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(Still) in Progress**

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# *Fiscal Decentralization in Colombia: A Work (Still) in Progress<sup>1</sup>*

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## **Abstract**

The degree of fiscal decentralization in Colombia is impressive. In some respects, however, Colombian decentralization has hardly changed since the process first began over 40 years ago. This review of the experience of the last few decades and the challenges now facing the country shows that there have been some clear successes as a result of decentralization. However, many problems have also arisen as a result of both perverse incentives built into the system and the failure to build up central and especially local capacity to manage a more decentralized system. Unless these critical problems are resolved, fiscal decentralization in Colombia will remain a work in progress with, at best, only partially successful outcomes whether in terms of providing public services to the country's growing population more effectively, efficiently, and equitably or in terms of improving subnational governance in general.

**Keywords:** Colombia; decentralization; transfers; subnational taxes; royalties

**JEL codes:** 023;H77

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In fiscal terms, Colombia has long been something of an anomaly in Latin America. Not only have its public finances generally been managed surprisingly well and responsibly in recent decades, through periods that were difficult both domestically and internationally, but at the same time, Colombia has also become one of the most fiscally decentralized countries in the region—more so than some formally federal countries. With the introduction in 1986 of locally elected mayors (*alcaldes*) in the (now) over 1,100 municipalities, the country also took a significant step toward political decentralization. Given the diversity and heterogeneity of Colombia's people and regions, the emergence of some degree of decentralization in both the fiscal and political dimensions is in itself not surprising. What is noteworthy, however, is that, despite continuing security problems and weak national government influence in substantial areas of the country, the constitution that was adopted in 1991 not only established a completely new structure for intergovernmental fiscal relations but also created, with the election of governors since 2001 in the (now) 32 regional governments or departments (*departamentos*), a new political foundation for subnational governments at the regional and local level.

These were big changes, enacted in large part in an effort to reduce internal conflict, so it is perhaps not surprising that the innovations in the 1991 constitution gave rise to a number of problems that were exacerbated in the 1990s by the increasing loss of national control over some parts of the country. One result was that, as the state gradually regained control over its territory, still further constitutional changes were made in 2001, in 2007 and, most recently, in 2011.

As conventionally measured (as the share of subnational expenditures in total public expenditures), the degree of fiscal decentralization in Colombia is impressive (Table 1), with only Brazil and Argentina being more decentralized in Latin America (Daughters and Harper 2007).<sup>2</sup> Despite the many changes to Colombia's decentralization system in recent years, however, in some respects Colombian decentralization has hardly changed in a number of critical respects since the process first began over 40 years ago. There have been some clear successes as a result of decentralization. But many problems have also arisen as a result of both perverse incentives built into the system and the failure to build up central and especially local capacity to manage a more decentralized system. Unless and until these critical problems are resolved, fiscal decentralization in Colombia will remain a work in progress with, at best, only partially successful outcomes in terms of providing public services to the country's growing population more effectively, efficiently, and equitably, and in the closely related, and arguably more important, task of improving subnational governance.

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<sup>2</sup> Although the figures in the different sources cited (and others consulted) are seldom identical, the direction and rate of change in different sources seem broadly comparable, so the general picture sketched in table 3.1 should be roughly correct.

**Table 1**  
**Summary of Fiscal Decentralization in Colombia since 1990**

<b>Year</b>	<b>(1) Total Taxes as % of GDP</b>	<b>(2) Subnational Taxes as % of GDP</b>	<b>(3) Subnational Taxes as % of Total Taxes</b>	<b>(4) Subnational Expenditures as % of Total Expenditures</b>	<b>(5) Transfers as % of National Government Expenditures</b>
<b>1990</b>	<b>8.2</b>	<b>1.7</b>	<b>20.2</b>	<b>n.a.</b>	<b>47.0</b>
<b>1995</b>	<b>10.0</b>	<b>1.9</b>	<b>21.0</b>	<b>18.5</b>	<b>46.7</b>
<b>2000</b>	<b>11.7</b>	<b>2.2</b>	<b>19.3</b>	<b>24.9</b>	<b>51.6</b>
<b>2005</b>	<b>15.2</b>	<b>2.8</b>	<b>18.1</b>	<b>29.4</b>	<b>58.2</b>
<b>2007</b>	<b>16.2</b>	<b>2.8</b>	<b>17.1</b>	<b>30.4</b>	<b>52.5</b>

*Sources:* Columns 1, 2, 3, and 5 are calculated from CEPALSTAT data ([www.eclac.org/estadistica/](http://www.eclac.org/estadistica/)); column 4 is calculated from data in Zapata 2010 except for 1995 (from [www.banrep.gov.co/series\\_estadisticos/](http://www.banrep.gov.co/series_estadisticos/))

*Note:* n.a. = not available.

