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Making Reform Happen in Colombia: The Process of Regional Transfer Reform

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Abstract

This paper studies the interaction between different actors in the policy-making process of fiscal transfer reform in Colombia. To analyse this reform, we use the "life cycle of reform" framework. In that context, we follow critical phases in the reform process: planning, dialogue and adoption, and implementation and sustainability stages. This paper shows that the economic context and institutional factors, such as the new political structure for interactions between agents after the 1991 Constitution, were fundamental in achieving the reform. Moreover, it confirms previous studies showing that communication and compensation strategies play a key role in the approval of reforms. When the "sustainability" of the reform is analysed, this study shows that there is a need to improve the co-ordination of public policies at different levels of government.

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I. Introduction

This case study analyses the process of regional transfer reform in Colombia. In particular, it studies the interactions between different actors in the policy-making process (PMP) of fiscal transfer reform, within a context of economic crisis and a new political regime following the 1991 Constitution. This paper contributes to research on the PMP in Latin America.[1]

The study focuses on the reform aimed at improving the system of transfers from the central government to sub-national governments.[2] The main purpose of this reform was to reduce exposure to a fiscal crisis at the beginning of the 2000s due to an increase in these transfers (*i.e.* from 2.5% of GDP in 1991 to more than 5.5% of GDP in 2001). The second objective was to improve the methodology to allocate these transfers in education and health (*i.e.* it depended on the operational expenditure, such as the number of teachers per region, and shifted to depend on the coverage).

This analysis shows that the economic context at the end of the 1990s (when Colombia suffered its deepest economic crisis since 1930) and the "new" PMP after the 1991 Constitution (*i.e.* interactions between executive and legislative given a new political framework) were key to achieving this reform. Additionally, it confirms previous studies showing that communication and compensation strategies play a role in the approval of reforms.

In a nutshell, the transfer reform stabilised the level of public expenditures and implemented both an incentive and an anti-cyclical scheme for these transfers. In doing so, this reform accomplished three main objectives. Firstly, it prevented an unsustainable increase in the amount of transfers given the solvency of the State. Secondly, it helped to improve the effectiveness of transfers in increasing the coverage of public education and healthcare. Thirdly, it reduced the transfers' dependency on the economic cycle.

However, challenges remain to better manage transfers and other sources of revenues for local authorities (mainly royalties). While the transfer reform adopted at the beginning of 2000s aimed to avoid a fiscal crisis, today's challenges are different. This case study shows that measures seeking to improve the management of fiscal revenues at local level are sorely needed.

The remainder of this paper is organised as follows. Section II presents the economic and political context, and the main actors of this reform. Section III analyses the main phases of the policy process, namely the formulation and planning, the dialogue and adoption, and the implementation and sustainability stages of the reform. Finally, Section IV concludes and presents the main policy lessons.

[1] See IDB (2006), Stein and Tommasi (2008), Ardanaz *et al.* (2010), Scartascini *et al.* (2010), and Dayton-Johnson *et al.* (2011) for extensive analyses of interactions between agents and institutions in the arenas of public policies in Latin America.
[2] The legal framework of this reform was the Legislative Act 01 of 2001 and the Law 715 of 2001.

II. Context and Actors

II.A. The context: the 1999 economic crisis and the 1991 Constitution

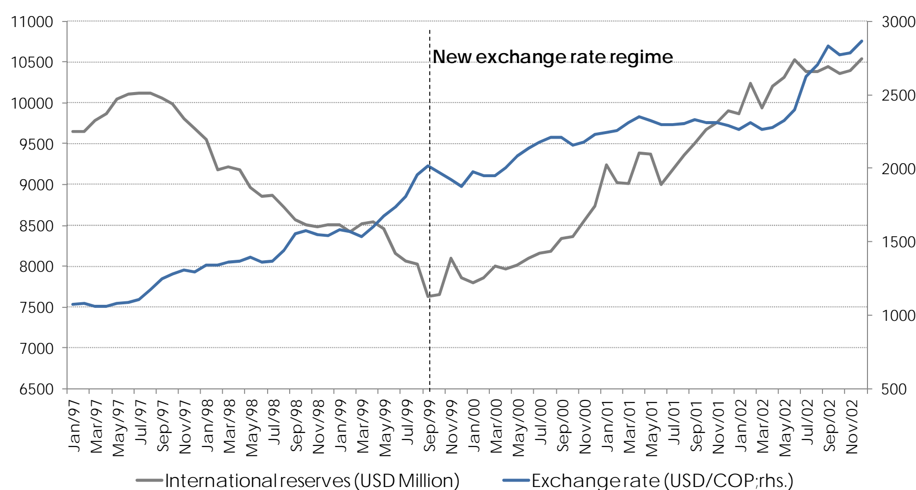
The 1999 economic crisis

In the early 1990s, Colombia underwent a process of financial liberalisation. Almost simultaneously, there was an important surge in capital inflows which prompted a large monetary and credit expansion, which itself led to higher private and public spending. Public and private saving rates diminished and demand for non-tradable goods expanded (especially real estate), leading to a rise in both local credit and asset prices, and an appreciation of the Colombian peso in real terms.[3]

Between 1997 and 1999, there was a reversal in capital inflows and a sharp decline in the terms of trade, which induced an abrupt correction of aggregate expenditure and a current account deficit. Asset prices dropped and, in particular, real estate prices fell by more than 27% in real terms between 1995 and 1999.[4]

In a context of large fiscal and external imbalances, the terms of trade shocks and the "sudden stop" of 1998-99 led to a devaluation of the peso. Between August 1997 and September 1999, international reserves fell by almost USD 2 500 million while the exchange rate depreciated 72%, ultimately forcing the abandonment of the exchange rate bands' regime in September 1999 (Figure 1). Loan interest rates attained near record-high levels, reaching more than 50% in June 1998. A floating regime was then established and monetary policy converged to a fully-fledged, inflation-targeting framework.

Figure 1. Exchange rate and international reserves around the 1999 economic crisis



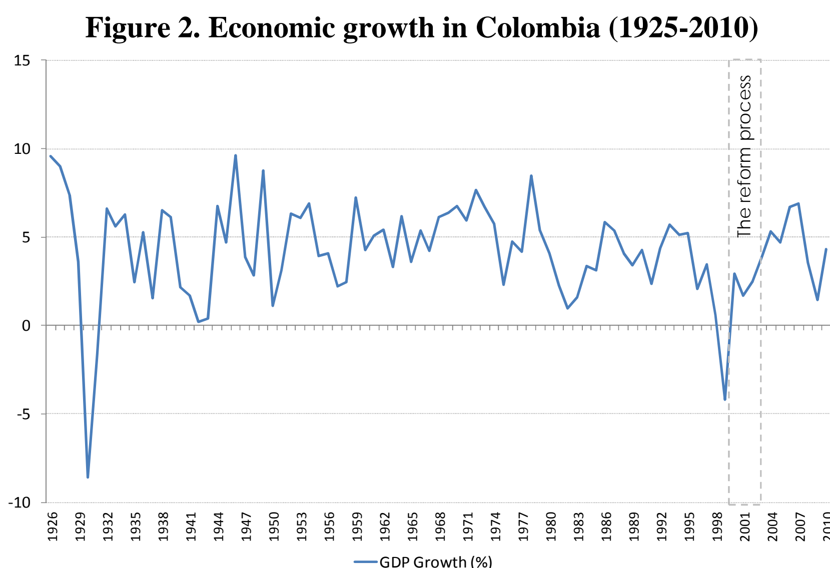
Source: Central Bank of Colombia (Banco de la República).
Note: The right axis depicts the exchange rate.

