difficult. The available international evidence suggests that Colombia ranks relatively poorly, but not extremely poorly, in terms of test scores, if compared with other countries with similar level of development. There is some evidence that the results on these standardized tests have slightly improved in the nineties. Whether or not the large investment in education in the nineties has paid off remains to be seen. However, too much of this effort has been devoted to increasing the salaries and pensions for teachers, a category which was already relatively privileged<sup>8</sup>.

Some specific reform initiatives seem to have had much success. One is the Escuela Nueva Program, adopted in the rural sector. Under this program, teachers have much greater flexibility in making their own decisions regarding the education process in their classroom. The curriculum is also more independently targeted to different students and stresses practical problem solving, so that it more easily engages the students. Parents are also involved through increased participation in school activities. It would be worthwhile to examine whether this type of program could be expanded to cover Colombia's public schools in urban areas.

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<sup>8</sup> See the Appendix of the paper "Decentralization in Colombia" for a discussion of measures of improvements in the quality of education in the nineties.

## 2. Proposals

### ***a. The hiring and salary decisions should be made by the same government jurisdictions***

This simple change in the «rules» would encourage those who make the decision of hiring a teacher to pay attention to the cost of the decision; as well as encourage those who set teacher salaries to pay more attention to the factors that determine how many and which teachers are employed.

### ***b. The government should allow nominal pay differences across regions to account for difference in the cost of living***

More generally, the policy of uniform wage should be abandoned to give localities more flexibility.

### ***c. In the context of a broader pension reform, the overly generous treatment of teachers' retirement should be brought in line with other categories of workers***

Reforming the pension treatment of teachers should receive the highest priority in any pension reform plan.

### ***d. Experiments like the Escuela Nueva should be supported by grants***

### ***e. A system of teachers' performance evaluation should be introduced. Salaries should reflect the results of these evolutions***

## E. Provision of social services<sup>9</sup>

### 1. The Issues

The Colombian Constitution (art 350) states that "public social spending will have priority over any other spending." But what is Social Expenditure? By art. 41 of the Estatuto Organico de Presupuesto, public social spending is "any expenditure whose objective is the satisfaction of unsatisfied basic needs in health, education, environment, drinkable water, housing, and those aiming at the general well-being and the improvement of the quality of life of the population". Thus, Colombia combines a very loose definition of social expenditure with a very strong constitutional mandate to protect it. The result is, inevitably, confusion.

A standard classification of social security services distinguish between social services (like education and health), social insurance (like old age and invalidity pensions and unemployment insurance), social assistance (cash transfers to the poor, family assistance benefits, maternity benefits, in kind transfers and employment generating programs).

Most industrialized countries have built their social protection systems around social insurance, leaving social assistance to pick up the uninsured who fell through the cracks and to subsidize large families and maternal leaves. There are three reasons why Latin American countries cannot aspire to the same structure of social protection. First, Latin American can rely only on much smaller reve-

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<sup>9</sup> This section is based upon Robert Perotti: "The provision of social services in Colombia".

nues. Second, because of the widespread rates of informality and of technical problems, it is difficult to keep track of the work and contributory history of individuals; in any case, few workers would have unbroken records of contributions. Third, for many poor individuals, it makes sense to stay out of an insurance system, even if subsidized: poor individuals have much shorter life expectancies, and they put a high premium on liquidity. On the other hand, the experience of industrialized and developing countries alike has shown that universal, untargeted social assistance programs can quickly become very costly, too costly for Colombia.

This leaves two more options: targeted social assistance, or social service spending. So far, Colombia has clearly chosen the latter, devoting a large fraction of its effort in health and education<sup>10</sup>.

One of the main arguments of this section is that given the limited amount of fiscal resources, this emphasis on health and education has left out of its reach large pockets of extreme rural poverty. Since it is hard to think of social objectives that do not include the welfare of the extremely poor, this calls for restructuring of social spending. More effort should be devoted to targeted social assistance programs.

As for the question of how to target, one has to keep in mind several considerations. The same objectives in terms of poverty reduction are achieved more cheaply: i) by targeting the very poor; ii) by reducing overlaps between programs; iii) by achieving organizational simplicity; iv) by a proper account of long-run sustainability: the long run costs of a program may be much higher than the initial costs, as membership increases toward its steady state.

Finally, a word on "community involvement" as a targeting device. This view has been very influential in Colombia, and in other Latin American countries. It has taken various forms: local residents initiate and even control the implementation of certain local services (e.g. child care centers in Colombia); they present the menu of projects for employment and housing programs; and they help locate the beneficiaries of targeted programs. Unfortunately, programs relying heavily on community involvement rarely reach the very poor. The very poor are exactly those that, for a variety of reasons, do not have the ability or the incentives to participate in the community initiatives. For instance, they do not have the financial means and the technical skills required to develop projects for local public employment programs; or they do not have the human capital to participate effectively in local debates and assemblies.

