

**The Political Economy of Fiscal Reform:
The Case of Colombia, 1986 - 2006**

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I. Introduction

During the last two decades, the Colombian Central Government (henceforth CG) expenditures increased substantially. From an average of 9.8% of GDP between 1981 and 1991, CG expenditures increased to 21.5% in 2007, with an average of 17.6% for the period 1992-2007. Such trends were the consequence of a generalized recognition, endorsed by consensus in the 1991 Constitutional Assembly, that Colombia had an excessively weak and small State to deal effectively with security, globalization and social challenges. Thus, Colombia was the only Latin American country in which the pro-market economic policies of the early nineties (i.e. trade and capital account opening, privatizations, etc.) were not accompanied by an objective of “reducing the State”, but on the contrary, to strengthen it.

Consequently, after a century of political and administrative centralism, one of the objectives of the 1991 reform was to increase the presence of the State by giving fiscal and political power to departments and municipalities², increasing the reach of basic social services and strengthening the judiciary, among other reforms, resulting in a significant

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² During the Conservative government of President Belisario Betancur (1982-1986) a constitutional reform allowed the popular election of mayors. It was believed that the excessive centralism established in the Constitution was partially responsible for the political crisis the country was suffering. Not only political representation was limited, but local governments were dependent on central government allocation of resources for most local public expenditures, which made it difficult for voters needs to be heard. The 1986 constitutional amendment reform, which started political decentralization, was reinforced by the decisions made by the 1991 Constitutional Assembly establishing administrative decentralization and expanding popularly elected offices for governors.

increase in public expenditures.³ Politically, the 1991 reform resulted in renewed political participation from non-traditional sectors (Pizarro 1995, Garcia 2001).

Although there was consensus on this strengthening of the State, the strategy to finance such a rapid pace of expenditure increases to maintain fiscal discipline was uncertain. CG fiscal balance deteriorated. From being one of the exemplary cases of fiscal discipline in Latin America in the 80s, CG deficit increased from an average of 1.2% of GDP in the second half of the 80s to 7.6% in 1999 and to an average of 5% for the period 2000-2007.

As a consequence, all governments since the new Constitution was enacted attempted to finance expenditure increases, or control expenditure growth, by a combination of fiscal reforms that included tax, pension and decentralization reforms. Tax reforms were the most frequent. They mostly intended to increase revenues in the short run, with exceptional concerns for efficiency. Nonetheless, post-1991 tax reforms had only a partial effect on their objective of closing the fiscal unbalance. While expenditures increased 11 percentage points between 1990 and 2007, tax revenues increased only 7 percentage points, despite the fact that almost one tax reform per year was enacted (i.e. 14 tax reforms for the period 1990-2007).

Reforms to decentralization were not as frequent, but were more effective at controlling CG expenditure growth and the fiscal deficit (See Figure 1). Nevertheless, their net effect was somewhat reduced by increased direct regional expenditures of the CG.⁴ Other related reforms that limited sub-national debt and expenditures, drove regional governments fiscal balance from an average deficit of 1% of GDP in the middle of the 90s, to a surplus of more than 1,5% ten years later.

Few expenditure reforms were debated, perhaps because policy-makers considered those not to do enough to control expenditures in the short run and also because reforms to the budget process could provide an opportunity for Congress to regain decision power

³ The increase in expenditures was also a consequence of increased defense expenditures required to cope with the deterioration of public order fueled by the association of drug money with guerrilla warfare and paramilitary activities. Finally, a structural pension reform in 1993 put further stress on CG finances, over a long transition period, as the CG continued to pay pension liabilities incurred until then, but lost the contributions of those that shifted to private pension funds.

⁴ Actually, the decentralization reforms had some re-centralization objectives on top of pure fiscal objectives. See Section IV. Furthermore, the fact that the fiscal objectives were partially achieved does not imply that the efficiency of the decentralization process improved.

over expenditures.⁵ Thus, fiscal discipline is still an important issue in the agenda, as has again become evident during the present slowdown⁶.

Figure 1
Central Government Revenues, Expenditures and Sub-national Transfers,
1981-2007 (% of GDP)



Source: DNP database.

This paper explores which characteristics of the political economy process conditioned the scope and success of the combination of fiscal reforms after 1991. In particular, the paper analyzes the interaction among different actors in the Policy Making Process (PMP) of economic policy, within varying economic and political circumstances (i.e. political crisis, economic crisis, and economic boom). Four types of reforms are analyzed: tax reforms, decentralization reforms, reforms to the budgetary process and, more incidentally, pension reforms.

Methodologically we adopt a series of complementary strategies. First, we study the formal characteristics of the PMP for each type of reform (tax, decentralization and expenditures). Second, to understand fully the actual PMP process, we conduct a considerable number of semi-structured interviews with the principal actors in the reforms: Finance Ministers, National Planning Department Directors, Congress members, and Business Associations directors.⁷ Third, we compare our period of analysis with the reforms enacted before the 1991 constitutional reform, and suggest that the different results observed are due to the political fragmentation and limited unilateral executive power. The

⁵ Currently, the Organic Budget Law states that if Congress does not approve the annual budget bill, the executive can enact it by decree (article 59).

⁶ Exceptionally high fiscal revenues during the recent economic and commodity prices boom, masked for a while this fact and, actually, led to some reversals in tax reforms, as discussed in Section 5.

⁷ See Annex 1 for the list of interviews.

political fragmentation is explained by an explicit effort by the new Constitution to widen political participation, which translated into very limited restrictions to forming a political party and holding office, changes in the average district magnitude and the electoral formula, and considerable political decentralization. The limited unilateral power refers to the significant restrictions imposed in the 1991 Constitution to issue decrees or change the status quo unilaterally. Fourth, to understand fully the fiscal strategy, we analyze in detail the bundle of reforms enacted by each president between 1991 and 2008 and important cases of individual tax, decentralization and expenditure reforms.

The paper is divided in five sections including this introduction. The second part describes the most important players in the policy-making process, and the formal policy-making process (PMP) and the formal rules, and derives the hypotheses to be tested in the following sections. The third part describes briefly the different economic and political contexts under which the fiscal reforms were enacted for the period 1990-2007. Section four analyses the hypotheses, using the input of the interviews made to the principal actors involved in each of the processes. Finally, the fifth section concludes.

II. Policy making Processes and the Difficulty of Enacting Reforms

After 1991, how to finance or limit the growth of increasing total expenditures became the priority for all governments. Presidents were faced with the short term difficulty of having enough revenue to execute policy. Thus, economic teams seemed to prioritize reforms to rapidly produce revenues or to limit certain expenditures (like regional transfers) as opposed to more structural reforms with long term consequences.⁸

What were the obstacles and constraints a President and his Finance Minister faced when choosing one or another strategy to tackle the fiscal deficit problem? To help answer the question, we first describe the main actors involved and their incentives, analyzing the different agencies within the executive, and the interaction among branches. Then, we describe formal rules, i.e. the differences in the legislative process required in order to get enacted decentralization and tax reforms, as well as modifications to the budgetary process. Finally, we extract from the literature some of the hypothesis that the paper intends to examine.

Actors:

The Executive Branch

Undoubtedly, the President is the most prominent figure in the executive branch. The president conducts economic policy and determines which strategy to pursue to strike

⁸ The primary objective of structural reforms is to change the status-quo to improve efficiency, rather than just increasing revenues, limiting expenditures, redistributing income or protecting vulnerable groups (Lora and Olivera, 2004).

the right balance between his policy agenda execution and decent economic performance. To achieve this goal, the Finance Minister and the Director of the National Planning Agency are his main advisors. Traditionally, both the Finance Ministry and the National Planning Agency have been directed by highly educated technocrats (Caballero, forthcoming) with no previous electoral experience, who are also members of the network of economists that embody academia, think tanks, and the Central Bank.

While both share similar goals, the Finance Minister mandate is to focus on fiscal discipline and macroeconomic stability, while the National Planning Department's mandate is to plan and execute development policies in the long run, using as instruments the National Development Plan and the investment budget.⁹ Both the finance minister and the director of the National Department of Planning are in charge of allocating public resources, and, with line-item agencies, of planning and programming policies and budget execution.

The criteria for choosing ministers in other cabinet posts are different, and vary depending on the presidential governing strategy -which depend on the contextual variables and the president's own knowledge on the policy area. He might choose a more technical cabinet or a more political one depending on the size of his coalition, or the type of policy he is most interested in. Variation on these strategies may also occur depending on the timing. It could be that in times of surplus, the president might choose loyalty over expertise and in times of crises, he could choose otherwise.¹⁰

Other ministries are partially involved in the making of economic public policy, implementing policy towards specific sectors. Since their role as executors make them budget maximizers, as a result, they may not always support the Finance Minister budgetary restriction, and press for additional expenditures for their sector.

In Colombia, as in most Latin American countries, the Government holds a monopoly on bills that deal with budgetary and tax issues. Thus, if any bill or amendment introduced by legislators has budgetary implications, it is required that previous to its passage through Congress, the bill or amendment is accepted in written form by the Finance Minister. Consequently, it is uncommon to find legislative authored bills or constitutional amendments addressing these policy areas.

In addition to having the rights of exclusive introduction, since 1968 the president can issue legislative decrees on economic matters when a *state of economic and social emergency* is

⁹ The National Development Plan is the road map that, since 1991 constitutional reform, each new administration must prepare and discuss with the Congress during the first semester in power. The constitutional reform aimed to strengthen the planning stage of public policies converting each National Development Plan into a Law. This road map contains a multi-annual investment plan that should be executed through the annual budget. The National Planning Department is in charge of both budgetary tools.

¹⁰We do not systematically look at the profiles of the ministers here, but we suggest that the "type" of cabinet can have an effect on the fate of the policy and its content.

declared.¹¹ Although the use of the state of emergency changed after 1991 making it harder for the president to use it indiscriminately (control by the Constitutional Court, expiration of legislation after state of emergency is over), it is still a powerful instrument to get things done whenever the president is confronted with a crisis situation.

Political Parties and Legislators in Congress

After legislation has been debated within the cabinet, bills go to Congress. Thus, individual legislators and parties alike play a key role in the drafting and approval of any reform. In Colombia, two traditional political parties - the Liberal and Conservative Party - managed to monopolize public office since the early years of the republic till the 1980s. It was not until the 1990s where their vote percentage highly diminished changing the factionalized, one dominant party system, to a multiparty system with high levels of fragmentation.

During the National Front and its aftermath (1958-1980s) the Party Directorates were usually consulted to ensure that policy got enacted in Congress. Although party organizations were decentralized at the time, compared to others with the same longevity as in Venezuela or Costa Rica (Latorre, 1972) the president's nomination power kept legislators attached to the party label. This was no longer the case after the decentralization reform and the 1991 Constitution.

The fragmentation of political parties and independence of legislators from their Directorates has been widely studied after the 1991 Constitution (Botero 1998, Shugart and Nielson 1999, Crisp and Desposato 2004, Pizarro 2001). Some key institutional changes in 1991 have been suggested as possible causes. First, the Constitution established a very low threshold for political party formation. To form a party or a citizen's independent movement, only 50,000 signatures were required. In addition, the combination of a low threshold with a 100 seat district (national constituency of the Senate) decreased the incentives for collective action within parties. Furthermore, belonging to one party or citizen's movement did not mean multiparty politics, as legislators could belong to more than one party organization. Consequently, incumbents formed new political movements to have better access to public campaign funding, while also increasing intraparty fragmentation.

Finally, it has been suggested that the decentralization reform was a significant factor explaining fragmentation. Previous to 1991, the president had ample nomination powers that allowed him to control the career path of most of his co-partisans (Gutiérrez 2000, Carroll and Pachon 2007). After 1986 however, those nomination powers were drastically reduced. Although the president could still name governors, those governors

¹¹ Several analysts have illustrated that the use of state of siege was also very common as means to legislate via decree on economic matters previous to 1968.

could no longer name majors. Consequently, local politicians did not depend on national politicians to further their career. After 1991, the president lost the power to name governors. Thus, regional politicians became even more independent from the partisan central network, and coordinated collective action among co-partisans became very challenging.¹²

Consequently, from having a system of factionalized parties with a relatively weak Congress previously to the 1991 Constitutional reform, we transited towards an institutionally stronger (i.e. limitation on the constitutional power of the president), and more fragmented Congress with a larger number of parties, and more individualized bargains compared to the previous period (Archer and Shugart 1997; Cárdenas, Junguito and Pachón 2008).

