



## Decentralization and Bailouts in Colombia

Juan José Echavarría  
Carolina Rentería  
Roberto Steiner

## "DECENTRALIZATION AND BAILOUTS IN COLOMBIA\*\*"

Juan José Echavarría  
Carolina Rentería  
Roberto Steiner

Fedesarrollo

### Abstract

Decentralization has many benefits, but it can also weaken fiscal discipline: specifically, expectations on the possibility of a bailout by the central government create incentives for fiscal misbehavior; fiscal discipline does not pay because it carries a smaller expected bailout. In Colombia the substantial transfers from the central government to the sub-regions created structural expenditure pressures and irresponsible behavior in terms of debt (mainly loans from the banks), brought the departments into default and forced the central government to bail them out.

The amount of transfers, the level of indebtedness, and regional poverty were the main factors behind the bailouts related to PAs (performance agreements). But we also show in the paper that the PAs did not work, since taxes decreased (in relation to "income") and expenditure increased, both in absolute and relative terms. There is a second type of "bailout" we analyze in the paper: The departments and municipalities appointed teachers, and "forced" the central government to bail them out later on with additional money. Those governors belonging to the party in power got more money than their conservative friends.

We finally considered the case of the rail system build in Medellín. Since the project could not be defended on technical grounds, President Betancur (born in that department) and the government justified its undertaking on very doubtful externalities and as the instrument for the economic recovery of Antioquia. All Colombians ended up paying.

---

\* This paper is part of an IDB - Research Network Project on Decentralization and Fiscal Discipline in Sub-National Governments. When the project began in 1998, all three authors were affiliated with Fedesarrollo. Currently, Rentería is at the Ministry of Finance and Steiner at Universidad de los Andes. The authors would like to thank Paulina Lecompte and Juan Pablo Fernández for their research assistance. We have received useful comments from E. Stein, E. Fernández-Arias, J. Von Hagen, A. Carrasquilla, I. Fainboim, H. Mora, Juan Gonzalo Zapata, and project participants. This paper would not have been possible without the help and information received from the Ministry of Finance (División de Apoyo Fiscal, División de Crédito Público and División de Presupuesto), DNP (Unidad Administrativa Especial de Desarrollo Territorial, Unidad de Desarrollo Social and Unidad de Análisis Macroeconómico), and the "Misión Social" at DNP, particularly Alfredo Sarmiento.

## I. Introduction

Within the Latin American context Colombia is in a relatively advanced stage in terms of decentralization. According to the IDB (1997), it ranks third in the region, after Argentina and Brazil, two countries organized as Federal States. While in 1995 average public expenditure allocated by sub-national governments amounted to 15% of total public expenditure in Latin America and to 35% in the OECD countries, it reached 39% in the case of Colombia (IDB, 1997). Economic activity is also very decentralized compared to other Latin American countries<sup>1</sup>.

This advanced stage of decentralization is the result of a process that began at the onset of the eighties, and has covered aspects of economic, administrative and political nature. In 1991 this process received a definitive push with a new Constitution. The development of a decentralized system for over 15 years has revealed its strengths and weaknesses, and has prompted the need to implement changes in order to correct existing problems.

Historically, Colombia has shown a reasonable degree of macroeconomic stability, one plausible explanation being the quality of its budgetary institutions<sup>2</sup>. According to an index developed by the IDB (1997), during the first half of this decade Colombia had the best budgetary institutions in the region -i.e. it had a highly transparent budgetary process, closely ruled by fiscal restrictions that followed a hierarchy lead by the Ministry of Finance (*Ministerio de Hacienda*, MoF, in what follows) in the elaboration, approval and application of the budget (Alesina, 1998a). These characteristics should translate themselves into greater fiscal discipline<sup>3</sup>.

Macroeconomic management has deteriorated abruptly during the 1990s. One of the main causes for the fiscal imbalance has been the increase in the Central Governments' (CG) current expenditures, which went from 9% of GDP in 1990 to 16% in 1998. This increase is explained by a rise of 4.6% of GDP in transfers and of 1.7% in interest payments.

Despite the increase in transfers, there have been several situations in which sub-national governments have faced (or are facing) deep financial problems. These have been especially strong at the departmental level, in part due to their low degree of fiscal autonomy and their highly inelastic tax structure. In recent years departments have been asking for a special treatment, both in terms of their debt with the CG and/or in the request of loans to be used in paying wages and pensions and loans to the commercial banking system.

According to the information available for 22 (out of 32) departments, in 1997 their expenditures amounted to 2.9% of GDP while their revenues, excluding transfers, only represented 1.4% of GDP. The expenditures were financed with transfers (1.27%) and credit (0.22%). The accumulation of vertical imbalances and excessive departmental indebtedness exploded in 1996. In 1997 the departmental deficit amounted to 0.6% of GDP and debt reached 1.4% of GDP.

---

<sup>1</sup> Montenegro (1996) estimates gini coefficients for the concentration of population in 19 Latin American countries. Colombia comes first in terms of lack of concentration, with a gini of 0.42, followed by Brazil (0.49), Venezuela (0.54), Bolivia (0.56) and Ecuador (0.57). The more regionally concentrated countries are Chile, Uruguay, Guatemala and Paraguay.

<sup>2</sup> During 1970-92 Colombia was the least volatile economy within the Latin American context (IDB, 1995), and had the most stable economic policy of the countries analyzed. Recently, Jaramillo et al (1999) tied the stability of economic policies to the stability of some institutions and to the consociationalist character of its democracy -one in which the centrifugal tendencies inherent in a pluralistic society are counteracted by the cooperative attitude of the leaders of different segments of the population.

<sup>3</sup> See also Alesina et.al (1998b) where Colombia comes in fourth place, after Jamaica, Mexico and Chile, when considering an index of budgetary procedures for 1980-92. Results are relatively robust when considering different assumptions about substitutability between the components of the index.

In February 1999 15 departments had received loans from the CG for the restructuring of their administrative, financial and fiscal structures, totaling US \$ 107 million, and there are 13 additional petitions in waiting list. Payments to retirees are not current in 14 departments, affecting around 18,000 persons. In four cases the delays are older than 12 months, (MoF, 1999a).

A system of "traffic lights" is being used to control indebtedness. Currently, of 27 departments for which there are calculations, 17 are in red, 1 in yellow and 9 in Green, which means 18 of them are facing liquidity and/or solvency problems. These departments cannot have access to new credit without permission of the Ministry of Finance, which is only granted after signing a performance agreement (PA).

As will be seen throughout the paper, there are failures in the institutional framework of decentralization that have reduced the fiscal discipline of the sub-national governments, affecting its fiscal balance and increasing the pressure for a bailout from the CG. There is an unavoidable need to modify the fiscal contract among the three levels of government, in order to enhance the principals' (CG) capacity to monitor and control the agent (territorial entities, TE).

Decentralization has many benefits, allowing a better match between local preferences and the basket of goods (and taxes) available. But it can also weaken the fiscal discipline of the sub-national governments. Specifically, expectations on the possibility of a bailout by the central government create incentives for fiscal misbehavior; fiscal discipline does not pay because it carries a smaller expected bailout. According to Fernández-Arias, Stein and Von-Hagen (1999):

- "The classical moral hazard problem stems from the difficulty of designing a contract that offers security to the agent when her actions cannot be a part of the contract due to lack of or legal force. In a principal - agent setting, for example, the effort of the agent may not be observable...there is an element of incompleteness of contracts, given by the inability of the central government to monitor, evaluate and control all activities of the sub-national government...
- "...There is also an element of time inconsistency. Even if the higher-level government knows perfectly well that the lower-level government caused its own financial distress by irresponsible behavior, it may not be willing ex-post to punish the lower-level government or simply leave it in distress, and may instead choose to provide a bailout, for one of more of the following reasons: i) because it cares about the welfare of the citizens of the jurisdiction in question; ii) because it benefits politically from extending the bailout; or iii) because, in the absence of the bailout, there would be negative externalities on the rest of the country".

Bailouts can be explicit, when the central government formally assumes the liabilities of the sub-national government, or implicit, when the central government pays transfers to the sub-national entities allowing the latter to serve its liabilities. They may come with or without political and/or financial conditionality.

This document is divided into 4 sections, including the introduction. The second section provides a summary of the basic features of the decentralization process in Colombia, including an analysis of the revenue and expenditure assignments, the intergovernmental transfer system and recent developments in terms of territorial indebtedness.

The third constitutes the core of the paper. It deals with three types of bailouts by the CG and their determinants: the provision of soft loans to be used by departments in financial restructuring programs; the bailout of education expenditure of TE; and, the case of the metro of Medellín. The last section brings the conclusions and presents some policy recommendations.

## II. The Decentralization Process in Colombia<sup>4</sup>

### A. Current Political and Administrative Division

Colombia is divided in departments, which in turn are composed of municipalities. There are 32 departments and 1,064 municipalities, including 4 special districts: Bogotá, Cartagena, Barranquilla and Santa Marta.

Each department constitutes an electoral circumscription for the election of governors, members of the House of Representatives (*Cámara de Representantes*) and deputies to the Departmental Assembly. Senators are elected in a national circumscription. The 1991 Constitution gave departments autonomy in the administration of sectional matters, and in the planning and promotion of economic and social development within its territory. The Departmental Assemblies are administrative corporations, elected by popular vote. Its size varies between 11 and 31 members, elected for three years.

The Governor is the legal representative and the administrative head of the Department, and acts as an agent of the President in relation to the management of public order, the execution of economic policy and as a bridge for agreements between the nation and the department. The governors are elected for three years, there is no possibility of reelection, and they can be suspended or dismissed by the President.

Municipalities represent the fundamental entity of the political and administrative division of the State. The Municipal Councils are administrative corporations, elected by popular vote for a period of three years, with its size varying between 7 and 21 members. The mayor, elected for three years, is the head of the local administration and its legal representative. Reelection is not allowed, and the mayors can be suspended or dismissed by the President or the Governor of the department.

### B. The First Stage of Fiscal Decentralization: 1982-1991

During the early stages of the decentralization process, the dominant goal was to achieve fiscal independence among levels of government, while protecting the budget balance at the central level (Rojas and Campbell, 1993). Regarding fiscal and administrative decentralization, the most aggressive efforts were condensed in two laws. Law 14 of 1983 restructured tax structures, allowing lower levels of government to define tariff rates and exemption mechanisms within limits determined by the law. Law 12 of 1986 (and Decree 77 of 1987) redistributed functions among levels of government, strengthened the system of CG transfers and established the co-financing system —basically a matching grant system that allowed the CG to participate in the funding and implementation of projects assigned to municipalities and departments.

Modifications to the provision of education and health were implemented in 1989 and 1990. Mayors became responsible for the appointment of teachers and for the administration of school payrolls and other expenses. The CG was made responsible for designing health policies, for transferring resources to sub-national levels, and for overall coordination and supervision. The nation was given the monopoly over lotteries and gambling activities, the rents from which should be dedicated to finance health programs. Departments and municipalities were made responsible for executing those programs directly or through contracts with the private sector.

---

<sup>4</sup> This section draws heavily, among others, on Correa and Steiner (1999).

## C. Decentralization After the 1991 Constitution

The first article of the 1991 Constitution reads: "Colombia is a legally organized social state under the form of a unitary, decentralized Republic with autonomous regional entities....". The main reform regarding political decentralization was to establish the popular election of governors. The new Constitution gives greater fiscal autonomy to municipal and departmental authorities, which now have the right to administer and modify taxes so as to comply with their assigned functions. In terms of responsibilities, it dictates that the different territorial levels will be guided by the principles of coordination, concurrence and subsidiarity. It modifies the system of transfers, establishing new rules for departments and *special districts (Situado Fiscal)*, for municipalities (participation in the CG's current revenues), and for the distribution of royalties from natural resource exploitation. Most important of all, it introduces the principle of balance between functions and resources by stating that no new responsibilities can be delegated to lower levels of government without previous assignment of the corresponding resources to finance them. As will be seen below, this principle has been systematically violated.

## D. Revenue and Expenditure Assignments, Vertical Imbalances and Transfers

### 1. Tax System

The tax assignment structure in Colombia follows closely the principles of intergovernmental finance and tax administration (Ahmad and Baer, 1997). As can be seen in Table 1, the CG collects the value-added tax, income taxes and international trade taxes.

Table 1. Taxes and Transfers as a % of GDP

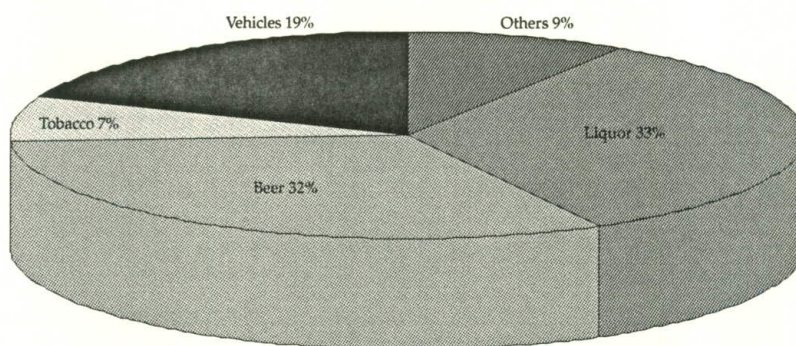
	1991	1992	1993	1994	1995	1996	1997	Average 1991-1996
<b>TAXES</b>	13.7	13.7	14.2	14.3	13.9	14.6	n.a.	14.1
<b>National Level</b>	11.4	11.3	12.2	12.0	11.7	12.1	12.7	11.8
Rent	5.4	5.5	5.1	5.0	4.9	4.5	5.0	5.1
Value Added Tax	3.5	3.9	5.0	5.0	4.9	5.0	4.9	4.5
Foreign Commerce	1.7	1.0	1.3	1.3	1.2	1.0	1.2	1.2
Others	0.9	1.0	0.8	0.7	0.7	1.5	1.7	0.9
<b>Departmental Level</b>	1.3	1.2	1.0	0.9	0.9	1.0	1.0	1.1
Liquor	0.6	0.6	0.4	0.4	0.4	0.3	0.3	0.5
Beer	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3
Cigarette	0.2	0.2	0.1	0.1	0.1	0.1	0.1	0.1
Vehicles	-	-	0.1	0.1	0.1	0.1	0.2	0.1
Others	0.2	0.2	0.1	0.1	0.1	0.1	0.1	0.1
<b>Municipal Level</b>	1.0	1.2	1.0	1.3	1.3	1.5	n.a.	1.2
Industry and Commerce	0.5	0.5	0.5	0.6	0.6	0.7	n.a.	0.6
Property tax	0.4	0.5	0.4	0.5	0.5	0.6	n.a.	0.5
Vehicles	0.1	0.1	0.0	0.0	0.0	0.0	n.a.	0.0
Others	0.2	0.2	.1	0.2	0.2	0.2	n.a.	0.2
<b>Transfers</b>	4.2	5.0	4.9	5.4	5.7	6.1	6.2	5.2
Situado Fiscal	2.0	2.3	2.3	2.6	2.6	2.9	2.9	2.5
Participation	1.1	1.5	1.4	1.5	1.7	1.8	2.0	1.5
Cofinancing	0.4	0.5	0.5	0.6	0.7	0.9	0.6	0.6
Royalties	0.8	0.7	0.6	0.6	0.7	0.6	0.8	0.7

Source: Contraloría General de la República, Banco de la República, Steiner and Soto (1999), Author's Calculations.