How effective has social spending in Colombia? Most statistical sources about poverty agree that poverty has been declining in the nineties, after a peak in 1991-92. Some sources (probably the most reliable) indicate that poverty reduction is only an urban phenomenon; on the contrary rural poverty is increasing. According to these sources, Colombia has one of the most skewed urban/rural distribution of Latin America. Other sources indicate a more uniform distribution of poverty. However, even with these imperfect data, it is almost certain that greater results in terms of poverty reduction can be achieved by targeting more the rural areas.

In summary the discussion and proposals that follows are driven by the general idea that Colombia has to refocus its spending priorities toward targeted social assistance programs that alleviate extreme poverty.

## **2. Proposals**

The task of examining shortcomings and making proposals for the entire social service sector is enormous. Nevertheless, the background paper underlying this section, has managed to touch a

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<sup>10</sup> See also the discussion of this issue in the chapter on decentralization.

remarkable number of issues with great care. The present summary only touches briefly upon not even all the issues addressed by the background chapter.

**a. Policy toward the elderly and the disabled**

It goes beyond the scope of the present report to fully discuss the pension system, currently under reform. It is important, however, to review what distributional flows are implied by the current system.

First of all, pensions in Colombia are very generous but have a very low coverage. Only about 2% of the population receive a pension, or 30 percent of the population over 60. However, average pensions are very high, about 2 times the GDP per capita. The pension system is based upon three pillars: The first is the state-run defined benefit pension scheme (or Prima Media). The second is the private sector, defined contribution system of AFP's, Chilean-style. In contrast to other countries, like Argentina, these two pillars are mutually exclusive for an individual. Together they make up the "social insurance" component of the policies toward the elderly. The third pillar is a purely redistributive scheme for the elderly poor that are not entitled to a social insurance pension. At present, this pillar is represented by a small program, REVIVIR, and by many small programs run by municipalities. This is the "social assistance" component of the policies towards the elderly.

The Prime Media "pillar" has implied redistributive flows toward the relatively well off workers in the formal sector (and the relatively well off amongst those). Also, hosts of special benefits for civil servants have redistributed toward them, especially teachers, as discussed above. The system provides very little explicit targeting to the very poor. Within the pension system, two programs target the very poor: i) the minimum pension guarantee and ii) the Fondo de Solidariedad Pensionel. They are both quite small and suffer of serious problems of low membership, especially in rural areas. Also, administrative problems have vastly undermined the efficacy of the system and even the collection of information about the system. Outside of the main pension system, the program REVIVIR established in 1993 and is directed toward indigent elderly, identified by municipalities. Once again, very low membership and administrative shortcomings are very serious problems.

In summary, the key problem of the current pension system is clear: it spends too much on too few people. For a country like Colombia, with limited fiscal resources, pensions must be used to protect elderly individuals from poverty, not to ensure the continuation - or the improvement, as in the case of teachers - of their living standards into old age. One of the key problems is that the minimum wage is fairly high in Colombia, relative to the GDP per capita of the country, and legally and politically, it is difficult for the government to pay less than the minimum wage.

A second, related problem is the remarkable complication of the current system, with its large numbers of special regimes, each obtained by small groups bargaining for special treatment. A consequence of this fragmentation is that the system is to a large extent unable to keep track of contributors and pensioners. But no effective reform can be achieved without this type of information.

A third problem has to do with a tendency toward decentralization of social assistance programs. An emphasis on decentralization and municipal cofinancing defies the purpose of a redistributive program directed precisely at the poorest: presumably the poorest municipalities are also those with the highest incidence of elderly indigent. As we discussed in the decentralization chapter, this can be only partially corrected by a system of transfers from the Central Government to localities that favors the poorest regions.

The bottom line is pretty clear, although difficult to implement in practice. Resources should be moved away from relatively privileged groups (civil servants, relatively well off elderly members of the formal labor market) to the very poor, including those teachers in rural areas.

## ***b. Policies toward families and children***

At present, policies towards families and children are run mostly by ICBF, a central government agency with a 1998 total budget equal to about .5 of GDP (.6% with municipal participation), and funded with the proceeds of a 3% payroll tax. A few programs are run by the RED de Solidaridad Social, often in coordination with ICBF. The present system contains elements of several different types of programs:

- day care
- food distribution and nutrition help
- school feeding
- help for mothers heads of families
- preventive and health care
- in-kind support for children in school age
- various programs for adolescents and minors

As for child care, there are three programs: CAIP, the older one, HCB, and Jardinos Comunitarios de Bienestar; in 1997 the former represented 12.5% of all spending by ICBF, HCB 41% and Jardinos Comunitarios a small .1%.

