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## **The Case of Colombia, 1986-2006**

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## Abstract<sup>1</sup>

This paper explores the characteristics of the political economy process that conditioned the scope and success of the combination of fiscal reforms before and after Colombia's 1991 constitutional reforms. Using formal analysis of reforms and interviews with actors, reforms in taxation, decentralization, the budgetary process and pensions are examined in times of political crisis, economic crisis, and economic boom. The results generally confirm the hypothesis that increased political fragmentation and limited unilateral executive power after the 1991 reforms restricted the extent of reforms, particularly in tax law. Nonetheless, the enactment of piecemeal reforms was encouraged by crisis conditions.

**JEL Classifications:** H20, H71, H77

**Keywords:** Policymaking process, Political economy, Structural reform, Colombia

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## 1. Introduction

During the last two decades, Colombian central government (henceforth CG) expenditures increased substantially. From an average of 9.8 percent of GDP between 1981 and 1991, CG expenditures increased to 21.5 percent in 2007, averaging 17.6 percent between 1992 and 2007. Such trends were the consequence of a general recognition, endorsed by consensus in the 1991 Constitutional Assembly, that Colombia's public sector was too weak and small 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 1990s (i.e., trade and capital account opening, privatizations) were not accompanied by the objective of reducing the role of the State; on the contrary, the aim was 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 devolving fiscal and political power to departments and municipalities,<sup>2</sup> increasing the reach of basic social services and strengthening the judiciary, among other reforms, resulting in a significant increase in public expenditures.<sup>3</sup> Politically, the 1991 reform resulted in renewed political participation from non-traditional sectors (Pizarro, 1995; García, 2001).

Although there was consensus on the need to strengthen the State, the strategy to finance such a rapid pace of expenditure increases to maintain fiscal discipline was uncertain. The CG's fiscal balance deteriorated. From being one of the exemplary cases of fiscal discipline in Latin America in the 1980s, the central government deficit increased from an average of 1.2 percent of GDP in the second half of the 1980s to 7.6 percent in 1999 and to an average of 5 percent for the period 2000-2007.

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<sup>2</sup> During the Conservative government of President Belisario Betancur (1982-1986), a constitutional reform enabled 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 was political representation limited, but local governments were dependent on the allocation of CG resources for most local public expenditures, which made it difficult for voters' needs to be met. The 1986 constitutional reform, which started the process of political decentralization, was reinforced by the decisions made by the 1991 Constitutional Assembly establishing administrative decentralization and expanding popularly elected offices for governors.

<sup>3</sup> 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 up to that point but lost the contributions of those who shifted to private pension funds.

Consequently, every administration 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 were mostly designed to increase revenues in the short run, with exceptional concerns for efficiency. Nonetheless, post-1991 tax reforms only partially achieved their objective of closing the fiscal gap. While expenditures increased 11 percent between 1990 and 2007, tax revenues increased only 7 percent, despite the fact that almost one tax reform per year (i.e., 14 tax reforms for the period 1990-2007) was enacted.

Reforms aimed at 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.<sup>4</sup> Other related reforms that limited subnational debt and expenditures drove regional governments' fiscal balance from an average deficit of 1 percent of GDP in the mid-1990s to a surplus of more than 1.5 percent 10 years later.

Few expenditure reforms were debated, perhaps because policymakers felt that they did not do enough to control expenditures in the short run and also because reform of the budget process could provide an opportunity for Congress to regain decision-making power over expenditures.<sup>5</sup> Thus, fiscal discipline is still an important issue on the agenda, as has again become evident during the present slowdown.<sup>6</sup>

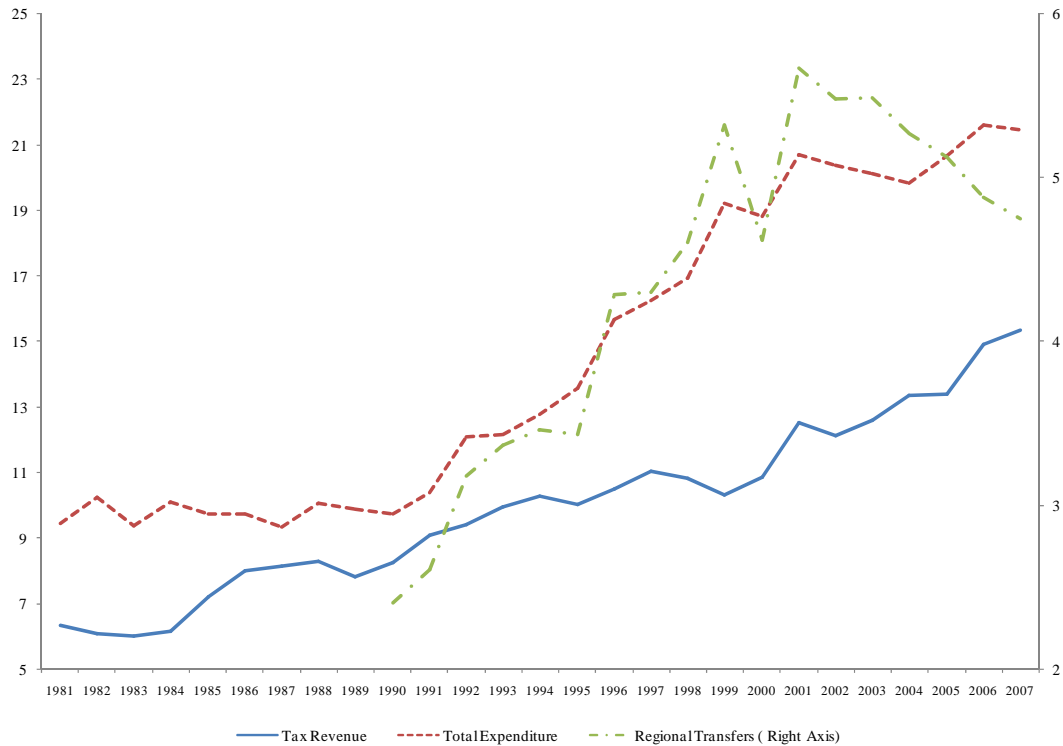
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<sup>4</sup> Actually, the decentralization reforms had some re-centralization objectives in addition to purely fiscal objectives; see Section 4. Furthermore, the fact that the fiscal objectives were partially achieved does not imply that the efficiency of the decentralization process improved.

<sup>5</sup> 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).

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

**Figure 1. Central Government Revenues, Expenditures and Subnational Transfers, 1981-2007 (percent of GDP)**



Source: Departamento Nacional de Planeación (DNP) database.

This paper explores the characteristics of the political economy process that 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 policymaking 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 adopted a series of complementary strategies. First, we studied the formal characteristics of the PMP for each type of reform (tax, decentralization, and expenditures). Second, to understand fully the actual PMP process, we conducted a number of semi-structured interviews with the principal actors in the reforms: finance ministers, National Planning Department directors, members of Congress, and business association directors.<sup>7</sup> Third, we compared our period of analysis with the reforms enacted before the 1991 constitutional

<sup>7</sup> See Annex 1 for the list of interviews.

reform and suggest that the different results observed are due to political fragmentation and limited unilateral executive power. The political fragmentation is explained by the explicit aim of the new Constitution to broaden political participation, which translated into very limited restrictions on forming a political party and holding office, changes in the size of the average district and the electoral formula, and considerable political decentralization. The limited unilateral power refers to the significant restrictions imposed by the 1991 Constitution to issue decrees or make unilateral changes in the status quo. Fourth, in order to illuminate the fiscal strategies employed, we analyzed in detail the bundle of reforms enacted by each president between 1991 and 2008 and some important cases of individual tax, decentralization, and expenditure reforms.

The paper is divided in five sections, including this introduction. The second section describes the most important players in the policymaking process, the formal PMP and the formal rules, and derives the hypotheses to be tested in the subsequent sections. The third section summarizes the different economic and political contexts under which the fiscal reforms were enacted between 1990 and 2007. Section 4 analyzes the hypotheses, using the information provided by the principal actors involved in each of the processes. Finally, the fifth section contains the conclusion.

## **2. Policymaking 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 to obtain enough revenue to execute policy. Thus, economic teams seemed to prioritize reforms that would rapidly produce revenues or limit certain expenditures (such as regional transfers) as opposed to more structural reforms with long-term consequences.<sup>8</sup>

What were the obstacles and constraints faced by presidents and finance ministers when choosing a strategy to tackle the fiscal deficit problem? To help answer this question, we first describe the main actors involved and their incentives, as well as the different agencies within the Executive and the interaction among branches. We then explain the formal rules, i.e., the legislative processes required to enact decentralization and tax reforms, as well as modifications

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<sup>8</sup> The primary objective of structural reform is to change the status quo to improve efficiency, rather than merely increasing revenues, limiting expenditures, redistributing income, or protecting vulnerable groups (Lora and Olivera, 2004).



to the budget process. Finally, we extract from the literature some of the hypotheses that the paper intends to examine.