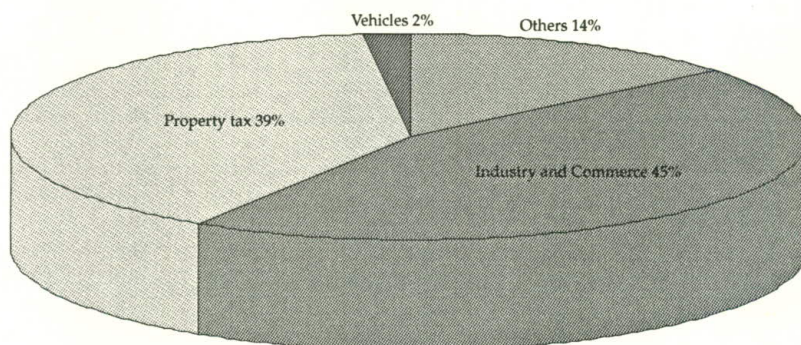
Following the 1991 Constitution, the evolution of departmental and municipal taxes differs. While the ratio of departmental taxes to GDP decreased from 1.28 in 1991 to 0.98 in 1997, municipal taxes increased from 1.02 to 1.54. Excise taxes on the consumption of liquor, beer and tobacco represent the bulk of departmental revenue, although taxes on motor vehicles have gained importance. Municipal taxation is concentrated in the property and industry and commerce taxes, but there are at least 10 more taxes and contributions over which municipalities have little or no control (Graphs 1 and 2).

In relation to the property tax, it is charged over the cadastral value, mainly determined by a centralized government agency<sup>5</sup>. Additionally, there has been an optional surcharge on gasoline since 1993 (classified as a non-tax resource). In the 1998 national tax reform it became mandatory for all municipalities to charge it. A recent report (BID, 1998) highlighted the following limitations of the current territorial tax regime: (i) excessive number of taxes, which generate little revenue and are inefficient. In many instances, departments and municipalities administer taxes of a very similar nature. (ii) Taxation power remains highly centralized. (iii) Tax administrations are highly fragmented, organized by taxes rather than functions, and with functions overlapping among the divisions. There is almost no systematic program of inspection and collection.

**Graph 1. Departmental Tax Composition 1997**



**Graph 2. Municipal Tax Composition 1996**



Source:

<sup>5</sup> Some major cities have used self-assessment of property values, with positive results in terms of revenue.

## 2. Expenditure Assignment

There is a remarkable lack of clarity regarding the distribution of responsibilities among the different levels of government in the Constitution of 1991 and in the related legislation that followed it. Undue interference by upper levels of government and special interests results, with lower levels demanding support from higher levels, and with widespread weak accountability at all levels of government. The CG remains involved even when responsibilities have been transferred to the lower levels.

Table 2 (based on IDB, 1997) describes the overlapping functions in the provision of different public services in Colombia. According to the Constitution of 1991, a new Law (*Ley de Ordenamiento Territorial*) should be designed to define precisely the functions and responsibilities for each level of government, but has not been presented by the government to Congress. This Organic Law should prevail over all other related legislation.

On the other hand, the actual law did not order the CG to stop playing a key role in the areas of education and health or in the other areas in which decentralization was chosen. Central government expenditures in education and health increased from 0.9% of GDP in 1991 to 2.7% in 1997, while local expenditures increased from 3.3% to 5.4% in the same period. The expenditure executed by the National Public Administration still amounted to 25.6% of GDP in 1995, while the departmental administration executed 5.3% and the municipalities 5.7%. This helps to explain why the CG has been facing continual and increasing fiscal deficits since 1993.

Two patterns of decentralization overlap in Colombia, and the conflict between the two became more evident after 1991. There is the idea, on the one hand, that the central government (the principal agent) should design all policies, and local governments should execute them. According to the IMF (1995) "decentralization in Colombia favors a model of functional administration, where the center takes the decisions, and asks local entities to execute them". But others think that local authorities should define policies at the regional level and get their income directly from local potential voters. According to Steiner and Soto (1999, p.126) "in the long run, the expected benefits from fiscal and political decentralization will depend of the control of taxes at the regional level".

**Table 2. Distribution of Functions by Level of Government**

Public Service	Amount	Structure	Execution	Supervision
National Defense	N	N	N	N
Natural Resources (Oil)	N	N	N,D,M	N
Education	-	-	-	-
Elementary	N,D,M	N,D	N,D,M	N
High School	N,D	N,D	N,D	N
Universities	N	N	N	N
Health	N,D,M	D,M	N,D,M	N
Housing	N,M	N,D,M	M	M
Hospitals	N,D,M	N,D,M	N,D	N
Water Service and Sewerage	M	M	M	N
Public Transportation	M	M	M	M
Streets	M	M	M	M
Waste Disposal and Cleaning	M	M	M	N
Public Lighting	N,M	N	N,M	N
Highways	N,D	N,D	N,D	N,D
Telecommunications	N,M	N,M	N,M	N
Ports	N,M	N,M	N,M	N

Source: IDB, 1997. N: National, D: Departmental, M: Municipal Amount: Who decides the amount to be spent? Structure: Who decides the expenditure structure? Execution: Who executes the expenditure? Supervision: Who supervises the function?

### 3. Vertical Imbalances and Intergovernmental Transfers

The current structure, in which the main taxes are assigned and administered at the national level but significant expenditures are allocated by the TE, gives rise to important vertical fiscal imbalances (Table 3). During the 1990s CG revenues have exceeded own expenditures (excluding transfers to TE), though this surplus has continuously decreased. In 1996-1997 only 37% of department's own expenditures were financed with own resources, while for the municipalities the indicator was 45%. As pointed out by Ahmad and Baer (1997), the previous indicators may be understating the extent of the problem, given the high degree of earmarking at the territorial level.

The system of transfers corresponds mainly to a revenue sharing system. It is expressed in four mechanisms: *Situado fiscal*, municipal participations, royalties and the *co-financing funds system*<sup>6</sup>. In 1997 the Situado and the participations represented 78% of total transfers, royalties 13% and the *co-financing funds* 9% (Graph 3).

#### a. *Situado Fiscal*

The Situado Fiscal was created in 1968 as a transfer to Regional Education and Health Funds but departments did not receive resources directly since the regional managers were appointed at the central level. The 1991 Constitution ordered to give money directly to the departments and stated that the amount transferred to the regions should be an increasing proportion of current revenue, until it reaches 46.5% in year 2,002 (Table 4), a solution not without problems<sup>7</sup>. According to Law 60 of 1993, 15% of total revenue of the Situado is to be distributed equally among departments and special districts, the remaining 85% according to a formula (Table 5).

The 15% to be distributed equally favors smaller departments -sparsely populated and with low administrative capacity-, mainly those created by the 1991 Constitution<sup>8</sup>. In relation to its destination, at least 60% of the Situado should go to education and 20% to health. The remaining 20% can be assigned by departments, either to education or health<sup>9</sup>. The criteria used to assign transfers does not have a direct relation with their use (IDB, 1998). For example, the 1992 distribution of teachers, which has been considered unequal, still rules transfers (see Section III.B.1).

#### b. *Municipal Participations*

Municipal Participations (in CG's current revenue) correspond to transfer to municipalities, designed to finance current expenditure and investment in basic services (health, education, water provision, sanitation, sports, recreation and culture). The share of current income to be transferred to municipalities, that represented 14% in 1993, should increase to 22% in 2002.

---

<sup>6</sup> In relation to royalties, the CG does not receive resources and the co-financing funds correspond to matching grants.

<sup>7</sup> The dependence of transfers on current revenue limited discretionary behavior, but also had negative effects: it institutionalized the lack of correspondence between transfers and costs (the main criteria are geographical, demographical and sectoral); and it introduced a pro-cyclical element to transfers which complicates macroeconomic management (IDB, 1998).

<sup>8</sup> Their expenditure needs should be lower. Obviously, other factors affect needs, including the prices of the inputs used to produce services (Rafuse, 1990).

<sup>9</sup> 75% of total expenditures have gone to education, and 25% to health.

**Table 3. Vertical Fiscal Imbalances**  
(Revenues/expenditures adjusting for intergovernmental transfers)

	National level	Departmental level	Municipal level
1991	131.6	74.3	46.6
1992	116.5	70.3	47.3
1993	137.7	67.9	42.8
1994	153.0	67.1	45.6
1995	120.2	65.9	48.8
1996	112.6	45.6	45.5
1997	104.2	37.4	n.a.

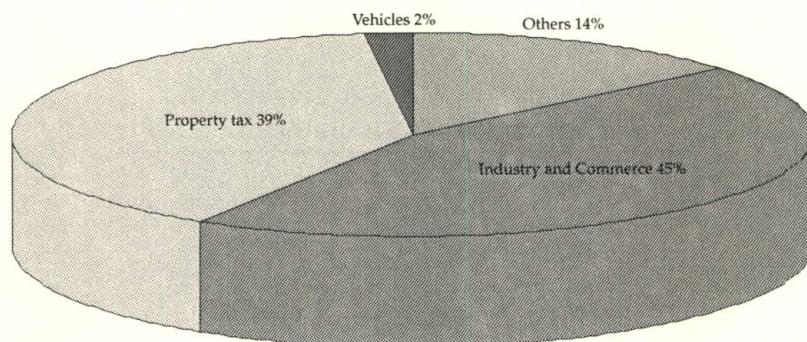
Source: Own calculations, based on CGR (1997) and DNP (1998).

**Table 4. Transfers of Central Government Current Revenue**  
(In percent of total current revenue)

	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002
Participations (Municipalities)	14.0	15.0	16.0	17.0	18.0	19.0	20.0	21.0	22.0	22.0
Situado Fiscal (Departments)	22.5	23.0	23.5	24.5	24.5	24.5	24.5	24.5	24.5	24.5
Total	36.5	38.0	39.5	41.5	42.5	43.5	44.5	45.5	46.5	46.5

Source: Constitution of 1991.

**Graph 3. Composition of Transfers 1997**



Source:

The geographic distribution of the participations follows a complicated formula (Table 6). The destination of the resources, as in the case of the Situado, is highly earmarked, and the municipalities can freely allocate only 20% of the participations (Table 7)<sup>10</sup>.

<sup>10</sup> After a couple of years, some municipalities, specially the smaller ones, were not able to finance their operating and debt service expenditures due to a lack of own tax revenue. As a result, legislative Act 01/95 increased the percentage of transfers that can be freely allocated by municipalities with lower degree of relative development.

**Table 5. Transfers of Departments and Especial Districts - Situado Fiscal  
(Formulae for geographical distribution)**

15%	85%	85%-X%
To be distributed in equal parts among all the departments and districts	X%	
	Variable share which should guarantee enough resources (adding up the 15% of the previous column) to cover the health and educational services prod in 1992, under conditions of adminis efficiency.	Portion to be distributed according to the following criteria: 1. Potential population of the T.E 2. Fiscal effort (share of all resources in total state income).

Source: Law 60 of 1993.

**Table 6. Geographic Distribution of Participations to Municipalities**

x%			Indian Territories (the share is determined by a certain amount of per capita income)
5,0%			Municipalities with less than 50.000 inhabitants
1,5%			Municipalities on Magdalena river
			Distribution criteria:
(93.5-x)%	60%	20%	According to population with basic unsatisfied needs (UBN)
		40%	According to relative poverty indexes
	40%	22%	Population / Total national population
		6%	According to fiscal efficiency
		6%	According to administrative efficiency in public services supply
		6%	According to the evolution of an indicator of quality of life

Source: Law 60 of 1993.

**Table 7. Formulae for Sectoral Distribution**

Education	30%
Health	25%
Water and Sanitation	20%
Culture and Recreation	5%
Discretionary	20%

Source: Law 60 of 1993.

### **c. Co-financing Funds**

The *Co-financing funds* system was established as a matching grant system in 1992, allowing the CG to pursue specific priorities to be executed at the territorial level. Its level and composition is defined in the executive's budget, and is then assigned through negotiations at the congressional level. Once defined, the relevant ministries determine the technical, financial and institutional conditions. Municipalities identify, formulate and execute the projects, while the departments coordinate, promote, plan and evaluate them.

The allocation of resources to the funds and their geographical distribution are characterized by an arbitrary process, subject to strong political pressure. There are global items in the budget (*partidas globales*) that correspond to allocations managed directly by specific congressmen. In 1996 they represented around 20% of total resources allocated through the funds (BID, 1998).

The *co-financing funds* are divided into two kinds: of specific destination and of free allocation. The former corresponds to those approved in the budget; the latter are allocated directly by the funds, in order to finance projects presented by the TE<sup>11</sup>. The criteria to assign funds to TE are similar to that used to distribute the *Situado* and participations, so the geographical distribution of grants tends to follow that of transfers, rather than national investment priorities. The programs, on the other hand, are independently formulated by the different agencies involved in the process, with indeterminate criteria for project selection and cost sharing (Coyuntura Económica, 1998).

#### *d. Royalties*

The purpose of royalties is to distribute the resources generated from the exploitation of natural resources. Once the amount of royalties is determined, it is distributed to departments and municipalities involved in production and transportation. A share goes to the National Royalties Fund, to be distributed to the rest of TE. Currently, 28 departments and 328 municipalities receive royalties (IDB, 1998).

Departments are mandated to invest 100% of resources from royalties in priority projects included in the development plans of departments and municipalities. However, if there are deficits in terms of coverage of health, education, water and sewerage, at least 50% of royalties should be directed towards these sectors.

It has been argued that the distribution of royalties is highly skewed. Departments with small populations receive a large share, which has resulted in misuse of resources. Departments that receive a larger portion of royalties are those that levy relatively lower taxes. In addition, a large share of royalties has financed current expenditure rather than investment.

### **E. Territorial Indebtedness, Performance Agreements and "Traffic Lights"**

#### **1. General Considerations**

The greater autonomy for contracting credit that TE received in the 1991 Constitution, the lack of regulation, more potential leverage given by new transfers, and the aggressive behavior of banks, produced a rapid increase in TE indebtedness, especially in 1992-94, the term of the first elected governors.

Until 1993, domestic credit operations by TE were under no control by the Ministry of Finance, besides a registration requirement. In that year, Law 80 forced financial intermediaries to monitor the destination of loans and the indebtedness capacity of TE. Banks became responsible for grading loans, for constituting provisions for non-performing assets, and for monitoring the nature and quantity of acceptable guarantees. Loans to TE were to affect the equity to risk-weighted assets ratio.

---

<sup>11</sup> There are four funds: Fondo de Inversión Social (FIS), for social investment; Fondo para la Inversión Rural (DRI), for infrastructure projects in rural areas; Fondo de Cofinanciación de Vías (FCV), for intermunicipal roads; and Fondo para la Infraestructura Urbana (FIU), for municipal transport.

However, TEs were able to contract credit based on their revenues, without consideration of expenditures, accumulating pressing commitments. Departments and capital cities' debt with the CG grew 279% in seven years, 22% per year. Debt increased from 0.9% to 2.7% of GDP in a relatively short period of time (Table 8).

## 2. Performance Agreements and Traffic Lights

It is only until 1997 that Law 358 develops the constitutional mandate of limiting debt to payment capacity, establishing a system of "traffic lights" based on indicators of liquidity (interest payment/operational savings)<sup>12</sup> and solvency (debt/current revenue)<sup>13</sup>. As described in Table 9, a regional entity with the liquidity indicator lower than 40% and a solvency indicator lower than 80% is under «Green light» and has total autonomy to contract new credits. However, those regions considered in the red light zone (liquidity indicator between 40% and 60% and solvency indicator lower than 80%) or in one (of the two) modality in the yellow zone<sup>14</sup>, have to sign a performance agreement.