[3] Total credit rose from 29% to 44% of GDP between 1991 and 1997.
[4] See Uribe-Escobar and Vargas (2002) and Vargas (2005) for an analysis of the causes and consequences of the 1999 economic crisis in Colombia.

The financial system went through a deep deterioration of its solvency and profitability, as well as a sharp contraction in credit growth. The reduction of the annual real credit growth was close to 4.0% on average between 1998 and 2001. The fall in the solvency ratios was related to the large increase in past due loans, which, at the end of 1999, reached the historical high of 16% of total loans.

As the result of a monetary and banking crisis, GDP growth fell by more than 4% in 1999, the highest depression in the Colombian economy since 1930 (Figure 2).[5] A fiscal reform was needed to avoid the amplification of this recession into a debt crisis. In that context, central government adopted a regional transfer reform. This particular reform (highlighted in red in Figure 3) constitutes the case study for this research.

Figure 2. Economic growth in Colombia (1925-2010)



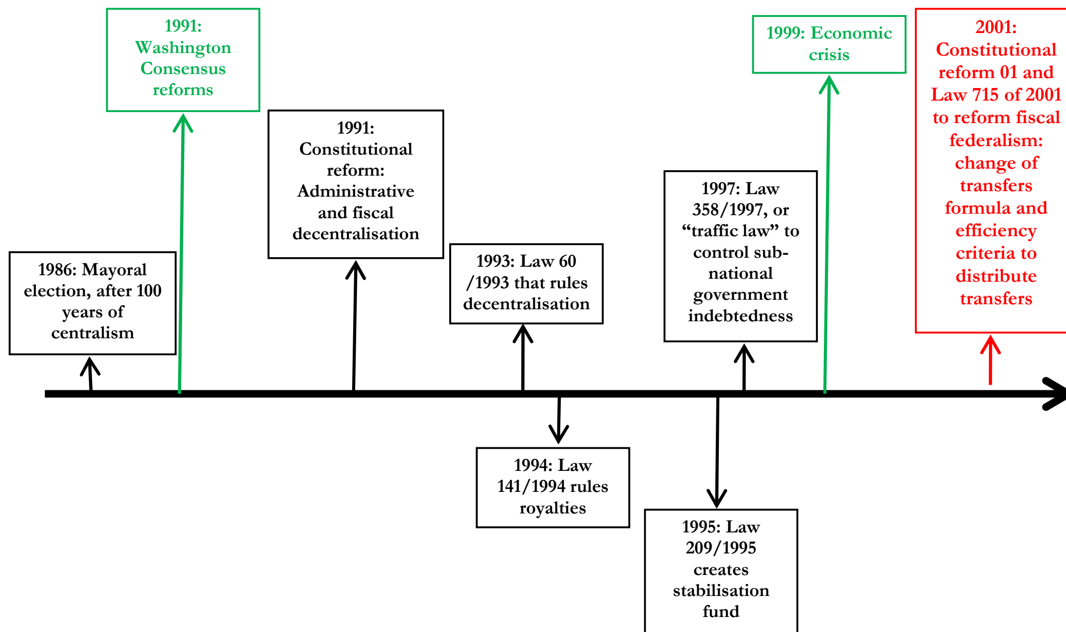
Source: Central Bank of Colombia (Banco de la República) and ECLAC (The Economic Commission for Latin America and the Caribbean).
Note: Annual GDP growth is exhibited in percentage.

The political context and the 1991 Constitution

In the last 25 years, the fiscal decentralisation panorama in Colombia has changed dramatically (see Figure 3 for an overview). Until 1985 Colombia was politically and economically centralised. The first decentralisation move was the establishment of mayoral elections in 1986.

[5] The average real GDP growth has been 4.2% in Colombia for the last 85 years and by excluding 1930 (-8.6%), 1931 (-1.6%), and 1999 (-4.2%) all years observed positive annual real GDP growth.

Figure 3. Evolution of regional reforms in Colombia



Source: Authors.
Notes: Economic and external events are highlighted in green (i.e, Washington Consensus and Economic Crisis).
Reform analysed in this case study is highlighted in red (i.e, 2001 Reform).
Above the line the figure presents the evolution of regional fiscal reforms.
Below the line the figure presents the evolution of royalties.

At the end of the1980s, Colombian political institutions were under pressure by the civil society. In addition to an improvement in security and political stability, civil society requested more political inclusion (Cárdenas and Pachón, 2010).[6] A centralised bi-political party system pushed regional political leaders and voters to insist on a decentralisation reform. As a result, political actors adopted the 1991 Constitution, establishing a new political regime in which new actors and transaction costs became crucial components of the PMP of reforms[7].

The adoption of a new Constitution introduced a transformation of the political and economic context at sub-national level. Firstly, at the political front, governors of the 32 departments began to be chosen through popular election, instead of being appointed by the executive (and resulting from a close dialogue with the congress). This implies that governors and mayors dependence on national party directorates diminished, making them more independent. Secondly, financial resources of sub-national governments increased considerably. In that context, first, departments and municipalities exploiting natural resources started to receive a large percentage of royalties from that production.

[6] The increase of the insecurity and the conflict with traffic drugs dealers amplified political instability. In 1989, the top candidate in the polls for the 1990 presidential elections, Luis Carlos Galán, and two other presidential candidates, Bernardo Jaramillo Ossa and Carlos Pizarro, were assassinated.
[7] See Lora and Scartascini (2010) for the impact of the 1991 Constitution on the Policy Making Process in Colombia.