The resulting equilibrium due to the lack of coordinated action became critical in Pastrana's period -the first minority president after the 1991 Constitution-, and although several numbers of electoral reforms were debated, none got enacted. Thus, Uribe's campaign promises were insistent to include an electoral reform as means to deal with the corruption scandals and the subsequent difficulty of enacting reforms.

Since the Constitutional Reform of 2003 approved during Uribe's first term, the incentives for fragmentation have decreased, and although there is still room for intraparty competition (optional open list PR), the existence of a higher threshold in the Senate and the change to d'Hondt formula ensures that no longer "going solo" is a better strategy compared to forming a pre-electoral coalition (Pachón and Shugart, mimeo).¹³

Constitutional Court

The role of Constitutional review became more significant after the creation of the Constitutional Court in 1991, which is characterized for having one of the most powerful combinations of constitutional review in the region (Rodríguez-Raga, 2008). First, citizens can use the *acción pública de inconstitucionalidad* to question the constitutionality of any bill or decree enacted. Second, the Court has the obligation of reviewing all legislative

¹² Cárdenas, Junguito and Pachón (2008) show this increasing fragmentation with different indicators such as the number of lists introduced per seat in each congressional election, which was already high in the previous period. From having 1,5 lists per seat on average previous to 1991 (1970 -1990), the number of lists went to 6 per seat in 2002 for the House, and 3 for the national constituency of the Senate. Since each list is closed, the number of candidates significantly increased. The effective number of parties also increased in 2002, as well as the number of parties winning at least one seat. From an average of three in the previous period, the number went up to 45 in 2002.

¹³ However, it is not possible to evaluate the effect of this reform to the rules of the game since the economic boom from 2003 to 2008 reduced the necessity of fiscal reforms and the only significant fiscal reform enacted in that period was the Constitutional reform to regional transfers in 2007, that was limited to extending in time the effects of the 2001 reform. The 2006 structural tax reform proposal would have been the right experiment to evaluate the effect of the 2003 electoral reform, but, as it was not supported by the president it never really went through the legislative process. See sections III and IV.

decrees issued at exceptional times (i.e. state of internal commotion or state of economic emergency) and all constitutional amendments enacted. Finally, the Court also should serve as an arbiter in cases where Congress disagrees with the Executive's veto.

Since 1991, the Constitutional Court has rejected several declarations of state of interior commotion and economic and social emergency. Furthermore, the Court decided over the constitutionality of 2.987 bills (till 2002), which account for 30% of all of its decisions. From those, 33% (2 out of 6) of the constitutional amendments have been declared unconstitutional, and 24% (352/1466) of regular bills have been also declared unconstitutional (Cepeda 2004). The role of the Constitutional Court and its decisions on highly controversial economic policy issues has been systematically questioned, as the interpretation of the Constitution has become a limitation on the capacity to enact structural reforms (Kalmanovitz 2001) and reduce public expenditures.¹⁴

Private Sector

Business associations and economic conglomerates are an important link to understand congressional behavior and presidential preferences over policy. Historically, pressure groups from the productive sectors, both industrial and agricultural, were consulted in the drafting of policy (Sáenz Rovner 1992). This pattern became clearer and somehow institutionalized during the National Front, where all pressure groups had, in their Directing Boards, representatives of both political parties. Additionally, presidents would turn to the private sector for support for economic policies stuck in Congress due to the 2/3 approval majority requirement in Congress. Presidents tried to go "public" and use the pressure from the private sector to further incentive congressmen to support their congressional agenda, or alternatively support their extraordinary measures (Hartlyn, 1993). Of course, the weight of coffee exports made the Colombian Coffee Federation a very important actor, along with the SAC - Colombian Association of Agricultural Producers, and the ANDI -Colombian Association of Industrial Producers- (Palacios, 1979).¹⁵

The changes in the 1980s and early 1990s, however, meant an important departure from this state of affairs.¹⁶The new constitution and new economic model implemented opened up the market for new private actors. In addition, changes in the economic structure of production and revenue diminished the role of the coffee and agricultural sectors. Thus, although consultation was still a common practice when drafting policy, the approval of business associations and support could not replace congressional consent. Thus, the end of

¹⁴ As examples, the Court has declared unconstitutional several pension reforms intended to limit the cash pension deficit that was a consequence of the 1993 pension reform and has ruled that public salaries, or at least those close to the minimum wage, must be raised yearly at least by the increase in the inflation index

¹⁵ Other associations are: FENALCO (Federación Nacional de Comerciantes), FEDEGAN (Federación Nacional de Ganaderos) ASOCOLFLORES (Asociación de Floricultores de Colombia).

¹⁶ Although all private sector organizations had a National Council (Consejo Gremial), its power had greatly diminished.

the bipartisan agreement challenged the common practices between the private sector and the government. Given their capacity to adapt to these economic changes, economic conglomerates became dominant in their relationship with the president (the so-called “cacaos”), as their capacity and will to finance national political campaigns was uncontested (Rettberg, 2003).¹⁷

Consequently large business associations saw a major reduction of their former influence in tax and other legislative matters at the expense of an increased influence of conglomerates (“grupos”) and more narrow sub-sectoral associations or specific large firms.¹⁸ This was part of a more encompassing trend of a displacement of lobbying from the national Executive (in which large business associations had a major influence) towards Congress and sub-national governments, as a consequence of a major reduction in Executive discretionary powers in trade protection (given substantial trade opening in 1990/91) and subsidized credit (due to the gradual privatization of most major public banks and the 1991 Constitutional prohibition to use Central Bank credit lines except for liquidity support to banks), as well as of the decentralization and privatization of many public services.

Due to these various political and economic changes, members of the private sector -who previously exercised lobbying through business associations- decided to diversify their strategy to influence more decisively members of Congress. Although pressure groups continued as a collectivity to pressure the governments in the different episodes of changes in economic policy, individual businesses opted to fund campaigns of individual legislators. This way, specific businesses had the possibility to intervene with help from their legislator to include exemptions, or other favorable policies. For individual legislators, these relationships with individual businesses represented a good bargain. Since their campaign funding mostly would be a function of their own individual effort, the willingness of the private sector became an important funding source. Consequently, the constant fragmentation of political competition made congressmen lobby to the private sector.

Rules: Legislative Process

To become a law, a bill usually is required to have two debates per House: one in the permanent committee, and another in the floor (see Table 1). The rule of open amendment applies during the committee and floor debates, which means that legislators can include amendments to the original proposal at any point during the legislative process. Also, at any point in the process, if the bill is authored by the executive, he is authorized to withdraw the bill if he/she considers that the bill’s original purpose has been modified to

¹⁷ “En Colombia, existen más de quince grupos económicos, pero cuatro dominan el panorama empresarial. Del total de los activos e ingresos de los grupos colombianos, estos cuatro controlan el 70 y más del 60%, respectivamente.” Rettberg, Angélica.2003. *Cacaos y tigres de papel: El gobierno de Samper y los empresarios colombianos*. Bogotá, Ediciones Uniandes, CESO.

¹⁸ As corroborated in a meeting with current and previous business association heads.

the extent that it does not reflect its original intent. A bill authored by a legislator can only be withdrawn if its legislative process has not yet started.

If disagreement should arise due to different approved versions of the bill in the two houses, a conference committee (*comisión accidental*) must be formed to debate the final version of the bill, and then return for a final approval vote in each House.¹⁹ If approved, the bill goes to the executive, who decides whether to veto the bill (there are a number of different vetoes: partial, full, amendatory; see Alemán and Schwartz 2006). If not vetoed, the bill becomes law after its publication in the Congressional Gazette (*Gaceta del Congreso*).

Table 1: Legislative Process

Committee Stage	Tax Bills		Organic Budgetary Laws		Constitutional Amendment*
	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% + 1 of decisory quorum (First 4 debates), 50% +1 members (Last 4 debates)
Ex-ante revision of the Constitutional Court	No	No	no	no	Yes

*Decentralization reforms require constitutional amendments.

Depending on the policy, there are subtle or radical departures from this basic legislative procedure. In addition -depending on whether it is an executive bill- there are shortcuts to expedite the number of debates or total time lapsed to debate. The President can request the first debate to occur jointly having both the Senate and House Committees debate and vote the bill together. Additionally, the President can make an urgency request for the bill to be debated in 30 calendar days, and can insist on the emergency, making the bill to be the priority of the legislative agenda.

Organic laws, which follow constitutional amendments in rank and procedural difficulty (such as the Organic Budgetary Law), only require four debates. The only significant difference from the regular procedure is that they need to be voted by an absolute majority of committees and the floor. Finally, all bills which change or introduce changes to the taxation regime, follow the regular procedure, but need to be introduced first in the House, followed by the Senate.

¹⁹ Alemán and Pachón (2007) show that these conference committees are frequent, and since there is no rule for its appointment, they over-represent the government's coalition.

Regional transfers require constitutional reform. When reforms are introduced as constitutional amendments, the procedural requirements become more difficult (See Table 1). Instead of the usual two or four debates, constitutional amendments are to be debated eight times -two rounds in both houses. They too, have a different majority requirement. To be approved, a constitutional amendment needs to be voted by simple majority in the first round -just as a regular bill- and by an absolute majority in the second round of debate. Amendments are allowed in both voting rounds adding to the difficulty of having a unified text, and increasing the probability for the creation of a conference committee²⁰. Finally, constitutional amendments are required to be revised both in content and procedure by the Constitutional Court²¹. The Court has the final decision on whether the content of the amendment fulfils the requisites established in the Constitution and the law (we develop this point further in Constitutional Review).

Thus, among the different reforms under scrutiny, there are differentiated procedures which create the opportunity for interested parties to intervene, lobby, and defend the type of policy they are most interested in seeing enacted. After looking at the formal procedure, the next section develops some expectations over the passage and differentiated content of fiscal reforms.

Hypotheses

There have been numerous attempts to explain the likelihood of reforms and structural adjustment, especially after the wave of the so-called *Washington Consensus* reforms implemented in Latin America at the beginning of the 90s. In this section we describe different hypotheses tested in the literature which we consider are relevant for fiscal reforms in the Colombian case (see for instance, Lora and Olivera, 2004; Arbache 2004; Haggard and Webb 1993, 1994). We adapt these hypotheses for the purpose of the paper. First we present two more structural hypotheses -congressional fragmentation and cabinet delegation- and then the entourage hypothesis -crisis vs. non crisis- differentiating economic crisis (i.e. in 1999 Colombia suffered the most profound economic crisis with a negative real GDP growth of 5%) and political crisis (i.e. President Samper (1994-1998) was impeached).

Congressional fragmentation.

The heterogeneity of Congress has been considered as a significant factor explaining high political transaction costs in the drafting of policy (i.e. Mainwaring 1993; Tsebelis 1999). In addition to the number of parties, other research has suggested that the

²⁰ The Organic Law of Congress establishes in its Article 178 that, whenever amendments are introduced in the plenary, if they are considered to change the bill substantially from the version approved in the Committee, the bill should return to the Committee for an additional vote.

²¹ The jurisprudence of the Constitutional Court has evolved to include the revision of content of the Constitutional amendments.

presence of institutional incentives to cultivate a personal vote determines what legislators would exchange in order to get policy passed (Carey and Shugart 1995; Haggard and McCubbins, 2001). Thus, if there exists high incentives for cultivating personal vote, and party organizations do not have control over nomination procedures, we should expect relatively high transaction costs, compared to party systems where party organizations are more hierarchical.

Our hypothesis is that the increasing congressional fragmentation in the 1990s played a key role in making it difficult for the president to engage in structural reforms as opposed to piecemeal reforms. The way coalitions were formed in the post-1991 period conditioned legislative passage to the representation of very diverse particularistic interests.