The PA is based on a negotiation between the regional entity and the financial institution, monitored and reviewed by the Division of Fiscal Support (División de Apoyo Fiscal, DAF) at the Ministry of Finances. It can be additionally monitored by a department when the new credit is given to one of its municipalities<sup>15</sup>. In case of not complying, access to future credit is limited.

It consists of a series of targets and recommendations that the TE must comply with, within a predetermined time frame. These include increases in own resources, control of expenditures, generation of current savings and surpluses and a better debt profile. There are also limits to the evolution of total wages<sup>16</sup>. Information procedures should be improved in order to guarantee access by the central government and a census of the taxpayers must be available. New programs designed to avoid tax evasion and contraband should be designed with taxes increasing no less than 20% per year.

Table 10 presents an estimation of the legal capacity of indebtedness of departments and capital cities for 1998. Out of 27 departments for which there are estimations, 17 are in red, 1 in yellow and 9 in Green. Most of the liquidity problems can be tracked down to negative operational savings. In relation to municipalities of 26 cases, 13 municipalities have a red light, 6 have yellow and 8 have Green light. The problem, however, seems to be less acute than in the case of departments.

According to the National Federation of Departments (1999), the use of transfers as leverage for indebtedness (Law 85 of 1995) resulted in TE financing current expenditures with loans, and, in many cases, paying debt service with new credits. Debt service increasingly compromised all sources of revenue, since they had been used as collateral. Resources ended up in the financial institutions without even going through the government's "cashier".

---

<sup>12</sup> Operational savings is defined as current revenue - current expenditure (excluding interest payments).

<sup>13</sup> A better indicator of solvency would relate liabilities to net worth.

<sup>14</sup> A performance agreement has to be signed in the yellow light situation only when the new credit increases the real value of the stock of debt.

<sup>15</sup> Further regulation developed the risk weighting that financial institutions must apply to TE loans. Operations under Green light should be computed for 100% of their value, operations under yellow and red (with authorization) for 130%. However, when these operations have the CG's guarantee, they will be computed for 0% of its value. This distinction, as will be developed later on, obviously constitutes a perverse incentive.

<sup>16</sup> Total wages can not increase more than the percentage allowed each year for unit wages for public employees. This is (relatively) similar to having the number of public employees constant.

**Table 8. Territorial Debt**

As a of GDP	1990	1991	1992	1993	1994	1995	1996	1997	Average 1990-1997
Departments	0.44	0.51	0.47	0.72	0.86	0.90	1.17	1.43	0.81
Capitals	0.48	0.55	0.64	0.85	1.08	1.13	1.22	1.22	0.90
Total	0.93	1.07	1.10	1.57	1.94	2.03	2.39	2.65	1.71

Real rate of growth		1990-91	1991-92	1992-93	1993-94	1994-95	1995-96	1996-97	Growth 1990-97
Departments (%)	-	18	-5	62	27	10	32	28	327
Capitals (%)	-	17	20	41	35	10	10	5	235
Total (%)	-	18	8	50	31	10	20	16	279

Source: Author's calculations, Contraloria General de la República.

**Table 9. Indebtednes Alert Signals**

Indicator	Autonomous indebtedness Green Light	Intermediate Indebtedness Yellow Light	Critical Indebtedness Red Light
Debt Interests / Operational Savings (Liquidity indicator)	<40%	40% - 60%	>60%
Debt balance / Current revenue (Solvency indicator)	<80%	<80%	>80%
Effect	ET is allowed to contract new credit autonomously	A) ET can contract autonomously B) Requires indebtedness authorization of the Ministry of Finance or the Department, which will be conditioned to the signing of a Performance Plan with the Financial Institutions	Authorization is required to celebrate credit operations, thus a Performance Agreement with the financial entities should de signed

Source: Ministerio de Hacienda.

As a result, governments postponed payments to contractors, employees and retirees, or relied on liquidity loans and overdrafts. These short run loans became recurrent and were not repaid during the year, as mandated. It is important to stress that these practices cannot get done without the connivance of the financial institutions.

In 1995, in order to address the critical situation faced by three departments (Chocó, Nariño and Putumayo), the CG loaned them resources. As a condition for the loans, departments had to sign performance agreements with the Ministry of Finance. Since 1996, the Ministry has received an increasing flow of petitions of support. To attend them in a systematic way, and in order to have the resources to finance the interventions, the PASFFIET was created. This program (Program of Support for Fiscal Reorganization and Institutional Development of TE) is currently the main instrument to promote and finance performance agreements.

Due to difficulties faced in the signing of agreements under the PASFFIET -especially because of lack of interest on the part of financial intermediaries-<sup>17</sup> last December a decree relaxed some of the

<sup>17</sup> According to a person directly related to the program, the lack of interest was due, in part, to the fact that financial intermediaries did not believe in the diagnosis prepared for the agreements nor in the proposed solutions.

restrictions to extend credit. In particular, the weighting for entities with red light decreased to 100% if an agreement with the Ministry of Finance, within the PASSFIET, was signed. If there is national guarantee, financial intermediaries are allowed to reduce the weighting by the percentage guaranteed by the Nation. This legislation, once again, appears to go in the wrong direction, since a moral hazard problem clearly emerges.

It is important to note that the indebtedness law has not been effective. Some entities with red light have contracted new credits without permission of the Ministry of Finance. According to the MoF (1999), out of 21 departments that required permission for new loans in 1997, 10 apparently got new credit without permission from the Ministry. And five other departments that were authorized subscribed performance agreements impossible to comply with. In order to be able to violate the law, departments presented defective financial information, and the financial institutions made superficial analysis of it. In addition, the Ministry of Finance gave its authorization in cases where it should have denied it.

Performance agreements have also been signed with the Ministry of Finance, outside the PASSFIET. There is one Agreement that was signed between Valle Department (which had the largest debt in 1997, 23% of the total debt of departments), and all its creditors.

### 3. Recent Developments<sup>18</sup>

The financial system is in a precarious situation, and its exposure to TE is one of the explanatory factors. In 1996 the debt of the TE represented almost 9% of the loans of the financial system and almost 18% of the banking system, in 1998 the relations kept being high: 8% and 13% respectively (Table 11).

In September 1999, the debt of the TE with the financial system (credit institutions) was col \$ 3.2 billions (million's millions), of which 45.4% correspond to the departments, 31.7% to capital cities, 14.4% to municipalities, and 8.3% to other decentralized entities. The Metro of Medellín represents 40% of debt of decentralized entities. Five other enterprises explain an additional 40%.

The stock of debt of the TEs with the financial sector fell 8.9% (col \$ 318.9 thousand millions) between December, 1998 and September, 1999 (partially due to the restrictions imposed by the financial system), but 36.4% of the payments were overdue (créditos vencidos): 60.8% for the departments, 41.6% for capital cities, 26.4% for municipalities, and 19.2% for other decentralized entities. The proportion of bad loans is larger for small - medium size departments, and for large municipalities<sup>19</sup>.

The quality of the loans has deteriorated fast. Thus, the relation between non-performing and total loans rose from 1.71% in 1997 to 39.2% in September 1999 for the departments as a group; from 1.70% to 41.7% for capital cities; and from 8% to 19% for municipalities. The "other decentralized entities" did not present a similar trend, however, with figures of 17.5% in 1997 and 19.2% in 1999.

### 4. Preliminary Evaluation of PAs

Although an evaluation of debt agreements and the PASSFIET system will be presented in the next section, it is important to stress some implications of this scheme.

---

<sup>18</sup> This section is based on Asociación Bancaria (2000).

<sup>19</sup> The ratio for those departments with a population lower than 500.000 is 0.40, with figures of 1.95, 1.35 and 0.40 for ranges of population of 500.000 - 1 million, 1 to 2 million, and larger than 2 million, respectively. The figures for municipalities are 0.22, 0.24, 0.26 and 1.86 for ranges of population of "lower than 50.000", "50 - 100.000", "100 - 200.000" and "larger than 200.000".

Table 10. Legal Capacity of Indebtedness

Department	Ratios		Traffic Lights		
	Liquidity	Solvency	Liquidity	Solvency	Situation
Valle	(23.7)	222.3	Red	Red	Red
Antioquia	(163.4)	46.9	Red	Green	Red
Atlántico	339.0	65.2	Red	Green	Red
Tolima	(13.1)	86.6	Red	Red	Red
Nariño	(64.7)	186.5	Red	Red	Red
Magdalena	(18.2)	57.0	Red	Green	Red
Huila	(30.5)	11.5	Red	Green	Red
Cesar	70.6	38.0	Red	Green	Red
Santander	106.9	11.1	Red	Green	Red
Caldas	(7.6)	16.0	Red	Green	Red
Bolívar	273.5	5.2	Red	Green	Red
Sucre	233.8	22.7	Red	Green	Red
Quindío	(4.8)	12.2	Red	Green	Red
Amazonas	(1.2)	101.3	Red	Red	Red
Vaupés	(0.5)	81.2	Red	Red	Red
Vichada	(4.2)	28.0	Red	Green	Red
Córdoba	(326.3)	-	Red	Green	Red
Norte de Santander	47.4	10.9	Yellow	Green	Yellow
Cundinamarca	9.6	30.8	Green	Green	Green
Risaralda	19.8	39.6	Green	Green	Green
Guajira	12.7	76.9	Green	Green	Green
Arauca	16.8	14.8	Green	Green	Green
Cauca	30.1	18.3	Green	Green	Green
Boyacá	17.4	11.6	Green	Green	Green
Caquetá	7.2	9.2	Green	Green	Green
Putumayo	27.5	13.6	Green	Green	Green
Meta	30.7	-	Green	Green	Green
<b>Municipality</b>					
Medellín	(87.5)	26.4	Red	Green	Red
Barranquilla	94.2	29.2	Red	Green	Red
Santafé de Bogotá D.C.	105.9	7.0	Red	Green	Red
Cartagena	(72.6)	44.7	Red	Green	Red
Tunja	78.3	27.5	Red	Green	Red
Florencia	209.5	36.5	Red	Green	Red
Popayán	67.4	42.7	Red	Green	Red
Montería	103.9	333.9	Red	Red	Red
Neiva	(12.3)	32.6	Red	Green	Red
Santa Marta	102.5	44.6	Red	Green	Red
Bucaramanga	128.7	94.3	Red	Red	Red
Pasto	(18.5)	48.6	Red	Green	Red
Inírida	(7.3)	99.5	Red	Red	Red
Pereira	52.9	26.1	Yellow	Green	Yellow
Manizales	45.9	74.0	Yellow	Green	Yellow
Sincelejo	44.0	35.6	Yellow	Green	Yellow
Ibagué	43.1	5.1	Yellow	Green	Yellow
Cali	49.7	-	Yellow	Green	Yellow
Cali	49.7	53.6	Yellow	Green	Yellow
Villavicencio	22.7	19.5	Green	Green	Green
Armenia	16.8	19.2	Green	Green	Green
Arauca	27.1	63.7	Green	Green	Green
Yopal	30.0	67.2	Green	Green	Green
Mocoa	16.4	31.6	Green	Green	Green
Leticia	21.4	15.6	Green	Green	Green
Mitu	-	26.8	Green	Green	Green
Puerto Carreño	5.2	6.4	Green	Green	Green

Liquidity: interest payment/operational savings; solvency: debt/current revenue. Operational savings is defined as current revenue - current expenditure (excluding interest payments).

Source: DNP.

**Table 11. Exposure of Banks to Government Indebtedness  
(As a % of total loans)**

	1996	1997	1998
Loans to Central Government	10,1	12,1	16,0
Loans to Departaments	4,7	5,7	5,6
Loans to Municipalities	12,8	10,7	7,7

Source: Central Bank and author's calculations.

- Despite the fact that the indebtedness law specifies that the agreements should be signed with financial institutions, the Ministry of Finance has actively pursued the signing of agreements with the nation. Under this scheme, the nation diminishes the responsibilities of the financial sector. In words of the National Controller Agency (CGR, 1997, pp. 112) "Law 358 and the performance agreements are instruments that continue with the paternalistic tradition of helping bad administrators of local finances..."
- Only the Department of Valle has signed an agreement with its debtors. The agreement differs radically from those signed with the nation, since the basic criteria behind it are the recuperation of loans by the financial institutions. Issues such as modifying the organizational structure of the department, diminishing its personnel plant and other adjustments are implicit in the agreement.
- The two main actors -the CG via the Ministry of Finance, and the Departments through their National Federation- agree that the indebtedness law has been violated and, therefore, does not really act as a restriction. Also, they note that the ratio assessing the liquidity of the TE only includes payment of interest, excluding amortization, thereby undervaluing the debt service that the TE must respond for.
- The critical situation has resulted in a paradox. TES have to sign performance agreements with the CG, shifting power back to the center. In some cases, TE end up controlled by the financial system, with banks in charge of collecting revenue and distributing it.

### **III. Different Types of "Bailouts"**

The basic concepts that underlie the analysis made in this paper as well as the design of inter-governmental relations in Colombia are (a) bailouts, (b) soft budget constraint and (c) moral hazard. It is useful to clearly state how these concepts apply to our analysis, since they will help understand why we define as "bailouts" the phenomena under study.

The budget constraint refers to a behavioral characteristic of a decision-maker (in this case a TE): the department should be able to cover its expenses with its financial resources. The budget constraint should be a constraint on ex ante decisions (Kornai, 1986). The softening of the budget constraint occurs when the strict relationship between expenditure and earnings has been relaxed, because someone else, probably the next major or governor or, in our case, the CG, will finance excess expenditure. A further condition for softening is that the TE expects such external financial assistance (bailout) with a high probability, and this probability is firmly built into his behavior.

Thus, a bailout of a TE by the CG occurs when there is no explicit ex-ante agreement or understanding that the CG would assume any responsibilities of the lower level of government in case the latter was unable to meet them. However, the lower level of government can anticipate that, under some conditions, there is a positive probability of a bailout, prompting a strategic behavior from the TE in order to induce the bailout.

A softening of the budget constraint faced by the TE precedes the bailout. The bailouts that will be analyzed for the Colombian case softened the budget constraint that departments were facing<sup>20</sup>. We will analyze three types of "bailouts".

Type 1 "bailout": Provision of loans by the CG, to be used by the departments in their financial restructuring. Type 2 "bailout"<sup>21</sup>: Violation of the contract that settled the criteria for assigning transfers for financing school education (*Situado Fiscal*), and the expansion of the *Situado* by means of the *Educational Compensation Fund* (FEC). Finally, we will look at the specific case of the Metro de Medellín.

In the first case, the CG implemented a restructuring program by conditioning the TE's access to new loans to the signing of performance agreements (PAs). As explained in Section II.E (also see below) the credit contracts have not been enforced, and some departments have signed more than one agreement when the first one was violated and their financial condition worsened. The mechanism has become perverse. Wrong incentives are being created, a moral hazard situation is clearly emerging, and a further softening of the TE budget constraint has developed.

The second case corresponds to the expansion of the *Situado Fiscal* by means of the *Educational Compensation Fund* (FEC). Since the Constitution of 1991, the *Situado Fiscal* has financed access to preschool and basic education (primary and secondary up to 9th grade), and it has been shown that it should be possible to finance almost all the educational needs with the money from the *Situado* (Vargas and Sarmiento, 1997).