Second, sub-national governments were allowed to issue debt or to have access to the credit system.[8] Third, a higher percentage of central government current revenues should be transferred to sub-national governments. More than 80% of these transfers were earmarked for education and healthcare.[9]

Since the 1991 constitution, a series of reforms have been approved in order to improve both fiscal sustainability and efficiency in the execution of public resources at regional level.[10] Firstly, at the beginning of the 1990s, a stabilisation fund and rules concerning royalties were adopted (see Figure 3 above). These reforms were particularly necessary after oil income began to increase substantially in 1994 thanks to the discovery of oil fields. Today, royalties from natural resources (mainly coal and oil) are a large source of regional revenue. However, the lack of a national comprehensive approach to managing royalties, the concentration of royalties in only 8 departments (out of 32) and a small number of municipalities, the institutional weakness in these departments, and the expectation of a big oil boom, have generated the need for further reform of royalties today.[11]

Secondly, in order to avoid the unsustainability of regional public finances, the Samper administration (1994-98) presented a draft law in 1995 (finally approved in 1997) to contain regional debt.[12] The increase in transfers observed in Figure 4 generated a significant rise in sub-national revenues, and regions used these new revenues to leverage debt, generating an imminent need for reform. The new law introduced thresholds to solvency and sustainability indicators and a system of "green", "yellow" or "red" lights depending on observed ratios, according to which departments and municipalities can automatically either incur more debt, require special permission from upper levels of government to do so or cannot issue new debt until they undertake a fiscal adjustment programme (Olivera *et al.*, 2010).

Thirdly, the crisis helped the Pastrana administration (1998-2002) to enact several reforms to increase revenues at central government level and to control sub-national expenditures even without a congressional majority. Towards the end of its term, it passed a constitutional reform (the focus of this study) which reduced the pace of growth of regional transfers highlighted in Figure 3 and exhibited in Figure 4 (*i.e.* the 2001 regional transfer reform).

In particular, before the approval of the 2001 reform, regional transfers were increasing and depended on the current revenues. They supposed to represent 46.5% of current revenues in 2002. More precisely, the 1991 Constitution (articles 356 and 357) and the Law 60 of 1993 regulated these transfers. According to these rules, as a percentage of

[8] In contrast, the Constitutional reform does not affect the sub-national taxation system, which is still under the Law 14 (1983), and other complementary norms. Sub-national governments are restricted to modifying tariffs and goods and services taxed. Moreover, the autonomy regarding the utilisation of these incomes is low since the legislation defines on which items some of these taxes should be spent.

[9] The regulation of these transfers was implemented only in 1993. Indeed, Law 60 of 1993 regulated articles 356 and 357 of the 1991 Constitution.

[10] In contrast to tax reforms, decentralisation reforms (Figure 3) were less frequent but more effective in improving the solvency of the State. While almost one tax reform per year was enacted (i.e. 14 tax reforms for the period 1990-2007), reforms aimed at decentralisation were not as frequent, but were more effective at controlling central government expenditure growth and the fiscal deficit (Olivera *et al.*, 2010).

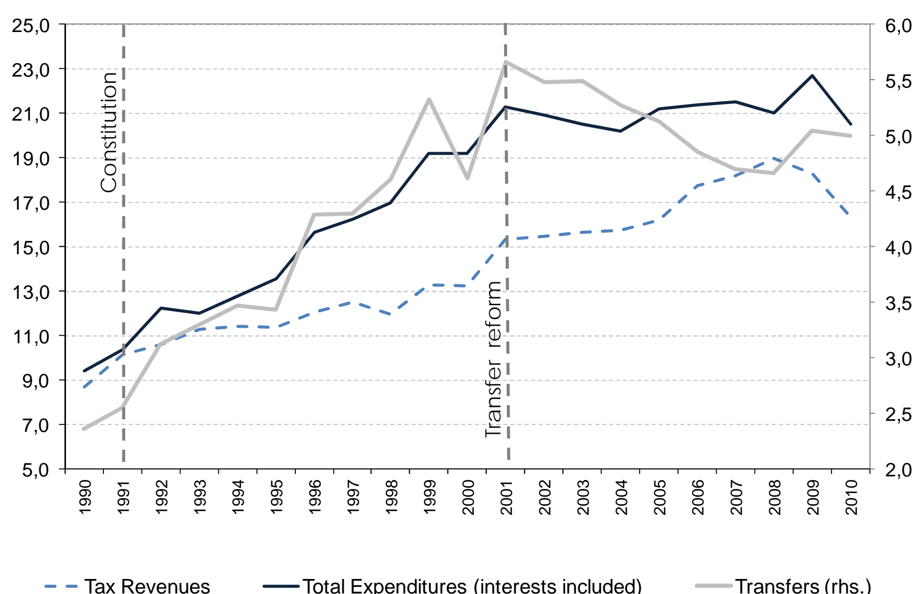
[11] See Perry and Olivera (2009) for an analysis of the link between royalties and the institutional framework in Colombia.

[12] Law 358 of 1997 and popularly known as the *Ley de Semáforos* (traffic light law).

current revenues, regional transfers for departments represented 23% in 1994, 23.5% in 1995, and 24.5% from 1996 (*i.e.* regional transfers = 24.5%*current revenues from 1996). In addition, transfers for municipalities should increase from 15% of central government current revenues in 1994 to 22% in 2002.

The high increase of regional transfers affected considerably national public finances. In particular, before the adoption of the 2001 reform, regional transfers increased from 2.5% of GDP in 1991 to more than 5.5% of GDP in 2001, affecting total expenditures. While expenditures and regional transfers increased 125% and 140% respectively, tax revenues increased "only" 75% between 1990 and 2001 (Figure 4).[13]

Figure 4. Regional transfers, national expenditures and revenues after the 1991 Constitution (% of GDP)

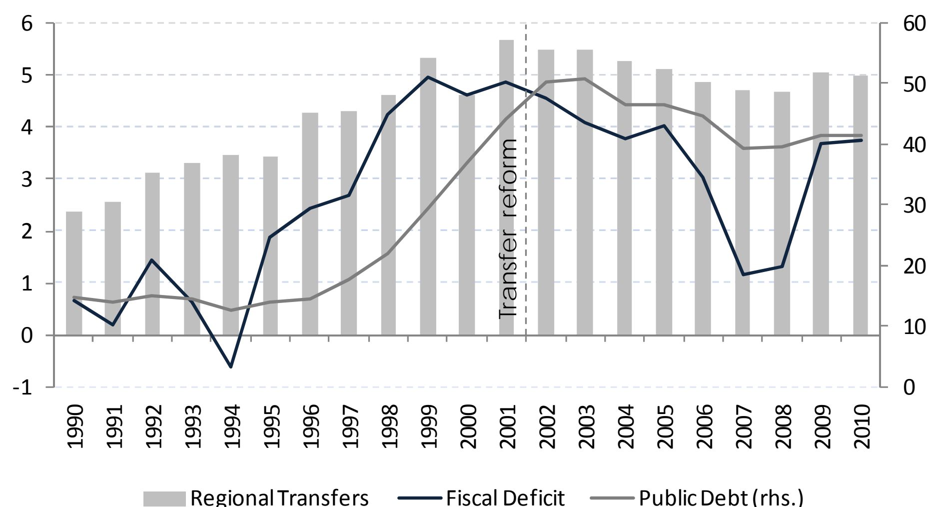


Source: Authors' calculations based on the Central Bank of Colombia (Banco de la República) and the Ministry of Finance of Colombia (Ministerio de Hacienda y Crédito Público).
Note: The right axis depicts the regional transfers.