## **2.1 Actors**

### *2.1.1 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 the right balance between executing his policy agenda and achieving adequate 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 who work in academia, think tanks, and the Central Bank.

While both share similar goals, the finance minister's mandate is to focus on fiscal discipline and macroeconomic stability, while the National Planning Department's mandate is to plan and execute long-term development policies, using as instruments the National Development Plan and the investment budget.<sup>9</sup> Both the finance minister and the director of the National Department of Planning are in charge of allocating public resources, and, with line 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 in turn depends on the contextual variables and the president's own knowledge of 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 macroeconomic situation. In times of surplus, the president might choose loyalty over expertise, and in times of crisis he might choose otherwise.<sup>10</sup>

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<sup>9</sup> 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 six months of its term. The constitutional reform aimed to strengthen the planning stage of public policies, converting each National Development Plan into law. This road map contains a multi-year investment plan that should be executed through the annual budget. The National Planning Department is in charge of both budgetary tools.

<sup>10</sup> We do not systematically examine the profiles of the ministers here, but we suggest that the "type" of cabinet can affect the policy and its content.

Other ministries are partially involved in the making of economic public policy, implementing policy toward specific sectors. Since their role as executors makes them budget maximizers, they may not always support the budgetary restrictions imposed by the finance minister and may instead press for additional expenditures for their sector.

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

In addition to having the right of exclusive introduction, since 1968 the president has had the power to issue legislative decrees on economic matters when a *state of economic and social emergency* is declared.<sup>11</sup> 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 a state of emergency has ended), it is still a powerful instrument to get things done whenever the president is confronted with a crisis situation.

### *2.1.2 Political Parties and Legislators in Congress*

After legislation has been debated within the Cabinet, bills are sent to Congress. Individual legislators and political parties alike play a key role in the drafting and approval of any reform. In Colombia, the two traditional political parties—the Liberal and the Conservative Party—managed to monopolize public office from the early years of the republic until the 1980s. It was not until the 1990s that the percentage of the vote garnered by these two parties fell, changing the factionalized, once dominant two-party system to a multiparty system with high levels of fragmentation.

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

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<sup>11</sup> Several analysts have shown that the use of the state of siege was also very common as a means to legislate via decree on economic matters prior to 1968.

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

It has also been suggested that the decentralization reform was a significant factor explaining fragmentation. Before 1991, the president had ample appointment power, which allowed him to control the career path of most of his co-partisans (Gutiérrez, 2000; Carroll and Pachón, 2007). After 1986, however, the president's appointment power was drastically reduced. Although the president could still appoint governors, those governors could no longer appoint mayors. Consequently, local politicians no longer depended on national politicians to further their career. After 1991, the president lost the power to appoint governors. Thus, regional politicians became even more independent from the central party network, and coordination collective action among co-partisans became very challenging.<sup>12</sup>

Thus, a system of factionalized parties with a relatively weak Congress prior to the 1991 constitutional reform shifted toward an institutionally stronger (i.e., more limited presidential power) but more fragmented Congress with a larger number of parties, and more individualized bargaining 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 during the administration of President Pastrana—the first minority party president after the 1991

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<sup>12</sup> 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 prior to 1991 (1970-1990), the number of lists went to six per seat in 2002 for the House, and three 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.

Constitution—and, although several electoral reforms were debated, none were enacted. Thus, Uribe’s campaign promises included electoral reform as a means to deal with the corruption scandals and the difficulty of enacting reforms.

Since the constitutional reform of 2003 approved during President Uribe’s first term, the incentives for fragmentation have decreased. Although there is still room for intra-party competition, the existence of a higher threshold in the Senate and the change to the d’Hondt formula ensure that “going solo” is no longer a better strategy compared to forming a pre-electoral coalition (Pachón and Shugart, mimeographed document).<sup>13</sup>

### 2.1.3 Constitutional Court

The role of constitutional review became more significant after the creation of the Constitutional Court in 1991, which is recognized as having one of the most powerful combinations of constitutional review mechanisms 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 to review all legislative 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 serves 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. The Court ruled on the constitutionality of 2,987 bills (until 2002), which account for 30 percent of all of its decisions. Of those, 33 percent (two out of six) of the constitutional amendments were declared unconstitutional, and 24 percent (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 have been systematically questioned, as the interpretation of the Constitution has become a limitation

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<sup>13</sup> However, it is not possible to evaluate the effect of this reform on the rules of the game, since the economic boom from 2003 to 2008 reduced the need for fiscal reforms. The only significant fiscal reform enacted in that period was the Constitutional reform on regional transfers in 2007, which was limited to extending 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 because it was not supported by the president it never went through the legislative process. See Sections 3 and 4.

on the capacity to enact structural reforms (Kalmanovitz, 2001) and reduce public expenditures.<sup>14</sup>

#### *2.1.4 Private Sector*

Business associations and economic conglomerates are an important link to understand congressional behavior and presidential preferences regarding 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 representatives of both political parties on their boards of directors. Additionally, presidents would turn to the private sector for support for economic policies stuck in Congress due to the requirement of a two-thirds majority for approval in Congress. Presidents tried to go “public” and use pressure from the private sector to further incentivize congressmen to support their congressional agenda, or alternatively to support their extraordinary measures (Hartlyn, 1993). The importance of coffee exports made the Colombian Coffee Federation a major actor, along with the Colombian Association of Agricultural Producers (SAC) and ANDI, the Colombian Association of Industrial Producers (Palacios, 1979).<sup>15</sup>

The changes in the 1980s and early 1990s, however, meant an important departure from this state of affairs.<sup>16</sup> The 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 reduced the role of the coffee and agricultural sectors. Thus, although consultation was still a common practice in drafting policy, the approval and support of business associations could not replace congressional consent. Thus, the end of 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

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<sup>14</sup> 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. It has ruled that public sector wages, or at least those close to the minimum wage, must be raised yearly at least by the amount of the increase in the inflation index.

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

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

with the president (the so-called “cacaos”), as their capacity and will to finance national political campaigns was uncontested (Rettberg, 2003).<sup>17</sup>

Consequently, large business associations saw a major decline in their influence on 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.<sup>18</sup> This was part of a broader trend: the focus of lobbying efforts shifted from the national Executive (on which large business associations had a major influence) towards Congress and subnational governments, thanks to the 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 new constitutional prohibition against using Central Bank credit lines for anything besides providing liquidity to banks). Moreover, many public services were decentralized and privatized.

Because of these various political and economic changes, members of the private sector—who previously lobbied through business associations—decided to diversify their strategy to influence members of Congress. Although pressure groups continued collectively to pressure governments at different phases of the 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 on matters such as exemptions or other policies favorable to their interests. For individual legislators, these relationships with individual businesses represented a good bargain. Since their campaign funding would be primarily a function of their own individual effort, the private sector became an important funding source. Consequently, the fragmentation of political competition induced members of Congress to lobby the private sector.

## ***2.2 Rules: Legislative Process***

To become law, a bill must usually be debated twice per house of Congress: once in the permanent committee, and then on the floor (see Table 1). The open amendment rule applies during the committee and floor debates, which means that legislators can include amendments to

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<sup>17</sup> “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 por ciento, respectivamente.” Rettberg (2003).

<sup>18</sup> As corroborated in a meeting with current and previous business association heads.

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, the Executive is authorized to withdraw the bill if he/she considers that the bill's original purpose has been modified so much that it no longer reflects its original intent. A bill authored by a legislator can only be withdrawn if the legislative process to pass it has not yet begun.

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, after which the bill is returned for a final vote in each house.<sup>19</sup> 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 percent+ 1 of decisory quorum |                  | 50 percent+ 1 of members |                  | 50 percent + 1 of decisory quorum (First 4 debates), 50 percent +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

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<sup>19</sup> 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.

calendar days, and can insist on the emergency, making the bill the priority of the legislative agenda.

Organic laws, which follow constitutional amendments in rank and procedural difficulty (such as the Organic Budgetary Law), require only four debates. The only significant difference from the regular procedure is that they need to be voted on by an absolute majority of committee members 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.

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 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 on by a simple majority in the first round—just like 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 committee.<sup>20</sup> Finally, the Constitutional Court must review both the content and the procedure of any constitutional amendment.<sup>21</sup> The Court makes the final determination about whether the content of the amendment fulfills the requirements established in the Constitution and the law.

Thus, for the different reforms under scrutiny, different procedures must be followed, which creates the opportunity for interested parties to intervene, lobby, and defend the type of policy they are most interested in seeing enacted.

### ***2.3 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 1990s. In this section, we outline different hypotheses tested in the literature which we consider to be relevant for fiscal reforms in the

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<sup>20</sup> 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.

<sup>21</sup> The jurisprudence of the Constitutional Court has evolved to include the revision of content of the Constitutional amendments.



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 (e.g., the 1999 economic crisis, characterized by negative real GDP growth of 5 percent) from political crisis (e.g., the impeachment of President Samper (1994-1998)).