However, in 1995 an agreement signed between the CG and the teacher's union, created another fund (*Educational Compensation Fund* - FEC) to finance a deficit of *Situado* and the additional education expenditure responsibilities of departments and municipalities. In its first year, 1996, the FEC represented 7.5% of the *Situado*, and 31.7% in 1998. The CG announced recently the elimination of the FEC, but this idea lasted only weeks, and the Nation is currently trying to negotiate with the departments the allocation of FEC resources subject to the signing of a Performance Agreement. Neither the CG nor the departments have the backing of the main force, however, the national teacher's union (Fecode).

The cases that will be analyzed are experiences that started as ad hoc interventions by the CG to support a TE in crisis, but within a very short period of time became common practice. They lost their transitorily character and increased its size. In both the CG was unable to enforce a commitment to its announced policies. Evidently, a trade off is taking place between beneficial short run interventions, and long run reputation and incentives (Wildasin, 1997).

Our final objective is to identify factors that determine bailouts of departments by the CG, especially those that could presumably be affected by changes in the institutional framework. According to the IDB (1998), there could be three kinds of determinants: ex-post, ex-ante and reputational factors.

---

<sup>20</sup> The case of the Metro de Medellín will be analyzed as a third bailout experience. However, its nature and analysis is very different from these two.

<sup>21</sup> Limitations of information prevented the analysis of another bailout experience: CG's involvement in secondary and tertiary road systems. According to the law, expenditure on these items should strictly be a TE responsibility.

Bailouts are less likely when local governments have a robust tax base, generate a large part of their revenue (vertical balance), have autonomy for modifying the tax base (more flexibility on the tax bases and on rates) or when expenditure responsibilities are less widespread.

The causality is less clear when we enter into political considerations, however. Thus, bailouts could be larger or more likely when the lower level government belongs to the same political party as the higher level government, but we must also recognize that bailouts could be also extended in exchange for a favorable vote in congress from the opposition, and mainly when party discipline is weak, when the political system is unstable, when reelection is not allowed, and when elections are close. Obviously, bailouts are more likely when the local crisis can be partly traced to actions by the central government (i.e. education in Colombia).

Institutional arrangements clearly matter. Bailouts will be more likely when the Constitution stipulates that rescue is mandatory, when there are no debt limits for local entities (as is the case in the United States), or when there are local banks owned by the states (as in Brazil) and when transfers can be used as guarantees<sup>22</sup>.

For the purpose of the analysis that follows, we classified the possible determinants in five groups: dependence variables, debt, fiscal effort, vertical unbalance, size, political affiliation and poverty.

## **A. "Bailout" Type 1: Restructuring Central Government Loans to Departments**

### **1. Documentation of Early Experiences<sup>23</sup>**

In 1995 the CG launched a program to assist three departments that were presenting structural fiscal deficits and negative current savings- Chocó, Putumayo and Nariño. The idea was to give them resources, in the form of soft credit and technical assistance, and help them achieve a healthy financial situation. The recovery was to be attained by following the conditions agreed upon on the Performance Agreements (PA's) that the TE should sign. We will show below that PA's did not work, fiscal effort or expenditure did not change in the right direction, and money was permanently needed by these TEs.

The size of the loans given to these departments was high, especially in the case of Chocó and Putumayo, where it represented 77% and 74% of their 1994 current revenue (Table 12). The three departments were small, meagerly populated, and with per capita GDP and revenue collection well below the national average; the per capita GDP of Chocó and Nariño amounted to a third of the national average. In the case of Putumayo, a department highly dependent on oil royalties, the participation of income from taxes was only a quarter of the national average. These limitations in terms of income were not mirrored by their expenditures: per capita general expenditures were close to the average in Chocó and Nariño, 60% higher in the case of Putumayo. All three had important vertical imbalances and negative current savings as a result.

The critical situation was attained in Chocó by a combination of weak growth in current revenue -as a result of a sharp decrease in tax income, not compensated by increases in transfers from the CG- and rapid increment in debt service and operating expenditures. Between 1992 and 1994 Nariño's current expenditures were greater than its revenues (i.e. negative current savings). Fiscal deficits and debt rollover became the norm. The department was forced to obtain new loans in order to pay its

---

<sup>22</sup> See Fernández-Arias, Stein and Von-Hagen (1999).

<sup>23</sup> This section includes information from Gutiérrez (1996) and from the PA's signed by the TE's.

**Table 12. Indicators for Chocó, Nariño and Putumayo**

	Chocó	Nariño	Putumayo
Loan in millions of pesos	3.000	2.860	3.200
Loan in millions of dollars	3.3	3.1	3.5
Date of PA	Jul-95	Sep-95	Jul-95
Loan / Department's Current Revenue	77	24	74
Population	363.438	1.192.515	237.166
Per capita GDP (% of National per capita)	28.33	43.76	16.98
Per capita current revenue (% of National per capita)	34.33	32.63	58.82
Per capita general expenditure (% of National per capita)	82.10	73.90	163.40
Current Savings / Current Revenues %	5.5	-14.4	-16.5

Source: Gutiérrez. 1996.

employees. In 1994 Putumayo had an impressive fiscal deficit (25% higher than total current revenue), mainly as a result of a sharp reduction in royalties and, to a lesser extent, in tax revenue. By contrast, there was a significant increase in operating expenditure (due to a large number of new employees) and in interest payments.

## 2. Evaluation of the Early PA's

There is a special division in the Ministry of Finance (MoF) to deal with TE and with the signing of PA's -DAF, for División de Apoyo Fiscal or Fiscal Support Division)<sup>24</sup> but the control and evaluation of PA's has been extremely complicated, disorganized and inefficient. This situation promotes fiscal indiscipline at the regional level, and negatively affects the credibility of the CG. Conceivably, the TE may even be providing untimely and unreliable information as a strategic behavior to drive a bailout. We could not easily collect the information needed for the paper, and total reliability is not guaranteed.

The PA signed with Chocó, Nariño and Putumayo has not worked as expected. Debt has increased and the financial situation has turned worse, despite some reduction in personnel and increments in taxes. The CG has often been forced to commit additional resources to these TE when new PA's are signed. Table 13 shows that the CG signed two additional PA's with Chocó (for a total of \$7.9 million), one with Nariño (for \$5.5 million) and three with Putumayo (for a total of \$7.8 million). All told, in the last three years the CG has provided \$21.2 million to three departments that, currently, continue to be facing an extremely difficult financial situation.

**Chocó.** The department complied with most of the conditions imposed in the first PA<sup>25</sup> on the revenue side but not on expenditure reduction. The removal of personnel was timid, the salaries of the departmental assembly members kept rising and the budget that was approved implied a 30% reduction in expenditures, despite the fact that the PA asked for a reduction of 60%. The second loan was designed to finance personnel reduction but the accumulation of obligations with employees and retired personnel, the weakening (once again) of the tax base and legal problems, caused additional

<sup>24</sup> Another division at the MoF, Public Credit (División de Crédito Público) also deals with TE's and PA's.

<sup>25</sup> Revision and verification of the payable accounts and legal procedures against the Department, refinancing of debt, compliance with measures designed for increasing own revenues, administrative restructuring.

Table 13. CG Loans to Chocó, Nariño and Putumayo

Department	Date	U\$ Millions
Chocó	Jul-95	3,3
Chocó Amendment No.1	Dec-95	0,0
Chocó Amendment No.2	Dec-96	1,1
Chocó Amendment No.3	Nov-98	3,5
Chocó Total	-	7,9
Nariño	Sep-95	3,1
Nariño	Oct-98	2,4
Nariño Total	-	5,5
Putumayo	Jul-95	3,5
Putumayo Amendment No.1	Dec-96	1,0
Putumayo Amendment No.2	Dec-97	1,1
Putumayo Amendment No.3	Jul-98	2,3
Putumayo Total	-	7,8
Total 3 Cases	-	42,5

Source: PA and authors calculations.

financial problems. Again, the third loan mentioned the reduction of personnel and the rationalization of expenditures.

*Nariño.* The reduction of personnel attained after signing the first PA was aggressive, very expensive (due to the existence of an onerous labor contract) and not sufficient for the financial constraints involved. Tax revenue declined in real terms, the burden of retirees and teachers kept draining the limited resources, and the level of indebtedness almost doubled between 1996 and 1997.

*Putumayo.* Although important reductions in personnel took place and there was compliance with the tax goals set in the PA, the obligations with retirees, wage increases, and higher costs at the Departmental Assembly and the Department's fiscal control office (Contraloría), new legal demands and a reduction in royalties, did not permit a healthy financial situation. The second and third loans were directed at further reducing personnel, at limiting wage increases and special privileges for assembly members, the Governor and upper level managers.

The conditions imposed by the PA's were weak, implied no real penalty because lack of compliance, and the financial situation of the three departments continues to be critical. PAs were used to circumvent short run liquidity problems without solving structural imbalances. It is politically difficult and costly to lay off a large number of employees, particularly the regional Assemblies are weak, when compensation costs and the probability of future legal demands is high. A moral hazard situation is clearly developing when the CG is expected to grant the bailouts.

According to, ad hoc fiscal relations between governments characterized by bailouts and soft budget constraints, if present, ought to be characterized by transparency, accountability and predictability (Wildasin, 1997), but none of these features were present in the previous examples. Restructuring loans has become pervasive, wrong incentives are being created, and a "bailout" situation has clearly emerged. The introduction of a balanced budget amendment has become a necessity, and departments should have never been allowed to get loans from the banks using CGs transfers as collateral.

### 3. The PASFFIET and other PA's

The financial situation of territorial entities, although in deficit, seemed sustainable until 1995, with TEs being able to cover their operational expenditures and generate some savings and investment.

However, things began to deteriorate at a rapid pace after 1996, especially for the departments, with lower savings (and increasing debt) financing larger investments. The situation became critical in 1997, as most departments started to show negative current savings, forcing them to rely on loans to pay wages, other general expenditure and interests, and to delay payments to employees, contractors and retirees.

The causes of the recent crisis are both exogenous and endogenous (MoF, 1999). The exogenous factors are lower aggregate growth (and consequently lower current revenue for the CG and lower transfers to the TE), extremely high interest rates<sup>26</sup>, and the inelastic nature of tax revenue at the departmental level. The endogenous factors include the inefficient and inadequate tax administration (no classification of tax payers, no follow-up of their accounts and lack of systematization); large increases in operating expenditures; a mismatch between employees' skills and their functions; lack of discipline in bureaucratic assemblies and control offices; a very complex problem with retirees; and unsustainable levels of debt.

The PAs were originally designed to control TE's debt, without too much involvement by the CG, but this only happened in the case of the Valle's agreement. In the rest of instances, the CG has become the main sponsor of the program, helping in the design of the PA and its conditions, weakening the conditions imposed by the PASFFIET on the financial institutions, and serving as guarantor to the TE's PASFFIET credits. The scope of the CG became larger once new fiscal and administrative conditions were established to regain access to credit. Some new loans have been directed to finance personnel laid-offs, administration and financial restructuring<sup>27</sup>.

As of February 1999, 15 out of 32 departments have received loans from the CG, under the PASFFIET or under other mechanisms, directed towards the restructuring of their administrative, financial and fiscal structure, for a total of \$115.7 million. Under the PASFFIET umbrella, 8 departments have signed PA, while the other 7 have signed them with the Dirección de Crédito Público of the MoF<sup>28</sup>. There are 13 additional requests in the CG's waiting list.

Table 14 provides information regarding the departments that have signed PA's<sup>29</sup>. The need to extent financial resources increased dramatically in the last two years, as the CG provided almost us\$100 million to 12 departments. It is also interesting to note that the size of the loan in relation to the current income of the receiving entity varies significantly, from a minimum of 2.7% in the case of Meta to 70.7% for Guajira. Out of the 15 departments that have received a "bailout" from the CG, five -Chocó, Cauca, Guajira, Nariño and Putumayo- have signed more than one PA, basically because the first one did not solve the financial crisis.

The control mechanism it is not working irrespective of the large number (36) of conditions imposed before the disbursement<sup>30</sup>, and despite all the stories about their (presumed) impact on debt

---

<sup>26</sup> Real interest rates jumped from 3% to 19% between January and December, 1998, the largest in Latin America after Brazil.

<sup>27</sup> It is important to stress that the vast majority of resources are directed towards the financing of the retirement of personnel. The technical assistance component is very small.

<sup>28</sup> They are: Caquetá, Bolívar, Huila, Cauca, Cesar, Magdalena, Meta and Norte de Santander.

<sup>29</sup> For those cases where more than one loan per year was received, the relation with current revenue corresponds to the sum of the loans over the current revenue of that year. For those cases where PA have been signed for different years, the relation is based on the sum of all the loans over the sum of the current revenues for the corresponding years. For Chocó, however, there is only information about current income for 1995, and PA have been signed for 1995, 1996 and 1998. In this case, the relation corresponds to the sum of the loans over three times the current revenue of 1995.

<sup>30</sup> The authors have tables (available upon request) that summarize the causes included in the diagnosis as well as the conditions imposed by the PA.

**Table 14. Performance Agreements Signed by Departments**  
(US\$000)

Department	1995	1996	1997	1998	Total U\$	PA/Current REV %
Atlántico	-	-	5.565	-	5.565	5,70
Bolívar	-	-	-	6.193	6.193	19,80
Caquetá	-	-	4.638	-	4.638	58,20
Cauca	-	-	-	12.310	12.310	27,00
Cesar	-	-	3.782	-	3.782	25,20
Chocó	3.288	1.061	-	3.505	7.854	57,70
Guajira	-	5.875	-	-	5.875	70,70
Huila	-	-	-	12.741	12.741	46,10
Magdalena	-	-	-	6.846	6.846	43,40
Meta	-	-	1.314	-	1.314	2,70
Nariño	3.134	-	-	2.384	5.518	11,80
Norte de Santander	-	1.929	-	-	1.929	8,10
Putumayo	3.507	965	1.052	2.314	7.838	31,50
Tolima	-	-	8.796	-	8.796	10,20
Valle del Cauca	-	-	24.537	-	24.537	7,50
Total	-	-	-	-	115.736	14,15

Source: Own calculations based on PA from DAF and Crédito Público, MoF.

restructuring, on reducing current expenditure, modernizing the tax structure, accelerating personnel retirement and eliminating positions.

The situation has not changed much during the period 1995-98: 13 out of 15 cases considered in Table A. 1 presented deficits when the agreements were signed; 14 reported accelerated increases in expenditures (with large increases in personnel costs, 11 cases); and 11 mentioned a deficient behavior of revenues. 12 departments reported large debts and debt service. Reduction of CG transfers and royalties were mentioned as causes of the crises in as mentioned as sources of the crisis in some special cases.

The story does not end here. The treasury "lent" short-term money to the Departments (and to some municipalities) to be repaid during the same "fiscal year", but it was not, and the amount of money involved increased due to interests caused. Later on the very "unorthodox" Law 488 of 1999 allowed short-term loans to be converted into long-term loans guaranteed by the central government. This is clearly another area where bailouts surged. The only requirement was to sign a PA.

There are two clearly defined sources for funding the performance agreements: those coming from the *Program of Support for Fiscal Reorganization and Institutional Development of TEs (Programa de Saneamiento Fiscal y Fortalecimiento Institucional, PASFFIET)*, and those coming directly from the national budget. However, there is a third, very irregular source, the short-term créditos de tesorería: supposedly they should be repaid during the fiscal period, but soon became long-term debt<sup>31</sup>.