Indeed, after the 1991 Constitution the gap between total expenditures and tax revenues considerably increased and public finances deteriorated. A higher expansion of national expenditures with respect to the national revenues growth affected the fiscal deficit and the public debt. Part of this deterioration was the high increase in regional transfers. Central government fiscal balance in terms of GDP passed from close to 0% in 1991 to close to -5% in 1999. In the same vein, total public debt over GDP increased from close to 14% in 1991 to 44% in 2001 (Figure 5).

[13] Moreover, as we study below, the tax revenues represent a small proportion of the GDP with respect to OECD economies (OECD 2011a).

Figure 5. Regional transfers, central government fiscal deficit and public debt around the 1999 crisis (% of GDP)



Source: Authors' calculations based on the Central Bank of Colombia (Banco de la República) and the Ministry of Finance of Colombia (Ministerio de Hacienda y Crédito Público).
Note: The right axis depicts the total public debt.

The need to reduce fiscal imbalances is more pressing when a economic crisis episode has occurred. An increasing deficit that generates an unsustainable level of indebtedness would need at some point a fiscal reform to close the fiscal gap and reduce debt. If reforms are not implemented, the economy will default on its debt and capital markets would be closed for some time. This was the case in Colombia at the moment of the worst recent economic crisis.

II.B. Actors and interests

Several actors played a crucial role in the PMP of the 2001 regional transfer reform. The key actors studied in the main phases of this process are the executive (in particular the President, the Minister of Finance, and the National Planning Department Director), the legislative and political parties, the sub-national authorities (*i.e.* mayors and governors), the Media, the IMF (International Monetary Fund), and the unions (in particular education and health workers unions).

The main winner from this reform was the executive and, in particular the Minister of Finance, Juan Manuel Santos (current President of Colombia), who was pushing forward the reform in order to avoid a fiscal crisis. As observed below, Minister Santos belonged to the opposition party (*partido liberal*) of the Pastrana administration (*partido conservador*).[14]

The legislative was another winner thanks to a slower rate of increase in the transfers to sub-national authorities. After a century of political and administrative centralism, the 1991 Constitution aimed to increase citizen representation by delegating fiscal and

[14] See Santos (2006) for an analysis – as an actor - of the main political economy aspects presented in this reform.

political power to departments and municipalities. This transfer reform could be perceived as a measure that prevented the development of political fragmentation and the independence of sub-national authorities from their directorates of political parties.

Another winner was the IMF. In times of crisis, when access to private international financial markets is severely limited, the IMF and the US Treasury play an important role. Their participation facilitates consensus building within government and in congress (within major traditional parties), as all players realise that structural reforms are needed not only to help finance the budget directly, but also to get access to foreign credit. In that context, in December 1999 the IMF approved the Three-Year Extended Fund Facility for Colombia.[15] The reform agenda included measures to strengthen the finances of the territorial governments and to reduce the non-financial public sector deficit.

The main losers were the education and health workers unions, which are FECODE (*Federación Colombiana de Educadores*) and ANTHOC (*Asociación Nacional de Trabajadores Hospitalarios de Colombia*), respectively. Since transfers were dependent on the operational expenditure, such as number of teachers per region (and independent of the number of students per teacher), a reduction in the growth of these transfers directly affected the members of these unions. Since these unions have as one of the implicit target the increase of employees in education and healthcare, a reduction of operational expenditure was contrary to their objectives. Among unions, the main actor against the reform was FECODE. Teachers and in general employees in the education sector initiated numerous strikes and protests in a number of cities at the planning stage of the reform. According to Santos (2006), these demonstrations affected the support of a certain number of congressmen since they associated the approval of this reform with a "political suicide".

The sub-national authorities were key losers. In the political arena, a reduction in the regional revenues indicated a loss of political power for regional political actors (*i.e.* governors, mayors) *vis-à-vis* the executive and the congress. As studied below in the adoption and dialogue stage, the executive and in particular the Ministry of Finance, proposed compensation measures in order to obtain the support of sub-national authorities (Santos, 2006)[16]. The dialogue and compensation measures favoured the support of the Colombian Federation of Municipalities (*Federación Colombiana de Municipios)*.

Other losers were within the executive: the Ministers of Education, Employment and Health. The stabilisation of regional transfers implied a decrease in the financing of education and healthcare with respect to the total public budget. According to Santos (2006), the opposition came above all from the Ministry of Health that threatened the Ministry of Finance to form a coalition against the reform within the congress. Additionally, The Ministry of Employment, under the head of Angelino Garzón (current Vice-President of Colombia), supported arguments raised by the education union (*i.e.* FECODE) against the reform.

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[15] It was the first IMF Programme since 1965 and was a three-year credit of USD 2.7 billion under the Extended Fund Facility (EFF) "to support the government's economic reform program for 1999-2002" (see http://www.imf.org/external/np/sec/pr/1999/pr9963.htm).

[16] See section III.B for a description of these compensation measures.

III. The Phases of the Regional Transfer Reform

To analyse this reform, we use the "life cycle of reform" framework. In that context, we follow critical phases in the reform process: planning, dialogue and adoption, and implementation and sustainability stages. In general, these different stages help to identify the main activities, actors and bottlenecks in the process of reform (see Dayton-Johnson *et al.*, 2011 for an analysis of the "life cycle of reform" in Latin America). Although these phases do not always – or even usually – unfold in precisely this sequence, it is analytically useful to distinguish them in this way (OECD, 2010a). In fact, these stages often unfold concurrently and there may be some overlapping or leapfrogging of phases, depending on the type of reform in question. However, reviewing each stage in the policy making process, it enables a more thorough understanding of the bottlenecks and challenges, and the relative importance of different actors at different stages.

The first phase, called the "planning" phase, identifies the problem, designs the policy and builds the reform agenda. In the regional transfer reform, the executive was the key actor in this phase. After the policy is designed and the reform agenda is set, the policy continues into a "dialogue" phase, in which, the executive, and in particular the Minister of Finance actively communicated the proposal of this reform. The "adoption" stage involves the approval of the reform. In this reform, the adoption process was long and all three branches of the State were involved. The fourth stage, the "implementation" phase, involved mainly the sub-national governments, since they executed the regional transfers' resources. Finally, to sustain the reform, it must be evaluated appropriately, and the results must be transparently assessed and evaluated. The analysis of the "sustainability" stage of this reform shows that new incentive mechanisms should be introduced. In particular, since today's challenges differ from past priorities, this reform should be revisited.