### **Changing Policies but Unchanging Realities**

Four important facts about Colombia's extended and extensive decentralization process have remained virtually unchanged over the decades. They are:

- At no point have subnational governments ever obtained any significant new access to “own” tax sources. Indeed, as World Bank (2009) notes, the Colombian case is in some ways unique in Latin America since it tripled the importance of subnational spending from 1986 to 2005 while at the same time decreasing the relative importance of subnational taxes.<sup>3</sup>
- One result is that both the departmental governments and all but the largest municipal governments remain almost entirely dependent on transfers from the national government—and indeed this dependence grew sharply in the 1990s (table 3.1). In reality, however, as World Bank (2009) correctly notes, to a considerable extent the much discussed increase in such transfers since 1991 amounts to little more than a relabeling of central expenditures on health and education. Although these expenditures now flow through the budgets of the 32 departmental governments (and Bogotá, the capital district), those governments have very little control over how these funds are spent.
- Despite this fact, it is not surprising that the national government has seldom if ever been happy with how the recipients spend fiscal transfers, a concern that has been exacerbated in recent years by the increasing flow of resource royalties that have flowed to some subnational governments. In response to such concerns, and to its own macroeconomic

<sup>3</sup> See figure 1.1 in World Bank (2009), which is based on data from International Monetary Fund Government Finance Statistics. Such comparisons are dependent on both the data source and the period chosen. Using data from the United Nations Economic Commission for Latin America, for example, Gomez Sabaini and Jimenez (2009) show that subnational spending in Colombia, although it has grown as a share of GDP over the period mentioned, has hardly changed as a share of general government spending.

and deficit problems, the central government has repeatedly attempted to restrict and control subnational spending (and borrowing) and has, as discussed below, succeeded to a considerable extent in doing so to the point where it may now be argued that Colombia's real model of decentralization may perhaps best be characterized as one of delegation rather than devolution. We consider this question briefly later in this chapter.

- Whether the implicit model underlying Colombian decentralization has shifted or not, it seems unarguable that, despite the prolonged discussion and many laws in recent decades about decentralization, no Colombian government as yet has either implemented a fully coherent decentralization strategy or done enough to develop an adequate institutional basis for effective decentralization at either the national or subnational level.<sup>4</sup>

Since these are strong statements, it may be useful to elaborate on each of them briefly before moving to the main subject of this chapter—a detailed examination of how each of these factors has once again been underlined (but not resolved) by recent and prospective developments.<sup>5</sup>

### ***A Weak Subnational Revenue System***

To understand the present—or to speculate usefully about the future—one must first understand the past. In many ways, Colombia's march toward decentralization began in the late 1960s with two measures: (a) the introduction of a new sales tax (later changed to a value-added tax [VAT]) that was, for the first time shared with subnational governments through the first formula-based transfer; and (b) a subsequent constitutional amendment that resulted in 1971 in the effective assumption by the national government of primary responsibility for financing education and health, again through a new fiscal transfer.

An early study of the outcomes of this system suggested a number of detailed reforms but emphasized, in particular, the need to strengthen local revenue-raising powers if the increased transfers were to improve outcomes (Misión 1981). Although subsequent laws moved in this direction to some extent, in the end little came of this effort (Bird 1990). Indeed, the question of increasing local revenue autonomy then virtually disappeared from the national policy arena, being revived only to a limited extent with respect to the departments in a recent report (Comisión 2008). To this day, neither level of subnational government has a real tax code, and, despite decades of fiscal decentralization legislation, the only subnational governments in Colombia that have any significant degree of revenue autonomy are the larger cities, which have always had substantial revenue-raising powers largely under their own control.<sup>6</sup>

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<sup>4</sup> Many reports and studies by both Colombians and outside observers have noted these deficiencies and made recommendations intended to deal with them in one way or another. See, for example, Misión (1981), and Wiesner (1992, 1995), among others. But the problems remain.

<sup>5</sup> What follows inevitably draws, in part, on previous reviews by the author of various earlier stages of Colombia's fiscal decentralization. See, for example, Bird (1984, 1990), Bird and Fiszbein (1998), and Acosta and Bird (2005), and such more recent reviews such as MHCP (2009) and World Bank (2009).

<sup>6</sup> In the early 1960s, before any system of general intergovernmental transfers existed, Colombia's public finances in many ways were similar to the picture today: the central government collected most taxes, but others (including the then-large national decentralized agencies, especially in education and health) did most of the spending, while regional divergences were great and subnational spending (as well as own-source revenues) was highly concentrated in the major cities (Bird 1970). Of course, as the same source emphasizes, some regions—notably Antioquia—as well as the larger municipalities, and in particular the capital, Bogotá, have always in practice had much more control over both revenues and expenditure in their territory than others.

As the “second-generation” theory of fiscal federalism (Oates 2008; Weingast 2006) emphasizes, however, in these circumstances even if intergovernmental transfers are as carefully designed as possible, the incentives facing subnational governments receiving fiscal transfers are unlikely to be conducive to economically sensible behavior. On the whole, Colombian experience appears to support this argument.

### ***A Problematic Transfer System***

Having put the issue of revenue autonomy to one side, Colombia’s decentralization policy over the last three decades has largely concentrated on doling out ever more and different transfers. How well those transfers were designed and implemented thus became by far the most critical factor in shaping outcomes. Initially, the level of general transfers to the departments and to the municipalities, especially the smaller ones, was determined as a share of sales tax revenues. This transfer was allocated in accordance with a formula that changed from time to time but was heavily weighted by population. In contrast, the much more important transfer to the departments to finance education and health was intended primarily to pay the salaries of teachers and health service employees and was determined as a share of national government current revenues. In 1991, however, Colombian decentralization entered a new era when another constitutional amendment substantially altered this system in three ways:

- It clearly divided the transfers between those going (mainly) to departments for health and education (the *situado fiscal*, or, loosely, fiscal share) and the more general transfers to municipalities (*participaciones municipales*).
- The amount of both transfers was determined as a percentage of national current revenues.
- These percentages were to be gradually increased each year until 2000.