Table 15 shows the composition of the credits approved in the period 1997-1999 and the corresponding type of financing. It is clear the sums involved increased drastically after 1997, reaching their highest level in 1998. The Table also shows the composition of the col \$ 306 billions (thousand millions) effectively disbursed up to June, 1999 (a figure close to 8.5% of total regional debt): short term créditos de tesorería (col \$ 235 billions) represent the largest part, followed by resources coming from PASFFIET (col \$ 47 billions) and from the national budget (col \$ 25 billions)<sup>32</sup>.

<sup>31</sup> According to Law 488 of 1998, those short term credits can be converted into long term.

**Table 15. Credits Approved. Short Term "Créditos de Tesorería", Performance Agreements and Pasffiet (Millions of Col \$)**

Department	Pasffiet*				Performance Agreements						Créditos de tesorería		
	1997	1998	1999	Total	1995	1996	1997	1998	1999	Total	1997	1998	Total
Bolívar	-	-	5.01	5.015	-	-	-	-	-	-	9.913	12.000	21.913
Boyaca	-	-	-	-	-	-	-	-	-	-	-	4.000	4.000
Caqueta	5.494	-	-	5.494	-	-	-	-	-	-	-	-	5.494
Cauca	-	-	6.803	6.803	-	-	-	-	-	-	-	-	6.803
Cesar	652	-	-	652	-	-	-	-	-	-	-	-	652
Choco	-	-	-	-	3.000	1.100	-	-	3.000	7.100	-	-	7.100
Cordoba	-	-	-	-	-	-	-	-	-	-	-	11.885	11.885
Guajira	-	-	-	-	-	3.700	-	-	-	3.700	-	-	3.700
Huila	-	10.742	-	10.742	-	-	-	-	-	-	-	4.920	4.920
Magdalena	-	-	10.070	10.070	-	-	-	-	-	-	4.220	5.620	9.840
Nariño	-	-	-	-	2.860	-	-	-	-	2.860	-	-	2.860
N. de Santander	-	-	-	-	-	1.500	-	-	-	1.500	590	-	590
Putumayo	-	-	-	-	3.200	1.000	1.200	4.500	9.900	-	-	-	9.900
Risaralda	-	-	-	-	-	-	-	-	-	-	-	4.000	4.000
San Andres y Prov.	-	-	-	-	-	-	-	-	-	-	-	5.000	5.000
Santander	-	-	-	-	-	-	-	-	-	-	-	26.462	26.462
Tolima	-	-	-	-	-	-	-	-	-	-	14.220	25.651	39.871
Valle del Cauca	-	-	-	-	-	-	-	-	-	-	24.828	17.460	42.288
Total departament.	6.146	10.742	21.888	38.776	9.060	7.300	1.200	4.500	3.000	25.060	53.771	116.998	170.769
Barranquilla	-	-	-	-	-	-	-	-	-	-	2.101	2.000	4.101
Cali	-	-	-	-	-	-	-	-	-	-	-	21.000	21.000
Cartagena	-	-	-	-	-	-	-	-	-	-	4.700	-	4.700
Ibague	-	3.590	-	3.590	-	-	-	-	-	-	9.967	12.632	22.599
Monteria	-	-	3.629	3.629	-	-	-	-	-	-	-	-	3.629
Palmira	-	-	-	-	-	-	-	-	-	-	-	5.000	5.000
Santa Marta	-	-	-	-	-	-	-	-	-	-	-	4.100	4.100
Sogamoso	-	898	-	898	-	-	-	-	-	-	-	-	898
Tulua	-	-	-	-	-	-	-	-	-	-	-	2.100	2.100
Total municipalities	0	4.488	3.629	8.117	0	0	0	0	0	0	16.768	46.832	63.600
Total departments and municipalities	6.146	15.230	25.517	46.893	9.060	7.300	1.200	4.500	3.000	25.060	70.539	163.830	234.369

\* At sept 30, 1999; \*\* At april 19, 1999; \*\*\* At dec 31, 1998.

Source: Dirección General de Apoyo Fiscal, Ministerio de Hacienda y Crédito Público.

#### 4. Did PA's Work?

Table 16 compares "fiscal effort" before and after the adoption of the PA, using two definitions: the relation between taxes and "income" (taxes plus transfers), and the relation between expenditure and "income". We expect taxes to increase and expenditure to fall after signing the PA. We considered the behavior of each variable before and after 1995, 1996 and 1997, and in each case we defined departments with PAs as those departments signing the PA in that year and in the previous years. The information is available for the period 1994-1998.

The average relation between taxes and "income" was 0.68 in 1994 and 1995, and 0.33 in those years following the signature of the PA (1996-98). The relation between those two numbers is less than 1 (0.48), which shows that "effort" decreased; those two averages are statistically different at the 5% level of significance. Similar reductions (values lower than 1) are shown for those PAs signed up to 1996 and up to 1997. Effort also decreased based on our second definition, the relation between expen-

<sup>32</sup> There is no direct information on the amount effectively disbursed under the signed performance agreements. We assume the credit is effectively disbursed when there is more than one credit given to that particular regional entity. Thus, the total sum of credits approved to the department of Nariño was col \$ 2.860 millions in 1995 and col \$ 3.400 in 1998. The amount we considered in our calculation corresponds to the first credit.

**Table 16. Impact of the Performance Agreements, 1993-1998**  
(Average after/average before)

PAs signed on:	1995			1996			1997		
	Before	After	Relation	Before	After	Relation	Before	After	Relation
	(1)	(2)	(3) (2)/(1)	(4)	(5)	(6) (5)/(4)	(7)	(8)	(9) (8)/(7)
No.		3			5			11	
Taxes/(Taxes+Transfers)	0.68	0.33	0.48 (19.06**)	0.57	0.32	0.56 (3.30**)	0.59	0.14	0.23 (9.96*)
Expenditure/(Taxes+Transfers)	2.44	3.95	1.62 (-1.03)	2.78	5.96	2.14 (-2.41**)	n.a	n.a	n.a

Statistics in parenthesis correspond to t values for the difference of means; \*: significant at 1% level; \*\*: significant at 5% level  
1995 (3): Chocó, Nariño and Putumayo; 1996 (4): Choco, La Guajira, Norte de Santander, Putumayo; 1997 (7): Atlántico, Caqueta, Cesar, Meta, Putumayo, Tolima, Valle; 1998 (8): Atlántico, Cauca, Choco, Huila, Magdalena, Nariño, Putumayo, Valle.

diture and "income": 2.44 for 1994-95 and 3.95 for 1996-98, and even more clearly before and after 1996 when averages (before and after) are statistically different<sup>33</sup>.

Table 17 compares the behavior of PAs and non-PAs, and allows us to see how «typical» was the reduction in effort. Numbers for PAs are taken from the last Table. The results confirm our previous conclusions, since PAs behaved worse than non PAs: taxes decreased more for PAs in the three years considered, and expenditure increased more in 1996<sup>34</sup>.

On the whole, a perverse story seems to emerge. Money from the central government, in the form of transfers (and cofinancing) created structural expenditure pressures, and irresponsible behavior in terms of debt (mainly loans from the banks) brought the departments into default and forced the central government to bail them out. No only that, but the PAs did not work. On the contrary, taxes decreased and expenditure increased (in relation to "income") both in absolute and relative terms. The empirical results of this section confirm our previous intuition of important deficiencies around the PA's program: they were implemented ad-hoc, and the rules of the game were not changed for the new comers. The program increased its size and scope but no important modifications were introduced.

## 5. The Case of the Department of Valle

Valle, the most indebted department, signed a PA with the Nation in December 1997 as a previous step before getting new loans. The new obligations were not fulfilled, however, and a new PA was signed with the banks on September 1998, without too much government involvement. This makes it a special case since the 23 financial institutions (eight of them accounting for 70% of total debt), and not the CG, impose the obligations. The agreement is primarily aimed at refinancing debt with the financial system, reduce the level of indebtedness to sustainable levels, and recover the financial viability of the Department.

<sup>33</sup> We alternatively compared those departments signing the PA in that year (instead of up to that year) with those not signing, but results are almost identical. The ratios are 0.66 and 1.90 for 1996 (instead of 0.56 and 2.14) and 0.23 for 1997 (instead of 0.25).

<sup>34</sup> Again, results are almost identical when we use a simpler calculation. See note 33.

**Table 17. Impact of Performance Agreements, PAs vs Non PAs  
(Average after/average before)**

	1995		1996		1997	
	Pas	Non Pas	Pas	Non Pas	Pas	Non Pas
Taxes/(Taxes+Transfers)	0.48	0.76	0.56	0.67	0.23	0.47
Expenditure/(Taxes+Transf	1.62	1.80	2.14	1.57	n.a	n.a

Figures for Pas taken from the previous Table

It is worth describing the conditions imposed by the financial institutions to Valle, and compare them with the other agreements in which the Nation was more involved:

- Valle is forced to contract an irrevocable trust deposit with a fiduciary society which will receive and administer the resources of the department. It will transfer to the Department resources to pay personnel and other general expenditures, transfers by law and other responsibilities in force by the date of the agreement. The fiduciary will expeditiously cancel the debt service.
- The Department is forced to contract an irrevocable trust deposit with a fiduciary society, which will value, administer and sell shares owned by the Department in the areas of energy and ports<sup>35</sup>.
- To adhere to the PA the Department needed an authorization to reprogram and refinance short-term loans, and to increase its level of indebtedness, to pay the overdue interests and short-term credits, and the interests to be generated from October 1 1998 to December 31 1999.
- Personnel and other current expenditures not covered by the Situado Fiscal<sup>36</sup> have to be cut by at least 5% in real terms during 1999 and 2000. The (mandatory) increments in current revenue should be firstly directed to honor the debt service. The department can freely allocate 50% of the additional revenue only when the annual real increments are larger than 2.5%.

In general terms, this PA improves the debt profile: the amortization period increases and the interest rates decrease. Should one of the non-fulfillment clauses occur, the Financial Institutions can declare the total amount of the debt, the restructured debt, the interests and other obligations as under non-fulfillment and therefore, as immediately due.

#### **6. Quantitative Analysis of the Determinants of Type 1 "Bailouts" (Performance Agreements, PAs)**

In this section we present the results of a probit regression analysis in order to predict the probability of a Department signing a PA between 1995 and 1998. The explanatory variables, grouped in five categories, are to be seen as determinants of bailout of departments by the Colombian central government. The dichotomous variable is 1 if there was agreement, 0 if not.

<sup>35</sup> The Empresa de Energía del Pacífico S.A. (EPSA) and in the Sociedad Portuaria Regional de Buenaventura S.A. If the product of the sale of the shares to be given to the financial institutions is lower than \$ 120.000.000.000, the Department is forced to provide alternatives to complete this amount and be able to credit it to the debt balance.

<sup>36</sup> From 2,001 on, the expenditures cannot grow at a rate higher than the inflation rate.

Table 18 presents the variables we considered potentially relevant in the explanation of the bailouts, classified under 5 categories: financial, size, political, poverty, and violence; the financial variables were sub-divided into dependence, fiscal effort and vertical unbalance. Table A. 3 uses factor analysis to see how well our a priori guesses produce solid results. We found four factors after (marimax) rotating the factors: cofinancing and transfers (both in per capita terms) clearly form the first group; size (population and GDP) is an important part of the second factor, though large departments seem to collect large taxes in per-capita terms; debt is the central variable involved in the third factor (highly indebted departments seem to have low current revenues/current expenditures); the political variables are the central ones behind the fourth factor.

Table 19 presents the probit regressions (White) adjusted for heteroscedasticity. The dependent variable takes a value of 1 when a PA was signed by that department during the period 1994-97 and 0 otherwise. As independent variables we considered the averages for the period 1994-97 of those variables important in the previous factor analysis: per-capita transfers and cofinancing (proxys for dependence), debt per capita (indebtedness), per capita tax revenue (fiscal effort), GDP per capita and the % of Population with Unsatisfied basic needs (poverty). For each regression we present the coefficient and the level of significance of the (asymptotic) t statistic, the (2 statistic and the level of significance for the regression ( $Pr > (2)$ ). Ramsey (RESET) tests (not shown) reject the hypothesis of omitted variables. The 23 (out of 32 departments) we considered (GDP and GDP per capita are not available for all of them) account for 97% of the total population, 91% of total debt, and 87% of cofinancing.

We expect PAs to be more likely when DEPENDENCE, DEBT, VERTICAL IMBALANCES and POVERTY are large, and when FISCAL EFFORT and SIZE are low. Finally, we expect PAS more likely when the department had a liberal governor at a time when the President of Colombia was liberal. The results of the table confirm some of our expectations.

PAs are in fact more likely for those departments receiving large per capita transfers, highly indebted, and poor, with coefficients significant at the 1% level in all 7 regressions. Additionally, cofinancing funds (+), per-capita tax revenue (-), total revenue/total expenditure (-), gdp (-) and population (-) have the expected signs, but the coefficients are not significant. Only current revenue/current expenditures and "liberal governor in 1994" do not have the expected signs (but are not significant). Graph 4 presents the (partial) regression lines for the relation between PAs and per capita transfers

**Table 18. Variables Potentially Relevant. PAs**

Type or Family	Variable
Financial	<b>Dependence</b>
	Per capita transfers
	Co-financing Funds
	<b>Fiscal Effort</b>
	Per capita tax revenue
Size	<b>Vertical Umbalance</b>
	Total revenue / total expenditures
	Current revenues / Current expenditures
	GDP
Political	Population
Poverty	Political Party of Governor in 1994
	Per capita GDP
Violence	% of population with unsatisfied basic needs
	Rate of criminal activities per 10000 people

**Table 19. PROBIT Regressions for PAs (Bailout 1)**

Dependent Variable: PA(1 or 0)							
Independent Variables							
<b>Dependence</b>							
PerCapita Transfers	151.1 (2.00*)		151.1 (2.00*)	152.1 (2.06*)	149.8 (1.98*)	130.8 (2.04*)	164.5 (1.81**)
Cofinancing Funds per capita		67.1 (0.71)					
<b>Dedt (stock)</b>							
Debt per capita	295.2 (2.52*)	114.6 (2.35*)	295.2 (2.52*)	295.1 (2.50*)	314.9 (2.53*)	258.1 (2.69*)	369.7 (2.16*)
<b>Fiscal Effort</b>							
Per Capita Tax Revenue		6.97E03 (0.78)					
<b>Vertical Unbalance</b>							
Total Revenue/Total Expenditures			1.53E01 (0.04)				
Current Revenue/Current Expenditures				6.37E01 (0.42)			
<b>Size</b>							
GDP	4.6E07 (1.34)	3.59E (0.19)	04.58E (1.34)	04.66E07 (1.34)	5.04E07 (1.35)		7.88E07 (1.63***)
Population						5.64E07 (0.88)	
<b>Political</b>							
Liberal Governor in 1994							1.3 (1.28)
<b>Poverty</b>							
GDP/capita	8.6 (2.39*)	2.7 (2.30*)	8.6 (2.39*)	8.6 (2.41*)	9.1 (2.44*)	8.0 (2.56*)	10.2 (2.18*)
% of Population with Unsatisfied basic needs							
Observations	23	23	23	23	23	23	23
Chi ^2	8.01	9.17	60.7	8.07	8.31	7.53	5.65
Prob > Chi^2	0.091	0.057	0	0.153	0.1401	0.1105	0.3418