### *2.3.1 Congressional Fragmentation*

The heterogeneity of Congress is considered a significant factor explaining high political transaction costs in the drafting of policy (Mainwaring, 1993; Tsebelis, 1999). In addition to the number of parties, other research has suggested that the 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 incentives exist for cultivating personal votes 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 the passage of legislation on the representation of very diverse particularistic interests.

A related hypothesis has to do with the effect of the distribution of political costs across the political system. We suggest that when reforms imply direct costs for congressional constituencies, the probability of their 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 enact (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 members of Congress were not accountable to governors or mayors and had a *loose* political relationship 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 reform that brought about popular election of governors and mayors was enacted: appointments were the currency to build political support in Congress, and regional authorities were closely tied with legislators. Thus, members of Congress participated in appointing governors, and governors appointed mayors. Thus, increasing automatic and unconditioned transfers was a privileged way to get money and show palpable results to their regionally based electorate.<sup>22</sup>

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 government in exchange for a fixed percentage of “pork” over which members of Congress had full control (the so-called *auxilios parlamentarios*).<sup>23</sup> In addition, appointments of governors (until 1991) and mayors (until 1986) were used to cement coalitions of support for government initiatives. After 1991, the elimination of *auxilios* and the popular election of governors and mayors, in addition to the increased political fragmentation and weakening of party discipline already mentioned, changed the way political equilibriums were achieved in Congress. Forming coalitions to pass legislation frequently required ample distribution of exemptions, protection of particular interests, and direct central government expenditures in the regions that had to be negotiated with members of Congress, 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 members of Congress became more accountable to narrow sector interests after the constitutional reform than to the party network. This process had been already underway since the 1980s, with the progressive weakening of party structures, making the

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<sup>22</sup> These changes in the political incentives of members of Congress 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 subnational 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—a development that could not have been foreseen at the time of the 1991 Constitutional Reform—added to frequent cases of common fraud and corruption.

<sup>23</sup> *Auxilios 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, initially through the *Fondos de Cofinanciación*, then through the *Fondo de Regalías*, and finally through large portions of the investment budget. Although there is no reliable data on the amount of pork, Cárdenas, Mejía and Olivera (2007) suggest that it did not surpass 2 percent of the total budget per year initially after the 1991 reform.

approval of structural reforms more difficult. We also suggests that the increase in political arenas through the election of governors and mayors 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.

### *2.3.2 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 ourselves from the perspective in which the Executive branch is considered to have homogeneous preferences, to illustrate divergent interests that cannot be easily observed when looking at aggregate data. In an interview undertaken for this study, President César Gaviria made a simple but powerful observation: it was one thing to be the minister of finance, and another to be the president.<sup>24</sup> While as minister he was interested in both 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 obtaining more resources to implement policy, and it was up to the minister to design the instruments to get there.

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 longer-term issues than when the president holds a tight leash on the finance minister. In this case, the president avoids paying a political cost, and consequently tries to avoid it by creating exceptions to the rule, not fully supporting the bill, or blaming Congress or other actors involved.

### *2.3.3 Crisis and the Feasibility of Reform*

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 need for

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<sup>24</sup>“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.

a change.<sup>25</sup> This hypothesis has been empirically validated by several authors. Weyland (2002) studied the circumstances under which the Washington Consensus reforms in the 1990s were implemented in Peru, Brazil, Argentina, and Venezuela, confirming the hypothesis put forth earlier by Kahneman 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.<sup>26</sup> The need to reduce fiscal imbalances is more pressing when a fiscal crisis episode has occurred or is about to occur. An increasing deficit that generates an unsustainable level of indebtedness would need at some point a tax reform to increase fiscal revenues, close the fiscal gap, and reduce debt. If reforms are not implemented, the economy will default on its debt and capital markets would be closed for some time. However, various questions remain unanswered. Who is more likely to bear the burden of reform? Which types of tax rates will be increased? The study of the political economy of reform would answer those questions.

However, we argue that economic crises 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 piecemeal tax changes that attempted to increase revenues mostly by increasing tax rates or introducing new distortionary taxes (such as the financial transaction or the net wealth tax).

### **3. Evolution of Fiscal Reforms in Different Economic and Political Contexts**

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

Table 2 shows the frequency of reforms, divided by their type and procedure. Between 1974 and 2008, tax reforms were the most frequent, with seven laws and six decrees between 1974 and 1990, and three 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

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

<sup>26</sup> In fact, Alesina and Drazen’s (1991) model is based on fiscal reforms.

decentralization regime reached 13 between 1974 and 2008, and nine since 1991. In the later period, a portion of these reforms were constitutional amendments, followed by a law to regulate the constitutional change. Finally, there were only seven reforms to the budget process, i.e., to expenditures, for the period 1974-2008, six of which were introduced between 1991 and 2008. Nonetheless, only two of them introduced significant changes. (i.e., the 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               |
| <b>1991-2008</b>       |             |                     |                          |                 |
|                        | 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 during five presidential terms: Gaviria (1990-1994), Samper (1994-1998), Pastrana (1998-2002), and two terms of Uribe (2002-2006 and 2006 to the present). It highlights the economic and political context in which every president had to maneuver to get things done and discusses the general trends that can be traced since the enactment of the 1991 Constitution.

Each presidential period had different economic and political characteristics. The Gaviria administration can be considered 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 percent of GDP in 1991 to 12.8 percent in 1994, due principally to the 1991 constitutional reform, and existing revenues decreased, due principally to the reduction of trade tariffs to open the economy. During this administration, the 1991 constitutional reform was enacted. The government had a majority coalition in Congress, and the opposition was “distracted” by the process of constitutional reform, thus facilitating the

enactment of difficult economic structural reforms.<sup>27</sup> In addition to the Washington Consensus-type reforms (i.e. trade openness, privatization, labor market reform, capital account opening, etc.), Gaviria's government enacted four tax reforms that, among other things, temporarily increased VAT and income tax rates to finance the increase in expenditures (See Table 3).

The Samper administration, which also began with a majority coalition, suffered a deep political crisis following allegations of campaign contributions from drug traffickers in January 1996, and the beginning of the increase in the central government deficit, as well as the first signs of deterioration in fiscal decentralization (i.e., an increase in subnational indebtedness and debt crises in some subnational governments). This administration had intended to enact a structural tax reform in 1995, designed to eliminate VAT and income tax exemptions and strengthen tax assessment and collection powers, but it 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 subnational indebtedness (Table 3).

The Pastrana administration was the first without a congressional majority after the 1991 constitutional reform. The deepest 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). Toward the end of his term, it passed a constitutional reform which temporarily reduced the pace of growth of regional transfers.

The first Uribe administration began in a recessionary period and then experienced a strong economic recovery, accompanied by a rise in presidential popularity after the failure of the peace process with the guerrillas during the Pastrana administration. During the first few years of the administration, three tax reforms were enacted which sought to increase revenues and to finance the security strategy, the so-called *seguridad democrática*. Once the economic boom took hold, 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 second Uribe 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.

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<sup>27</sup> Interview with former 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**

|                       | <b>Tax</b>             | <b>Decentralization</b>  | <b>Expenditures</b>   |   |
|-----------------------|------------------------|--|---|---|
| <b>Gaviria</b>        | VAT                    | from 10 to 14%   |   |   |
|                       | Income Tax             | From 30 to 37.5%   |   |   |
|                       | Other relevant reforms | Privatizations<br>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  |   |   |
| <b>Samper</b>         | VAT                    | from 14 to 16%   |   |   |
|                       | Income Tax             | fixed at 35%   |   |   |
|                       | Other relevant reforms | Privatizations<br>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  |   |   |
| <b>Pastrana</b>       | 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<br>Bonos de paz   | Laws 549 and 550 of 1999  |   |
| <b>Uribe I and II</b> | VAT                    | Failed structural reform   |   |   |
|                       | Income Tax             | Failed structural reform.<br>Initially increased and then decreased to 33% during the boom.  |   | (Failed) reform to the Organic Budget Law |
|                       | Other relevant reforms | Net wealth tax<br>Financial transaction tax from 2 to 3 and then to 4 per thousand<br>Pension reform to reduce the increasing the increasing cash pension deficit, annulled by the Constitutional Court<br>Tax incentives and reform to the free trade zone regime | Constitutional reform 04 of 2007 to control regional transfer increases | Fiscal Responsibility Law                 |

## 4. Characteristics of Fiscal Reforms and the Political Economy Process

### 4.1 Tax Reforms

#### 4.1.1 Structural (Efficiency-oriented) vs. Piecemeal (Revenue-oriented) Reforms

All tax reforms after 1991 were “piecemeal” or “quick-fix” reforms that either established temporary surtaxes or increased the rate of existing major taxes (VAT, income tax), 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 piecemeal is that as revenue goals were so pressing, given the fast pace of increase of expenditures, governments gave

preference to revenue-producing quick fixes over complex tax reforms in which efficiency or equity objectives predominated.<sup>28</sup> The latter are technically and politically more complex, usually take more time to be enacted, and have a lower ratio of “revenue to effort.”<sup>29</sup> 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 piecemeal reforms, in sharp contrast with what happened before 1991 (e.g., in 1974 and 1986).