The result of these changes was that the level of intergovernmental fiscal transfers (including also the matching investment grants allocated by the National Planning Department [*Departamento Nacional de Planeación*, DNP]) through the separate investment budget) were doubled in real terms and increased to more than half of the total central budget (Table 1). The constraint imposed by this commitment unsurprisingly made it more difficult for the central government to manage its own finances during a period in which it was being increasingly pressed to deal with widespread and growing security problems.

### ***Attempts to Control Subnational Spending***

The national government was understandably concerned with how and how well all these transfers are spent. Not only were many of the transferred funds apparently not well spent, but it was widely argued that subnational governments were not themselves taxing enough. In the case of the departments, however, neither of these problems should in principle have been serious, for two reasons.

First, virtually all transfers to the departments have always been earmarked, essentially to pay the salaries of employees in the health and education sectors. Since those salaries, and the number of employees, are set at the national level, departments have almost no discretion in spending these transfers.<sup>7</sup>

Second, apart from these transfers, departments have few “own-source” revenues (Table 2). In 2008, for example, when departmental revenues were 3.1 percent of GDP, departmental taxes were only 34 percent of subnational taxes and less than 1 percent of GDP (Zapata 2010). Moreover, most departmental own revenues come from taxes for which the rates are set nationally and the proceeds are earmarked for nationally designated purposes (Box 1).

**Table 2**  
**Departmental Revenues, Colombia, 2010**

As Percent of GDP		As Percent of Taxes	
<b>Total Revenue</b>	<b>4.2</b>	<b>Liquor</b>	<b>19.4</b>
<b>Total Current Revenue</b>	<b>2.8</b>	<b>Beer</b>	<b>30.0</b>
<b>Transfers</b>	<b>1.7<sup>a</sup></b>	<b>Tobacco</b>	<b>8.2</b>
<b>Total Own-Source</b>	<b>1.1</b>	<b>Gasoline</b>	<b>5.9</b>
<b>Total Taxes</b>	<b>0.9</b>	<b>Vehicles</b>	<b>7.8</b>
		<b>Registry</b>	<b>11.8</b>
		<b>Stamps</b>	<b>13.1</b>
		<b>Other</b>	<b>3.8</b>
		<b>Total</b>	<b>100.0</b>

*Source:* Author’s calculations using MHCP 2011b data.

*Note:* a. In addition to these transfers, royalty transfers (treated as capital income) to departments (of which 98 percent were “direct,” that is, to producing departments) were a bit more than 0.05 percent of GDP in 2010. In addition, other capital transfers from the central government amounted to another 0.01 percent of GDP. Since departmental “social investment” (a term encompassing the operating costs, excluding central administration, for education, health, water and sewerage, housing, and some other items) was 1.9 percent of GDP in 2010. In effect, about 90 percent of such “investment” was financed by earmarked national transfers.

<sup>7</sup> As World Bank (1996) notes, despite the strong role played by national policy, departments (and to some extent municipalities) were nonetheless able to exert some pressure on the national budget by, for example, hiring additional teachers from their own funds and subsequently managing to get those teachers included in the national *planta* (established number of employees).

## **Box 1**

### **Departmental and Municipal Taxes, Colombia**

#### ***Departmental Taxes***

Departments in Colombia have access to many tax sources; however, they have relatively little tax autonomy and are also restricted with respect to how freely they can spend their “own source” money. In fact, they can determine the tax base and tax rate freely only with respect to the registry tax (less than 10 percent of “own-source” revenues), and about 30 percent of tax proceeds are earmarked.<sup>a</sup>

*Liquor tax:* Delegated national tax varying by alcohol content, with rates (40 percent consumption tax and 8 percent VAT) set by the national government. All proceeds to department but 70 percent of the VAT portion is earmarked to health and 30 percent to sports. The tax is administered by the department. (In addition, some departments have their own liquor production and may receive profits from its operation.)

*Beer tax:* Delegated national tax with rates set by the national government. That part of departmental receipts corresponding to 8 percent of the VAT is earmarked to health. The tax is administered by the departments and the Capital District (Bogotá).

*Tobacco tax:* Delegated national tax, with rates set by the national government (varying by sales price), and 16 percent earmarked to sports. The tax is administered by the departments and Bogotá.

*Vehicle tax:* Rates set nationally, with 20 percent of proceeds to be shared with municipalities (Capital District and special frontier zones to receive 100 percent). The tax is administered by the departments and Bogotá.

*Gasoline tax:* Rates set nationally as a surcharge on the national tax base of 6.5 percent for departments and 18.5 percent for municipalities (25 percent to Bogotá); proceeds earmarked for road maintenance and public transport. All levels of government are involved in administering this tax.

*Diesel tax:* National tax, with 50 percent going to departments for roads. The tax is administered nationally.

*Registry tax (on business and property):* Determined by departments; 20 percent earmarked to cover pension debt. The tax is administered by the departments, although in Cundinamarca, 20 percent of the proceeds go to Bogotá.