One distinctive feature of the HCBs is the community involvement. A "community mother" (a person with no special qualification) is chosen by the community to be a child care provider. It is very difficult with the existing very poor data to evaluate the cost effectiveness of the two programs. In fact, some effort should be devoted to gather the necessary information. The available, imperfect, information shows that HCBs are heavily used in rural areas as well, where there are also indications of high unmet demand; the educational functions of HCB is extremely limited, and the quality of care provided is highly inferior to that of CAIP; there are concerns about the effectiveness of ICBF programs for children 0 to 2. It seems that the HCBs are more costly and, therefore, the policy of promoting HCBs against CAIP is misguided.

An important aspect of child care, in addition to its role in freeing time of adults for work, is in providing a nutrition subsidy. This is especially relevant for very small children (age 0 to 2), when malnutrition is especially dangerous. If child care support does indeed contain a large element of nutrition support, one may also consider moving to a system of food stamps. Food stamps have several advantages besides providing incentives for usage of other services. They can be targeted to the poor. Contrary to cash transfers, they do not require an extensive network of rural banks to be cashed. One could also link the collection of food stamps to the health care system, creating incentives for preventive medicine. More generally, food stamps could be used, instead of other forms of transfers, for other groups, such as elderly indigents.

In addition to the programs described above, there are many other tiny ones directed to children. Very unreliable information are available on how various program works. It is pretty clear that the ICBF should drop most of its programs for minors above 7, and concentrate on a core of key programs. It should consider a nationwide program of foods stamps (or cash grants) for families of primary and secondary school students, where disbursement of the subsidy is conditional on the children remaining in school. Like the previous proposal for preschoolers, this program has the advantage of combining a targeted subsidy with incentives to build human capital.

Finally, it is worth noting that except for HCB, and in part CAIP, there is virtually no usable public information available on ICBF. External evaluation of all major ICBF programs and the surviving RED programs should be a high priority.

### **c. *Employment and unemployment policies***

Colombia does not have formal unemployment insurance. Because of the high rate of informality and the difficulties in keeping records of the work history of individuals, a formal, well working unemployment insurance system is virtually impossible in a country like Colombia. In fact, few Latin American countries have one, and it is almost invariably limited to very few individuals (for instance, little more than 100,000 in Argentina).

Unemployment in Colombia is highly concentrated among the youths: the unemployment rate among individuals in the 18-24 age group is 25.7% against 6% in the 50-59 group. Training programs tend to be effective exactly in situations of high youth unemployment rate. The training of displaced adult workers rarely provides the necessary skills to return to the labor market, while short training programs might be adequate to provide young adults entering the labor force with job search skills.

Training in Colombia is the realm of SENA, the state training agencies patterned after Brasil's SENAI. SENA is a large organization, with a budget in 1998 equal to about .3% of GDP. It provides training both for youths entering the labor force and for displaced workers. The available evidence on this program raises serious questions. The SENA training is highly geared towards the upper quintiles. This is not just a reflection of the fact that it is mostly an urban program: even among urban individuals, the poor enroll in SENA less frequently than the non-poor.

Also, there is a growing consensus that SENA, like most training agencies in Latin America, is a highly rigid institution, very reluctant to change and to adapt to the changing labor market.

Colombia has had a limited experience with employment generation programs in the recent past, in the form of two programs administered by the RED, one for urban areas and one for rural areas. The urban employment program (*Empleo Urbano*)<sup>11</sup> is one of the few RED programs that has been the object of some quantitative evaluation. A striking characteristic of this program is the extremely high wage it paid: in infrastructure projects, on average in 1997 it was about 170% of that offered in the private construction sector; in services, it was about 150% of that offered in the "communal service" sector.

## **F. The Central Bank<sup>12</sup>**

### **1. The issues**

A widely accepted view in both the OECD and developing countries is that an independent Central Bank is more conducive to a stable, non politically motivated and non inflation prone monetary policy. On the contrary if the government (and in particular, the Treasury) has a day to day influence over of monetary policy, one observes a strong temptation to use the monetary instrument to finance government deficits and over stimulate the economy for short terms benefits (or to be "weak" in inflation fighting) at the cost of long term stability and growth. Central Bank independence is insured by three pillars: an "arms length" relationship between government officers and Central Bankers, appropriate appointment procedures for officers of the Central Bank, and a clear mandate for the Central Bank.

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<sup>11</sup> *Empleo Urbano* has three components: employment generation proper, training, and support for microenterprises. The last one was extremely small - less than 1% of the budget, covering only 56 projects in 26 municipalities - and will be ignored. Training received about 13% of the budget in 1996, and has been discussed in section 4.3.1. The remaining 86% of the budget was spent on employment creation programs.