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

#### *4.1.2 Party Fragmentation and Congressional Support*

Former ministers and congressmen interviewed largely supported the view that structural reforms, particularly the elimination of specific exemptions, became more difficult after 1991, mostly as a consequence of a weakening of party discipline. While most members of Congress 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 1980s, most were elected through single-candidate lists after 1991. Consequently, they were not responsive to party directives. Further, such candidate-based movements obtained a large part of their campaign financing from individual groups and firms and hence would ardently support their narrow tax interests (keeping or obtaining new specific exemptions).<sup>30</sup> Actors interviewed concurred that the discussion of tax reforms when party discipline used to be stronger dealt more with ideological orientation (e.g., the liberal party favored higher direct taxes, presumed to be more

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<sup>28</sup> Interviews with former Minister Juan Camilo Restrepo and former President César Gaviria.

<sup>29</sup> Former 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 only 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 rather “financing laws” with a more modest scope.

<sup>30</sup> This was partly a consequence of the strengthening of independent movements and the national circumscription for senators in the 1991 Constitutional reform.



progressive, than VAT increases, assumed to be regressive) than with specific articles affecting narrow private interests.

Before 1991, disciplined party votes were 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 that supported the López Michelsen Government (the Liberal Party Director, future President Turbay Ayala, and Alvaro Gómez, head of the fraction of the Conservative party that was a member of the governing coalition).<sup>31</sup> 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.<sup>32</sup>

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 in which 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 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 increase in CG expenditures.

The initial economic reforms, including the increase in VAT from 10 percent to 12 percent, passed easily through Congress with the disciplined vote of the Liberal Party majority.<sup>33</sup> 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).<sup>34</sup> The government also accepted that the income tax rate and part of the VAT tax increase were temporary, until

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<sup>31</sup> Interview with former Minister G. Perry, who was the main author of the 1974 tax reform while chairing the National Tax Office.

<sup>32</sup> Interview with former Minister Junguito.

<sup>33</sup> 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.

<sup>34</sup> Interview with former Minister Hommes.

1995, thus forcing the next government to return to Congress in order to maintain the level of revenues.

The Samper administration was liberal-leaning, though the Cabinet included some conservative party figures. Following practices common before 1991, the government sought 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 revenues:<sup>35</sup> it did not call for rate increases but envisaged significantly increasing revenues through a combination of a drastic cut in exemptions, a broadening of the tax base, strengthening of the minimum presumptive income regime, and increased effectiveness in tax collections (through, for example, introducing VAT withholding by major taxpayers).

While the Conservative Party directorate largely supported the draft law, the Liberal Party directorate frankly acknowledged that it could not guarantee that its Congress members would vote for the elimination of specific exemptions. Thus, it suggested increasing statutory rates in both the VAT and the income tax, despite 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 members of Congress for the rate increases and to consolidate the support of the majority of the Liberal Party.<sup>36</sup> 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.

#### *4.1.3 Cabinet Delegation*

The draft tax law of 2007, during the Uribe administration, proposing a structural change in 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.

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

<sup>36</sup> Interview with former Minister G. Perry.

Indeed, the reform was presented as revenue neutral by Minister Carrasquilla,<sup>37</sup> while all other reforms since 1990 had attempted explicitly to increase revenues. This was permitted by the fact that tax revenues were booming thanks to high commodity prices,<sup>38</sup> accelerated growth,<sup>39</sup> and administrative improvements.<sup>40</sup> Thus, fiscal deficits and debt ratios were diminishing in spite of continually increasing expenditures. The failure of the 2006 draft law seems to be due to a significant extent to the lack of commitment and support by the president. Former 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 certainly been 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) to maintain several key tax exemptions and introduce new ones that would significantly alter Carrasquilla’s proposed reform. Later on, President Uribe vehemently defended his conviction that tax incentives for specific sectors were good as well as 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 exemptions.<sup>41</sup>

Although the lack of presidential support was probably reason enough for failure, neither Congress nor the private sector was enthusiastic about the proposed reform.<sup>42</sup> 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.

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<sup>37</sup> He nonetheless thought that it would increase revenues (interview).

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

<sup>39</sup> Tax revenues normally have an income elasticity greater than one, and Colombia is no exception.

<sup>40</sup> The so called “Plan Muisca.”

<sup>41</sup> Interview with former Minister Junguito.

<sup>42</sup> 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.

#### 4.1.4 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 Asian and Russian crises. Colombia lost its investment grade rating, and access to international financial markets was suspended.<sup>43</sup> 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.<sup>44</sup>

Politically, Pastrana was the first minority president in the 1990s, supported by a multi-party coalition made up of heterogeneous political groups. The magnitude of the crisis, however, helped in many ways to bring about several fiscal reforms.

First, a temporary financial transactions tax was created in 1998, at a rate of 2 per thousand, *through emergency powers* to finance the financial sector rescue operations. In addition, the government enacted a tax reform in 1998 (Law 488) which envisaged a VAT tax-base increase, elimination of some exemptions, and a mandatory subscription of public bonds (*bonos de paz*) in proportion to net wealth (0.6 percent). A second tax reform was enacted in 2000 (Law 633) which made permanent the transactions tax and increased some VAT bases. In spite of these tax reforms and some harsh reductions in discretionary expenditures growth,<sup>45</sup> the CG deficit and public debt ballooned: the deficit increased from 4.7 percent of GDP in 1998 to 7.6 percent in 1999 and the public debt from 22 percent of GDP in 1998 to 52 percent of GDP in 2002. Former 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 faced a severe fiscal crisis and an impending currency crisis.<sup>46</sup>

President Uribe won 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 began in the midst of a recessionary period as well as a fiscal crisis, and without access to international financial

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<sup>43</sup> Investment grade had been achieved during the Gaviria (from most rating agencies) and Samper administrations (Moody's).

<sup>44</sup> 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 was made available, as President Betancur did not wish to incur the political costs of signing an IMF agreement.

<sup>45</sup> Most expenditures cannot be reduced, as they are either mandatory transfers, financed through earmarked taxes, or used to pay the salaries of public officials, judges, the military and the police, as well as to service the debt.

<sup>46</sup> Interview with former Minister Junguito, by then Minister of Finance.

markets. The fiscal and security crises that ensued following Pastrana's failure in his "peace process" with the guerrilla movements enabled the new government to obtain legislative support for fiscal reforms, despite the fact that it did not initially enjoy a congressional majority,<sup>47</sup> as well as the use of exceptional powers.

The government's security strategy required a major increase in defense 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 temporary reintroduction of the net wealth tax (which 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 were 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 this provision. At the same time, some new income tax incentives were created. Former Minister Junguito emphasized the role of negotiations with the IMF during crisis periods (1983 and 1999-2002) in facilitating support within the cabinet and in Congress.

Despite some setbacks in attempting to reform pensions and limit expenditures, the surviving Uribe reforms, the resumption of economic growth (as a consequence of both an improved external environment, perceived significant changes in security, and initial prudent macroeconomic management), the increase in commodity prices and the consequences of the constitutional reform of 2001 on regional transfers, enabled Colombia to regain access to international financial markets and to reduce central government fiscal deficits and public debt-to-GDP ratios in subsequent years. Moreover, the improved fiscal situation of subnational governments (due to the decentralization reforms and the resumption of economic growth) and public enterprises led to a sharp reduction in the consolidated public sector deficit.

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<sup>47</sup> President Pastrana did not enjoy a congressional majority, despite winning by a wide margin, as his was essentially a "go-it-alone" campaign.

#### *4.1.5 The Political Economy of New Distortionary Taxes*

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

First, the 1991 Constitution determined that subnational 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 proceeds went to subnational 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 both a fiscal and an economic crisis. 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 (already in use in Argentina and Brazil) provided an expedient recourse to obtain rapidly the considerable funds required to these ends and to avoid sharing its proceeds with subnational governments. Further, as these expenditures were not recurrent, the tax was to have a finite duration. Congress and public opinion would object less to financing such support with funds raised temporarily from the financial sector itself than from general taxpayers' money. Bankers' objections to such a distortionary tax were limited because of the need to avoid a systemic crisis and the allegedly temporary nature of the tax. All of these considerations were behind the selection of this instrument and its defense vis-à-vis Congress (though the tax was enacted through emergency powers), public opinion, and the IMF, which opposed such a tax, when the government later on had to ask for Fund resources.<sup>48</sup>

Later 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 to increasing the VAT tax base or rates in Congress

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<sup>48</sup> Interview with former Minister Restrepo.

and the income tax base or rates within the government.<sup>49</sup> 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 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 significant resources, avoid sharing them with subnational governments, and provide a conceptual link with beneficiaries, since security is more important for those that have higher wealth. Such arguments were indeed used with the private sector (which had enthusiastically supported Uribe’s campaign focus on the need to improve security), Congress, and domestic and international public opinion, particularly the U.S. Congress. Indeed, there was significant opposition to permitting the use of Plan Colombia resources (and even maintaining them) for security purposes (they had initially been approved exclusively for use against drug trafficking), as the government wanted, on the grounds that “wealthy 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 opposition.<sup>50</sup> 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 groups.<sup>51</sup>

Again, as with the financial transactions tax, the duration of this “temporary” tax was later on prolonged, as security needs did not abate, and will probably become a permanent feature of the Colombian tax landscape, as was being proposed by the government at the time of writing (July 2009).