*Stamp tax:* Proceeds are allocated to different sectors including social assistance, infrastructure, and rural electrification. The tax is administered by the departments.

#### ***Municipal Taxes***

Unlike departments, municipalities essentially have access to only two taxes of any significance. They have, however, much more autonomy with respect to how they apply these taxes and how they spend them. It is perhaps not surprising that the municipal sector is, in fiscal terms, considerably more important than the departmental sector, even though the latter is responsible for the two most expensive subnational public services—health and education.

*Property tax:* The tax base in most of the country is determined by the national cadastral institute (Instituto Geográfico Agustín Codazzi, IGAC). However, the Department of Antioquia and the four largest cities (Bogotá, Medellín, Cali, and Barranquilla) are responsible for assessing properties, and Bogotá has a “self-assessment” system. Property tax rates are set locally with a nationally defined range between 0.1 percent and 0.16 percent, with a higher rate (0.33 percent) on undeveloped land within urban areas. The tax is administered by the municipalities. In addition, municipalities may impose additional levies such as *valorización* (special assessment) and *plusvalía* (land increment tax) on increments in land value related to public improvements and regulatory changes, respectively.

*Industry and commerce tax:* The tax is imposed on average monthly gross income at the nationally set rates of 0.2 to 0.7 percent on industrial activities, 0.25 to 1.0 percent on commercial and service activities, with rates varying with municipality and the type of activity and 0.5 percent on the financial sector. In Bogotá, rates are higher, ranging from 0.41 percent to 1.38 percent. This tax is administered by the municipalities.

*Note:* a. Although World Bank (2009) estimates that, in 2005, 25.8 percent of departmental taxes were earmarked, this estimate does not include either the 20 percent share of the vehicle tax assigned to municipalities or the 20 percent of the registry tax earmarked to pension debt. Adjusting for these items, the earmarked share increases to 29.5 percent.

Municipal governments, however, have always had more freedom, both in terms of how much revenue they can raise and how they can spend it (Table 3). In 2008, for example, when 52 percent of departmental spending was financed by transfers, the corresponding degree of transfer dependence at the municipal level was only 44 percent, and municipal taxes were, at 1.9 percent of GDP, twice as important as departmental taxes (Zapata 2010). It is thus not surprising that, from the very beginning of national fiscal transfers to municipalities in the 1960s, repeated attempts have been made to restrict the extent to which local politicians can spend transfer funds on such presumably undesirable activities as placing their friends, relatives, and supporters on the public payroll. As discussed later, the principal way this objective has been sought has been by requiring that most such spending is not only restricted to investment projects, but also to particular types of investment (for example, water and sewerage projects), and by other requirements, such as spending a certain percentage of the total in the more rural parts of municipalities. Such earmarking of transfers was strengthened in recent years both legally and operationally, with increasing emphasis being placed on “results-based” (output) conditionality.<sup>8</sup>

The earlier “expenditure conditionality” (input) requirements appeared to be relatively more effective in the more transfer-dependent poorer and smaller municipalities than in the larger cities, which had much more revenue capacity and, hence, much more own revenue (Chaparro, Smart, and Zapata 2005). However, any beneficial effects along these lines were soon lost from sight as the commodity boom of the 2000s increasingly began to generate large royalty revenues, with most of these funds flowing directly into some poor but very sparsely populated departments and municipalities (Table 4). This sudden influx of unearned wealth soon resulted in apparently widespread (and certainly widely reported) waste and inefficiency in many of the jurisdictions fortunate enough to receive royalties. In addition, the fact that so large a share of

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<sup>8</sup> See, for an example, Gomez, Olivera, and Velasco (2009).

royalty income was directed to the departments and municipalities from which the resources were extracted made it increasingly difficult for the national government to manage its own finances in the face of the commodity boom.

**Table 3**  
**Municipal Revenues, Colombia, 2008**

As Percent of GDP		As Percent of Taxes	
Total revenue	6.3	Property tax	28.1
Transfers	2.8 <sup>a</sup>	Industry and commerce tax	44.5
Total current revenue	2.4	Gasoline surtax	12.0
Total own-source	2.2	Others	15.4
Total taxation	1.9		

*Source:* Author's calculations using Zapata 2010 data.

*Note:* a. Transfers include some small current transfers (0.2 percent of GDP) that are included in current revenue, but mainly consist of royalties (0.4 percent), investment "cofinancing" (0.1 percent), and especially the General Revenue-Sharing System (SGP) (2.1 percent), all of which are considered capital income.

When the increasing publicity (and reality) of "royalty waste" was added to the widespread perception—and to some extent demonstrated reality (World Bank 2009)—of the inefficiency in subnational spending, pressure understandably built up for the national government to do something to alleviate both the macroeconomic and allocative concerns with respect to royalty income which could, as a rule, be spent without being subject to the increasingly intensive central government supervision of general revenue transfers. It is thus no surprise that the most important recent change in the transfer system, as discussed further in the next section, focuses on these royalties. In addition, however, significant attempts have been made in recent years to devise and impose an effective set of "fiscal rules" to control not only subnational government spending from transfers but, by tightening controls on borrowing, more generally.