<sup>12</sup> This section is based upon Alberto Alesina, Alberto Carasquilla and Roberto Steiner "The Central Bank in Colombia".

The Constitution of 1991 which included sweeping reform of the Central Bank law, has considerably increased the degree of Central Bank independence relative to the previous arrangement. However, the 1991 reform is a compromise between two views: one which favored unconditionally the idea of Central Bank independence, the other which supported government intervention and control, especially in exchange rate policy. The resulting law was a compromise between these two views. While some of the wording of the law indicates a strong stance for independence, certain aspects of the Central Bank law are at odds with the same idea of independence. For example, the fact that the Treasury Minister not only is a voting member of the Central Bank Board but he is also its president is extremely unusual by international standards. Also, a fair amount of institutional confusion, testified by various Constitutional Courts rulings, remains, regarding the objectives of monetary policy and of the Central Bank. In fact, the 1991 Constitution wanted to delegate to the Central Bank the goal of inflation control. On the other hand, various Constitutional Court rulings do not make it clear who has precedence if the Plan de Desarrollo and the Central Bank have different inflation targets.

The 1991 Constitution was especially concerned about keeping the government involved in the choice of exchange rate policies and exchange rate regimes. However, for a small open economy like Colombia the exchange rate is a tool that cannot be detached from an inflation control policy package. If the government is part of the exchange rate management "team", it means that the government is involved in monetary policy. The unclear "status" of the Central Bank which stems from the 1991 Constitution, showed its consequences, for example, in a couple of occasions. In 1997 an over exposition of monetary policy in response to a downturn in 1996 contributed to monetary and financial turbulence in the ensuing year. In early 1997 the Samper government had the opportunity of appointing three new members of the board, all of them recruited within the rank of the government. Recent intervention in the banking sector have lead to a Government/Central Bank coordinated effort to bail out banks which seem to have gone beyond a temporary provision of liquidity.

This last example brings us to consider the important issue of which institution should supervise the financial system. A critical goal is to keep the Treasury at arms' length from financial supervision, given its incentive to meddle with banks to obtain financing for the public sector. Two possible institutional solutions are either to have an independent body to supervise the financial sector or to move the supervision to the Central Bank. One can raise arguments in favor of both solutions. The main drawback of an independent body is its ability to really keep its independence from the Treasury. Mainly for this reason, moving the supervision of the financial sector to a strong, capable and independent Central Bank is a superior choice.

In summary, the gist of our proposals is to eliminate the "confusion" surrounding the institutional position of the Central Bank and its mandate. The purpose is to reform the Central Bank law in order to make the latter an institution to which the government delegates the goal of maintaining inflation under control and supervise the financial stability of the country. It is important to stress that a truly independent Central Bank does not contradict the principle of democracy. Delegation and democracy are not incompatible. The "people" may democratically decide that a certain function (for instance monetary policy) should be delegated to an institution appointed by the people but that retain independence in the administration of its duty in the interest of the people itself.

## **2. Proposals**

### **a. *Composition of the Board***

- Removal of any member of the executive from the Board of the Central.
- Reduction from the current 5 members of the board to 3 plus the chairman; the latter would cast the tie breaking vote.

The purpose of these proposals is to make the board small, with a strong role for the chairman and without government participation.

***b. Appointment procedures***

- Lengthening the term of office of all members of the board to seven years;
- Introducing a staggered system of appointments so that no single administration has the prerogative of appointing a large fraction of the board.
- Restrictions on who can be appointed in the board; current members of the administration or those who have served in the previous two years should not be allowed to be appointed chairman or members of the board.

These proposals aim at making the board of the Central Bank a stable committee, that cannot be changed too frequently and overly influenced by a single government. Also restrictions on who can be appointed reduce direct government intervention.

***c. The goals of monetary policy***

- The Central Bank should set the inflation target; if in the Central Bank judgment a particular Plan de Desarrollo threaten the medium run goal of inflation control, the Central Bank's goal of inflation control has precedence.

This legislation should clarify the confusion between the Constitution and various Constitutional sentences about who is really in charge of setting the inflation targets.

***d. The Central Bank should be in charge of the supervision of the financial system***

- This reform has the goal of subtracting this control from the Treasury given the possible conflict of interest between the goal of financial solidity and that of financing government spending.

***e. Disclosure and secrecy***

- The Central Bank should adopt clear and binding procedures about who and when speaks officially for the bank. Specific rules about disclosures of board minutes and announcement to the markets should be adopted and closely followed.

The purpose of this is of course to give more «clarity» to the markets and remove uncertainty and speculations.