A related hypothesis is related to the effect of the distribution of political costs across the political system. We suggest that when reforms imply direct costs for the congressional constituencies their probability of getting enacted without being watered down is smaller than when costs are dispersed across subnational governments. More specifically, we suggest that although decentralization reforms were more difficult to be enacted (i.e. they require constitutional reforms), they had an easier time getting passed due to the dispersed costs across the political system. Since costs are dispersed among all subnational governments and most congressmen were not accountable to governors or mayors and had a *loose* political relation with them, they could vote with the government for limiting decentralized expenditures, while getting a better deal from maintaining their own influence over specific expenditures or tax exemptions.

This was in sharp contrast with what happened before the election of governor and mayors was enacted: appointments were the currency to build political support in Congress, and regional authorities were closely tied with legislators. Thus, congressmen participated in naming governors, and governors named mayors. Thus, increasing automatic and unconditioned transfers was a privileged way to get money and show palpable results to their regionally based electorate.²²

These trends were probably reinforced by the fact that fiscal law approvals after 1991 involved increased levels of discretionary “pork”. The 1968 Constitutional Reform had shifted most expenditure initiative to the hands of government in exchange for a fixed percentage of “pork” over which congressmen had full control (the so called *auxilios*

²² These changes in political incentives of Congressmen were reinforced by an increasingly generalized perception that the decentralization drive up to 1991 had been too fast and naïve, leaving the central Government without enough instruments to coordinate policies, impose fiscal discipline and avoid waste of resources transferred to sub-national agencies. The latter became increasingly common, as the effects of “capture” of some local governments by paramilitaries and guerrillas -which grew enormously in importance after 1991 as a consequence of drug trafficking financed, a development that could not be foreseen at the time of the 1991 Constitutional Reform- added to frequent cases of common fraud and corruption.

parlamentarios).²³ In addition, as explained, nominations of governors (until 1991) and majors (until 1986) were used to cement coalitions of support for government initiatives. After 1991 the elimination of *auxilios* and popular election of governors and majors, in addition to the increased political fragmentation and weakening of party discipline already mentioned, changed the way in which political equilibriums were achieved in Congress. Forming coalitions to approve government legislation frequently required ample distribution of exemptions, protection to particular interests and CG direct regional expenditures that had to be negotiated with congressmen, often on an individual basis.

Thus, we suggest that the content of the reforms and the frequency of short-term policy solutions reflect the fact that congressmen, after the constitutional reform, became more accountable to narrow sector interests than to the party network, a process that was already underway from the eighties with the progressive weakening of party structures, making more difficult the approval of structural reforms. We also suggest that the increase in political arenas through the election of governors and majors led to a “regime change”: from an “institutional” to a political “market” equilibrium in building government supporting coalitions, thus substantially increasing the demand for “pork” and reinforcing the difficulties in enacting structural reforms.

Cabinet delegation.

With few exceptions, current research focuses on the strain that the diverse regimes of “separation of powers” pose on negotiations, but does not address the heterogeneity of interests that exist within the Executive branch. Partially as a result of the specificity of the policy areas addressed in this paper, we distance from the perspective in which the executive branch is considered to have homogeneous preferences, to illustrate conflicts of interests that cannot be easily observed when looking at aggregate data. When being interviewed, President César Gaviria made a simple, but powerful observation: One thing was being the Minister of Finance, and another was being the President.²⁴ While as Minister he was interested both in fiscal equilibriums and efficiency considerations –and he enacted one of the most structural tax reforms as Minister of Finance in 1986, as President, his priority was increased resources to implement policy, and it was up to the Minister to design the instruments to get there.

²³Auxilios parlamentarios were fixed budgetary allocations for congressmen to distribute among their constituents for anything from public works to individual aid. This practice was allowed in the 1968 Constitutional reform, as a compensation for eliminating previous Congressional powers to increase the size of the budget or include new expenditures, and effectively limited the allocation of pork. After the prohibition of this practice in the 1991 Constitutional reform due to corruption scandals, the use of pork continued but in a less transparent way, through the Fondos de Cofinanciación, initially, the Fondo de Regalías, then, and large fractions of the investment budget at last. Although there is no reliable data on the amount of pork, Cárdenas, Mejía and Olivera (2007) suggest that it did not surpass 2% of the total budget per year initially after the 1991 reform..

²⁴“Yo no podía ser ministro de Hacienda toda la vida... Tenía que dejar a Hommes que se preocupara por conseguir la plata, y yo tenía que dedicarme a ser Presidente.” César Gaviria, interview, March, 2008.

Thus, which policy is chosen is a result of the interaction and extent of the presidential delegation to the Finance Minister. Thus, our hypothesis is that when the Finance Minister has the maximum delegation and back up from the President, reforms will tend to address more long term issues than when the president holds a tight leash on the Finance Minister. In this case, the president avoids to pay a political cost, and consequently tries to avoid it by creating exceptions to the rule, or not fully supporting the bill, blaming Congress or other actors involved.

Crisis and the feasibility of reform:

Besides the number of vetoes a policy has to overpass, several authors have observed the impact of contextual variables on economic policy and reform outcomes. One of the most important hypotheses is related to the connection between crisis and reforms. In their seminal paper, Alesina and Drazen (1991) show in their model that a change to the status-quo is more likely when the economy is in crisis. In fact, a crisis generates the necessity of a change²⁵. This hypothesis has been empirically explored by several authors. Weyland (2002) studies the circumstances under which the *Washington Consensus* reforms in the 90s were implemented in Peru, Brazil, Argentina and Venezuela, confirming the hypothesis given earlier by Kanhegan and Tversky (1979) that in times of crises, reforms are more likely to happen.

Consistent with previous findings in the comparative literature, our hypothesis is that economic crisis contributes to the enactment of fiscal reform.²⁶ The need to reduce fiscal unbalances is more imminent when a fiscal crisis episode has happened or is about to happen. An increasing deficit that generates an unsustainable indebtedness would need at some point a tax reform to increase fiscal revenues, close the fiscal gap, and stop indebtedness. If reforms are not implemented, the economy will default on its debt and capital markets would be closed for some time. However, various questions remain unanswered. Who is more likely to pay the burden for reform? Which type of tax rates will be increased? The study of the political economy of the reform would answer those questions.

However, we argue that economic crisis do not always favor “structural” reforms. When comparing the content of tax reforms, those of a structural nature had a much harder time getting enacted in Congress than “quick-fixes” or “piece-meal” tax changes that attempted to increase revenues mostly by increasing tax rates or introducing new distortionary taxes (as the financial transactions or the net wealth tax).

²⁵ Reforms can also create or contribute to economic crises. As this paper shows, the 1991 Constitutional reform contributed to the deterioration of fiscal performance since 1991 and, hence, to the fiscal and economic crises of 1999.

²⁶ In fact, Alesina and Drazen (1991) model is based on fiscal reforms.

III. The Evolution of Fiscal Reforms under Different Economic and Political Contexts

Between 1950 and 2007, 57 fiscal reforms were implemented in the four main sources of fiscal performance: taxes, expenditures, decentralization, and pensions. For the period 1990-2008, this number reached 30 reforms. The list of reforms is presented in Annex 1.

Table 2 shows the frequency of reform, divided by their type and procedure. For the period 1974-2008 tax reforms were the most frequent, with 7 laws and 6 decrees between 1974 and 1990, and 3 decrees and 10 laws for the period 1991-2008. Thus, the average number of tax reforms per year increased after 1990. The number of reforms to the decentralization regime reached 13 between 1974 and 2008, and 9 since 1991. In the later period, a portion of these reforms were constitutional amendments, followed by a law to regulate the constitutional change. Finally, reforms to the budget process, i.e. to expenditures, were only 7 for the period 1974-2008, 6 of these which were introduced between 1991 and 2008. Nonetheless, only 2 of them introduced significant changes. (i.e. Fiscal Responsibility Law in 2003 and Decree 4730 of 2005) .

Table 2: Fiscal Reforms 1974-2008

	Tax Reforms	Expenditure Reforms	Decentralization Reforms	Pension Reforms
Decrees	6	0	0	0
Laws	7	1	4	0
Constitutional Reforms	0	0	0	0
1991-2008				
	Tax Reforms	Expenditure Reforms	Decentralization Reforms	Pension Reforms
Decrees	3	3	0	0
Laws	10	3	6	3
Constitutional Reforms	0	0	3	0

This section focuses on fiscal reforms enacted along five presidential periods: Gaviria (1990-1994), Samper (1994-1998), Pastrana (1998-2002), Uribe (2002-2006 and 2006 to the present) It highlights the economic and political context in which every president had to manoeuvre to get things done and discusses the general trends that can be traced since the enactment of the 1991 Constitution.

Each presidential period transited through different economic and political characteristics. The Gaviria administration can be considered as a transition period during which the constitutional reform was enacted, as well as several structural economic reforms following the so-called Washington Consensus Agenda. This administration faced the first

large increase in expenditures -central government expenditures grew from 9.9% of GDP in 1991 to 12.8% in 1994- due principally to the 1991 constitutional reform, and a decrease in existing revenues due principally to reduction of trade tariffs to open the economy. During this administration, the 1991 constitutional reform was enacted. The Government had a majority supporting coalition in Congress, and, in particular, the opposition, were “distracted” in the process of constitutional reform, thus facilitating to enact difficult economic structural reforms²⁷. Besides *Washington Consensus* type reforms (i.e. trade openness, privatizations, labor market reform, capital account opening, etc.), Gaviria’s government enacted 4 tax reforms that, among other things, increased temporarily VAT and income tax rates to finance the increase in expenditures (See Table 3).

In turn, the Samper administration, which also began with a majority coalition, suffered a deep political crisis -allegations against drug traffic funding in the presidential campaign unfolded a political crisis in January 1996- and the beginning of the increase in central government deficit, as well as the first signs of deterioration in fiscal decentralization (i.e. increase in subnational indebtedness and debt crises in some subnationals). This administration intended to enact a structural tax reform in 1995 – seeking to eliminate VAT and income tax exemptions and strengthening tax determination and collection powers- but ended up increasing tax revenues mostly through a new increase in VAT rates. In addition, the Samper administration enacted the “Ley de Semáforos” to control sub-national indebtedness (Table 3).

The following administration -Pastrana- was the first one without a congressional majority after the 1991 constitutional reform, and the most profound economic (and fiscal) crisis unfolded during this administration. The crisis helped the administration to enact several reforms to increase revenues at the central government level and to control subnational expenditures (Table 3). Towards its end it passed a Constitutional reform reducing temporarily the pace of growth of regional transfers.

The first Uribe administration began in a recessionary period and then experienced a strong economic growth recovery, with a large presidential popularity after the failure of the peace process with the guerrilla during the Pastrana administration. During the first years of the administration three tax reforms were enacted, seeking to increase revenues and to finance the security strategy -“seguridad democrática”. Once the economic boom took over, the Finance Minister presented a structural tax reform, designed to lower corporate taxation and limit exemptions. However, the end result was a proliferation of new exemptions. In 2007, the Uribe second administration had to introduce a new constitutional reform to deal with the eventual consequences of a sharp increase in regional transfers, once the Pastrana reform period ended.

²⁷ Interview with ex President Gaviria.

In sum, under different circumstances, each administration combined a set of tax and decentralization reforms, accompanied by fewer expenditures reforms (see Table 3).