III.A. The planning phase

Since the executive branch holds a monopoly on bills that have budgetary implications, the planning of the reform started with the executive. Within the executive, political and technical players were aligned to lead this reform. In particular, key technical players were the planners of the reform. The Territorial Office and the Macroeconomics department of the Ministry of Finance, and the Director's Office of the Department of National Planning (DNP), under the head of Juan Carlos Echeverry, designed the reform[17]. This is consistent with Latin American evidence, where Presidents and cabinets play a preeminent role in setting the policy agenda and formulating policy proposals. In fact, cabinets (and the bureaucracies they head) have a "near-monopoly in the design of policy, only occasionally receiving input from political parties and/or interest groups" (Martinez-Gallardo, 2010).

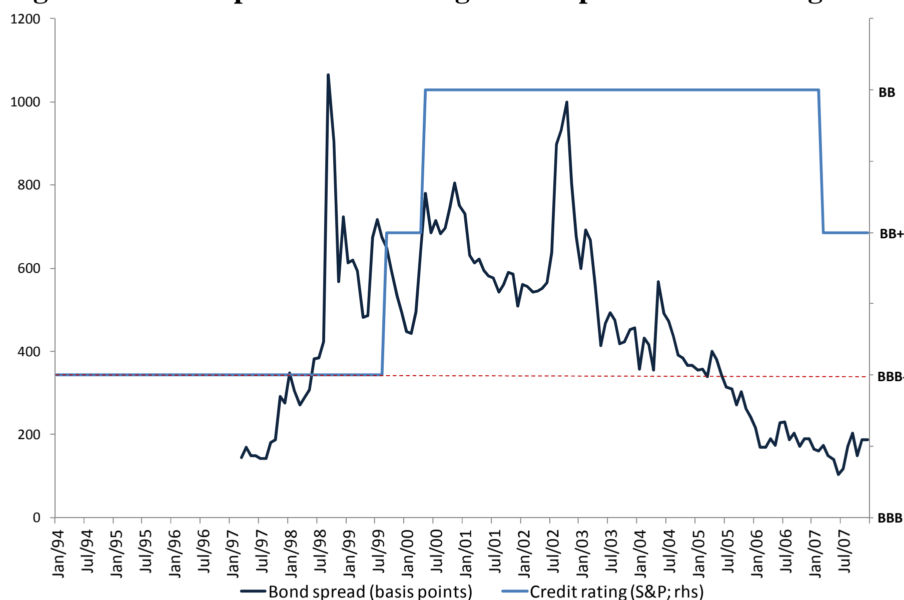
[17] A key technical player of the reform was Juan Carlos Echeverry (current Minister of Finance for the Santos Administration). Background and professional experience confirm that role. He holds a PhD in Economics from New York University and before he served as DNP Director, he worked at the Colombian Central Bank and at the DNP. After his appointment as DNP Director, he held the position of Economics Dean at the Universidad de los Andes.

Consultation and dialogue with former Ministers of Finance was determinant at the formulation stage of the reform. Juan Camilo Restrepo (previous Minister of Finance of President Pastrana) and Guillermo Perry (Chief Economist for Latin America at the World Bank at that time) were consulted in order to discuss the design and feasibility of the reform.

Consistent with previous findings in the comparative literature, our hypothesis is that the 1999 economic crisis contributed to the enactment of this fiscal reform. This has been the case for many OECD countries in general, and South Korea in particular (Lim, 2010). In Latin America, this has allowed many reformist governments to package different kinds of reform in the name of curing the crisis situation (Dayton-Johnson *et al.*, 2011). Focusing on Latin American countries between 1985 and 1995, Lora and Olivera (2004) find strong econometric support for the hypothesis that crises make reforms more viable. Indeed, during the 1980s macroeconomic crises that ended in hyperinflation and debt defaults spurred orthodox, first-generation policy reform. Similarly, the end-of-millennium crisis triggered fiscal responsibility laws that combined numerical spending and/or budget balance targets with measures to increase transparency (Hallerberg and Scartascini, 2011). Empirical evidence reinforces the argument that economic downturns may spur reform in Latin America.

Capital markets deterioration spurred Minister of Finance Santos and DNP Director Echeverry to plan and to formulate the need for a transfer reform. Colombian capital markets were under market pressure as a consequence of uncertainty and deterioration of economic conditions in Colombia as well as in other emerging economies of the region (*e.g.* Argentina and Brazil). Consequently, sovereign bond spreads (*i.e.* a proxy of the risk perception of institutional investors towards sovereign debt) increased and rating agencies downgraded Colombia below Investment Grade (Figure 6).

Figure 6. Market pressure. Sovereign bond spread and sovereign rating



Source: Datastream

Notes: S&P refers to the Standard and Poor's rating agency. Right axis depicts the S&P's rating.

The initial proposal of the regional transfer reform, presented as Legislative Act Proposal 012 of 2000 (*Proyecto de Acto Legislativo 012 de 2000*), stated for the period 2002-06 that the increase of the transfers were equivalent to 1.5% multiplied by the transfers of the previous year plus the inflation target (*i.e.* regional transfers = (1+1.5%)*transfers t-1 + inflation target). After 2007, transfers were supposed to increase at the average increase rate of current revenues of the four previous years. In contrast to the existent rule before the adoption of the reform (*i.e.* nearly half of the national current revenues earmarked to regional transfers), this proposal proposed a fixed real increase in the transfers and below the average GDP growth in Colombia (2.2% for the period 1980-2000). In doing so, this proposal first, prevented an unsustainable increase in the amount of transfers, and second it reduced the transfers' dependency on the economic cycle.

III.B. The dialogue and adoption phases

Such as OECD experiences (Blöchliger and Vammalle, 2012), political leadership was crucial to accelerate the reform. President Pastrana (1998-2002) appointed Juan Manuel Santos in 2000 as Minister of Finance in order to push forward economic reforms that helped to avoid a fiscal crisis. Given the economic situation at the beginning of the 2000s the main economic target of the Pastrana administration was to recover macroeconomic stability by achieving crucial economic and financial reforms such as the regional transfer reform.