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<sup>49</sup> Interview with ex Minister Roberto Junguito.

<sup>50</sup> Interview with ex Minister Junguito

<sup>51</sup> It was then exclusively a “personal” net wealth tax, while the new one applies to both individuals and firms with net wealth over a significantly higher minimum.

## ***4.2 Decentralization Reforms***

### *4.2.1 Structural vs. Piecemeal 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 governments (i.e., *situado fiscal* to departments and *participación municipal* to municipalities), 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 subnational governments, while the other two that required constitutional reform, implemented in 2001 and 2007, aimed to control increases in regional transfers. Among them, only the 2001 constitutional amendment introduced allocative efficiency criteria, through capitation, and can thus be classified as a “structural” reform.

Since 1993 the increase in transfers generated a significant rise in subnational revenues, and regions used these new revenues to leverage debt. In fact, between 1993 and 1994, municipal debt increased 95 percent nominally, and departmental debt 114 percent (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 1997<sup>52</sup>) in order to regulate regional indebtedness. This reform introduced limits through solvency (i.e., debt service not greater than 40 percent of savings) and sustainability (i.e., debt stock not greater than 80 percent 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 incur more debt, require special permission from upper levels of government or could not issue new debt until they undertake a fiscal adjustment program.

Three years later, in 2000, under the 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. In 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.

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<sup>52</sup> Popularly known as the *Ley de Semáforos* (traffic light law).



In sum, these three reforms aimed to guarantee fiscal sustainability in subnational governments, one through limits to debt and two through limits to expenditures.<sup>53</sup> However, other persistent problems in the decentralization process were identified. Transfers dependent on central government current revenues that were 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 CG's increased deficits and debt. Finally, this increase in transfers did not fully translate into improved outcomes. For example, while transfers for education expenditures increased 30 percent between 1995 and 2000, enrollment rates increased only 18 percent (see Fedesarrollo, 2006).

Two constitutional amendments attempted to deal with these problems. 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 child to be enrolled in education, or per occupied bed in the health sector). The constitutional amendment was regulated by Law 715 of 2001. This reform was implemented at the end of the Pastrana Administration. However, this change in the formula was temporary, until 2008. It generated the need 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 subnational governments, with additional increases for education and infancy. It also earmarked part of the transfers for water and sanitation expenditures. This reform was implemented under the second term of President Uribe. According to government calculations, if the amendment had not been enacted, transfers would have increased in 2009 ten percentage points of revenue 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 percent) after 2016.

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<sup>53</sup> 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).

#### *4.2.2 Fragmentation and Congressional Support*

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

The first hypothesis to explain these facts is related to the distribution of political costs across the political system. Decentralization made mayors and governors independent from members of Congress. Popular election made them politically independent compared to the previous period, before 1984, when they were appointed 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 members of Congress to accept Executive-driven decentralization reforms that would control transfers, indebtedness or expenditures to mayors and governors who are, in the best case, not completely aligned with them (and in the worst, their political opponents), vis-à-vis supporting structural tax reforms that would negatively affect 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. In sum, the hypothesis affirms that the decentralization process, which multiplied political arenas and made mayors 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 implement than structural tax or expenditure reforms, even though the policymaking process makes the latter easier in terms of the political process. These stylized facts contrast with what happened before the election of governors and mayors. Their nomination was used by the CG 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.

Former ministers and congressmen interviewed largely supported this hypothesis comparing (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, specifically mayoral and gubernatorial elections, deteriorated party discipline, and the multiplication of political arenas generated the support of members of Congress 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 Juan Carlos Echeverry, director of the National Planning Department in the Pastrana Administration, opposition to these reforms came mostly from public sector unions, even more than from mayors and governors, and less so from congressmen. The strongest opposition to the 2001 constitutional amendment came from FECODE, the teachers' union and ANTHOC, the hospital workers' unions, against efficiency indicators (the capitation criteria), more than to the reform of the transfers formula and its subsequent deceleration. For the 2007 reform, when efficiency criteria were not reformed, the strongest opposition came from the municipal federation representing mayors.

#### *4.2.3 Crisis and the Feasibility of Reform*

The crisis hypothesis was also largely supported by the interviewees, especially by members of Congress.<sup>54</sup> They argued that government and Congress became increasingly aware that the pace of resource transfers mandated by the constitutional reform of 1991 was indeed a major factor behind the CG's growing fiscal distress and eventual crises in 1999. Additionally, there were significant excesses, waste, and capture in subnational expenditures (many mayors and some governors had been prosecuted for fraud and in many cases diverted resources to paramilitary and guerrilla forces). Thus, these reforms were also aided by the overall context of growing fiscal distress, crises and disruptions of the public order.

For Juan Camilo Restrepo, finance minister in the Pastrana Administration, who implemented Law 617 of 2000, this legislation was easier to pass through the Congress because of the economic crisis of 1999 and the resulting fiscal crises of many subnational entities. Santos, a subsequent finance minister in the same administration, took further advantage of the fiscal crises of subnational governments to obtain support for the 2001 constitutional reform. Finally,

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<sup>54</sup> For example, Senators Valdivieso and Lopez supported this view.

for Alberto Carrasquilla, finance minister in the Uribe Administration, the constitutional amendment was enacted during an economic boom, but with a high risk of returning to the level of regional transfers prior to the 2001 constitutional amendment. This carried the risk of renewed fiscal crises of the central government.

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

#### *4.2.4 Political Economy of the 2001 Constitutional Amendment*

The political economy of implementing 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 director of the National Planning Department had to convince several actors. Within the Executive branch, several line-item ministers, including the minister of health, opposed the reform, while Congress, governors, and mayors supported it. In fact, this reform was implemented by a politically influential finance minister from the Liberal Party selected by Pastrana to form 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 unseat the other. In view of the growing magnitude of the fiscal problem and the increasing likelihood of a fiscal crisis, the finance minister and the director of the National Planning Department convinced the head of the Liberal Party, Horacio Serpa, who was most likely going to be the next president, that it was in his interest to convince liberal congressmen—who were the majority—to implement this reform. If not, the likelihood that the next administration would be beset by a fiscal crisis was high. Serpa agreed, though later on, as opposition by prominent governors and mayors grew in intensity, he asked the finance minister to urge mayors and governors to support the reform. Of course, the Liberal candidate did not want to squander his political capital to implement the reform, even though he was convinced that if the reform was not enacted his administration would face a fiscal crisis.

Santos explained that he was able to obtain the support of key governors and mayors because in that year many subnational governments were facing a fiscal crisis. For the first time

since 1991, the effect of the deep economic crisis on CG current revenues reduced the level of transfers to less than the amounts budgeted—against which regional authorities had made expenditure commitments.<sup>55</sup> Thus, the volatility risk 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 mayors and governors to support a reform that would avoid a crisis by guaranteeing a minimum real growth in transfers. The reform proposed a fixed real increase in transfers of 1.5 percent over the inflation rate.

To obtain their full endorsement, Santos further offered to support the restructuring of bank debts that had become binding. A large group of subnational governments was encouraged to file for bankruptcy under the recently approved Law 550. The government supported their claims against creditors by offering the banks central government debt guarantees if they would accept the proposed restructuring. This process took over a year. Thus, a tripartite win-win negotiation was achieved: banks agreed to reduce debt, as restructured debt was to be guaranteed by the government, thus limiting their potential losses; mayors and governors recovered the possibility to spend in the short run, thanks to both 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 acknowledged that the magnitude of the gains actually obtained by the central government was not anticipated by anyone, as it was highly improbable at the time that the economy would recover so fast and experience a major boom after 2003.

Teachers and hospital workers unions were opposed to the capitation criteria. While transfers for education previously depended on the number of teachers, the reform made them dependent on the number of students, requiring relocation of teachers, which was strongly opposed by the union. The reform was enacted with just one vote in favor, with liberal use of “pork barrel” distributions.<sup>56</sup>

In sum, the hypothesis that decentralization reforms have a more difficult policymaking process but are easier to enact because of the new incentives embedded in the political economy process after 1991 was supported by the information gathered in the interviews of key actors. In

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

<sup>56</sup> Interviews with former Minister Santos and former Planning Director Echeverry.

addition, the crisis hypotheses were also supported, under different definitions of crisis: regional or national fiscal crisis and public order issues.