Table 3: Combination of fiscal reforms by presidential period

	Tax	Decentralization	Expenditures	
Gaviria	VAT	from 10 to 14%		
	Income Tax	From 30 to 37.5%		
	Other relevant reforms	Privatizations Pensions reform	Regulation of regional transfers (Law 60 of 1993)	None
	Notes	Temporary increases of VAT and Income tax rates until the end of the administration		
Samper	VAT	from 14 to 16%		
	Income Tax	fixed at 35%		
	Other relevant reforms	Privatizations First (failed) attempt to enact a structural tax reform	"Ley de semáforos" to control regional indebtedness	None
	Notes	Technical Commission for the Rationalization of expenditures, agreed with the two main political parties directorates		
Pastrana	VAT	Constitutional reform 01 of 2001 to control regional transfer increases		
	Income Tax	Law 617 to control current expenditures (also affecting central government)	None	
	Other relevant reforms	(transitional) financial transaction tax at 2 per thousand Bonos de paz Laws 549 and 550 of 1999		
Uribe I and II	VAT	Failed structural reform		
	Income Tax	Failed structural reform. Initially increased and then decreased to 33% during the boom.	(Failed) reform to the Organic Budget Law	
	Other relevant reforms	Net wealth tax Financial transaction tax from 2 to 3 and then to 4 per thousand	Constitutional reform 04 of 2007 to control regional transfer increases	
	Other relevant reforms	Pension reform to reduce the increasing the increasing cash pension deficit, annulled by the Constitutional Court Tax incentives and reform to the free trade zone regime		Fiscal Responsibility Law

IV. Characteristics of Fiscal Reforms and the political economy process

Tax Reforms

Structural (efficiency oriented) vs. Piece Meal (Revenue oriented) Reforms:

All tax reforms after 1991 were “piece meal” or “quick fix” reforms that either set temporary surtaxes or increased tax rates of existing major taxes (VAT, Income), created distortionary taxes (financial transactions tax) or reinstated old ones (net wealth tax). There were no “structural reforms” that changed the overall tax structure or the structure of one of the existing major taxes, in which either efficiency or equity concerns predominated over those of increased revenues.

A first general answer that explains why tax reforms were “piece-meal” is that as revenue goals were so pressing given the fast pace of increase of expenditures, governments gave preference to revenue producing quick fixes than to complex tax reforms in which efficiency or equity objectives predominate.²⁸ The latter are technically and

²⁸ Interviews with ex Minister Juan Camilo Restrepo and Ex President César Gaviria.

politically more complex, usually take more time to be enacted and have a lower ratio of “revenue to effort”.²⁹ However, even accepting these arguments, the fact remains that even those draft tax laws after 1991 that attempted to introduce structural changes (1995 and 2006) failed and ended up being “piece meal” reforms, in sharp contrast with what happened before 1991 (e.g. in 1974 and 1986).

It is thus instructive to analyze in some detail the political economy process that lead to failure in these cases by looking at our main independent variables and contrast it with the process that permitted approval of structural tax reforms in 1974 and 1986, before the 1991 Constitutional reform.

Party fragmentation and Congressional Support

Former ministers and congressmen interviewed largely supported the view that structural reforms -and in particular the elimination of specific exemptions- became more difficult after 1991, mostly as a consequence of a weakening of party discipline. While most Congressmen from traditional parties were elected through closed lists elaborated by national or regional party directorates (or the heads of a few large factions) up to the early eighties, most were increasingly elected through one-candidate lists after 1991 and as a consequence were not responsive to party directives. Further, such candidate-based movements obtained a large fraction of their campaign financing from individual groups and firms and hence would ardently support their narrow tax interests (keeping or obtaining new specific exemptions).³⁰ Interviewed actors coincided in the appreciation that the discussion of tax reforms when party discipline used to be stronger dealt more with “ideological orientations” (e.g., the liberal party favored higher direct taxes, supposed to be more progressive, than VAT increases, assumed to be regressive) than with specific articles that affect narrow private interests.

Before 1991, disciplined party votes were the key for the approval of tax reforms. Thus, in 1975, when the Government introduced a draft tax law to preempt potential major changes to the structural tax reform enacted through emergency powers in 1974, approval in Congress was guaranteed through the explicit support of the directors of the coalition

²⁹ Ex Minister Restrepo indicated that in Colombia’s constitution and legal system there is no distinction between (structural) “tax reforms” that attempt to change the tax structure, and “financing laws”, which are just intended to provide additional resources needed to finance annual public budgets. In contrast, other countries make this distinction which often has implications for the process of discussion and approval in Congress. Thus in some countries “financing laws” proceed in parallel with budget laws through the same commissions or are an integral part of budget laws. The 1991 Constitution fell short of making this distinction when it permitted to present an “unbalanced” budget, provided that simultaneously a tax law to generate additional resources is presented and “excess” expenditures in the former can only be executed upon approval of the latter. However, such a tax law has no material or procedural differences with a tax reform proper. In other words, according to this view most tax laws after 1991 did not intend to be “tax reforms” but “financing laws” with a more modest scope.

³⁰ This was partially a consequence of the strengthening of independent movements and the national circumscription for Senators in the 1991 Constitutional reform.

that supported the Lopez Michelsen Government (the Liberal Party Director, future President Turbay Ayala, and Alvaro Gomez, head of the fraction of the Conservative party that was a member of the governing coalition).³¹ In 1984, under a Government with a minority in Congress, Minister Junguito negotiated the approval of a tax reform with the Directors of the majority party (the Liberal Party), and accepted major changes to the draft law suggested by them.³²

Although the elections in 1990 saw the beginning of political participation of new political forces, the Gaviria administration (1990-1994) did not face a lot of problems with Congress, as it was a transition government. After presidential elections where three candidates had been killed by drug cartels and the call for a constituent assembly, the expectation for change opened up a window of opportunity that left the government virtually without any opposition. This was proven by the fact that the Assembly closed the newly elected Congress, supported by the public need for change. And while public attention was mostly in the Constituent Assembly, the Finance Minister and the President focused their strategy on structural economic reforms and looked for viable ways to finance the central government expenditures increase.

The initial economic reforms, including the increase in VAT from 10% to 12%, passed easily through Congress with the disciplined vote of the liberal party majority.³³ The 1992 Tax Reform was more difficult to pass through Congress and involved significant negotiations over “pork” (until the 1991 Constitutional Reform a fixed percentage of the budget went to parliamentary “Auxilios”, over which there was no need to negotiate).³⁴ The Government also accepted that the income tax rate and part of the VAT tax increase were temporary, until 1995, thus forcing the following Government to return to Congress in order just to maintain the level of revenues.

The Samper administration was of liberal origin, though the Cabinet included some conservative party figures. Following practices previous to 1991, the Government sought for the support of the two main party directorates for the draft of its 1995 tax reform. This draft contemplated a structural reform that would also increase revenues³⁵: it did not contemplate any rate increases, but envisaged to significantly increase revenues through a combination of drastic cut of exemptions, widening of tax bases, strengthening of the minimum presumptive income regime and increased effectiveness in tax collections (through, for example, introducing VAT withholding by major taxpayers).

³¹ Interview with ex Minister G. Perry, who was the main author of the 1974 tax reform while chairing the National Tax office.

³² Interview with ex Minister Junguito.

³³ Gaviria nominated Ernesto Samper, head of the largest fraction of the liberal party, as Minister of Development in charge of trade opening, thus diffusing potential opposition within his own party.

³⁴ Interview with Ex Minister Hommes.

³⁵ Structural reforms before 1991 had also on occasions envisaged a significant revenue increase, when circumstances demanded it, as was the case in the 1974 tax reform. See Perry and Cardenas (1998).

While the Conservative Party directorate largely supported the draft law, the Liberal Party directorate frankly acknowledged that it could not guarantee the discipline of its Congress members in voting the elimination of specific exemptions. Thus, it suggested increasing statutory rates in both the VAT and the income tax, in spite of a Presidential campaign promise not to increase tax rates. With the proximity of a potentially harsh political crisis, the Government had no choice but to accept that liberal party members would not approve the proposed elimination of exemptions. The solution to get the bill passed was to use “pork” to obtain the support of a minority of conservative Congressmen to the increases in tax rates and to consolidate the support of the majority of the liberal party.³⁶ Due to the political crisis, and the lack of political capital, fiscal reforms (and any kind of economic legislative initiatives) during Samper’s administration were limited. In 1997 and 1998, the Government was only able to increase marginally some tax rates and bases (Law 383 and Decree 81 of 1997) and to reserve a minor fraction of transfers for funding regional pension liabilities.

Cabinet delegation

The draft tax law of 2007 -Uribe administration- introduced by Minister Carrasquilla, proposing a structural change of the income tax (adopting a “flat” or “cash-flow” tax, with full immediate deduction of investment expenditures and elimination of most exemptions and a lower tax rate) failed in Congress. Indeed, the reform was presented as “revenue neutral” by Minister Carrasquilla³⁷, while all other reforms since 1990 attempted explicitly to increase revenues. This was permitted by the fact that tax revenues were booming thanks to high commodity prices³⁸, accelerated growth³⁹ and administrative improvements⁴⁰ and thus fiscal deficits and debt ratios were diminishing in spite of continued increasing expenditures and, in this context,

Failure of the 2006 draft law seems to be due to a significant extent to the lack of commitment and support by the President. When interviewed, ex President Gaviria insisted that no tax reform in Colombia -before or after 1991- could succeed without significant presidential involvement and support to “align” the votes of the governing coalition.

Though such a condition does not seem to be as essential for the approval of quick fixes in periods of acute fiscal crises (as was the case in the Pastrana tax reforms), it has been certainly the case for successful structural reforms (such as those in 1974 and 1986). President Uribe actually began to offer publicly (mostly in business association meetings)

³⁶ Interview with ex Minister G. Perry.

³⁷ He, nonetheless, thought it would increase revenues (interview).

³⁸ Revenues from oil (royalties, gasoline consumption taxes, income taxes and profits of Ecopetrol) are a sizable part of fiscal revenues (approximately 2.3% of GDP for 2006). Income taxes from mining (especially coal and nickel) have also been increasing in importance

³⁹ Tax revenues normally have an income elasticity higher than one and Colombia is no exception.

⁴⁰ The so called “Plan Muisca”.

the maintenance of several key tax exemptions and the introduction of new ones, that would alter significantly Carrasquilla's proposed reform. Later on President Uribe defended publicly in an increasingly vehement way his conviction that "tax incentives" for specific sectors are good and were behind the investment boom after 2003. In practice, he had not supported initial proposals from Minister Junguito in 2003 to do away with most tax exemptions⁴¹.

Although the lack of Presidential support was probably a reason enough for failure, it must be said that neither Congress nor the private sector were either enthusiastic about the proposed reform⁴². In particular, several business associations lobbied against the reform with the President allegedly because of lack of flexibility of the Ministry of Finance in accepting, for example, a gradual phase out of some of the exemptions that the draft law proposed to eliminate.

Crisis and the feasibility of reform

The Pastrana administration faced an economic slowdown in 1998, a deep recession in 1999 and a serious fiscal and currency crisis, following the effects of the Asian and Russian crises. Colombia lost its investment grade and access to international financial markets was suspended⁴³. In addition, a serious mortgage crisis and the threat of a full blown financial crisis demanded additional fiscal expenditures to rescue depositors and banks. The Government had to ask for an IMF program for the first time since 1965.⁴⁴

Politically, Pastrana was the first minority president in the nineties, supported by a multiparty coalition made up from very heterogeneous political groups. The magnitude of the crisis, however, helped in many ways to enact several fiscal reforms.

First, a transitory financial transactions tax was created in 1998, at a rate of 2 per thousand, *through emergency powers* to finance the financial sector rescue operations. (The following subsection discusses the incentives in the political economy process in favor of creating new taxes). In addition, the Government enacted a tax reform in 1998 (Law 488 of 1998) which envisaged a VAT tax base increase, an elimination of some exemptions and a mandatory subscription of public bonds (Bonos de paz) in proportion to net wealth (0.6%). A second tax reform was enacted in 2000 (Law 633 of 2000) which made permanent the

⁴¹ Ex Minister Junguito interview.

⁴² From interviews with Congressmen and Business Associations. Congressmen interviewed mentioned that given strong political incentives contrary to elimination of exceptions, discussed above, success would have required a major commitment of the President, which was obviously lacking.

⁴³ Investment grade had been achieved during the Gaviria (from most rating agencies) and Samper Administrations (moody's)

⁴⁴ In 1984 Minister Junguito actually negotiated a "shadow" program with the IMF, in exchange for IMF support with private and multilateral banks. However, no formal agreement was signed and no IMF financial support became available, as President Betancur did not wish to incur the political costs of signing an IMF agreement.

transactions tax and increased some VAT bases. In spite of these tax reforms and some harsh reductions in discretionary expenditures growth⁴⁵, the Central Government deficit and public debt ballooned: the deficit increased from 4,7% of GDP in 1998 to 7,6% in 1999 and the public debt from 22% of GDP in 1998 to 52% of GDP in 2002. Ex minister Restrepo acknowledged that the magnitude of the fiscal and financial crises was instrumental in passing these reforms, in spite of the lack of a majority in Congress. The same happened in 1983, when President Betancur did not have a majority and the country had to face a severe fiscal crises and an impending currency crises⁴⁶.