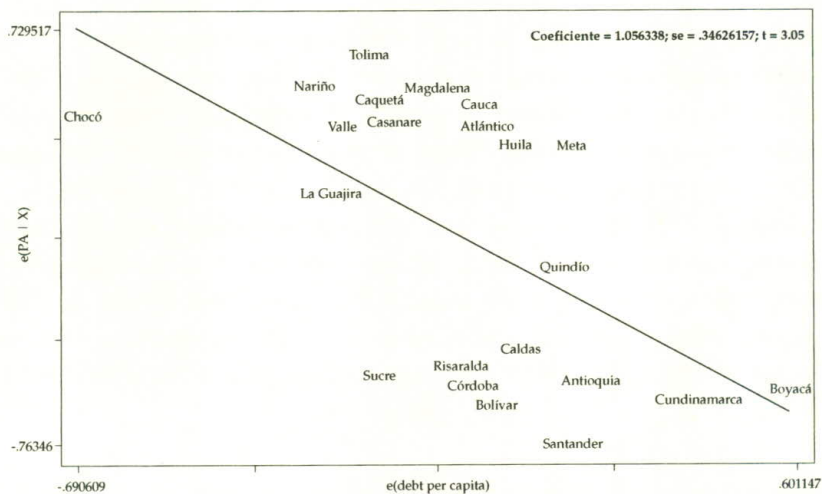
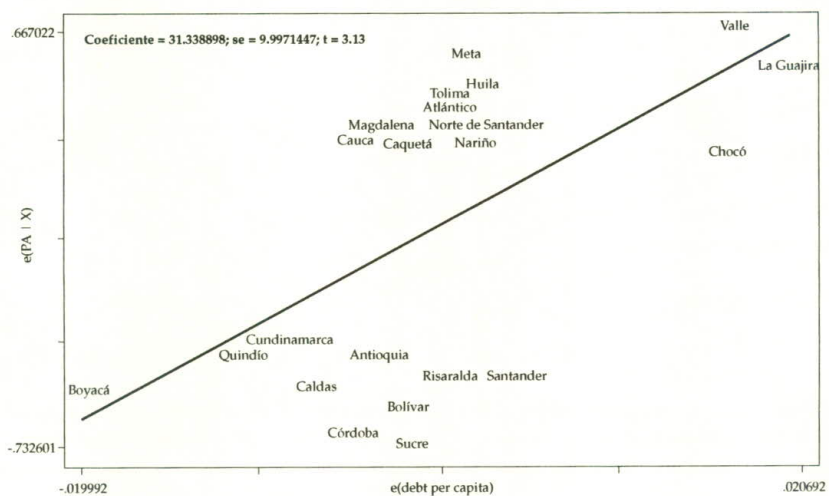
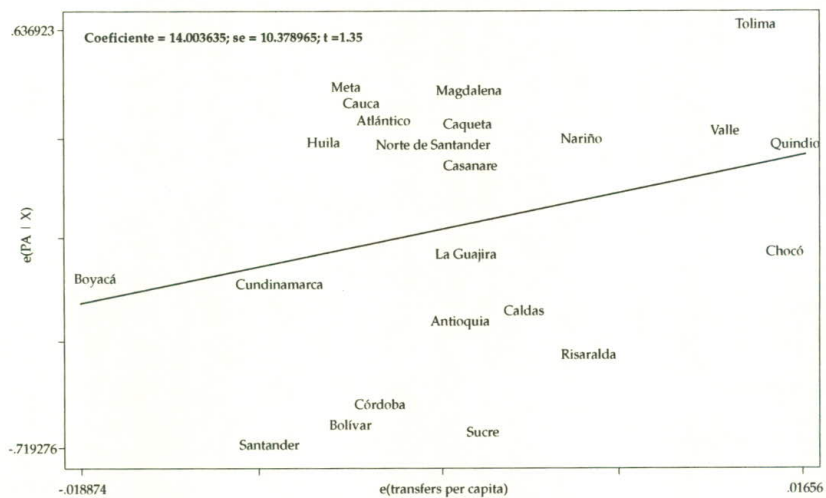
Probit regressions in all cases, based on averages for each variable for the period 1994-1997, (White) corrected for heteroscedasticity. Numbers in parenthesis correspond to the (asymptotic) t-statistic: \*: 1% level of significance, \*\*: 5%; \*\*\*: 10%; results for the constant not reported.

(transfers per capita), per capita debt (debt per capita) and per capita gdp (gdp per capita). No special outliers appear in the 3 graphs, something we confirmed looking at the standard tests<sup>37</sup>.

Fortunately, two of the three significant variables can be targeted as policy instruments, and can be modified in order to improve the institutional arrangement of decentralization in Colombia. Transfers have increased drastically during the 1990, as ordered by the Constitution of 1991, but they are under heavy discussion. The present government wants to reduce them in order to reduce the fiscal deficit, but the regions strongly oppose such idea; not only they will receive less money, but they argue that education and health are better provided at the sub-national level (something which has not been evaluated, see Alesina, Carrasquilla, Echavarría, 2000). However, our empirical exercise suggests that large transfers distort local finances and increases the probability of PAs and trouble.

<sup>37</sup> Dfits, Cook's distance and Welsch distance tests for the first regression of the table.

**Graph 4. Partial Regressions for Transfers, Debt and Poverty**



*Co-financing funds* have also been highly criticized: (i) they are assigned in an increasingly arbitrary manner, revealing political pressures and conflicts between congressmen, governors, mayors and the CG;<sup>38</sup> (ii) the institutional structure associated to the *co-financing funds* seems to reduce local autonomy at the territorial level; (iii) access mechanisms are complicated and lack transparency; and (iv) it is not working (as expected) as a CG mechanism for pursuing specific investment priorities to be executed at the territorial level (Coyuntura Económica, 1998).

Debt limits should be implemented. They restrict the amount of (future) resources transferred by the CG, promote fiscal discipline, and reduce the probability of bailouts. Poverty comes out as a significant variable in our results, and this suggests that special policies should be designed for this group of departments. They simply do not have the infrastructure needed to run a modern and efficient public administration.

As stated before, a very perverse history in the area of PAs emerges. The new resources offered by the central government (transfers and co-financing) and the banks (debt) allowed the (mainly poor) departments to reduce fiscal effort with predictable consequences. The system was originally designed in an ad-hoc manner, to solve the problems of 3 or 4 small departments, but no important modifications on the rules of the game were introduced when latecomers joined the club later on.

## **B. Bail to Out Type 2. The Educational Compensation Fund (FEC)**

The second type of bailout considered in the paper is related to the provision and financing of pre-school, elementary and secondary education in Colombia. The Constitution of 1991 and Law 60/1993 partially regulated the assignment of resources and responsibilities among levels of government, and provided the legal framework for education financing.

### **1. The Situado Fiscal**

The Constitution (article 67) defines education as mandatory for children between 5 and 15 years of age, covering at least one year of pre-school and nine of basic education (five of elementary and four of secondary). It should be free in state institutions but those who can pay should do so. Then, the constitutional responsibility of the CG and the TE remain vague.

Article 356 states that the Situado Fiscal (see also Section II.D.3) should be directed towards financing pre-school, primary and secondary education, and health services. Law 60 regulated this article, defined the Situado as the main instrument for financing education, and established the percentage of CG's current income that would be transferred to the departments, the Capital District (Bogotá) and four special districts, and the sectoral and regional distribution of the resources.

Out of 290,000 public sector teachers, 220,000 are paid through the Situado. The rest are financed through the co-financing system (around 15,000 teachers), municipal participations (that were intended to finance infrastructure investment and better quality), own resources, and (recently) the Education Compensation Fund (FEC).

---

<sup>38</sup> Despite being a transfer from the CG to the TE that in theory could work better than a general purpose non-matching grant, the co-financing fund system has become highly discretionary. In relation to the main body of the transfer system, the Situado and participaciones, the CG and the Congress have much more flexibility in determining the level and distribution of co-financing resources.

## Deficiencies in the Assignment of the Educational Resources through the Situado

- Confusion in the responsibilities and functions at each level. There is no clear definition of responsibilities among levels of government. Functions are fragmented and thus generate confusion and disorganization.
- Inefficiency. There are no incentives for the organizations to operate efficiently (Duarte, 1997): the departments do not have incentives to rationalize or reduce the number of teachers on the pay roll, since they perceive that the CG pays for these inefficiencies, and they hire teachers under the (correct) assumption that the CG will end up paying their salaries if they run out of resources<sup>39</sup>. Soft budget constraints are the best environment for Fecode, the national teacher's union, to operate (see Section III.B.2.a) below).
- Inequity in the assignment of resources. The formulae for resource allocation in terms of sectoral distribution (education, health and other services) does not take into account the particular needs of different regions, generating local excesses or lack of resources in health and/or education.

The formula for the distribution of the Situado for public education is based primarily on the number of teachers assigned to each region in 1993<sup>40</sup>. This arrangement, which originally motivated regions to accept the new decentralization scheme, helped to perpetuate the distortions, inefficiencies and inequities existent in relation to the regional distribution of teachers and thus, of education resources (Duarte 1997). The present model is based on the costs of the system, not on results, as there is no assignment on a per capita or per alumni basis<sup>41</sup>.

- Managerial and administrative problems. Lack of confident and timely information, and the politicization of the sector have resulted in continuous and growing demands for resources. There is no information on central variables such as the number and type of teachers at the national, departmental or municipal level, on the number of students or potential children to be covered.
- The FEC; not enough money? The amount of money going to Situado should be enough to cover all the educational needs (Vargas and Sarmiento, 1997) but, for reasons explained below,

---

<sup>39</sup> There is an additional ingredient that increases the pressure faced by the CG. The largest union is the teachers union, FECODE. It includes all national teachers and around 220,000 and 70,000 departmental and municipal teachers, respectively. When one TE stops payment of wages to the teachers under its responsibility, the union denounces that the "Government" is not fulfilling its responsibilities. It calls for a strike, and all public school teachers comply.

<sup>40</sup> As will be seen later on, when comparing the R2 and the significance of the coefficients for two different regressions that explain the departmental distribution of the Situado, the regression that includes the current distribution of teachers, rather than the one that includes the DNP criteria for allocating resources according to Law 60, is more robust.

<sup>41</sup> Currently, there is a Government proposal to modify Law 60, in order to distribute resources for health and education on a per capita basis. It decided to postpone the presentation of the proposal to Congress. It is a politically sensitive issue, opposed by FECODE. This was recently made clear with a national strike directed towards preventing the approval by Congress of the Development Plan presented by the Government, which includes measures directed towards flexibilizing the redistribution of teachers slots within departments and municipalities.

the CG created an additional fund, the Educational Compensation Fund (FEC), to compensate for the "Deficits in the Situado". Is the FEC a bailout?

The FEC was created to finance additional wages<sup>42</sup> negotiated in 1995 between the CG and the national teacher's union (FECODE) for all teachers in the country, but new goals have been added later on, such as the financial backing for teachers paid by departments and municipalities<sup>43</sup>, and the attention to families and teachers displaced by poverty and violence in rural areas. The size and importance of FEC has increased dramatically, from 7.5% of Situado in 1996 to 32% in 1998 (Table 20)<sup>44</sup>. The Situado and FEC amounted to 30% of CG's current income in 1998.

## 2. Is the Educational Compensation Fund - FEC a Bailout?

### a) What is a Bailout?

Wildasin (1997) proposes a bailout model constituted by a three-stage fiscal intervention:

- First premise: Fiscal affairs of an individual locality are not a matter of indifference to the CG. Local governments provide public goods that produce positive externalities and, therefore, the CG establishes a system of intergovernmental transfers that function as corrective subsidies.
- Second premise: Sequential structure to decision making. The transfer system produces a budget constraint for localities, which then choose their level of local taxes and expenditures.

**Table 20. Situado Fiscal and Educational Compensation Fund**  
(Millions of dollars)

	1995	1996	1997	1998
Situado Fiscal	2.004	2.348	2.459	2.248
Situado Fiscal for Education	-	1.706	1.751	1.597
Educational Compensation Fund (ECF)	-	128	317	507
Situado Fiscal for Education + ECF	-	1.834	2.067	2.104
Current Revenues *	8.526	9.583	10.036	9.176
Situado Fiscal / Current Revenues	23,5	24,5	24,5	24,5
Situado Fiscal + ECF / Current Revenues	-	25,8	27,7	30,0
ECF as a percentage of Situado Fiscal	-	5,5	12,9	22,5
ECF as a percentage of Situado Fiscal for Education	-	7,5	18,1	31,7

\* Calculated by applying the participation (by law) of the Situado in the current revenue.  
Source: NPD and M o F, Author's calculation.

<sup>42</sup> Due to wage increases, the promotion of teachers in the salary scale, and the incorporation to the National payroll of co-financed teachers (MoF, 1998). In 1995 the National Government and Fecode agreed to an additional increase in salaries for teachers and managers in the public education system, with respect to the raise given to the rest of the public officials.

<sup>43</sup> A share of it correspond to the agreements reached at the negotiations table in 1996 when organized marches by peasants of the Departments of Putumayo, Caquetá, Cauca, Guaviare, Bolivar, Santander, Meta and Nariño, resulted in a «bailout» by the CG.

<sup>44</sup> Annex 3.1 includes the evolution of the Situado and the FEC for 1996 to 1998.

- Third premise: The center moves last, observes local fiscal decisions, and either takes direct control over local expenditures or finances incremental local spending from central funds. It is this third-stage fiscal intervention by the center, which corresponds to a "bailout" and which, if it occurs, reveals the local government budget constraint to have been "soft".

#### *b) Fecode*

The Colombian Federation of Teachers (Fecode) assembles all employees working in public education, at most levels of schooling, and has become one of the few labor organizations in Colombia able to exert real pressure on the central government. The average period in power of the Minister of Education in Colombia during the last decade has been less than one year, and that defines very well who gains in a negotiation generally marked by strong confrontation. Fecode's demands are most of the time related to wage increases (the quality of education or related issues generally being absent from the negotiations) and results have been impressive.

In 1995 the government offered col \$ 300 billions for the educational sector, 30% of them related to "incentives", but after the strike of that year Fecode got col \$ 800 billions and only 18% for "incentives"; most of it went to wage increases. Nominal wages for teachers in the public sector have increased 8% faster than for the rest of the public sector year after year in 1996-98<sup>45</sup>.

In 1997 Fecode and the CG negotiated the construction of 5 new recreational centers in five departments, for the use of educators and their families. These recreational centers, together with the real increase of 26% in wages, correspond to a program of "incentives to educators designed to improve the quality of education". Fecode still argues that average wages for teachers are lower than for other public employees, but that seems to be dubious once you adjust for the number of hours worked (Ayala and Hernández, mimeo, 1998).

The Constitution of 1991 and Law 60/93 aim towards the decentralization of education, but Fecode opposes it. It has systematically opposed wage negotiations at the local level since that "promotes politicization". Fecode has also forced the CG to intervene and pay salaries and pensions when local authorities do not have the money or the will to do it.

#### *c) Is the FEC a Bailout?*

The definition of exactly what portion of the FEC constitutes a bailout is a tricky question, one that clearly reveals the problems of lack of accountability, confusion of responsibilities, existence of unreliable information and of perverse incentives. The CG knows that the contract for the provision and financing of education services that was established with the TE has been breached, but the CG is unable to monitor and evaluate the TE behavior because the contract is incomplete.