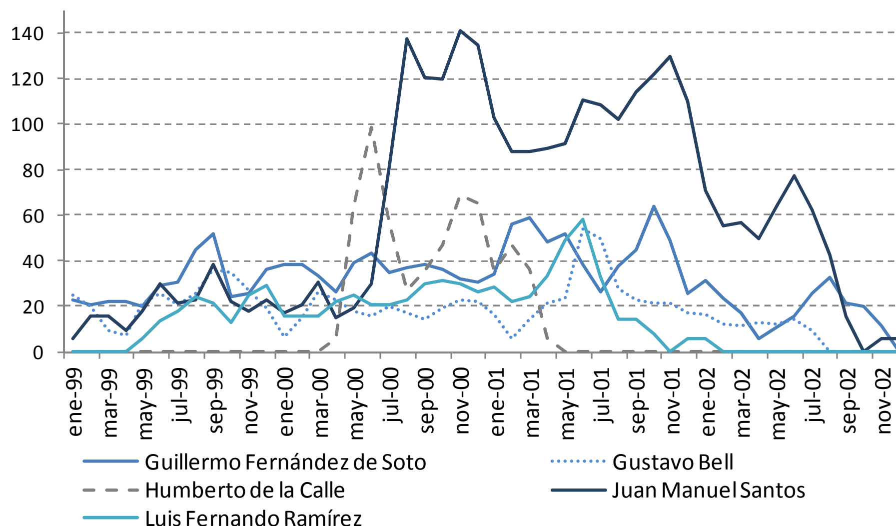
Minister Santos belonged to the opposition party (*i.e. partido liberal* or the equivalent to the Democratic Party) of the Pastrana administration (*i.e. partido conservador* or the equivalent to the Republican Party). When Santos was appointed, Pastrana administration was suffering a governance crisis since he threatened a Congress reform after corruption scandals. Consequently, Santos appointment had the clear objective of recovering governance and supporting reforms in the Congress. In particular, Minister Santos succeeded in convincing the opposition and in particular the chief of the opposition, Horacio Serpa, to approve the reform in the Congress.

The communication strategy was a key component to approve the reform. Juan Manuel Santos belongs to one of Colombia's foremost families, who are particularly influential in the areas of communication and politics. His family was the owner of *El Tiempo*, the country's leading newspaper, and Juan Manuel Santos, before joining the Ministry of Finance, spent periods as a journalist (in particular Deputy Director of *El Tiempo*) and as a policy maker (in particular Minister of Foreign Trade). Background and knowledge helped Minister Santos to develop a remarkable communication strategy, explaining to civil society the need for this reform, and indirectly obtaining the approval of the most important stakeholders. This strategy was consistent with past experiences in OECD and Latin American economies in which to harmonise divergent interests, a high level of communication is mandatory. Indeed, high and efficient levels of communication are needed not only to persuade voters and stakeholders of the need to undertake reform, but also to warn them of the costs of non-reform (Dayton Johnson *et al.*, 2011).

Figure 7 exhibits the press coverage of the main ministers during the Pastrana administration. After Santos' appointment his press coverage increased significantly

and was dramatically higher than the other ministers of the Pastrana administration in that period.[18]

Figure 7. Press coverage in the Pastrana administration
(Number of citations)



Source: Authors' calculations based on http://ngrams.cavorite.com/.
Notes: This database covers the most important press publications in Colombia (*i.e.* the newspaper *El Tiempo*, and the magazines *Semana* and *Dinero*). See Caicedo, Gaviria, and Moreno (2011) for more information and for an analysis of the press coverage in the changing reality of Colombia.
Ministers selected are: Humberto de la Calle (Interior Minister for the period 2000-01), Guillermo Fernández de Soto (Foreign Affairs Minister for the full period of President Pastrana), Luis Fernando Ramírez Acuña (Defense Minister for the period 1999-2001), Gustavo Bell Lemus (Defense Minister 2001-02), and Juan Manuel Santos (Finance Minister for the period 2000-02).

A second key component of the dialogue stage was the compensation measures. A "bundling" approach for the compensation measures helped to obtain the support of a large majority of sub-national authorities. Firstly, the reform proposal considered extending the election period for mayors from two to four years[19]. Secondly, central government helped local authorities to renegotiate loan conditions with the financial system (*e.g.* increase in the maturity and reduction in the risk premium). Thirdly, the reform prevented uncertainty and volatility of the future transfers (*i.e.* fixed real increase instead of dependent on the economic cycle), especially in a crisis period when regional transfers were small due to a small GDP growth and hence a small tax collection at the central government level.

At the adoption stage, the legislative was a key player. "Decentralisation" reforms, such as the regional transfer reform, require constitutional amendment and a long process in the congress composed of eight debates (Table 1). A stabilisation of the transfers to sub-national authorities was welcomed by congress, as it limited the former's political

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[18] An example of the vast communication strategy realised by Minister Santos was the presentation of this reform to the highest television audience , which was during the *Telenovela Betty la Fea* (Ugly Betty Series). As mentioned by Santos (2006), it was the last time that a Minister was able to interrupt Colombian TV channels'.
[19] However, this proposed measure was not approved by the Congress in 2001 but in 2004 during the Uribe administration (2002-2010).

power. Indeed, following the 1991 Constitution, regional politicians became more independent from the central party network and co-ordinating collective action among co-partisans became very challenging with the introduction of popular elections to regional authorities.[20] Consequently, the transfer reform has been perceived by congressmen as a constraint to regional politicians to further their career.

Table 1. Reform approval process

	Tax bills		**Organic budgetary laws**		**Constitutional Amendment***
Committee Stage	Regular	Joint committees	Regular	Joint committees	Regular
No. debates	4	2	4	2	8
Majority requirement	50% +1 of decisory quorum		50% +1 of members		50% +1of decisory quorum (first 4 debates), 50% +1 members (last 4 debates)
Ex-ante revision of the Constitutional Court	No	No	No	No	Yes

Source: Olivera *et al.* (2010).
Note: *Regional transfer reform refers to a Constitution Amendment.

Figure 8 compares the evolution of regional transfers after the adoption of the 2001 reform with a counterfactual analysis showing the high increase of transfers without this adoption. Without the adoption of the reform, transfers would have continued to increase and the solvency of the State was not guaranteed due to the relatively low level of tax revenues in Colombia. Indeed, tax revenues over GDP represent only 18% in Colombia, versus 35% in OECD economies (OECD 2010b; OECD, 2011a).

However, the long adoption process implied some costs related to the compromises with different stakeholders. These compromises were not envisaged in the initial proposal. Firstly, the reform implied a cost in terms of monetary policy. Since the reform has taken into consideration the observed inflation in contrast to the targeted inflation, regional transfers promoted inflation inertia. Secondly, real growth rate of the transfers increased by 0.5% for the period 2002-05 and by 1% for the year 2007 with respect to the initial proposal. Finally, this reform can be considered as a temporary reform. After 2008, regional transfers were supposed to increase dramatically (see next sub-section) since reform considered that these transfers were dependent on at least the same percentage of current revenues as 2001. Consequently, 2001 Reform defined regional transfers as it follows:

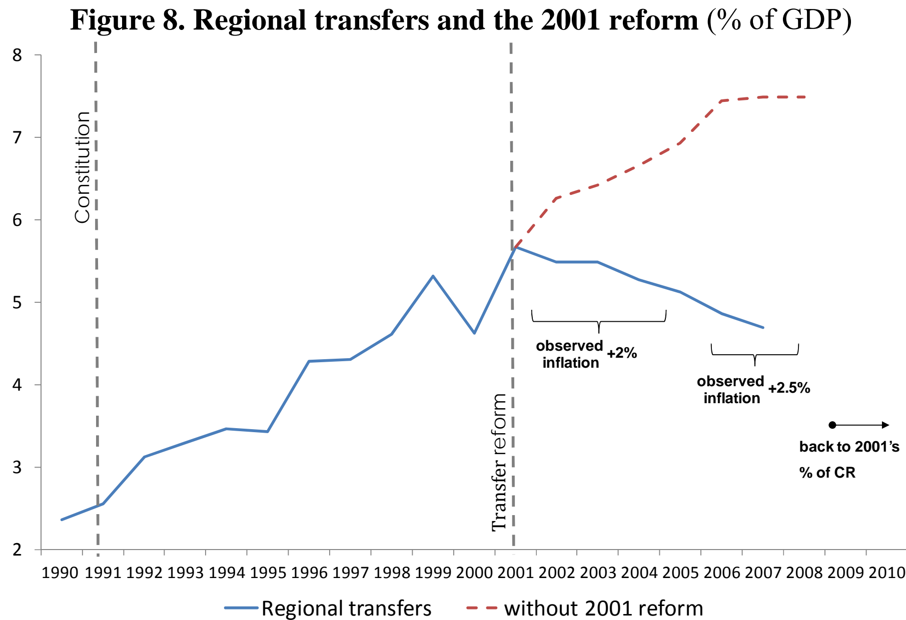
- Regional transfers = (1+2.0%)*transfers t-1 + observed inflation for the period 2002-05

[20] Elections of mayors and governors started in 1986 and 1991, respectively.

- Regional transfers = (1+2.5%)*transfers t-1 + observed inflation for the period 2006-08

- Regional transfers ≥ 46.5%*Current Revenues from 2009

Figure 8. Regional transfers and the 2001 reform (% of GDP)



Source: Authors' calculations based on the Central Bank of Colombia (Banco de la República) and the Ministry of Finance of Colombia (Ministerio de Hacienda y Crédito Público).
Notes: Red dotted line is a counterfactual analysis showing the evolution of transfers without the 2001 reform.
CR refers to Current Revenues.

Regarding the sequencing of the adoption of reforms after the 1999 economic crisis we observe that, rather than a "big-bang", approach the strategy was a short-term sequencing approach. Indeed, the only structural economic reform adopted in 2001 was that studied in this paper (Table 2). This experience contrasts with some literature showing that there are strong arguments for "bundling" reforms into a comprehensive package (OECD, 2010a).

Table 2. Bundling vs sequencing
Economic reforms after the 1999 economic crisis

1999: Housing Market Reform
(Law No. 549)
1999: Financial Reform
(Law No. 510)
2001: Regional Transfer Reform
(Legislative Act 01 and Law 715 of 2001)
2003: Financial Reform
(Law No. 795)

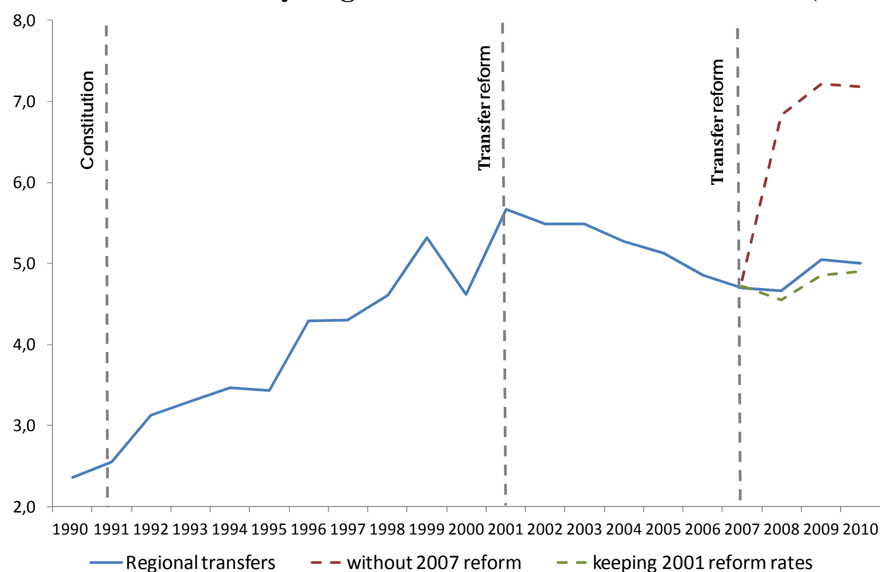
Source: Authors.

III.C. The implementation and sustainability phases

To analyse the implementation and sustainability stages of the reform, we consider, first, the revision of the formula to determine the total amount of regional transfers, and second the expenditure side of regional transfers by sub-national authorities.

As mentioned for the adoption stage, the 2001 reform can be considered as temporary. After 2008, regional transfers were supposed to increase dramatically since the reform established that these transfers were dependent on at least the same percentage of current revenues as 2001. In 2007, the Uribe administration adopted a new transfer reform in order to avoid a high increase in the regional transfers affecting the solvency of the State.[21] A counterfactual analysis shows that without this new reform, the increase of transfers might have been close to 2% of GDP in only one year (red dotted line in Figure 9). The 2007 reform set for the period 2011-16 a growth of regional transfers equal to 3% plus the observed inflation.[22] After 2016, regional transfers will increase at the average growth rate of the last four years of the national current income. Although the real growth rate is abandoned after 2016, by including the average of the four last years of national current income to determine regional transfers, these transfers should not be pro-cyclical in the future.

Figure 9. The sustainability stage: the extension of the 2001 reform (% of GDP)



Source: Authors' calculations based on the Central Bank of Colombia (Banco de la República) and the Ministry of Finance of Colombia (Ministerio de Hacienda y Crédito Público).
Notes: All values are in percentage of GDP.
Red dotted line is a counterfactual analysis showing the evolution of transfers without the 2007 reform. Green dotted line is a counterfactual analysis showing the evolution of transfers keeping 2001 reform rates.