In turn, president Uribe gained by a large margin, being the first president after 1991 to obtain an absolute majority in the first round of the presidential election. His first term initiated still in a recessionary period, a fiscal crisis and without access to international financial markets. The fiscal and Security crises, after Pastrana's failure in his "peace process" with the guerrilla movements, permitted the new government to obtain legislative support for fiscal reforms, in spite of not counting initially with a Congressional majority⁴⁷, as well as the use of exceptional powers.

The governments security strategy -"seguridad democrática-, required a major increase in defence expenditures, on top of their already significant growth from 1991 to 2002. To finance these expenditures, a "state of commotion" was declared in 2002 allowing the temporally reintroduction of the net wealth tax (that had been eliminated in the 1986 tax reform) through a Presidential decree (Decree 1838 of 2002). Private sector leaders accepted the net wealth tax as a means to improve the security situation.

Later on, two tax reforms got enacted in the first year of the administration (Law 788 of 2002 and Law 863 of 2003).The net wealth tax was extended and then became permanent. The financial transactions tax was also made permanent and its rate was increased from 3 to 4 per thousand. The income tax rate was also increased. The VAT base was substantially extended (previously exempted goods were taxed at a low rate), but the Constitutional Court annulled such a provision. At the same time some new income tax incentives were created. Ex minister Junguito, when interviewed, emphasized the role of negotiations with the IMF in periods of crises (1983 and 1999-2002) in facilitating support within the Cabinet and in Congress.

In spite of some setbacks in attempting to reform pensions and limit expenditures (see Section on Expenditure reforms), the surviving Uribe reforms, the resumption of economic growth (as a consequence of both an improved external environment, perceived significant changes in security and the initial prudent macroeconomic management), the

⁴⁵ Most expenditures cannot be reduced as they are either mandatory transfers, financed through earmarked taxes, public officials, judges and army and police salaries and debt service.

⁴⁶ Interview with ex minister Junguito, by then Minister of Finance

⁴⁷ The President did not enjoy a Congressional majority, in spite of winning by a wide margin, as his was essentially a "going solo" campaign

increase in commodity prices and the consequences of the regional transfers Constitutional reform of 2001, permitted regaining access to international financial markets and some reductions of Central Government fiscal deficits and public debt to GDP ratios in the following years. Further, the improved fiscal situation of sub-national governments (due to the previously mentioned decentralization reforms and the resumption of economic growth) and public enterprises led to a sharp fall of the consolidated public sector deficit.

The political economy process of new distortionary taxes:

Revenue pressures also contribute to explain the emergence of new distortionary taxes (or the revival of old distortionary taxes) since 1991. But there have been other institutional and political economy factors that explain this trend.

First, the 1991 Constitution determined that sub-national governments would receive transfers of resources as an increasing proportion of total revenues from existing taxes. Revenues from new taxes were exempted from this proviso. Thus, reforms that would increase revenues from existing major taxes (VAT and income taxes) were not very effective in reducing central government (or consolidated) deficits as almost half of their produce went to sub-national Governments and could be used to increase their expenditures. Second, specific new taxes could be closely linked to the beneficiaries of some new expenditure requirements and thus facilitate their political acceptance. The importance of these two considerations is highlighted by the political economy process of the adoption of the financial transactions tax during the Pastrana administration and the reinstatement of the net wealth tax during the first Uribe administration.

The Pastrana administration had to face, as discussed above, both a fiscal and an economic crises. To avoid a full blown financial crisis and to deal with the social consequences of the crises the Government required additional emergency funds to bail out depositors and rescue some banks, both public and private. The financial transactions tax (that was already in use in Argentina and Brasil) provided an expedient recourse to obtain rapidly the significant funds required to these ends and to avoid sharing its produce with sub-national Governments. Further, as these expenditures were not recurrent, the tax was to have a finite duration. Congress and public opinion would object less to finance such support with funds raised temporarily from the financial sector itself than from general "taxpayers money". Banker's objections to such a distortionary tax were limited because of the need to avoid a systemic crises and the allegedly transitory nature of the tax. All these considerations were behind the selection of this instrument and its defense vis a vis Congress (though the tax was enacted through emergency powers), public opinion and the IMF, which was against such a tax, when the Government latter on had to ask for Fund resources⁴⁸.

⁴⁸ Interview with ex Minister Restrepo

Latter on the duration of the tax was prolonged and it became permanent, at a higher rate, during the first Uribe administration. Minister Junguito justifies this decision because of the pressing revenue needs and the opposition found to increasing the VAT tax base or rates in Congress and the income tax base or rates within the Government⁴⁹. It is interesting to note that Congress accepted readily increased taxation of the financial sector with a populist overtone of "taxing rich oligopolical banks and bankers" when the real incidence of the tax falls on all bank clients (debtors and depositors) and the economy at large (through lost efficiency and volume of financial intermediation).

Similarly, at the beginning of the first Uribe administration, the Uribe Government chose to reinstate the net wealth tax allegedly to finance temporarily the required increase in defense expenditures to counteract the growing influence of guerrilla warfare and the significant deterioration of public order. Again, this tax (which was initially a forced subscription of low interest Government bonds) would produce rapidly significant resources, avoid sharing them with sub-national governments and provide a conceptual link with beneficiaries, as far as security is more important for those that have higher wealth. Such arguments were indeed used vis a vis the private sector (which had supported enthusiastically Uribe's campaign focus on the need to improve security), Congress, domestic and international public opinion, in particular the US Congress. Indeed, there was significant opposition to permit the use of Plan Colombia resources (and even to maintain them) for security purposes (it had been approved initially exclusively to be used against drug trafficking), as the Government desired, on the grounds that "rich Colombians should pay for their own security". The adoption of a net wealth tax, with the explicit support of Colombian business leaders and associations, was instrumental in diffusing such opposition⁵⁰. It is important to note that the elimination of the net wealth tax in 1986 had been seen as a major accomplishment by large private sector groups⁵¹

Again, as what happened with the financial transactions tax, the duration of this "temporary" tax was latter on prolonged, as security needs did not abate, and will probably become a permanent feature of the Colombian tax landscape, as it is presently (July 2009) being proposed by the Government.

Decentralization reforms

Structural (efficiency oriented) vs. Piece Meal (control oriented) Reforms:

Since 1993, when Law 60 regulated articles 356 and 357 of the 1991 Constitution that determined the percentage of current revenues that should be transferred to subnational

⁴⁹ Interview with ex Minister Roberto Junguito.

⁵⁰ Interview with ex Minister Junguito

⁵¹ It was then exclusively a "personal" net wealth tax, while the new one falls over both individuals and firms with net wealth over a significantly higher minimum.

governments (i.e. *situación fiscal* to Departamentos and *participación municipal* to municipios), five reforms to decentralization have been enacted.

Three of them, implemented as laws between 1997 and 2000, attempted to control excessive debt and expenditures in sub-national governments, while other two that required Constitutional reform, implemented in 2001 and 2007, aimed to control regional transfer increases. Among them, only the 2001 constitutional amendment introduced allocation efficiency criteria, through capitation, and can thus be classified as a “structural” reform.

Since 1993 the increase in transfers generated a significant raise in sub-national revenues, and regions used these new revenues to leverage debt. In fact, between 1993 and 1994, municipal debt increased 95% nominally, and departmental debt 114% (see Fedesarrollo, 2006). The central government was concerned that this rapid increase in regional debt could make regional public finances unsustainable. The Samper administration presented a draft law in 1995 that was approved in 1997 (Law 358 of 1997⁵²) in order to regulate regional indebtedness. This reform introduced limits through solvency (i.e. debt service not superior to 40% of savings) and sustainability (i.e. debt stock not superior to 80% of current income) indicators and a system of “green”, “yellow” or “red” lights depending on actual ratios, according to which Departments and Municipalities can automatically proceed with further indebtedness, require special permissions from upper levels of Government or could not issue new debt until they undertake a fiscal adjustment program.

Three years later, in 2000, under Pastrana administration, a complementary reform introduced limits to increases in current expenditures (Law 617 of 2000) as a percentage of non-earmarked current revenues. The reform aimed to control excessive increases on current expenditures (as percentage of non-earmarked current revenues), and to increase the capacity to finance labor liabilities and a fraction of capital expenditures. On the same vein, a reform implemented through Law 549 of 1999 created the Regional Pension Fund (FONPET) that forced subnational governments to save a percentage of transfers for pension liabilities.

In sum, these three reforms aimed to guarantee fiscal sustainability in sub-national governments, one through limits to debt and two through limits to expenditures⁵³. However, other persistent problems in the decentralization process were identified. Transfers dependence on central government current revenues that are affected by the economic cycle introduced volatility in subnational revenues, affecting their fiscal discipline and their expenditure efficiency. In addition, the increasing pace of regional transfers introduced by the Constitution was contributing to the Central Government

⁵² Popularly known as the Ley de Semaforos (traffick light).

⁵³ These two reforms are also complementary with Law 550 of 1999 that regulates bankruptcy, and Law 549 of 1999 that created the regional pension fund (FONPET).

increased deficits and debt. Finally, this increase in transfers was not fully translated into improved outcomes. For example, while transfers for education expenditures increased 30% between 1995 and 2000, enrolment rates increased only 18% (see Fedesarrollo, 2006).

Two Constitutional amendments attempted to deal with these problems. The Constitutional amendment 01 of 2001 reformed the formula to calculate transfers, delinking them from total current revenues and guaranteeing a modest real growth rate (inflation rate plus some real points), and distributing them under efficiency criteria (per kid to be enrolled in education, or per used bed in health). The Constitutional amendment was regulated by Law 715 of 2001. This reform was implemented at the end of Pastrana Administration. However, this change in the formula was transitory, until 2008. It generated the necessity for another Constitutional amendment that was enacted in 2007 (*Acto Legislativo 04*) and regulated through Law 1176 of 2007. This reform made permanent the real increasing rate of transfers to sub-national governments, with additional increases for education and infancy, and, in addition, earmarked part of the transfers for water and sanitation expenditures. This reform was implemented under the second period of President Uribe, and under the urgency to avoid the return to the previous formula and to a significant increase in transfers. According to Government calculations if the amendment had not been enacted, transfers would have increased in 2009 ten percentage points of revenues compared to 2008. In addition, compared to the previous Constitutional amendment, this one is more permanent, in the sense that transfers would continue under the same formula (inflation plus a constant growth rate of 3%) after 2016.

Fragmentation and Congressional Support

The political economy of decentralization reforms present interesting facts. First, some of them are Constitutional amendments, that to be enacted require a longer process (8 debates vs. 4 of a regular law) and a larger majority. However, according to all actors interviewed these reforms have been easier to be implemented compared to, for example, tax reforms. In addition, these reforms have been effective in terms of restoring, at least partially, fiscal discipline.

The first hypothesis to explain these facts is related to the distribution of political costs across the political system. Decentralization made majors and governors independent from Congressmen. Popular election made them politically independent, compared especially to the previous period, before 1984, when they were designated by the president in consultation with Congressional leaders. Transfers made them financially independent, compared to the period previous to the 1991 constitutional reform when transfers to the regions depended either on discretionary transfers or the pressure of Congressmen in each tax reform to include a growing portion of VAT revenues to be transferred to municipalities. In addition, Congressmen are now more aligned with specific constituencies and interest groups, due in part to multiple party lists, and to private funding of campaigns.

These facts created incentives for Congressmen to accept Executive driven decentralization reforms that would control transfers, indebtedness or expenditures to majors and governors that are, in the best case, not completely aligned with them (and in the worst, their political opponents), vis-a-vis supporting structural tax reforms that would affect negatively the interest groups that they represent in the Congress. Such incentives were further reinforced by generous allocations of “pork”, which in turn reduced incentives to enact reforms to the national budgetary process (see next section). In sum, the hypothesis affirms that the decentralization process, that multiplied political arenas and made majors and governors financially and politically independent from Congress, generated a political “market” equilibrium (in contrast to the previous more institutional equilibrium) where decentralization reforms are easier to implemented than structural tax or expenditure reforms, even though the policy making process make the later easier in terms of the political process. These stylized facts contrast with what happened before the election of governors and majors. Their nomination was used by the Central Government as a currency to consolidate support coalitions in Congress, thus giving incentives to congressmen to lobby for increased free transfers to be used by their subordinates.