As important, Fecode plays a crucial role in the negotiations. Is it a bailout to give additional money to the regions, in order to compensate for wage increases agreed at the national level between the CG and Fecode? Finally, could it be that part of the additional resources goes to those regions that appoint additional teachers and do not have enough resources to pay later on?

---

<sup>45</sup> In 1996 teacher's wages increased 25%, compared to 15-19.5% for public employees; figures for 1997 and 1998 are 21.5% vs 13.5% and 24% vs 16%, respectively.

One could argue that the costs of the increment of wages do not constitute a bailout (it was negotiated by the CG) but the rest does. To complicate the issue even more, an audit of the use of the resources of the FEC in 1997 reveals that some departments did not use all the FEC -they had a surplus of resources. Despite the excess of FEC in 1997, all departments reported deficits in Situado in 1998, and received more FEC.

The analogy to the issues posed by Wildasin (1997) is clear.

- There is a contract that has been established between the Principal (CG) and the agent (department) for the provision and financing of education services at the school level. The Situado has been defined as the mechanism through which the CG guarantees a level of education that it considers to be correct, and Law 60 provides the legal mechanisms through which the Situado should be assigned.
- In a second step, the TE makes decisions in terms of resource generation and expenditure (patterns and levels)<sup>46</sup>. Despite the existence of a contract with the CG, the department decides a level of education expenditure larger than the resources available, and a violation of the contract occurs.
- In the third step the CG steps in, and validates through FEC the local decisions. The budget constraint is no longer binding and a "bailout" has occurred.

### 3. Econometric Determinants of Type 2 "Bailouts" (Educational Compensation Fund, FEC)

The Colombian law considers that the Situado Fiscal gives departments and municipalities the money needed to finance education, and that all new teachers should be appointed with local resources. However, no amount of money is ever enough to guarantee optimal education, the central government has accepted large wage increases for teachers appointed at all levels in the negotiations with Fecode, and some regions have appointed new teachers, hoping that the central government will come to the rescue<sup>47</sup>. Despite all the ambiguity, it is relatively safe to presume that some part of the FEC money constitutes a bailout.

In the regressions of Table 21 we considered the amount of FEC transferred to each department as the dependent variable. The independent variables are the growth rate (for 1996-98) of teachers appointed at the local level (i.e. paid by the departments and municipalities) and teachers appointed at the national level<sup>48</sup>. We also included the Situado Fiscal for education, the relation students/teacher, the existence or absence of PAs (1 or 0), a dummy for liberal governor in 1994 in that department and the number of senators.

---

<sup>46</sup> In order to see the local decisions in our particular example, and to be able to analyze and measure the decisions of the TE, we would need to have an evolution of the number of national, departmental and municipal teachers in each department. This information, however, is not available.

<sup>47</sup> Portafolio, "El Poder detrás de la Tiza y el Tablero", April 14, 1999, p.7 reports: "the Ministry of Finances obtained new resources to pay those wages not paid by the departments and municipalities in the previous years".

<sup>48</sup> We thank Fabio Sanchez for providing this valuable (but not official) information.

**Table 21. Determinants of FEC (Bailout Type 2)**

Dependent Variable: FEC							
Independent Variables							
Growth rate of teachers	-	102,18 (2,41*)	78,32 (1,96**)	78,50 (1,93**)	102,57 (2,44*)	78,72 (1,88**)	79,45 (1,90**)
Growth rate of teachers	-	-322,79 (-2,44*)	-196,16 (-1,28)	-195,46 (-1,29)	-321,33 (-2,41*)	-264,02 (-1,76**)	-265,67 (-1,93**)
Situado Fiscal for	0,16 (4,60*)	0,13 (4,31*)	0,13 (4,97*)	0,13 (5,17*)	0,13 (4,47*)	0,13 (5,91*)	0,13 (3,40*)
Student/Teachers	-	-	-308,76 (-1,71***)	-308,82 (-1,72***)	-	-221,38 (-1,20)	-222,20 (-1,19)
PAs (0, 1)	-	-	-	112,33 (0,05)	241,10 (0,11)	1035,53 (0,54)	1062,95 (0,51)
Liberal Governor in 1994 (0, 1)	-	-	-	-	-	11531,66 (3,27*)	11534,92 (3,19*)
Senators per Department	-	-	-	-	-	-	41,92 (0,05)
Observations	81	69	69	69	69	69	69
Chi <sup>2</sup>	21,2	42,8	60,16	64,3	50,52	82,07	81,42
Prob > Chi <sup>2</sup>	0	0	0	0	0	0	0

Regression for a panel data with i: 32 departments; t: 1994-98; White correction for heteroscedasticity.

Numbers in parenthesis correspond to the (asymptotic) t statistic: \*: 1% level of significance, \*\*: 5%; \*\*\*: 10%; results for the constant not reported.

To include the expansion of teachers appointed at each level seems appropriate for our analysis since we want to detect signs of "misbehavior" at the local level: did the FEC increase because the regional authorities were appointing teachers, and the central government just validated such behavior ex-post? This could be a clear sign of bailout. We also include those teachers appointed at the central level to compare trends.

We also want to see if FEC was just an extension of Situado, as some people argue, and it thus seems appropriate to include Situado for education among the regressors. No other variable should result significant if this was the case. In any event, what is the logic of giving money to the regions for education, under different criteria? Are the allocation parameters of Situado wrong?

The inclusion of PAs seems obvious. Those departments that misbehave at a general level (Bailout Type I) could also be good candidates for misbehavior in the area of education expenditures. We also included the relation students/teacher is a good proxy for effort, efficiency and discipline in the area. Finally, we considered two political variables: the existence of a liberal governor (same party as the President at that moment) in 1994, which was tried in the previous exercise on the determinants type 1 bailout, and the number of senators per department.

The first regression show a significant and positive relation between FEC in education and Situado Fiscal, a relation that remains in the other regressions of the table. This suggests that additional money was given to the regions using similar criteria to Situado (money was not enough). But this is not the end of the story.

There is a positive and highly significant relation between FEC and (the growth rate of) teachers appointed at the departmental and municipal level, and a negative and significant relation when we consider teachers appointed at the central level. It seems, then, that local authorities appoint teachers

with their resources, and get additional funds from FEC later on<sup>49</sup>. Is this a statistical verification of the existence of bailouts in education? Different signs suggest that departments were appointing new teachers (and getting funds from FEC), but not necessarily because the total number of teachers in the department was increasing. Finally, the political affiliation of the governor of the department in 1994 has a very high explanatory power in those two regressions including such a variable. Liberal governors (in 1994) got more money from FEC than their conservative friends in other departments.

The relation students/teacher does not have a large explanatory power; it is significant in half of the regressions, and only at the 10% level, and even less important result other variables as PAs or senators per department.

### C. Medellín's Metrorail System

At the moment of making the decision to build Medellín's metro system there existed numerous institutional mechanisms at the regional and national level to ensure that only profitable projects were implemented, but unfavorable feasibility studies were disregarded, Ministers of Finance were pressured, a deceptive media campaign was carried out and laws were amended whenever needed. Medellín's Metro Rail system has produced a highly negative internal rate of return; demand has been three times lower than originally estimated, total cost three times higher<sup>50</sup>, and the benefits in terms of traffic reduction questionable<sup>51</sup>. At the end the CG had to assume a considerable portion of the cost of the Metro.

It was agreed from the beginning that the project should be financed with foreign resources, and the international private banks always conditioned their involvement to the procurement of a guarantee from the CG. To obtain it, it was necessary to have favorable concept from the planning office (DNP) and approval by the National Council on Economic and Social Policy (Conpes).

After creating a new enterprise -the Empresa de Transporte Masivo del Valle de Aburrá, ETMVA<sup>52</sup>-, commissioning several studies<sup>53</sup>, and overcoming multiple obstacles at the municipal level, a foreign indebtedness application for \$263 million was submitted to DNP and to the Ministry of Finance in 1979. It was not approved.

In September 1981, ETMVA submitted a new study to the DNP, with an Internal Rate of Return (IRR) of 22%. Following several corrections, DNP obtained an IRR of 8.4% (DNP, 1982<sup>a</sup>). A year later, EMTVA submitted a new indebtedness application, this time for \$656 million. DNP proposed two

---

<sup>49</sup> It would be ideal, of course, to consider a larger period of time which could allow us to analyze lags. Did FEC increase between 1996 and 1998 as a result of decisions taken by departments and municipalities in the previous years? Unfortunately, we only have information on teachers appointed at each level, and for FEC disbursements for 1996 and 1998.

<sup>50</sup> Pachón (1991, pp. 53-54) estimated an internal rate of return of -1.7%, assuming a demand of 900,000 passengers per day. In 1981 the DNP had put demand at 300,000 ppd. The actual figure for 1998 was 281,000 ppd.

<sup>51</sup> It is worth noting that the Avenida Caracas Trunk Road Project, in Bogotá, a transportation system with buses, mobilizes twice the amount of passengers, at a cost one hundred times less than the Medellín train.

<sup>52</sup> Incorporated as a partnership between the Municipality of Medellín and the Department of Antioquia. In those years the highest local authorities (Mayor and Governor) were appointed by the President of the Republic. From 1986, the mayors are elected by popular vote. The same would apply to Governors from 1991.

<sup>53</sup> Apparently very deficient. The main criticisms formulated by the DNP had to do with cost underestimation and demand overestimation, in a ratio of 20 to 1.

alternatives: a) that the project design should be concluded before being submitted again; or b) that the contract be started without final designs, with CONPES giving its opinion when the designs were completed.

The technical team of DNP proposed "indebtedness procedures authorized, on the assumption that the bidding forms will allow for competition of the bidders without a guarantee from the Nation" (DNP, 1982b, pp.39), and the Director of DNP considered that "all the studies carried out led to believe that, even under the most negative assumptions, the investment is profitable" (Conpes, 1982)<sup>54</sup>. The President congratulated DNP for the study and emphasized that "the project was essential to restore Medellín's lost dynamism and to open new horizons, to regain the leadership of Antioquia had traditionally exercised ..." (Conpes, 1982).

Conpes granted the Nation's guarantee, although the DNP study explicitly denied its convenience. This guarantee implied that the Nation would be liable for the project in the event that ETMVA was unable to meet its obligations. In case the guarantee was made effective, the Nation should eventually recover the funds by making effective counter-guarantees with the Municipality of Medellín and the Department of Antioquia.

On January 14, the Minister of Finance received the indebtedness application and a few days later granted the guarantee, without requiring the corresponding counter-guarantees from Medellín and Antioquia, that is, without committing the region pledge any sources of funds. The CGR believed that there was lack of diligence on the part of the Ministry of Finance, since it was aware of the fragility of the company and the project (CGR, 1994, Introduction).

Conservative President Betancur was originally from Antioquia, a traditionally conservative region that played a crucial role in his election. The conservative party had been a minority for years but the liberal party was divided and this helped him to finally win his fourth presidential campaign. Contrary to the moderate distance he kept in the previous campaign on this issue, Betancur now fully endorsed Medellín's metro. The arguments were based more on the (very doubtful) positive externalities than on its benefits in terms of providing citizens with a good transportation system. Instead of technical arguments, he considered the metro the instrument for the recovery of Antioquia.

Antioquia has always been an important region, economically and politically. It contributes with 15% of the national GDP, produces a significant portion of the coffee harvest, and has the second largest manufacturing sector in the country. Both Colombia and Antioquia were suffering a large economic crisis in 1982, with GDP and industry falling 1.3% and 6%, respectively. Unemployment jumped to 14% in Medellín in 1982, and to 17% in 1983. Ex post, it is evident that building the Metropolitan Train was not a solution to the region's serious problems, and the construction of the train only generated 2,500 direct jobs and approximately 7,500 indirect ones—between 1 and 1.5% of Medellín's total employment<sup>55</sup>.

Once Conpes approved the project, Spanish entrepreneurs pressured their government to obtain the contract. According to Madrid's newspaper *El País* (October 10, 1983) "the visit that the President

---

<sup>54</sup> Officials attending the meeting include, among others: The President of the Republic; the Ministers of Finance (who abandoned the room as soon as the discussion on the Train began), Foreign Relations, Development, Agriculture and Public Works and Transportation; the Governor of the Central Bank; the Manager of the National Coffee Growers Federation; the Head of the DNP; the President of ECOPETROL and the Mayor of Medellín.

<sup>55</sup> This amount of jobs is 20 times smaller than the variance of the quarterly employment series. In a regression to explain employment, a dummy for the metro rail system was not significant. Estimates are available from the authors.

of Colombia (and former ambassador to Spain), began on Friday the 7th, will be used by the Spanish administration to try to have construction of the Medellín Metro Rail system awarded to one of the Spanish consortiums that are competing for it [...] The Colombian Minister of Economic Development stated that Spain is very likely to be awarded the project [...] since not only will financing conditions be considered, but also the circumstances in which bilateral relations are being conducted" (Alvear, 1990, pp. 30-31).

The construction contract was awarded to the Spanish-German consortium METROMED on October of 1983, and the financing to a syndicate of Spanish and German banks. The cost of the project on the part of the ETMVA and METROMED was not established in the contract, which in practical terms meant the signing of a "blank check".

The Minister of Finance demanded regional counter-guarantees in August of 1984 since the project had a regional scope. But for Jorge Valencia (at that moment Senator for Antioquia) defined the line that would become the strategic behavior of the region, anticipating the conception of Law 310 of 1996 (see below). According to Valencia, the counter-guarantee should simply be considered "a declaration of good intentions" that must not be executed for the full amount of the project. Additionally, the pledge of departmental and/or municipal income will not be effected because sooner or later the Nation [will support] cities in projects such as this one" (El Colombiano, October 11, 1984, our emphasis).

In November 1984, the Departmental Assembly and the Municipal Council extended the counter-guarantees, but the Minister of Finance took some time to approve them. For the local press "the people anxiously await the works and international institutions are running out of patience... If the President has committed himself with such an important project, his Minister must act in accordance" (El Colombiano, cited by Acevedo, et al., 1993, pp. 76-77).

The construction of the train started to fall behind schedule and costs increased, but the consortium cited the devaluation of the peso and problems with import licenses that had to be granted by Incomex (a CG agency in charge of regulating foreign trade). Those justifications did not seem entirely reasonable.

The exchange rate adjustment was foreseeable given the balance of payments situation of the country, and devaluation had been mentioned by the Ministry of Finance as one of the reasons suggesting the inconvenience of the project. It turned out, ten years later, that the CG transferred resources to the project to assume the financial burden generated by such devaluation. The second reason is not clear either. In the contract it had been specified that import costs would be borne by METROMED, who stated that it was familiar with legal regulations on the matter.

The project was virtually bankrupt at the end of the 80's, and ETMVA was using working capital to pay interests. The Nation -at that time involved in improving the profile of its foreign debt- began facing major problems abroad. Following the depletion of foreign credit, the CG was forced to assume the obligations of the project, as ETMVA had barely received previously agreed contributions from the municipality and the department.

On July 1989 the Spanish Prime Minister requested President Barco (1986-1990) "to ensure the continuity and final completion of the project" (CGR, 1994, pp. 308), and in March 1989, the Colombian government and the banks held a meeting and subscribed the Madrid Protocol, aimed at refinancing the project. The banks conditioned their approval to the granting of new guarantees by the Republic of Colombia. In December 1989, the national government enacted the "Metropolitan Train Law"» (Law 86) aimed at creating a national and municipal tax infrastructure to allow for the financing of mass transportation projects, particularly Medellín's Metro Rail system.