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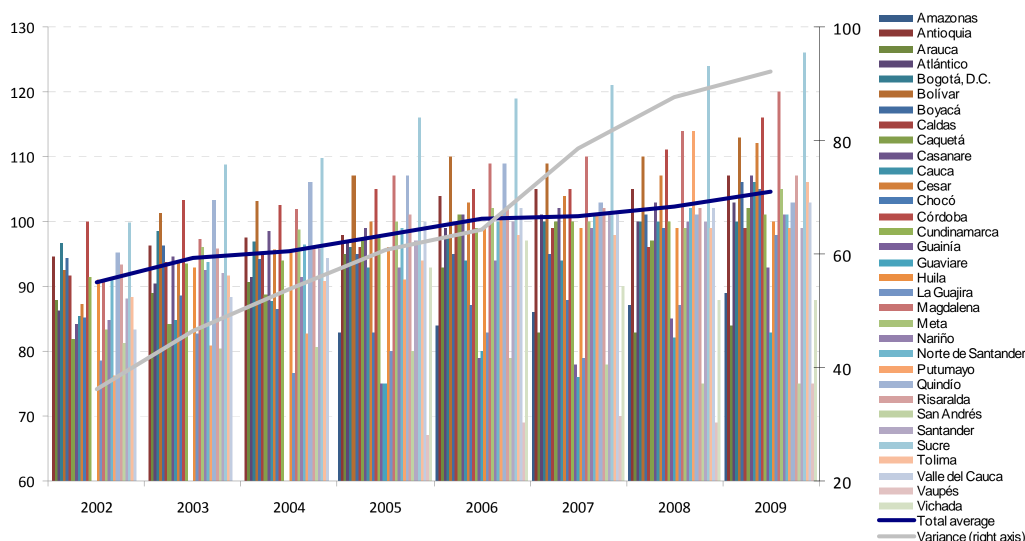
[21] The legal framework for this legislation was the Legislative Act 04 of 2007 and the Law 1176 of 2007.
[22] A real growth rate higher than the rate introduced in the 2001 reform (*i.e.* 2.5% after 2006) implied a slight increase in the transfers with respect to the case of a reform keeping the real growth rate introduced in the 2001 reform (green dotted line in Figure 9).

The second crucial component of the implementation and sustainability stages of the reform concerns the expenditure side of regional transfers by sub-national authorities and in particular the allocation system among sub-national authorities. As mentioned above, central government's transfers to sub-national governments were earmarked for education and healthcare. In particular, at least 60% and 20% of transfers should be spent in education and healthcare, respectively.[23]

Before the adoption of the regional transfer reform in 2001, transfers depended on operational expenditure, such as the number of teachers per region. One key aspect adopted in the regional transfer reform was to improve the allocation of regional transfers. Indeed, this reform fixed the allocation depending on the coverage. By analysing the education sector, a capitation scheme was introduced to calculate regional transfers per student, not per teacher. We observe an improvement in the enrolment rates thanks in part to incentive schemes introduced in the 2001 reform (Figure 10)[24].

Figure 10. Gross enrolment rates in Colombia (%)
Primary and secondary education



Source: Department of National Planning (DNP) and Ministry of Education.
Notes: Gross enrolment rate corresponds to the total enrolment in a specific level of education, regardless of age, expressed as a percentage of the official school-age population corresponding to the same level of education in give school-year.
The variance of the gross enrolment rates of Colombian departments is exhibited at the right axis.
Total average corresponds to the pre-primary, primary, and secondary education in Colombia. For each department it corresponds to the *básica* and *media* education (*i.e.* primary and secondary education).
See http://menweb.mineducacion.gov.co/nnormas/normas_basicas_4.swf for more information.

From the study of the "sustainability" stage of this reform, we note that new incentive mechanisms should be introduced. Firstly, although there is an improvement in the

[23] Since 2007, water and sanitation were included with 5.4% of the total allocation (education and healthcare expenditures continue to represent at least 60% and 25% of total allocation).
[24] Similarly, healthcare coverage is above 96%.

coverage (from 91% in 2002 to 105% in 2009), high disparities remain among departments. The variance of gross enrolment rates among departments have increased in the last years and in some departments, such as *San Andrés* and *Vichada*, enrolment rates have decreased (Figure 10). Secondly, new challenges are related to the quality of public services. For instance, in the PISA (Programme for International Student Assessment) reading examination, Colombia ranks statistically significant below all OECD economies (OECD 2010c). To facilitate evidence-based reforms, the results from the extensive empirical research carried out in the context of PISA could help reforms in Colombia (OECD 2010b).

Experiences with decentralisation of education systems in Latin America have varied in terms of gradualness, magnitude and attributes. The implementation of policies regarding education systems are concerned with four main functions: financing, management, planning, and regulation, all of which have been affected by the decentralisation agenda. In that context, it is useful to study the effect of decentralisation policies on student performance. Using OECD's PISA surveys for a group of Latin American countries, Avendano and Nopo (2012) explore the effect of the attribution of responsibilities (between schools, regional and national education authorities) and performance. Since the 1990s, the implementation of certain policies have been transferred from national to sub-national control (e.g. teachers' selection and salaries, budget allocations within the school, course content), having an impact on schools' performance and equity. This last dimension is explored, as evidence suggests that decentralisation policies can strengthen performance, but they can also create higher inequalities.

There is a need to improve the management and execution of regional resources at sub-national level (see OECD, 2011b for some lessons in OECD economies). The performance of these transfers should be evaluated through an improvement of public service delivery. Equity and quality principles should be considered. Incentive schemes, a better co-ordination of policies at different levels of government, and technical support from central-government authorities should improve the effectiveness of public policies in education and healthcare.

IV. Conclusion

This case study presents the policy-making process of the reform of regional transfers in Colombia. The main achievement of this reform was to stabilise the level of regional transfers in a context of uncertainty and risk of a sovereign debt crisis. This achievement was considerable since a significant reduction in the increase of transfers contributed to a levelling of public expenditure and to reducing central government deficit. Additionally, this reform helped to adopt an anti-cyclical scheme for these transfers and to improve the coverage in education and healthcare.

The study shows that the economic context and institutional factors, such as the new framework for interactions between agents after the 1991 Constitution, were fundamental in achieving the reform. It confirms previous studies showing that communication and compensation strategies play a role in the approval of reforms. Moreover, the long process of the reform (*i.e.* eight debates in Congress and a revision by the Constitutional Court) implied key negotiation costs.

When the "sustainability" of the reform is analysed, we show that challenges remain. There is a need to improve the management and execution of regional resources at sub-national level. In that context, the performance of these transfers should be evaluated through an improvement of public service delivery. Better incentive schemes and a better co-ordination of public policies at different levels of government should improve the management of these resources. These aspects are related to the effectiveness of the regional level economic and social policies in Colombia.

Finally, the nature and, in particular, the process of this reform brings insights about the future of regional policies in Colombia and in emerging economies in general. In the case of Colombia, past fiscal transfer reforms can help to understand current discussions between Congress and the government about an on-going royalty reform. This case study shows how political economy aspects and PMP aspects can affect fiscal reforms at the sub-national level of an emerging economy (see Blöchliger and Vammalle, 2012 for the case of OECD economies).

Since today's challenges (*i.e.* the reduction of income inequality, the improvement in the quality of public services) differ from past priorities (*i.e.* to guarantee the solvency of the State), this case study recommends revisiting this reform.

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