Ex Ministers and Congressmen interviewed largely supported this hypothesis comparing to (i) the period previous to 1991, and (ii) other fiscal reforms, such as tax or expenditure reforms. For Rudolph Hommes, Gaviria’s Minister of Finance, decentralization, and more specifically majors and governor elections deteriorated party discipline, and the multiplication of political arenas generated Congressmen support to control regional expenditures and reduce regional transfers in exchange for other political benefits. For Alberto Carrasquilla, Uribe’s second Finance Minister in his first administration, and for Juan Carlos Echeverry, National Planning Department under Pastrana Administration, the opposition to these reforms was mostly from public sector unions, even more than by majors and governors and less so by Congressmen. For the 2001 Constitutional amendment the strongest opposition to the reform came from FECODE, teacher’s union and ANTHOC, hospital workers unions, against efficiency indicators (the capitation criteria), more than to the reform to transfers formula and its subsequent deceleration. For the 2007 reform, when efficiency criteria were not reformed, the strongest opposition came from the municipal federation in representation of majors.

Crisis and the feasibility of reform

The crisis hypothesis was also largely supported by the interviewees, especially by Congressmen⁵⁴. They argued that Government and Congress became increasingly aware that the pace of resource transfers ordered by the Constitutional reform of 1991 was indeed a major factor behind the central Government growing fiscal stress and eventual crises in 1999, and that, in addition, there were significant excesses, waste and capture in sub-

⁵⁴ For example, senators Valdivieso and Lopez supported this view.

national expenditures (many majors and some governors had been prosecuted for fraud and in many cases diverted resources towards paramilitary and guerrilla warforces). Thus, these reforms were also aided by the overall context of increasing fiscal stress and crises and public order disruptions.

For Juan Camilo Restrepo, Pastrana Finance Minister that implemented Law 617 of 2000, this implementation was easier to pass through the Congress because of the economic crisis of 1999 and the resulting fiscal crises of many subnational entities. Santos, Finance Minister in the same administration, took further advantage of the fiscal crises of subnationals to obtain support for the 2001 Constitutional reform, as discussed below in more detail. Finally, for Uribe's Finance Minister Alberto Carrasquilla, the Constitutional amendment was enacted during an economic boom, but with a high risk to return to the regional transfers level previous to the transitory 2001 constitutional amendment, implying a major risk of renewed fiscal crises of the Central Government.

In sum, the 1999-2002 economic and fiscal crisis was a major determinant to reform the decentralization process, and, in particular, the pace in which the increase in regional transfers was taking place. Both then and in 1997 and 2007, a fear of a fiscal crisis generated by sub-national excesses, or a significant jump in regional transfers, was a trigger for reform.

Political economy of the 2001 Constitutional Amendment

However, the political economy process to implement decentralization reforms was not without difficulties. An example was the 2001 Constitutional amendment, enacted during the Pastrana Administration, from the conservative party, when the Finance Minister and the National Planning Department Director had to convince several actors. First, at the interior of the executive, where several line-item ministers that were not in favor of the reform (e.g. the health minister). Second, Congress, governors and majors support. In fact, this reform was implemented by a politically influential Finance Minister from the liberal party that was selected by Pastrana to achieve a supporting majority coalition in Congress. This coalition aimed to recover governability after a major clash with Congress in which each side threatened to promote a referendum to out seat the other. Understanding the growing magnitude of the fiscal problem, and the increasing possibility to suffer a fiscal crisis, the Finance Minister and the National Planning Department Director discussed with the head of the liberal party (Horacio Serpa), that was most likely going to be the next president, that it was in his interest to convince liberal Congressmen -that were the majority- to implement this reform. If not, the likelihood for next administration to suffer a fiscal crisis was high. Serpa agreed, though latter on, as opposition by prominent governors and majors grew in intensity, requested that the Finance Minister would obtain majors and governors support for the reform (of course, the liberal candidate did not want to waste his

political capital to implement the reform, even if convinced that if the reform was not enacted his administration would have to face a fiscal crisis).

When interviewed, Santos indicated that he was able to obtain the support of key governors and majors because in that year many sub-national governments were facing a fiscal crises, as for the first time since 1991, the effect of the deep economic crises on CG current revenues reduced the level of transfers below the amounts budgeted, against which regional authorities had made expenditures commitments.⁵⁵ Thus, the volatility risks associated with the existing formula had ceased to be a mere theoretical possibility and became a harsh reality. In this environment it was possible to convince majors and governors to support a reform that would avoid such crises by guaranteeing a minimum real growth in transfers. The reform proposed a fixed real increase in transfers: 1,5 percentage points over the inflation rate.

To fully obtain their endorsement, Santos further offered to support the restructuring of bank debts that had become binding. A large group of sub-national Governments was encouraged to file for bankruptcy under recently approved Law 550 and the Government supported their claims against creditors by offering the banks central government debt guarantees if they would accept the proposed restructuring. This whole process took over a year. Thus a protracted tripartite win-win negotiation was achieved: banks agreed to reduce debt as restructured debt was to be guaranteed by Government, thus limiting their potential losses; majors and governors recovered the possibility to spend in the short run, thanks both to the guaranteed minimum transfers and their reduced financial obligations; and the Government obtained support for a reform which would avoid a fiscal collapse going forward Santos admitted, though, that the magnitude of the gains actually obtained by the Central Government was not expected by anyone, as it was highly improbable at the time that the economy would recover so fast and enter into a major boom after 2003.

Finally, as described before, teacher's and hospital workers unions were opposed to the capitation criteria. While transfers for education depended before on the number of teachers, the reform made them dependent on the number of students, requiring reallocations of teachers that were strongly opposed by the union. The reform was enacted with a difference in the Congress of just one vote in favor, with liberal use of "pork barrel" distribution.⁵⁶

In sum, the hypothesis that suggest that, although decentralization reforms have a more difficult policy making process, they are easier to be enacted because of the new incentives embedded in the political economy process after 1991, was supported by the interviews. In addition, crisis hypothesis were also supported, under different definitions of crisis: regional or national fiscal crisis and public order issues.

⁵⁵ Articles 356 and 357 allocated regional transfers as a percentage of CG current revenues.

⁵⁶ Interviews with ex Minister Santos and ex Planning Director Echeverry

Further, the distribution of (political) powers between central and sub-national governments, or more specifically between the executive, Congressmen, and majors and governors has been one of the reforms drivers. Some Congressmen and ex-ministers suggested that although these reforms were mostly motivated by the fiscal problem, another objective from the central government (and Congress) was to regain some political power from the empowered and autonomous governors and majors.

Expenditure reforms

Structural and piece meal reforms

During the last two decades three substantial expenditures reforms have been enacted⁵⁷. This is a small number compared to tax or decentralization reforms. The first one, a reform to the Organic Budget Law, was enacted in 1989. The second one, the Fiscal Responsibility Law, was enacted in 2003. Finally, the Ministry of Finance issued in 2005 the Decree 4730 that introduced a set of reforms to the budget process. Among these three reforms, the only one that can be classified as structural is the 1989 reform. The objective was to balance the three pillars of the budget process: fiscal discipline with expenditures efficiency and allocation based on policy priorities, although with different focus. The 1989 reform was implemented under an annual-basis budget framework, while the Fiscal Responsibility Law and the Decree 4730 of 2005 introduced in the budget process multi-annual budget tools (i.e. The Medium Term Fiscal and expenditure Frameworks).

The 1989 Organic Budget Law reform aimed to coordinate the financial role of the government controlling the execution of public resources, with the role of planning, programming and executing public programs and policies with development objectives. This objective aimed to balance fiscal discipline with efficiency in the execution and implementation of public policies⁵⁸.

This reform had important effects over budget institutions. To allow line-item agencies to program their budget in an annual basis, with development objectives on their policies, decentralized the responsibility of planning and programming to the line-item agencies planning departments. The tool that the allocation agency for investment expenditures, DNP, designed, was the National Project Bank, though it did not fulfill its objectives in practice. As the need for pork barrel arrangements increased after 1991, the Government and Congress began to “negotiate” the inclusion of investment projects in the

⁵⁷ In the reforms inventory three other reforms, enacted in 1994, 1996 and 1996. The only important fact is the compulsory requirement to introduce in the BPIN investment projects to be included in the budget.

⁵⁸ Before the reform, the budget process was the main tool for fiscal discipline. Red tape for the line-item agencies to execute public resources, on a monthly basis, was sacrificing efficiency. Line-item agencies were uncertain about how much resources they could spend, hence they could not program their expenditures according to their mission.

budget and latter on registered them in BPIN, taking advantage of a loophole: the 1989 Budget Code required registration prior to execution, and not to inclusion in the budget. .

At the same time, decentralization was a work in progress. In the 80s the necessity to decentralize public responsibilities, especially the ones related to public services, was impending, and one of the objectives of this Organic Budget Law reform was to decentralize expenditure responsibilities to central government line-item agencies, but also to coordinate with subnational government investment projects that would be financed coordinately by both levels of government. This coordination also needed efficiency criteria to achieve development goals. Finally, the reform created a new budget institution, the Council of Fiscal Policy (Consejo Superior de Política Fiscal – CONFIS), to coordinate fiscal policy⁵⁹.

The new Organic Budget Law was enacted with an emergency message from the presidency, and the changes to the original bill proposed by the President and the Finance Minister were not important for the spirit of the law⁶⁰ (see the motivation exposition of the project bill, and the addresses made by the sponsors for the two debates in both chambers).

Fourteen years later, in 2003, another expenditure reform was implemented. This reform is known as the Fiscal Responsibility Law. The reform was part of a package of reforms accorded with the IMF under the stand-by agreement signed in 1999. The project was presented to the Congress during the last semester of Pastrana administration, in 2002⁶¹, and the debates continued with Uribe Administration. The reform was enacted in 2003. The main objective of the reform was to guarantee fiscal discipline and sustainability in the medium term. This objective would be achieved by making more predictable fiscal discipline under a medium term (i.e. ten years) framework with primary balance goals (i.e. numeric rules) for the Non Financial Public Sector. In this way, the reform would avoid temporary inconsistency problems, and reduce discretionality on fiscal policy. In addition, making the information available, the Fiscal Responsibility Law would make more transparent fiscal policy. The original bill includes also a set of procedures rules to limit sub-national indebtedness, following the “traffick light” reform enacted in 1997⁶². Another important innovation was to calculate the fiscal cost of new laws, and to calculate contingent liabilities (to avoid “skeletons in the closet”). Finally, since the budget process is an annual process, and the figure to introduce multi-annual programs is the approval of

⁵⁹ This council was composed of the Finance Minister, the National Development Planning Director, two line-item ministers, and the Economic Secretary of the President. The CONFIS was in charge of monitoring and evaluating fiscal policy and to approve the Annual cash Program.

⁶⁰ Two important changes made by the Congress were (i) removing the objective of the elimination earmarked expenditures, and (ii) allowing central government to use public enterprises profits to finance public expenditures.

⁶¹ Bill 230 of 2002 of the Lower House and 159 of 2002 for the Upper House.

⁶² An interesting discussion in this bill is related to the definition of “social investment”. Since social expenditure is considered as investment and not current expenditure, it is not included in the calculus of savings for the subnational governments, but it is not treated as recurrent expenditure either.

vigencias futuras, the reform introduced limits to this figure to avoid its use with political objectives (i.e. avoid the political budget cycle).