Additionally, the Nation's endorsement to restructure the debt of the Medellín train (the \$656 million of 1984) was conditioned to the counter-guarantee, backed by a pledge of local income from a 10% surcharge on gasoline and a property appreciation tax that the region committed itself to collect. The law authorized the Nation to contract or guarantee foreign credits for an additional \$500 million, destined for public transportation systems. To grant the guarantee it was established (Art. 4) that at least 80% of the debt service had to be pledged but this requirement was never met.

The position of the Gaviria administration (1990-1994) was apparently more responsible. His Minister of Finance stated "we are willing to help Antioquia, but this is a regional problem and no Minister of Finance can extend a \$2 billion guarantee without the certainty that the money can be recovered". In what became known later on as the Medellín Protocol, the Government agreed with the regional authorities<sup>56</sup> that if works were completed by September, 1994, the total cost of the project would amount to \$1.9 billion, of which \$1.2 were financed.

The remaining \$726 million would be covered as follows: \$500 million with a new foreign credit guaranteed by the Nation and \$226 with domestic resources. The Nation committed itself to procure the new guarantees before the CONPES and to obtain the credits. The ETMVA promised to settle the situation with METROMED and, jointly with the Mayor's Office and the Department, to pledge resources and deliver assets, whenever necessary.

The Nation has continued to service the train's foreign debt. The region has once again defaulted on payments -except for the pledge of income on which a contractual commitment was required in order to meet the first trench of \$650 million. The collection of the property appreciation tax was suspended and the Department ceased delivering the taxes on tobacco. Currently, only the gasoline surcharge -collected directly by the CG- is being pledged<sup>57</sup>.

The largest transfer from the CG to the Medellín Train (and probably the most significant strategic mistake) took place with the enactment of Law 310 of 1996, which set forth that the Nation would pay 40% of the net present value of the debt of the Medellín Train and for up to 70% of other trains to be built.

## IV. Conclusions

Within the Latin American context Colombia ranks well in terms of achieved decentralization. The process started at the beginning of the eighties and received a big push with the new Constitution of 1991. The level of expenditure allocated by sub-national governments is much larger than in the rest of Latin America and even higher than in the average OECD country. Decentralization allows a better match between local preferences and the basket of goods (and taxes) available, but it can also weaken the fiscal discipline of the sub-national governments.

One key factor that has promoted lack of fiscal discipline in Colombia is the model of decentralization implemented by the Constitution of 1991, a hybrid between the model of principal-agent and that of fiscal choice (Kure, 1995; Clavijo, 1998). While in the first model TE are executors of policies designed by the CG and must be accountable to it, in the second one they have more autonomy, making them accountable to their constituents. The hybrid character should imply that the TE is accountable to

---

<sup>56</sup> The meeting was held in December 4 of 1990, with the presence of President Gaviria, his Ministers of Finance and Public Works, the Head of DNP, the Governor of Antioquia, the Mayor of Medellín and the manager of ETMVA.

<sup>57</sup> According to our estimations, the Nation has received approximately \$150 million from the execution of guarantees.

both the CG and its constituents, but that has not been the case. The confusion that exists has allowed the TE to avoid its responsibilities with both the CG and the citizens.

Also, there are some aspects of the transfer system that weaken budgetary restrictions in Colombia. In particular, (i) Issues of efficiency and equity were introduced (BID, 1998). The search of two objectives with one instrument limits the transparency of the system and the accountability of the TE. (ii) The rigidity of the system constrains the discretionality of the TE, reducing accountability and promoting lack of fiscal discipline. (iii) The system has created a flypaper effect and fiscal laziness, especially in those TE that receive important resources from royalties. (iv) The link of transfers to CG's current revenues limits its capacity to undertake counter cyclical policies.

Substantial transfers from the central government to the sub-regions created structural expenditure pressures and irresponsible behavior in terms of debt (mainly loans from the banks), brought the departments into default and forced the central government to bail them out. The amount of transfers, the level of indebtedness, and regional poverty were the main factors behind the bailouts (type 1) related to PAs (performance agreements). But we also show in the paper that the PAs did not work, since taxes decreased (in relation to "income") and expenditure increased, both in absolute and relative terms.

There is a second type of «bailout» we analyze in the paper, regarding the additional money given by the central government to the departments and municipalities to pay teachers. The issues involved in this case are complex, however, and the amount of the bailout cannot be defined as neatly.

The Educational Compensation Fund (FEC) could be just the additional money given to the regions to complement the insufficient resources assigned originally for education (Situado), or the additional money needed to cover the wage increases agreed between the central government and the national teacher's union (Fecode). There is no bailout in the previous two elements.

It seems, however, that they do not account for the whole story behind FEC. To start with FEC represented more than 30% of Situado during the last years, and it would be difficult to explain such an under estimation in the original projections. Secondly, there have been constant reports in the press explaining how the central government obtains new resources to pay regionally elected teachers, and cover wages not paid by the departments and municipalities in the previous years.

Our empirical results preliminarily show that the FEC was transferred following the same rules of Situado (suggesting that some money was missing in the original calculations), but they also confirm the press reports. In particular, departments and municipalities appointed teachers, and "forced" the central government to bail them out later on. We also find that those governors belonging to the party in power got more money than their conservative friends.

We finally considered the case of the rail system build in Medellín. Since the project could not be defended on technical grounds, the President (born in that department) and the government justified its undertaking on very doubtful externalities and as the instrument for the economic recovery of Antioquia.

At the end of the 80's the project was virtually bankrupt. The Nation started servicing the train's foreign debt, and the region has recurrently defaulted on payments. A new Law approved in 1996 stated that the Nation would pay 40% of the net present value of the debt of the Medellín Train, and a bill currently under consideration would increase transfers to the Medellín project from 40 to 70% of the total cost.

## References

- Acevedo, J., Salazar, J.C. and Castañeda, W. (1993), *El Metro de Medellín, Una ilusión costada por todos los colombianos*, Fonade, Instituto SER de Investigación, Bogotá.
- Ahmad, E. and Baer, K. (1997), "Colombia". In: *Fiscal and Federalism in Theory and Practice*. IMF. Washington.
- Alesina, A. Cohen, G. Roubini N. (1991), "Macroeconomic policy and elections in OECD Democracies". In: NBER Working Paper Series. No. 3830. September 1991.
- Alesina, A. Roubini, N. (1992), "Political cycles in OECD Economies". In: *Review of Economic Studies*. No. 59. Págs. 663-688.
- Alesina, A. (1998a), Conferencia del profesor Alberto Alesina en el Foro "Hacia la reforma del estado", April.
- Alesina, A., et.al, (1998b), "Budget Institutions and Fiscal Performance in Latin America", *Journal of Development Economics*, v.59, pp.253-273.
- Alesina, A., Carrasquilla, A., Echavarría, J.J. (2000), "Fiscal Federalism in Colombia" (mimeo).
- Alvear, J. (1990), *El Negocio del Metro (Experiencias para Bogotá)*, Señal Editora, Medellín.
- Asociación Bancaria (2000), "Endeudamiento de los Entes Territoriales con el Sistema Financiero Colombiano".
- Ayala, U. and L.Hernández (1998), "La remuneración y el mercado de trabajo de los maestros públicos en Bogotá", *mimeo*, Fedesarrollo.
- Banco de la República (1996), *Indicadores del Sector Público no Financiero 1987-1995*, Subgerencia de Estudios Económicos.
- \_\_\_\_\_, *Revista del Banco de la República*. Bogotá. Several Issues.
- Banco Interamericano de Desarrollo (1996), "Fortalecimiento de las Entidades Territoriales" (Programa 977 OC-CO).
- \_\_\_\_\_(1997), "América Latina tras una década de reformas", *Progreso económico y social de América Latina*.
- \_\_\_\_\_(1998), "Descentralización en Colombia: Nuevos desafíos", *Serie de Estudios Económicos y Sectoriales*, Región 3, January.
- Clavijo, S. (1998), "Impuestos, gasto público y 'fiscalizadores creíbles': Breve historia de las Comisiones de Finanzas Públicas en Colombia", Documento CEDE 98-02, January.
- Comisión de Racionalización del Gasto y de las Finanzas Públicas (1997), Tema III: Descentralización, Informe Final.
- Consejo Nacional de Política Económica y Social (1982), Acta de la sesión No 484 efectuada el 14 de diciembre de 1982.
- Contraloría General de la República (1997), *La Situación de las Finanzas del Estado*.
- \_\_\_\_\_(1994), *Evaluación de la Gestión Financiera y Legal del Metro de Medellín*, Bogotá.
- Correa, P. and Steiner, R. (1999). «Decentralization in Colombia: Recent Changes and Main Challenges». Colombia an opening economy?. C.C Callahan and F.Gunter eds. Jai Press Inc.
- Departamento Nacional de Planeación (1982<sup>a</sup>). «Proyecto tren metropolitano de Medellín», Documento DNP - 1986 - UINF, April.
- \_\_\_\_\_(1997), "Política de consolidación de la descentralización". *Documento CONPES 2788*.
- \_\_\_\_\_(1982b), "Proyecto tren metropolitano de Medellín", *Documento DNP - 1957 - UINF*, December.
- \_\_\_\_\_(1998), "La situación financiera departamental, 1993-1997". *Documentos para el Desarrollo Territorial No.10.UAEDT*, July.
- \_\_\_\_\_(1998), "Agenda de ajuste de la política de descentralización". *Documentos para el Desarrollo Territorial No.7. UAEDT*. July.
- Duarte, J. (1997), "Problemas del esquema actual de asignación de recursos en educación y salud", *Coyuntura Social*, Fedesarrollo, No.16, May.

- Escobar, A. (1996), "Ciclos políticos y ciclos económicos en Colombia: 1950-1994", *Coyuntura Económica*. Marzo de 1996. Págs. 115-141.
- Federación Nacional de Departamentos (1999), "La crisis fiscal de los departamentos".
- Fedesarrollo (1998), "Análisis Coyuntural", *Coyuntura Económica*, June.
- Fernández-Arias, E, Stein, E, Von Hagen, H, (1999), Términos de Referencia al proyecto sobre bailouts regionales, Banco Interamericano de Desarrollo.
- Gutierrez, C. (1996), "Análisis de los convenios de desempeño suscritos entre la Nación y los Departamentos, los casos de Chocó, Nariño y Putumayo". Preliminary Draft, July.
- Inter-American Development Bank (1998), "Decentralization and Fiscal Discipline in Sub-National Governments: The Bailout Problem", Research Network Project, Terms of Reference.
- \_\_\_\_\_(1997), "Latin America after a decade of reforms". *Economic and Social Progress in Latin America*.
- IMF (1995), "Colombia: Reforming Territorial Taxation and Transfers", Aide Memoire, Fiscal Affairs Department, January 30.
- IMF (1997), Fiscal federalism in Theory and Practice. Teresa Ter-Minasian (ed.). Washington.
- Jaramillo, J.C., Steiner, R, y Salazar, N. (1999), "The political economy of exchange rate policy in Colombia", *Working Paper Series*, Fedesarrollo, No.11, January.
- Kornai, János (1986), "The Soft Budget Constraint". *Kyklos*, Vol.39.
- Kure, I. (1995), "La descentralización: retos para su consolidación". *Revista de Planeación y Desarrollo*, DNP, May.
- Ministerio de Hacienda y Crédito Público (1999), "La problemática fiscal de los departamentos y la posición del Gobierno Nacional en la búsqueda de soluciones". Ibagué, February, 1999.
- \_\_\_\_\_"Crisis fiscal y financiera de los departamentos", Análisis y Propuesta del Gobierno. Asamblea General de Gobernadores. February, 1999.
- \_\_\_\_\_"Programa de Apoyo al Saneamiento Fiscal y Fortalecimiento Institucional".
- \_\_\_\_Dirección de Apoyo Fiscal. Convenios de Desempeño suscritos entre la Nación y los Departamentos.
- Mora, Humberto (1999), "Financiamiento del Régimen Subsidiado en Salud" (Trabajo presentado para el Comité Intergremial en Seguridad Social en Salud), Fedesarrollo, Enero 1999.
- Moreno, A.(1998), "Ciclo político y política económica: un análisis del caso colombiano 1930-1995". En: Informe Financiero. Contraloría General de la República. Febrero de 1998. Págs. 13-73.
- Pachón, A. (1991), "Evaluación expost del Metro de Medellín", Preliminary Draft, Alvaro Pachón y Asociados.
- Rafuse, Robert (1990), "Representative Expenditures: Addressing the neglected dimension of Fiscal Capacity", Advisory Commission on Intergovernmental Relations, M-174, December, 1990.
- República de Colombia (1991), Constitución Política de la República de Colombia.
- Proyecto de Ley No.68 por la cual se reglamenta el artículo 364 de la Constitución y se dictan disposiciones en materia de endeudamiento. May, 1996.
- Rojas, F. and Campbell, T. (1994), "Poverty Reduction in a Decentralized Setting: Equity, Efficiency and Accountability", *mimeo*, World Bank.
- Rosas, G. (1998), "Papel de los Departamentos en la Descentralización", Federación Nacional de Departamentos, Bogotá.
- Steiner, R. and Soto, C. (1999), Cinco Ensayos sobre Tributación en Colombia, *Cuadernos de Fedesarrollo*, No.6. Bogotá.
- Vargas, J. and Sarmiento, A. (1997), "Descentralización de los servicios de educación y salud en Colombia", *Coyuntura Social*, Fedesarrollo, No.16, May.
- Wildasin, D. (1997), "Externalities and Bailouts: Hard and Soft Budget Constraints in Intergovernmental Fiscal Relations". Policy Research Working Paper no. 1843, World Bank, Washington, November.

**Table A1. Diagnostique of the situation of departments in the Performance Agreements**

Diagnostique	Atl	Bol	Cau	Caq	Ces	Cho	Gua	Hui	Mag	Met	Nar	Nor	Put	Tol	Vall	Cases
Current Deficit	X	X	X	X	X	X		X	X	X	X	X	X		X	13
Accelerated increment in expenditure		X	X	X	X	X	X	X	X	X	X	X	X	X	X	14
High dependence on transfers, cofinancing and royalties in some cases								X	X				X			3
Existence of non-authorized remuneration								X	X							2
Increase in personnel expenditure that has increased long term liabilities		X	X	X		X	X	X	X	X	X	X	X			11
High indebtedness	X	X	X	X	X		X	X	X	X	X	X			X	12
Inefficient organizational structure		X			X		X			X		X		X		6
High levels of liquidity				X	X		X									3
Deficient behavior of revenues		X		X	X	X	X			X	X	X	X		X	11
Loss in dynamism of revenue collection		X			X	X	X	X			X	X			X	8
Defficiencies in budget management						X							X			2
Judiciary processes						X							X			2

**Table A2. Factor Analysis**

Rotated Factor Loadings (varimax. 4 factors)				
Cofinancing per capita	<b>0.84</b>	-0.27	-0.13	0.01
Transfers per capita	<b>0.94</b>	0.03	0.00	0.00
Debt per capita	0.01	0.03	<b>0.81</b>	0.04
Population	-0.24	<b>0.73</b>	0.00	-0.29
Liberal Governor in 1994	-0.20	0.01	0.18	<b>0.57</b>
Per Capita Tax Revenue	-0.09	<b>0.85</b>	-0.07	0.09
Total Revenue/Total Expenditures	0.51	-0.13	-0.34	0.50
Current Revenue/Current Expenditur	0.26	0.51	<b>-0.65</b>	0.06