The distribution of political power among central and subnational governments, or more specifically between the Executive, members of Congress, and mayors and governors has been one of the reform drivers. Some Congressmen and former ministers suggested that although these reforms were mostly motivated by the fiscal problem, another objective of the central government (and Congress) was to regain some of the political power devolved to the empowered and autonomous governors and mayors.

### ***4.3 Expenditure Reforms***

#### *4.3.1 Structural and Piecemeal Reforms*

In the last two decades, three substantial expenditures reforms have been enacted.<sup>57</sup> This is a small number compared to the number of tax or decentralization reforms enacted. The first, a reform of the Organic Budget Law, was enacted in 1989. The second, the Fiscal Responsibility Law, was enacted in 2003. Finally, in 2005 the Ministry of Finance issued Decree 4730, which introduced a set of reforms into the budget process. Of 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, expenditure efficiency, and allocation based on policy priorities—although with a different focus. The 1989 reform was implemented under an annual budget framework, while the Fiscal Responsibility Law and Decree 4730 of 2005 introduced multi-annual budget tools into the budget process (e.g., the Medium-Term Fiscal and Expenditure Frameworks).

The reform of the 1989 Organic Budget Law aimed to coordinate the role of the government in controlling the expenditure of public resources, with its role in the planning, programming, and implementation of public programs and policies with development objectives. This objective aimed to balance fiscal discipline with efficiency in the execution and implementation of public policies.<sup>58</sup>

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<sup>57</sup> In the reform 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.

<sup>58</sup> 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.

This reform had important effects on budgetary institutions. Allowing line-item agencies to plan their budget on an annual basis 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 budget and subsequently registered them in BPIN, taking advantage of a loophole: the 1989 Budget Code required registration prior to execution, not to inclusion in the budget.

At the same time, decentralization was a work in progress. In the 1980s, the need to decentralize public responsibilities, especially those related to public services, was pressing. One of the objectives of the 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 jointly 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 policy.<sup>59</sup>

The new Organic Budget Law was enacted with an emergency message from the president. The changes to the original bill proposed by the president and the finance minister were not important for the spirit of the law<sup>60</sup> (see the rationale for the project bill, and the addresses made by the sponsors during 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 Standby Arrangement signed in 1999. The project was presented to the Congress during the second half of 2002, the last year of the Pastrana Administration,<sup>61</sup> and the debates continued during Uribe Administration. The reform was enacted in 2003. Its main objective was to guarantee fiscal discipline and sustainability in the medium term. This objective would be achieved by making fiscal discipline more predictable by

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<sup>59</sup> 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.

<sup>60</sup> 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.

<sup>61</sup> Bill 230 of 2002 of the Lower House and 159 of 2002 for the Upper House.

means of a medium-term (i.e., 10-year) framework with primary balance goals (i.e., numerical rules) for the non-financial public sector. In this way, the reform would avoid problems of temporary inconsistency and reduce discretionality in fiscal policy. In addition, by making the information available, the Fiscal Responsibility Law would make fiscal policy more transparent. The original bill also included also a set of procedural rules to limit subnational indebtedness, using the “traffic light” reform enacted in 1997.<sup>62</sup> 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 budget formulation is an annual process, and the figure to introduce multi-annual programs is the approval of *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 attempted in 2005, along the lines of the Fiscal Responsibility Law, with medium-term frameworks. This bill had three main objectives. The first was to introduce the Organic Budget Law and strengthen the articles of the Fiscal Responsibility Law in order to consolidate the fiscal rules of the game in a single law. The second was to balance fiscal discipline and efficiency in the use of public resources (see Fedesarrollo, 2004). For example, the bill sought to set boundaries around the definition of social expenditures and to strengthen the budget constraint. For 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 expenditure caps by sector for the next four years, to allow the line-item agencies to program and prioritize their expenditures in a multi-annual framework, and to increase efficiency in the use of public resources. The third objective was to simplify budget procedures.

#### 4.3.2 Constitutional Review

In order to control expenditure growth, the Uribe administration attempted to reduce the growing 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 Constitution, increasing the number of weeks required to save in order to obtain a pension, and raising the retirement age. The Constitutional Court

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<sup>62</sup> 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.



declared these articles unconstitutional due to vested rights. This sentence implied a cost of 16 percent of GDP in pension liabilities.

Another effort during the Uribe Administration was a major expenditure reform (reducing pension payments and freezing public sector wages for two years) through a constitutional reform referendum in 2003. In 2000, the Executive branch attempted to institute increases in public sector wages below the inflation rate due to fiscal problems derived from the 1999 economic crisis. However, Constitutional Court rulings declared these attempts unconstitutional and required a Constitutional reform for these purposes. Despite a significant positive vote, which was related to the president's popularity, the Referendum did not achieve the constitutionally required minimum number of votes.

#### *4.3.3 Congressional Support*

Among the two reforms to the budget process enacted after 1991, the 2003 Fiscal Responsibility Law was subjected to the requisite four debates in the lower and upper house without any substantial modifications.<sup>63</sup> According to Senator Juan Carlos Restrepo, one of the sponsors of the law, this reform was one of the easier to pass (compared to, for example, Laws 617 of 2000 or 715 of 2001) for various reasons. On the one hand, the law was more technical than the other laws. On the other, although it affected regional public finances (and some governors and mayors opposed the reform), this item was discussed only at the end of the discussion with 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 effect on the budget process has been negligible. Indeed, as was noted 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 the authorities liable for unjustified deviations from medium-term approved plans) or quantitative targets (like FRL in Argentina and Peru, that were effective for a time but had to be abandoned in times of recession because, for lack of cyclical adjustments, they became excessively pro-cyclical).<sup>64</sup>

The 2005 reform to the budget process opened the possibility for the Congress to discuss the “fiscal dictatorship” under which, if the Congress does not approve the proposed budget bill,

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<sup>63</sup> 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.

<sup>64</sup> See Perry (2007).

the budget will be proposed by the Executive. The discussions of the bill with the Budget Commission in Congress opened this risk, and the project was removed from Congress. In addition, the project was presented when the constitutional reform on re-election was being discussed, a high priority of the president, and the Congress responded. In the end, the Ministry of Finance issued Decree 4730 with those points included in this reform project that did not need legal sanction.

#### *4.3.4 Crisis and the Feasibility of Reform*

While the 1989 Organic Budget Law reform was passing through Congress to be enacted, Decree 4730 was a result of a failed attempt to reform the Organic Budget Law in 2005. Both reforms were designed to be discussed in good economic times. In 1989, Colombia and Latin America were in a reform mood following the crisis of the 1980s. In turn, the 2005 (failed) reform was presented to Congress when the economy was growing at 4 percent, and under the administration of one of the most popular presidents in recent history. This suggests that after 1991, reforms became more difficult to implement during economic booms. Out of the two reforms to the budget process enacted after 1991, only the Fiscal Responsibility Law was enacted amid a crisis. In 2003, Colombia was suffering the last vestiges of the 1999 financial (and fiscal) crisis, which had been the most devastating crisis in the last 60 years, although President Uribe was already in power (since 2002). This reform was a consequence of a Stand-by Arrangement with the International Monetary Fund. Finally, the pension reform of 2002 was also enacted in a time of economic crisis.

In conclusion, reforms to the budget process either failed or were relatively minor after 1991, as compared to the pre-1991 period. This stylized fact may be explained by the fact that negotiations over pork barrel spending increased considerably after 1991 (as the former institutional balance provided by *auxilios* and the appointment of governors and mayors as a currency to consolidate coalitions for legislative support): neither the government nor Congress was particularly keen on modernizing reforms that would limit the scope for such negotiations.

## 5. Conclusions

All tax laws approved after 1991 were of the “quick-fix” or “piecemeal” variety: increases in some tax rates and the introduction of distortionary taxes on financial transactions and 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 “piecemeal” laws. Overall, tax revenues increased but not as fast as expenditures. Increasing deficits contributed to the fiscal crisis at the end of the 1990s, and the central government maintained high deficits even during the 2003-2007 boom. These results were mainly a consequence of fragmented and weakened political parties and a Congress more responsive to narrow economic interests (that financed individual campaigns), which has made it more difficult and costly to enact any tax reform, particularly those that are structural in nature.

In periods of economic and fiscal crises, the approval of revenue-enhancing reforms was strongly facilitated, as predicted by theory. According to former ministers of finance who carried out tax initiatives during such periods (1984 and 1999-2002), congressmen from the two major parties recognized the need to increase revenues, and the discussion centered more on the type of quick fixes (i.e., whether based on VAT or income tax rate increases). Structural reforms were not attempted during such periods.