**Table 4**  
**SGP and SGR, by Department, Colombia, Average, 1990–2007**  
(national average = 100)

Department	Share of National Population (%)	Per Capita GDP	Growth in Per Capita GDP (%)	Per Capita Royalties	Per Capita Transfers
Casanare	0.5	349	5.3	2,582	179
Arauca	0.5	214	-6.4	3,078	145
Bogotá	25.3	158	3.0	0	0
San Andrés	0.2	138	0.6	54	297
Santander	4.7	125	4.5	100	63
Valle	9.8	116	1.9	12	76
Antioquia	12.9	115	1.6	21	71
Meta	1.6	112	1.8	460	100
Cundinamarca	5.0	104	1.9	12	119
La Guajira	1.2	93	-2.3	476	124
Atlántico	5.0	85	2.3	6	41
Boyacá	3.4	83	3.6	33	128
Huila	2.2	82	1.2	358	118
Risaralda	2.2	80	2.5	3	96
Tolima	3.2	79	1.6	61	110
Caldas	2.7	78	2.5	3	92
Bolívar	5.3	75	4.6	12	52
Guaviare	0.2	74	-3.7	64	255
Quindío	1.3	73	1.6	0	85
Cesar	2.2	72	3.0	109	1
Vichada	0.1	69	-0.6	97	455
Vaupés	0.1	65	-1.3	170	496
Córdoba	3.2	64	3.6	27	100
Caquetá	1.0	56	-0.3	0	135
Norte Santander	3.2	55	1.9	21	90
Amazonas	0.2	53	1.0	42	398
Cauca	3.0	51	3.0	6	100
Magdalena	3.2	48	3.0	3	71
Nariño	3.8	44	2.9	0	85
Putumayo	0.8	42	1.5	161	109
Sucre	1.9	41	2.8	15	118
Guainía	0.1	40	2.4	107	475
Chocó	1.1	35	0.9	3	104

Source: Author's calculations using data in Perry and Olivera 2009.

Note: SGP = General Revenue-Sharing System. SGR = General Royalty System.

### ***Decentralization without Decentralizing***

In summary, as we later discuss in some detail, with the latest (2011) set of constitutional amendments and implementing laws, Colombia appears once again to be pursuing what has become the holy trinity of its repeated attempts to get decentralization policy "right":

- To reduce, yet again, the automaticity of the flow of resources to subnational governments (thus adjusting the vertical fiscal imbalance)
- To attempt, once again, to reduce regional divergence by evening out the flow among recipients in some rational way (thus, to at least some extent, reducing the horizontal fiscal imbalance—although, in general, Colombian policy has not focused on this objective, as discussed further below)
- To attempt to earmark and control how the funds are spent essentially by adding still more conditions, approvals, and obstacles that subnational governments have to satisfy before they can spend national money—or even, to some extent, their own.

Colombia thus continues to pursue the understandably elusive goal of decentralizing expenditures without letting those who receive the money have much freedom with respect to how it is spent. Or, to put it another way, the goal of decentralization in Colombia in recent decades seems increasingly to have become what might perhaps be called “decentralization without decentralizing.”

### The Way Forward

To some extent, Colombia’s extensive and frequently changed fiscal decentralization efforts, including the policies announced in 2011, arguably reflect some continuing degree of incoherence in the central government’s decentralization policy. Essentially, what Colombia has done over the last few decades is increasingly to decentralize the administration of a number of key functions— education, health, roads, water and sanitation—to subnational governments. Over this period, those governments, especially in the bigger cities, faced substantial problems not only because they had to accommodate the infrastructure and local service needs of a population expanded by the usual urban migrants “pulled” by urban growth, but also because millions of additional migrants were being “pushed” out of rural areas by widespread violence.

Although substantial transfers have gone to the traditional departments and municipalities to finance these activities, and these governments have attained more political legitimacy with the election of governors and mayors, they have received no additional revenue-raising powers, very little assistance in terms of capacity building, and a flood of changing and not always consistent directions from the central government—directions that have reflected primarily macroeconomic concerns on one hand, and responses to problems in particular regions and areas on the other.<sup>9</sup> For example, for many years the primary concern with respect to education was to ensure that teachers were paid in a timely fashion, although recently more attention has, in line with the general trend toward more “results-oriented” transfers, been paid to ensuring that students

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<sup>9</sup> Although a considerable amount has been spent over the years by both the central government and international organizations with the aim of increasing subnational capacity, with much of the money flowing through the National School of Public Administration (*Escuela Nacional de Administración Pública*), it does not seem unfair to say that, for the most part, this substantial effort appears to have been directed more to “teaching the rules”—explaining to local governments the ever changing national laws and regulations affecting them—than to improving subnational government performance.

actually get an education. Inevitably, perhaps, this change in orientation has been accompanied by an increased degree of central monitoring and control over decentralized functions.

All these factors have influenced the continued changes in decentralization policy over the last decade, culminating in the measures introduced in 2011 that will, in turn, shape developments in the next decade. As discussed in this chapter, viewed from the perspective of experience with fiscal decentralization around the world, these measures seem unlikely to resolve the substantial challenges continuing to face decentralization in Colombia and may prove to be little better than the past substantial fiscal and political decentralization in terms of improving outcomes in much of the country. The point is not that decentralization has failed in Colombia; on the contrary, in some instances, as noted elsewhere in this chapter, it has clearly led to better results than the previous, more centralized, approach. To do better along these lines, however, Colombia needs both a more adequate institutional structure at the national and subnational levels and a more coherent decentralization policy—a policy that, among other things, pays more attention to developing local revenue sources on one hand and to developing both central and local management capacity on the other—if it is to see better results in the future than it has in the past.