A new reform to the budget process was intended in 2005, following the lines of the Fiscal Responsibility Law in terms of medium term frameworks. This bill had three main objectives. First, to introduce in the Organic Budget Law and to strengthen the articles of the Fiscal Responsibility Law, in order to consolidate the fiscal rules of the game in one only Law. Second, and more important objective, was to balance fiscal discipline and efficiency in the use of public resources (see Fedesarrollo, 2004). For example, the bill wanted to set boundaries to the definition of social expenditures, and to strengthen the budget constraint. For the efficiency, the reform proposed the introduction of the Medium Term Expenditure Framework (MTEF), a budgetary tool that based on the goals of the MTEF would distribute by sector expenditure caps for the following 4 years, to allow the line-item agencies to program and prioritize their expenditures in a multi-annual framework and make more efficient the use of public resources. Third, the objective was to simplify budget process procedures.

Constitutional Review

In addition, to attempt to control expenditure growth, the Uribe's administration attempted to reduce the increasing cash pension deficit through a pension reform (Law 797 of 2003) whose effects were largely annulled by the Constitutional Court. In particular, this Law attempted to reduce the transition regime of the pension reform enacted by the 1991, increasing the number of weeks to save to obtain a pension, and the age for retirement. The Constitutional Court declared these articles unconstitutional due to vested rights. This sentence implied a cost of 16% of GDP on pension liabilities.

Another attempt during Uribe Administration was a major expenditure reform (reducing pension payments and freezing for two years public sector wages) through a Constitutional reform referendum in 2003. Since 2000, the executive power attempted to increase public wages below the inflation rate due to fiscal problems derived from the 1999 economic crisis. However, Constitutional Court rulings declared unconstitutional these attempts, and required a Constitutional reform for these purposes. In spite of a significant positive vote, responding to the high popularity of the President, the Referendum did not achieve the constitutionally required minimum votes.

Congressional Support

Among the two reforms to the budget process enacted after 1991, the 2003 Fiscal responsibility Law surpassed the 4 debates in the lower and upper house without any

substantial change⁶³. According to one of the sponsors of the Law, Senator Juan Carlos Restrepo, this reform was one of the easier to pass (compared for example with Laws 617 of 2000 or 715 of 2001) for various reasons. On one hand, the Law was more technical compared to other laws. On the other, although it affected regional public finances (and some governors and mayors were opponents to the reform) this item was discussed only at the end of the discussion with the Congress (see Fedesarrollo, 2006). However, the authors of the Law, Roberto Junguito and Juan Ricardo Ortega, Finance Minister and Vice Minister respectively, think that the other side of an easy implementation of the reform is that the effect on the budget process has been negligible. Indeed, as was noticed by commentators at the time of approval, the law did not contain effective enforcement mechanisms (as was the case in Brazil where the FRL was complemented by a “law on fiscal crimes” that rendered authorities liable for unjustified deviations from medium term approved plans) or quantitative targets (as FRL in Argentina and Peru, that were effective for a time, though had to be abandoned in times of recession because, for lack of cyclical adjustments, became excessively pro cyclical⁶⁴).

The 2005 reform to the budget process, opened the possibility for the Congress to discuss the figure of “fiscal dictatorship”, under which if the Congress does not approve the proposed budget bill, nevertheless the budget will be the bill proposed by the executive. The discussions of the bill with the Budgetary Commission in the Congress opened this risk, and the project was removed from the Congress. In addition, the project was presented when the Constitutional reform for the re-election was being discussed, to which the President gave full priority, and the Congress responded. At the end, the Ministry of Finance issued the Decree 4730 with those points included in this reform project that did not need legal sanction.

Crisis and the feasibility of reform

While the 1989 Organic Budget Law reform passed through the Congress to be enacted, the Decree 4730 was a result of a failed intent to reform the Organic Budget Law in 2005. Both reforms were designed to be discussed in good times of the economy. In 1989 Colombia and Latin America were in a reform mood after the crisis of the 80s. In turn, the 2005 (failed) reform was presented to the Congress when the economy was growing 4%, and under the administration of one of the most popular presidents in recent history. This suggests that after 1991, the reforms are more difficult to be implemented during economic booms. Out of the two reforms to the budget process enacted after 1991, only the Fiscal Responsibility Law was enacted under a crisis context. In 2003 Colombia was suffering the last effects of the 1999 financial (and fiscal) crisis, which was the most devastating crisis in the last 60 years, although President Uribe was already in power (since

⁶³ It is important to notice that the Medium Term Fiscal Framework (MTFF), the most important budgetary tool in the reform, was introduced for the second debate with the Senate.

⁶⁴ See Perry (2007).

2002). This reform was a consequence of a stand-by agreement with the International Monetary Fund. Finally, the pension reform of 2002 was also enacted under a crisis period.

In conclusion, reforms to the Budget Process have either failed or been relatively light after 1991, as compared to the pre 1991 period. This stylized fact may be explained by the fact that negotiations over pork barrel increased considerably after 1991 (as the former institutional balance provided by “auxilios” and the nominations of governors and majors as a currency to consolidate coalitions for legislative support): neither the Government, nor Congress, were particularly keen in modernizing reforms that would limit the scope for such negotiations.

V. Conclusions

All tax laws approved after 1991 were of the “quick fix” or “piece meal” types: increases in some tax rates and introduction of distortionary taxes –financial transactions, net wealth. Most Government initiatives were dominated by revenue objectives and disregarded efficiency considerations. The only two that were significantly driven by efficiency considerations (and were thus of the “structural” type: the 1995 draft law that also intended to raise revenues, and the 2007 draft law that was in principle revenue neutral) failed in Congress and ended up being two more “piece meal” laws. Overall, tax revenues increased but not as fast as expenditures. Increasing deficits contributed to the fiscal crisis at the end of the nineties and the Central Government kept high deficits even during the 2003-2007 boom. These results were mainly a consequence of fragmented and weakened political parties and Congressmen more responsive to narrow specific economic interests (that finance their individual campaigns), which have made more difficult and costly to enact any tax reform, especially those of a structural nature.

In periods of economic and fiscal crises the approval of revenue enhancing reforms was strongly facilitated, as predicted by theory. According to ex Ministers of Finance that carried on tax initiatives during such periods (1984 and 1999-2002), Congressmen from the two major parties recognized the need to increase revenues and the discussion lingered more on the type of quick fixes (e.g. whether more based on VAT or income tax rate increases). Structural reforms were not attempted, though, during such periods. An important difference in crises periods, when access to private international financial markets is severely limited, is the important role played by the IMF and the US Treasury. Their participation facilitates consensus building within Government and in Congress (within major traditional parties), as all players realize that tax reforms are needed not just to help finance the budget directly, but also to get access to foreign credit.

Decentralization related reforms -indebtedness and expenditure controls and regional transfers for sub-nationals- were easier to enact and quite successful, in the sense that they achieved a significant reduction of transfers/GDP ratios, contributed to a levelling of

public expenditures/GDP ratios since 2001 and to reduced CG deficits and led to aggregate surpluses in sub-national balances during the boom period. This in spite of the fact that transfers reforms required Constitutional changes and thus a more demanding political process in Congress. Such results were mostly associated with a major change in incentives of Congressmen as a result of the election of governors and majors: they are now more willing to accept limitations to regional transfers or expenditures executed by officials that do not depend on them (while previously the Executive nominated governors in consultation with regional Congress leaders and governors named majors), provided they can influence CG direct expenditures in the regions and avoid harming the narrow economic interests they now represent (through elimination of exemptions).

With respect to the crisis hypothesis, decentralization reforms have been enacted independent of the economic cycle, although with a constant fear of a sub-national fiscal crisis that would affect overall public finances. Law 358 of 1997 was enacted under the political crisis of Samper administration. Laws 549 of 1999, 617 of 2000 and constitutional amendment 01 of 2001 were implemented under a deep economic crisis, and by a government with no majority in Congress. Finally, Constitutional amendment 04 of 2007 was implemented during an economic boom.

Only one important expenditure reform (the Fiscal Responsibility Law of 2003) was approved during the period. This reform introduced an important innovation: it required the use of medium fiscal frameworks, though it did not include enforcement instruments –as the highly successful Brazilian FRL- or quantitative targets, as other FRL's. It is difficult to assess its actual effects on expenditures growth. Another Government initiative failed in 2005. Expenditure reforms that reduce inflexibilities would have to face the opposition of groups that benefit from them (and that help finance individual Congressmen). As long as inflexibilities remain, reforms to the budget process law do not achieve much in terms of expenditure control, while they may make more difficult future negotiations over pork and run the risk of Congress weakening some of the Government actual handles of control.

Traditional expenditure adjustment measures normally used by Governments worldwide, such as reductions in pension benefits and real public wages, have become almost impossible due to jurisprudence established by the Constitutional Court since 1991. As a consequence, President Uribe, at the height of its popularity, attempted to limit pension and wage payments through a Constitutional referendum in 2002, when the economy had not yet recovered from the 1999 crisis, but did not obtain the high voting threshold established in the Constitution for such a procedure.

Finally, whether intended or not, the simultaneity of reforms may affect significantly the political economy process of tax reforms. Thus, the tax reforms of 1990 and 1992 were more easily accepted by business associations and the private sector in general (even while the 1992 reform increased substantially the income tax rate for

corporations) because they took place simultaneously with trade, labor and capital account reforms. In particular, industrialists were more concerned with trade opening than with an increase in the corporate tax rate, and the flexibilization of the labor law and the liberalization of the capital account brought some compensatory benefits⁶⁵. Perhaps more importantly, the Constitutional reform dominated the political and public opinion debate and thus the economic reforms went through Congress in a relatively low key tone which facilitated their approval.

On a more structural note, the reforms of transfers in 2001 and 2007 may facilitate future revenue enhancing tax reforms, as now increases in central government revenues are not automatically participated with sub-national governments and thus required tax rate increases will be correspondingly lower given a net revenue goal or need by the Central Government. Further, they may favor more structural reforms. At the very least they will significantly reduce the previous existing incentive to introduce and increase new distortionary taxes to a large extent because their proceeds did not have to be participated with sub-national Governments. Similarly, the 2003 electoral reform may lead to significant changes in incentives of Congressmen and to some strengthening of parties, thus shifting again the balance in favor of structural reforms.

⁶⁵ According to R. Hommes, Minister of Finance during that period, the labor law was much more valued by the industrial sector than the liberalization of the capital account that was actually opposed by Andi.

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Annex 1: Minister Interviews

Private Associations Interviews

Interviews	Main Positions
Maria Mercedes Cuellar	<ul style="list-style-type: none"> • President of Asobancaria from 2006 to date. • Member of the Board of Directors – Colombian Central Bank (From 1991 to 1996). • National Department of Planning Director - Barco Administration.
María Mercedes Vélez	<ul style="list-style-type: none"> • Head of Tax Law Unit - ANDI.
Claudia Elena Niño Gómez	<ul style="list-style-type: none"> • Legal Assistant ANDI President.
Juan Manuel Ospina	<ul style="list-style-type: none"> • Government Secretary of Bogota (From 2002 to 2006). • Senator (From 1998 to 2000). • SAC President in 1995.
Rafael Mejia	<ul style="list-style-type: none"> • SAC President from 2001 to date.
César González Muñoz	<ul style="list-style-type: none"> • President of Asobancaria in 1986.
Manuel Bermúdez	<ul style="list-style-type: none"> • Current Executive Vice President Cotelco

Senators Interviews

Interviews	Positions
Cecilia Lopez	<ul style="list-style-type: none"> • Senator from 2006 to 2010. • National Department of Planning Director • Agriculture Minister • Environment Minister
Rodrigo Lara	<ul style="list-style-type: none"> • Senator from 2008 to 2010.

	<ul style="list-style-type: none">• Director of anticorruption department.
Alfonso Valdivieso	<ul style="list-style-type: none">• Senator from 2008 to 2010.• Attorney General.• Education Minister.• Senator from 1986 to 1990.
Telosforo Pedraza	<ul style="list-style-type: none">• Senator from 2008 to 2010.• Chamber Representative.• Education Secretary of Bogota.