In times of crisis, when access to private international financial markets is severely limited, the IMF and the U.S. Treasury play an important role. Their participation facilitates consensus building within government and in Congress (within major traditional parties), as all players realize that tax reforms are needed not only 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 subnational governments—were easier to enact and quite successful, in the sense that they achieved a significant reduction of transfers/GDP ratios, contributed to a leveling of public expenditures/GDP ratios since 2001 and to reduced CG deficits, and led to aggregate surpluses in subnational 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 as a result of

the election of governors and mayors: members of Congress are now more willing to accept limitations to regional transfers or expenditures executed by officials who do not depend on them (while previously the Executive appointed governors in consultation with regional congressional leaders, and governors appointed mayors), 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 regardless of the economic cycle, although with a constant fear of a subnational fiscal crisis that would affect overall public finances. Law 358 of 1997 was enacted during the political crisis of the Samper administration. Laws 549 of 1999, 617 of 2000 and Constitutional Amendment 01 of 2001 were implemented during 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-term fiscal frameworks, though it did not include enforcement instruments, as did the highly successful Brazilian FRL, or quantitative targets, as did other FRLs. It is difficult to assess its actual effect on expenditure 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 future negotiations over pork more difficult and may run the risk of Congress weakening some of the government's control.

Traditional expenditure adjustment measures 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 substantially increased 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 benefits.<sup>65</sup> More importantly, the constitutional reform dominated the political and public opinion debate. 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 increases in central government revenues are no longer automatically shared with subnational governments. 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 previously existing incentive to introduce and increase new distortionary taxes to a large extent because their proceeds did not have to be shared with subnational governments. Similarly, the 2003 electoral reform may lead to significant changes in incentives of members of Congress and to some strengthening of parties, thus shifting once again the balance in favor of structural reforms.

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<sup>65</sup> 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. Ministers Interviewed

### Representatives of Business Associations Interviewed

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

### Senators Interviewed

| Interviews         | Positions  |
|--------------------|--|
| Cecilia López      | <ul style="list-style-type: none"> <li>• Senator (2006-2010).</li> <li>• Director, National Department of Planning</li> <li>• Minister of Agriculture</li> <li>• Environment Minister</li> </ul> |
| Rodrigo Lara       | <ul style="list-style-type: none"> <li>• Senator (2008-2010)</li> <li>• Director, Anticorruption Department</li> </ul>   |
| Alfonso Valdivieso | <ul style="list-style-type: none"> <li>• Senator (2008-2010)</li> <li>• Attorney General</li> <li>• Education Minister</li> <li>• Senator (1986-1990)</li> </ul>                                 |
| Telosforo Pedraza  | <ul style="list-style-type: none"> <li>• Senator (2008-2010)</li> <li>• Chamber Representative</li> <li>• Education Secretary of Bogota</li> </ul>   |

## Annex 2. Reforms Inventory

### Expenditure Reforms

| Laws   | Provisions  |
|--|---|
| Decree 164 of 1950                                       | <ul style="list-style-type: none"> <li>• Earmarked expenditures eliminated.</li> <li>• Autonomous budgeting of decentralized agencies.</li> </ul>   |
| Decree 294 of 1973<br>(Reform to the Budget Organic Law) | <ul style="list-style-type: none"> <li>• Stricter control over decentralized agencies' expenditures.</li> <li>• Better coordination in budget programming.</li> <li>• Decentralized agencies budget included in the CG budget.</li> <li>• More hierarchical budgeting.</li> <li>• Budget coverage expanded (i.e. principle of unity).</li> <li>• Power of the executive to do budget additions while Congress is not in session.</li> </ul> |
| Law 38 of 1989<br>(Reform of the Budget Organic Law)     | <ul style="list-style-type: none"> <li>• Budget flexibility improved.</li> <li>• Autonomy of line-item agencies spending.</li> <li>• Expenditure effectiveness institutions introduced (e.g. Investment Projects Bank, BPIN).</li> <li>• Mandatory evaluation for investment projects established.</li> <li>• Annual cash program created.</li> <li>• National Fiscal Council (CONFIS) created.</li> </ul>                                  |
| Law 179 of 1994  | <ul style="list-style-type: none"> <li>• Law 38 of 1989 update for the new Constitution.</li> <li>• Compulsory registration of investment projects.</li> </ul>  |
| Law 225 of 1995  | <ul style="list-style-type: none"> <li>• Standards of budget planning, preparation, and performance established in accordance with Decree 111 of 1996.</li> </ul>   |
| Decree 111 of 1996                                       | <ul style="list-style-type: none"> <li>• Law 38 of 1989, Law 179 of 1994, Law 225 of 1995 joined without modifications.</li> </ul>  |
| Law 819 of 2003<br>(Fiscal Responsibility Law)           | <ul style="list-style-type: none"> <li>• Medium-Term Fiscal Framework (MTFF) created.</li> <li>• Management and performance indicators included in the budget.</li> <li>• 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 MTFF goals.</li> </ul>  |
| Decree 4730 of 2005                                      | <ul style="list-style-type: none"> <li>• Medium-Term Expenditure Framework (MTEF) created.</li> </ul>   |
| Decree 1957 of 2007                                      | <ul style="list-style-type: none"> <li>• Budget reserves limited to 2 percent of operational expenditure and 15 percent of investment expenditures.</li> </ul>  |

## Tax Reforms

| Laws  | Provisions   |
|---|--|
| Law 81 of 1960  | <ul style="list-style-type: none"> <li>• Reduced labor income tax and its complementary taxes.</li> <li>• Created tax incentives for basic industries.</li> <li>• Established presumptive income taxes on rural land.</li> </ul>   |
| Law 21 of 1963  | <ul style="list-style-type: none"> <li>• Created a general sales tax (except on food, medicine and text books).</li> </ul>   |
| Decree 1366 and 1366 of 1967                              | <ul style="list-style-type: none"> <li>• Established the repatriation of capital.</li> <li>• Created a limit on tax deductions.</li> <li>• Created instruments to control evasion.</li> <li>• Established withholding regimes.</li> <li>• Amnesty for late interest payments and liabilities not included in tax return.</li> </ul>  |
| Law 38 of 1969.   | <ul style="list-style-type: none"> <li>• Created labor taxes.</li> </ul>   |
| Law 6 of 1971   | <ul style="list-style-type: none"> <li>• General tax on imports increased from 5 percent to 10 percent.</li> <li>• Executive power can reform tariffs.</li> </ul>  |
| Law 6 of 1973   | <ul style="list-style-type: none"> <li>• Increased corporate tax incentives.</li> <li>• Increased personal tax exemptions.</li> <li>• Exemptions to excess profits tax when profits used for investment in public bonds.</li> </ul>  |
| Decreets 2053 and 2247, special decree and Law 23 of 1974 | <ul style="list-style-type: none"> <li>• Most tax incentives eliminated.</li> <li>• Unification of income tax regimes (both for personal and corporate income taxes).</li> <li>• State enterprises taxed as corporations.</li> <li>• Introduced partial correction for inflation.</li> <li>• Income tax exemptions if income invested in public bonds.</li> <li>• Introduced capital gains tax.</li> <li>• Established a general minimum presumptive income tax.</li> <li>• Inheritance tax modified.</li> <li>• Sales tax converted to a VAT at manufacturing level and dispersion of tax rates increased.</li> </ul> |
| Law 54 of 1977  | <ul style="list-style-type: none"> <li>• Established full correction for inflation.</li> <li>• Amnesty on capital gains tax.</li> <li>• Established an additional tax credit for all firms.</li> <li>• Increased income tax exemptions and tax credits for many state companies.</li> </ul>  |
| Law 20 of 1979  | <ul style="list-style-type: none"> <li>• Capital gains tax modified.</li> <li>• Maximum rate and progressivity of capital gains tax reduced.</li> <li>• Total exemption of capital gains tax for reinvested profits.</li> </ul>  |
| Decree 3803 of 1982                                       | <ul style="list-style-type: none"> <li>• Established more controls in the tax payment system.</li> </ul>   |

|                               |  |
|-------------------------------|--|
| Law 9 of 1983                 | <ul style="list-style-type: none"> <li>• Strengthened the minimum presumptive income tax regime and adjustments for inflation.</li> <li>• Established new incentives for investment and debt.</li> <li>• Reduced double taxation.</li> <li>• VAT extended to retail level.</li> </ul>  |
| Decree 2666 of 1984           | <ul style="list-style-type: none"> <li>• Increase in tariffs.</li> <li>• Simplification of administrative customs procedures.</li> </ul>   |
| Law 75 of 1986                | <ul style="list-style-type: none"> <li>• Tax base broadened eliminating income tax exemptions (e.g. education and health discounts).</li> <li>• Elimination of double taxation through tax credits for dividends.</li> <li>• Net wealth tax abolished.</li> <li>• Income tax procedures simplified.</li> <li>• Reduced income tax rates (to 30 percent)</li> <li>• Reestablished taxation of Ecopetrol.</li> <li>• Eliminated some exemptions for occasional profit tax.</li> </ul>  |
| Decrees 2503 and 2540 of 1987 | <ul style="list-style-type: none"> <li>• Tax procedures simplified (e.g. elimination of documents and financial sector in charge of receiving revenues).</li> <li>• Tax devolutions established.</li> </ul>  |
| Law 49 of 1990                | <ul style="list-style-type: none"> <li>• Dependence on tariffs reduced.</li> <li>• VAT basic rate increased from 10 percent to 12 percent.</li> <li>• Tax exemptions reduced.</li> <li>• Amnesty for repatriated capital.</li> <li>• Unified the National Tax and Customs Administration (DIAN).</li> </ul>  |
| Law 50 of 1990                | <ul style="list-style-type: none"> <li>• CG bonds (TES) created, increasing the capacity of domestic borrowing.</li> </ul>   |
| Law 6 of 1992                 | <ul style="list-style-type: none"> <li>• VAT increased from 12 percent to 14 percent.</li> <li>• Exemptions on tax payments to indigenous territories, metropolitan districts, associations of municipalities, black communities, and special administrative units and superintendencies.</li> <li>• Some goods excluded from VAT (i.e. basic consumer basket and some agricultural equipment not produced in the country).</li> <li>• Income tax rate increased to 37.5 percent.</li> <li>• VAT on capital goods made deductible (shift from income to consumption VAT).</li> </ul> |
| Law 174 of 1994               | <ul style="list-style-type: none"> <li>• Inventories valuation decreased gradually.</li> <li>• Tax treatment for leasing established.</li> <li>• Executive power empowered to dictate rules on labor tax.</li> <li>• Inflation rates between the accounting and tax issues unified.</li> </ul>   |