Alternatively, if, as some developments in recent years suggest, Colombia has now chosen to replace its bold attempt to devolve substantial fiscal, administrative, and political responsibility for service provision to its subnational governments by a much more centralized approach to delegated expenditure decentralization, it still faces a serious challenge in developing an adequate and sustainable system to manage and coordinate policy in a diverse and sometimes unruly environment. We return to this point later.

### Emerging Problems

As studies such as Fiszbein (1997) and Faguet and Sanchez (2007, 2009) have shown, the major shift in decentralization policy launched by the 1991 constitutional reform undoubtedly improved service coverage in some respects in some areas. On the whole, however, most political attention over the last two decades has been directed to resolving a number of important problems that many attributed to the unbalanced attribution of new spending powers to untried and unready regional and local governments unconstrained by much pressure to raise their own revenues.

In particular, four criticisms have frequently been made of the post-1991 decentralization:

- That inadequate own tax effort (*pereza fiscal*, fiscal laziness) was a common subnational response to increased transfers
- That, particularly in the first decade after the 1991 reform, some of the macroeconomic difficulties encountered by the central government were attributable to the considerable share of revenue devoted to transfers
- That many of the funds distributed to the regional and local governments were not only being badly spent but also often stolen as a result of increasing corruption
- That, owing largely to the growing importance of royalties, the overall distribution of transfers to subnational governments was both unbalanced and undesirable.

Although the first two of these criticisms were politically influential, they do not appear to be particularly well founded. Although accusations of fiscal laziness on the part of many municipal and departmental governments were common, and some studies (such as Chaparro, Smart, and Zapata 2005) provide some supporting evidence, the task of assessing tax effort is not simple, and different conclusions have emerged from different studies. Although no formal “meta-study” has been carried out, a recent, balanced assessment of the evidence concludes that, despite the many empirical studies carried out over the years in search of support for the hypothesis that the subnational tax effort has been adversely affected by increased transfers in Colombia, the evidence that local fiscal laziness has been a widespread, let alone pervasive, problem is far from persuasive (Vargas 2010).<sup>10</sup>

Much the same may be said with respect to the argument that the 1991 decentralization unduly exacerbated Colombia’s problems in managing the fiscal deficit at the national level by altering the intergovernmental distribution of fiscal and macro risks in an unbalanced way (for example, Echeverry 1999). The indisputable existence of such problems in such decentralized countries as Argentina in the 1990s may have heightened sensitivities to this issue, and Colombia certainly encountered some fiscal difficulties in this period (Dillinger, Perry, and Webb 2003). However, the numbers suggest that these problems arose less from runaway subnational spending than from the effects of the almost simultaneous deterioration in the security situation combined with the difficulties the central government had in reducing national expenditure, even on functions like education and health, which had presumably been largely transferred to the subnational sector (Acosta and Bird 2005).

Unfortunately, although the extensive theoretical and empirical argument about the relation between decentralization and corruption is far from settled (see Martinez-Vazquez, Arze de Granado, and Boex 2007), there is no reason to doubt that the frequent reports in the Colombian press of subnational waste and corruption often reflected reality. In addition, at times a significant number of local governments in some regions have been in effect “captured” by illegal groups (International Crisis Group 2011). At least five factors support the argument that many transfers to subnational governments have been badly spent.

First, since the extensive expenditure decentralization was never supported by a significant and sustained effort to improve local capacities, many departments and municipalities were probably simply unable to spend the money or to control their finances properly. This problem has been dealt with over the last decade to a considerable extent by the development of an elaborate central oversight system through the Fiscal Support Agency (*Dirección General de Apoyo Fiscal*, DAF) of the Ministry of Finance and the DNP.

Second, owing in part to the fact that the new transfer system was not accompanied by an equally new (and better) subnational revenue system and that the transfer system itself is not really properly designed to encourage adequate local fiscal effort (Bird and Smart 2002), it

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<sup>10</sup> In addition to the six studies of subnational response to transfers reviewed by Vargas (2010), at least nine other empirical studies—two involving the present author—were carried out in the last three decades (World Bank 2009) with similarly conflicting and inconclusive results. Those seeking simple answers to complex questions in a heterogeneous environment seldom find one.

seems likely that even those recipients capable of spending the money well had little incentive to do so—although, as always, good leadership in some instances triumphed over circumstances to produce better-than-average results.

Third, although the amounts involved were small, for some years, especially during the 1990s, the national government regularly delivered transfers to a significant number of small rural municipalities that were largely or totally controlled by guerrilla or paramilitary forces, presumably because there were considered to be good political or social reasons for doing so. Since such recipients never submitted any accounting of what was done with the funds, it seems unlikely they were put to their intended use. Over the last decade, however, these problems have been substantially reduced and all municipalities now appear to be reporting.