Annex 2
Reforms Inventory

Expenditure Reforms

Laws	Provisions
Decree 164 of 1950	<ul style="list-style-type: none"> • Earmarked expenditures eliminated. • Autonomous budgeting of decentralized agencies.
Decree 294 of 1973 (Reform to the Budget Organic Law)	<ul style="list-style-type: none"> • Higher control on decentralized agencies expenditure. • Better coordination in budget programming. • Decentralized agencies budget included in the CG budget. • More hierarchical budgeting. • Budget coverage expanded (i.e. principle of unity). • Power of the executive to do budget additions while congress is not working.
Law 38 of 1989 (Reform to the Budget Organic Law)	<ul style="list-style-type: none"> • Budget flexibility improved. • Autonomy of line-item agencies spending. • Effectiveness expenditures institutions introduced (e.g. Investment Projects Bank, BPIN). • Mandatory evaluation for investment projects established. • Annual cash program created. • National Fiscal Council (CONFIS) created.
Law 179 of 1994	<ul style="list-style-type: none"> • Law 38 of 1989 update for the new constitution. • Compulsory registration of investment projects.
Law 225 of 1995	<ul style="list-style-type: none"> • Standards of planning, preparation and performance of budgeting according to decree 111 of 1996 established.
Decree 111 of 1996	<ul style="list-style-type: none"> • Law 38 of 1989, Law 179 of 1994, Law 225 of 1995 joined without modifications.
Law 819 of 2003	<ul style="list-style-type: none"> • Medium Term Fiscal Framework (MTFF) created. • Management and performance

(Fiscal responsibility Law)	<p>indicators included in the budget.</p> <ul style="list-style-type: none"> • Confis can authorize expenditure increases in future budgets if and only if the execution was done with current budget appropriation and if it is consistent with MTEF goals.
Decree 4730 of 2005	<ul style="list-style-type: none"> • Medium Term Expenditure Framework (MTEF) created.
Decree 1957 of 2007	<ul style="list-style-type: none"> • Budget reserves limited to 2% of operational expenditure and 15% of investment expenditures.

Tax Reforms

Laws	Provisions
Law 81 of 1960	<ul style="list-style-type: none"> • Reduced labor income tax and its complementary taxes. • Created tax incentives for basic industries. • Established presumptive income taxes on rural land.
Law 21 of 1963	<ul style="list-style-type: none"> • Created a general sales tax (except foods, medicine and schoolbooks).
Decree 1366 and 1366 of 1967	<ul style="list-style-type: none"> • Established the repatriation of capitals. • Created a limit of tax deduction. • Created several instruments to control evasion. • Established withholding regimes. • Amnesty to late interest payments and liabilities not included in tax return.
Law 38 of 1969.	<ul style="list-style-type: none"> • Created labor taxes.
Law 6 of 1971	<ul style="list-style-type: none"> • General tax on imports increased from 5% to 10%. • Executive power can reform tariffs.
Law 6 of 1973	<ul style="list-style-type: none"> • Increased Corporations tax incentives. • Increased personal tax exemptions. • Exemptions to excess profits tax when profits used for investment in public bonds.
Decreets 2053 and 2247, special decree and Law 23 of 1974	<ul style="list-style-type: none"> • Most tax incentives eliminated. • Unification of income tax regimes (both for personal and corporation income taxes).

	<ul style="list-style-type: none"> • State enterprises taxed as corporations. • Introduced partial correction for inflation. • Income tax exemptions if income invested in public bonds. • Introduced capital gains taxation. • Established a general minimum presumptive income tax. • Inheritance tax modified. • Sales tax converted into a VAT at manufacturing level and dispersion of tax rates increased.
Law 54 of 1977	<ul style="list-style-type: none"> • Established full correction for inflation. • Amnesty to capital gains tax. • Established an additional tax credit for all firms. • Increased income tax exemptions and tax credits for many state's companies.
Law 20 of 1979	<ul style="list-style-type: none"> • Capital gains tax modified. • Maximum rate and progressivity of capital gains tax reduced. • Total exemption of capital gains tax for reinvested profits.
Decree 3803 of 1982	<ul style="list-style-type: none"> • Established more controls in the tax payment system.
Law 9 of 1983	<ul style="list-style-type: none"> • Strengthened the minimum presumptive income tax regime and adjustments for inflation. • Established new incentives for investment and debt. • Reduced double taxation. • VAT extended to retail level.
Decree 2666 of 1984	<ul style="list-style-type: none"> • Increase in tariffs. • Simplification of administrative custom procedures.
Law 75 of 1986	<ul style="list-style-type: none"> • Tax base broaden eliminating income tax exemptions (e.g. education and health discounts). • Elimination of double taxation through tax credits for dividends. • Net wealth tax abolished • Income tax procedures simplified. • Reduced income tax rates (to 30%) • Reestablished taxation of Ecopetrol. • Eliminated some exemptions of occasional profit tax.

Decreets 2503 and 2540 of 1987	<ul style="list-style-type: none"> • Tax procedures simplified (e.g. elimination of documents and financial sector in charge of receiving revenues). • Tax devolutions established.
Law 49 of 1990	<ul style="list-style-type: none"> • Dependence on tariffs reduced. • VAT basic rate increased from 10% to 12%. • Tax exemptions reduced. • Amnesty for repatriation capitals. • Unified the National Tax and Customs Administration (DIAN).
Law 50 of 1990	<ul style="list-style-type: none"> • CG bonds (TES) created, increasing the capacity of domestic borrowing.
Law 6 of 1992	<ul style="list-style-type: none"> • VAT increased from 12% to 14%. • Exemptions on tax payments to indigenous territories, metropolitan districts, associations of municipalities, black communities, and special administrative units and superintendencies. • Some goods excluded from VAT (i.e. basic consumer basket and some agricultural equipment not produced in the country). • Income tax rate increased to 37.5%. • VAT on capital goods made deductible (shift from income to consumption VAT).
Law 174 of 1994	<ul style="list-style-type: none"> • Inventories valuation decreased gradually. • Tax treatment for leasing established. • Executive power empowered to dictate rules on labor tax. • Inflation rates between the accounting and tax issues unified.
Law 223 of 1995	<ul style="list-style-type: none"> • Income tax rate reduced to 35%. • VAT rate increased to 16%. • Reduced exemptions in income tax and VAT • Strengthened the minimum presumptive income tax regime. • New VAT exemptions to a set of inputs used in housing building. • Personal enterprise considered as a private limited company. • Tax treatment to commercial leasing

	<p>defined.</p> <ul style="list-style-type: none"> • Capital losses deduction against the capital gains tax.
Law 383 and Decree 81 of 1997	<ul style="list-style-type: none"> • Smuggling and tax evasion penalized with imprisonment from 3 to 6 years and ticket of 200% on the CIF value. • New incentives for inter-institutional cooperation against smuggling. • Tax discounts limits. • Foreign investment and academic research incentives created. • External financing tax created (tax value: fixed term deposit interest rate - Libor - Annual depreciation). • Tax to transactions with government increased from 0,5% to 1%. (Stamp tax).
Law 488 of 1998	<ul style="list-style-type: none"> • VAT tax base increased. • VAT tax rate reduced to 15%. • Some income exemptions eliminated. • New system of public bonds created. (Bonos de paz).
Decree 2331 of 1998	<ul style="list-style-type: none"> • Financial transactions tax rate created at 2 per thousand.
Law 633 of 2000	<ul style="list-style-type: none"> • VAT expanded to houses of high strata and used cars. • Financial transactions tax rate increased from 2 to 3 per thousand.
Decree 1838 Of 2002	<ul style="list-style-type: none"> • Net wealth tax created (1,2% of patrimony once).
Law 788 of 2002	<ul style="list-style-type: none"> • Income tax rate increased to 38,5% • Number of goods excluded from VAT reduced. • Controls to evasion established. • New exemptions for specific activities.
Law 863 of 2003	<ul style="list-style-type: none"> • Financial transactions tax rate increased from 3 to 4 per thousand. • Net wealth tax re established (to finance increased defense expenditures). • Deductions to investment established.
Law 1004 of 2005	<ul style="list-style-type: none"> • Income tax rate equal to 15% to firm established in free trade zones.
Law 1111 of 2006	<ul style="list-style-type: none"> • Decreased income tax rates from 35% in 2006 to 34% in 2007 and to 33% in 2008.

	<ul style="list-style-type: none"> • Eliminated dividend tax on non residents. • Financial transaction tax permanent.
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Decentralization Reforms

Laws	Provisions
1957 Plebiscite	<ul style="list-style-type: none"> • First transfer law created.
Law 33 of 1968	<ul style="list-style-type: none"> • Percentage of alcoholic beverages tax, registration tax, lotteries tax transferred to regions. • Percentage of sales tax transferred to regions from 10% in 1971 to 30% in 1973.
Law 46 of 1971	<ul style="list-style-type: none"> • Percentage of CG income transferred for education expenditures to the Departamentos established.
Law 43 of 1975	<ul style="list-style-type: none"> • Percentage of sales tax transferred to Departamentos for pensions to teachers established.
Law 7 of 1981	<ul style="list-style-type: none"> • Regional internal debt regime established. • Budget autonomy to regions.
Law 14 of 1983	<ul style="list-style-type: none"> • Property tax and alcoholic beverages and cigarette tax regimes transferred to the regional governments.
Law 12 of 1986	<ul style="list-style-type: none"> • Progressive increase in the percentage of VAT transferred to regions from 30,5% in 1986 to 50% in 1992.
Constitutional reform of 1991 Articles 356 and 357	<ul style="list-style-type: none"> • General participations system of regional transfers created. • Percentage of CG current revenues of government that should be transferred to the regions established.
Law 60 of 1993	<ul style="list-style-type: none"> • Annual percentages that should be transferred to the regions established (For the Departments the “Situado Fiscal” that began at 23% of current revenues in 1994 and increased to 23,5 in 1994, 24% in 1995 and to 24,5% in 1996, and for municipalities the “Participación municipal” that began at 15%, increasing by 1

	<p>percentage point until 2001).</p> <ul style="list-style-type: none"> • Earmarked expenditures to education and health.
Law 358 of 1997	<ul style="list-style-type: none"> • Local debt cannot exceed its financial capacity. • Solvency and sustainability debt indicators introduced. • Debt service should be lower than 40% of regional operational savings.
Law 549 of 1999	<ul style="list-style-type: none"> • Regional Pension Fund (Fonpet) created. • All pension liabilities should be canceling before 30 years. • Percentage of Financial transactions tax, registration tax, privatization and earmarked current revenues transferred to Fonpet. • Ministry of finance's administration of Fonpet.
Law 617 of 2000	<ul style="list-style-type: none"> • Categories of regional governments created. 6 categories depending on population and current fiscal revenues. • Regional current expenditure of regions should be financed with non earmarked current revenues. • Regional current expenditure cannot exceed earmarked current revenues limits depending on the regional categorization established. (Special category 50%, first category 55%, second category 60% and third and fourth 70%).
Constitutional Reform 01 of 2001	<ul style="list-style-type: none"> • Increase of transfers to regional governments equal to the average increase of current revenues over the last 4 years.
Law 715 of 2001 (Regulated the Constitutional reform 01 of 2001)	<ul style="list-style-type: none"> • Efficiency procedures to distribute transfers to departamentos and municipios. • Limitation of current expenditures for subnationals.
Constitutional reform 04 of 2007	<ul style="list-style-type: none"> • Increase of transfers to regional governments equal to the inflation rate plus 4% in 2008 and 2009, plus 3,5% in 2010, and plus 3% between 2011 and 2016. In addition if GDP growth rate is higher than transfers

	growth rate, the difference will be transferred to the regions.
Law 1176 of 2007 (Regulated the Constitutional reform 04 of 2007)	<ul style="list-style-type: none"> • GSP divided into four sectors (Education (58.5%), health (24.5%), water (5.4%) and others (11.6%). • The powers of the departments were clarified. • 85% of percentage of water sector transferred to municipalities and 15% to departamentos.

Pension Reforms

Laws	Provisions
Law 100 of 1993	<ul style="list-style-type: none"> • Pension system divided into two schemes (private and public). • Wage contributions to social security increased from 8% to 13.5%.
Law 797 and 860 of 2003	<ul style="list-style-type: none"> • Pension contribution increase (1% on average). • Compulsory membership of dependent and independents employers established. • Maximum pension of 25 minimum wages established. • Gradual increase in pension contribution weeks. • Pension allowance calculated on the average wage of the last 15 years established.