|                                      |   |
|--------------------------------------|---|
| <p>Law 223 of 1995</p>               | <ul style="list-style-type: none"> <li>• Income tax rate reduced to 35 percent.</li> <li>• VAT rate increased to 16 percent.</li> <li>• Reduced exemptions in income tax and VAT</li> <li>• Strengthened the minimum presumptive income tax regime.</li> <li>• New VAT exemptions to a set of inputs used in housing construction.</li> <li>• Personal enterprise considered a limited liability company.</li> <li>• Tax treatment of commercial leasing defined.</li> <li>• Capital losses deduction against the capital gains tax.</li> </ul>   |
| <p>Law 383 and Decree 81 of 1997</p> | <ul style="list-style-type: none"> <li>• Smuggling and tax evasion penalized with imprisonment from 3 to 6 years and fine of 200 percent of the CIF value.</li> <li>• New incentives for inter-institutional cooperation against smuggling.</li> <li>• Tax discounts limits.</li> <li>• Foreign investment and academic research incentives created.</li> <li>• External financing tax created (tax value: fixed term deposit interest rate - Libor - Annual depreciation).</li> <li>• Tax to transactions with government increased from 0,5 percent to 1 percent. (Stamp tax).</li> </ul> |
| <p>Law 488 of 1998</p>               | <ul style="list-style-type: none"> <li>• VAT tax base increased.</li> <li>• VAT tax rate reduced to 15 percent.</li> <li>• Some income exemptions eliminated.</li> <li>• New system of public bonds created (<i>Bonos de paz</i>).</li> </ul>   |
| <p>Decree 2331 of 1998</p>           | <ul style="list-style-type: none"> <li>• Financial transactions tax rate created at 2 per thousand.</li> </ul>  |
| <p>Law 633 of 2000</p>               | <ul style="list-style-type: none"> <li>• VAT expanded to houses of high income strata and used cars.</li> <li>• Financial transactions tax rate increased from 2 to 3 per thousand.</li> </ul>  |
| <p>Decree 1838 of 2002</p>           | <ul style="list-style-type: none"> <li>• Net wealth tax created (1.2 percent of patrimony once).</li> </ul>   |
| <p>Law 788 of 2002</p>               | <ul style="list-style-type: none"> <li>• Income tax rate increased to 38.5 percent</li> <li>• Number of goods excluded from VAT reduced.</li> <li>• Controls to evasion established.</li> <li>• New exemptions for specific activities.</li> </ul>  |

|                  |  |
|------------------|--|
| Law 863 of 2003  | <ul style="list-style-type: none"> <li>• Financial transactions tax rate increased from 3 to 4 per thousand.</li> <li>• Net wealth tax re established (to finance increased defense expenditures).</li> <li>• Deductions to investment established.</li> </ul> |
| Law 1004 of 2005 | <ul style="list-style-type: none"> <li>• Income tax rate equal to 15 percent to firm established in free trade zones.</li> </ul>   |
| Law 1111 of 2006 | <ul style="list-style-type: none"> <li>• Decreased income tax rates from 35 percent in 2006 to 34 percent in 2007 and to 33 percent in 2008.</li> <li>• Eliminated dividend tax on non residents.</li> <li>• Financial transaction tax permanent.</li> </ul>   |



### Decentralization Reforms

| Laws  | Provisions   |
|---|--|
| 1957 Plebiscite                                       | <ul style="list-style-type: none"> <li>• First transfer law created.</li> </ul>  |
| Law 33 of 1968  | <ul style="list-style-type: none"> <li>• Percentage of alcoholic beverages tax, registration tax, lotteries tax transferred to regions.</li> <li>• Percentage of sales tax transferred to regions from 10 percent in 1971 to 30 percent in 1973.</li> </ul>  |
| Law 46 of 1971  | <ul style="list-style-type: none"> <li>• Percentage of CG income transferred for education expenditures to the departments established.</li> </ul>   |
| Law 43 of 1975  | <ul style="list-style-type: none"> <li>• Percentage of sales tax transferred to departments for pensions to teachers established.</li> </ul>   |
| Law 7 of 1981   | <ul style="list-style-type: none"> <li>• Regional internal debt regime established.</li> <li>• Budget autonomy to regions.</li> </ul>  |
| Law 14 of 1983  | <ul style="list-style-type: none"> <li>• Property tax and alcoholic beverages and cigarette tax regimes transferred to the regional governments.</li> </ul>  |
| Law 12 of 1986  | <ul style="list-style-type: none"> <li>• Progressive increase in the percentage of VAT transferred to regions from 30.5 percent in 1986 to 50 percent in 1992.</li> </ul>  |
| Constitutional reform of 1991<br>Articles 356 and 357 | <ul style="list-style-type: none"> <li>• General participation system of regional transfers created.</li> <li>• Percentage of CG current revenues of government that should be transferred to the regions established.</li> </ul>  |
| Law 60 of 1993  | <ul style="list-style-type: none"> <li>• Annual percentages that should be transferred to the regions established (For the Departments the “Situado Fiscal” that began at 23 percent of current revenues in 1994 and increased to 23.5 in 1994, 24 percent in 1995 and to 24.5 percent in 1996, and for municipalities the “Participación municipal” that began at 15 percent, increasing by 1 percentage point until 2001).</li> <li>• Earmarked expenditures to education and health.</li> </ul> |
| Law 358 of 1997                                       | <ul style="list-style-type: none"> <li>• Local debt cannot exceed its financial capacity.</li> <li>• Solvency and sustainability debt indicators introduced.</li> <li>• Debt service should be lower than 40 percent of regional operational savings.</li> </ul>   |
| Law 549 of 1999                                       | <ul style="list-style-type: none"> <li>• Regional Pension Fund (Fonpet) created.</li> <li>• All pension liabilities should be canceled before 30 years.</li> <li>• Percentage of financial transactions tax, registration tax, privatization and earmarked current revenues transferred to Fonpet.</li> <li>• Ministry of Finance’s administration of</li> </ul>   |

|  |   |
|--|---|
|  | Fonpet.   |
| Law 617 of 2000  | <ul style="list-style-type: none"> <li>• Categories of regional governments created. Six categories depending on population and current fiscal revenues.</li> <li>• Regional current expenditure of regions should be financed with non earmarked current revenues.</li> <li>• Regional current expenditure cannot exceed earmarked current revenue limits depending on the regional categorization established. (Special category 50 percent, first category 55 percent, second category 60 percent and third and fourth 70 percent).</li> </ul> |
| Constitutional Reform 01 of 2001                                     | <ul style="list-style-type: none"> <li>• Increase of transfers to regional governments equal to the average increase of current revenues over the previous four years.</li> </ul>   |
| Law 715 of 2001<br>(Regulated the Constitutional reform 01 of 2001)  | <ul style="list-style-type: none"> <li>• Efficiency procedures to distribute transfers to departments and municipalities.</li> <li>• Limitation of current expenditures for subnationals.</li> </ul>  |
| Constitutional reform 04 of 2007                                     | <ul style="list-style-type: none"> <li>• Increase of transfers to regional governments equal to the inflation rate plus 4 percent in 2008 and 2009, plus 3.5 percent in 2010, and plus 3 percent between 2011 and 2016. In addition if GDP growth rate is higher than transfer growth rate, the difference will be transferred to the regions.</li> </ul>   |
| Law 1176 of 2007<br>(Regulated the Constitutional reform 04 of 2007) | <ul style="list-style-type: none"> <li>• GSP divided into four sectors ( Education (58.5 percent), health (24.5 percent), water (5.4 percent) and others (11.6 percent).</li> <li>• The powers of the departments were clarified.</li> <li>• 85 percent of percentage of water sector transferred to municipalities and 15 percent to departments.</li> </ul>   |

## Pension Reforms

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