Fourth, the prolonged commodity boom of recent decades resulted in a number of the most sparsely populated regions of the country—some of which were again only loosely, if at all, under national control—receiving increasingly huge royalty income, mainly from oil and coal (box 2). Perhaps unsurprisingly, it appears that much of this income was apparently often spent in ways that were neither nationally nor locally particularly beneficial as Perry and Olivera (2009) discuss. Too much revenue too easily obtained can be as much of a “curse” at the subnational level as at the national level (Collier and Hoeffler 2005).

Fifth, the General Revenue-Sharing System (*Sistema General de Participaciones*, SGP) introduced in 2000, although it distributes funds on a much more equal per capita basis than royalties (Table 4), on the whole did little to redistribute income regionally or to rectify the basic regional inequalities evident in Colombia. Moreover, although most royalty income went to poorer departments, far too much went to too few for the resulting distribution (Table 4) to be considered by many to be fair.

## **Box 2**

### **Royalties (as of 2011), Colombia**

#### **Royalty Rates**

**Oil and other hydrocarbons:** 8 percent for production less than 5,000 barrels per day (KBPD), increasing by 0.1 percent for production greater than 5 KBPD up to 20 percent at 125 KBPD, then to a maximum of 25 percent for greater than 600 KBPD.

**Coal:** 5 percent for less than 3 million tons and 10 percent on greater than 3 million tons.

**Other minerals:** At various rates ranging from 1 percent on limestone and construction materials, 5 percent on nickel, 4 percent on iron and copper, 6 percent on gold and silver, up to 10 percent for radioactive minerals, and 12 percent for salt.

#### **Distribution of Royalties**

##### **Hydrocarbons**

Producing department (47.5 percent, but 52 percent if production is less than 10,000 barrels)  
 Producing municipality (12.5 percent, 32 percent if less than 10,000 barrels, with next 10,000 at 25 percent)  
 Port municipality (8.0 percent)  
 National Royalty Fund (32.0 percent [8.0 percent if less than 10,000 barrels, with next 10,000 at 19.5 percent]).

##### **Coal**

Producing department (42 percent, but 45 percent if less than 3 million tons)  
 Producing municipality (32 percent, but 45 percent if less than 3 million tons)  
 Port municipality (10 percent)  
 National Royalty Fund (16 percent if more than 3 million tons).

**Other minerals:** Shares vary for producing department from 55 percent for nickel to 10 percent for gold, silver, and platinum, for producing municipality from 37 percent for nickel to 87 percent for the precious metals, and for the National Royalties Fund from 3 percent for precious metals to 15 percent for salt and radioactive minerals.

### **Policy Responses**

The four common criticisms of the post-1990 decentralization mentioned above have led to a number of attempted “fixes” to the transfer system over the last decade. On the macroeconomic level, Colombia followed a number of other countries in introducing fiscal rules aimed at controlling subnational indebtedness. In addition, a number of changes were introduced in the SGP to tighten national control over how the money was spent, including the introduction of the extensive monitoring system mentioned above. Some changes were also considered in the revenue-raising powers of subnational governments, although in fact none have really been made. Finally, and most recently, a new system for distributing royalties is being introduced.

### ***Fiscal Rules***

Fiscal rules and fiscal responsibility laws are in vogue throughout Latin America, and Colombia was the second country, after Brazil, to introduce such a law (Liu and Webb 2011).<sup>11</sup> To some extent, these rules and laws have been aimed more at the perceived excesses of subnational rather than national governments. Unsurprisingly in view of the rapid rise of transfers—from only 13 percent of national current revenues in 1973 to 49 percent in 2000, with the rate of increase being particularly rapid after the 1991 constitutional amendment (MHCP 2009)—many in Colombia argued that the fiscal pressure affecting national macroeconomic stability in the late 1990s arose in large part from a combination of excessive transfers to subnational governments, inadequate fiscal effort by those governments, and their excessive recourse to borrowing (MHCP 2009).

Given this diagnosis, the solution seems simple: reduce the level of transfers and restrict their misuse by subnational governments while simultaneously exhorting them to try harder and restricting their access to borrowing. The extent to which macroeconomic imbalance can be attributed mainly to the actions of subnational governments may be arguable in some respects.<sup>12</sup> Nonetheless, Colombia has at one time or another and to varying degrees pursued all of these corrective avenues.<sup>13</sup>

A first reaction to the growing concerns about uncontrolled subnational borrowing was the so-called “traffic light” law (Law 358 of 1997), which provided a rating system for subnational governments based on the ratios of interest to budgetary current account savings and debt to current revenues. This law was rather loosely applied, however, so that a new “bankruptcy” law (Law 550 of 1999) was soon introduced with the idea of restructuring debt in order to secure service delivery when subnational governments fell into financial difficulties. The principal way this was to be done was by imposing tighter controls on resource allocation, in part through still more earmarking aimed at making it even more difficult to use transfers to pay for general administration (*gastos de funcionamiento*). Such fiscal adjustment programs have in fact been applied to 10 (mostly small) departments and over 60 (some not so small) municipalities (MHCP 2011a).

However, it appears that these efforts were not considered enough, since Law 617 of 2001—the implementing law for the 2001 constitutional amendment discussed next—explicitly imposed new limits on administrative expenditure on all subnational governments and established a new adjustment package intended to facilitate debt service and repayment. This law established four

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<sup>11</sup> The most recent statement of the “fiscal rule” governing the national government (in Law 1473 of 2011) specifies that the structural deficit must be decreased to not more than 2.3 percent by 2014, with further decreases to 1.9 percent in 2018 and 1.0 percent in 2022.

<sup>12</sup> As World Bank (2009) correctly notes, it might be more sensible to locate the imbalance problem in the relatively weak party system in Congress, which permits and encourages excessive “regionalism” in national legislation. From this perspective, much of Colombia’s recent decentralization history may perhaps best be understood as reflecting the waxing and waning of regional rather than national factors in determining national legislative outcomes during three decades of substantial economic change and political uncertainty. For interesting perspectives on the political economy aspects of Colombian fiscal policy, see Alesina (2002).

<sup>13</sup> For a detailed discussion of all the measures mentioned here (and others), see MHCP (2009); a briefer account may be found in World Bank (2009).

categories of departments and six categories of municipalities in terms of “freely disposable revenue” (essentially, current revenue after excluding transfers and earmarked revenues) (see Box 3). Finally, Law 819 of 2003 introduced a new medium-term budgetary framework system for subnational governments, coupled with new budgetary management and transparency rules, including mandatory credit risk analysis before borrowing.

### **Box 3** **Categories of Departments and Municipalities (Law 617), Colombia**

#### **Departments**

Five categories of departments are established, in terms of population and the size of current non earmarked income, as follows:

Special: Population over 2,000,000 and income over 600,000 monthly legal minimum wages (LMWs)

Category 1: Population of 700,001 to 2,000,000 and income of 170,001 to 600,000 LMWs

Category 2: Population of 390,001 to 700,000 and income of 122,001 to 170,000 LMWs

Category 3: Population of 100,001 to 390,000 and income of 60,001 to 122,000 LMWs

Category 4: Population of 100,000 or less and income of less than 60,000 LMWs.

The critical criterion is really the level of “free” current income: if a department’s income exceeds that in its population category, it is classified in the next-higher category, while if its income is less than that for its category, it is classified in the category encompassing that level of income.

To give this categorization teeth, the salaries of members of the departmental assemblies are tied to these categories: those in the “special” category receive 30 LMWs, while those in Category 1 receive 26 LMWs, those in Category 2 receive 25 LMWs, and those in Categories 3 and 4 receive only 18 LMWs. In addition, the maximum level of current expenditure (*gastos de funcionamiento*) is set at 50 percent of “free” current income for departments in the Special category, 55 percent for Category 1, 60 percent for Category 2, and 70 percent for Categories 3 and 4. Any department that exceeds these limits is reclassified in the next-lower category, the salaries of members of the departmental assembly are reduced to the level of those in Category 4, additional limits are imposed on expenditures on nonsalary expenditures of departmental assemblies and on the expenditures of department comptrollers (*contralorias*), and the department has to adopt a plan approved by the Ministry of Finance (DAF) to restore its “fiscal health.”

As table B1 shows, unsurprisingly, the bigger departments in terms of revenue differ in some important respects from those in the lowest categories.

**Table B1 Comparison of Revenues among  
Categories of Departments in Colombia**

<b>Category</b>	<b>As % of Total Revenue</b>	<b>Own-Source Revenues (as % of total revenue)</b>	<b>Operating Expenditures (as % of total Expenditure)</b>
Special	48	47	27
1	16	23	16
2	21	21	12
3	10	15	9
4	6	10	16

*Source:* Author’s calculations using MHCP 2011a data.

## **Municipalities**

Similarly, seven categories of districts and municipalities are established, as follows, with the limits set for current expenditure as a proportion of free current income shown in parentheses:

- Special category: Population over 500,000 and income over 400,000 LMWs (50 percent)
- Category 1: Population 100,001 to 500,000 and income of 100,001 to 400,000 LMWs (65 percent)
- Category 2: Population 50,001 to 100,000 and income of 50,001 to 100,000 LMWs (70 percent)
- Category 3: Population 30,001 to 50,000 and income of 30,001 to 50,000 LMWs (70 percent)
- Category 4: Population 20,001 to 30,000 and income of 25,001 to 30,000 LMWs (80 percent)
- Category 5: Population 10,001 to 20,000 and income of 15,001 to 25,000 LMWs (80 percent)
- Category 6: Population 10,000 or less and income of 15,000 or less LMWs (80 percent)

As in the case of the departments, additional limits are placed on the proportion of free current income that can be spent on both the salaries of local officials and on the extent to which “free” funds can be spent on municipal and district councils, treasuries, and comptrollers, and local governments are required to meet these limits subject to Ministry of Finance supervision.

In 2005, when 49 percent of the population lived in the 26 municipalities with populations of over 200,000, 33 percent still lived in the over 1,000 municipalities with populations of less than 50,000 (Categories 3 to 6, inclusive) (González Salas 2011). As table 3.5 shows, revenue was even more concentrated, with only 19 percent of local taxes going to these smaller municipalities, and over 60 percent going to the five largest cities.

The conclusion in World Bank (2009) that the effect of all these measures up to 2005 was some improvement in subnational fiscal balances is generally confirmed for municipalities by data for 2002–09, which show that the sector ran a surplus (0.20 percent of GDP) compared to its deficit of 0.65 percent in 1997–2001.<sup>14</sup> This turnaround was attributable, in part, to a reduction in the rate of growth of expenditure, which rose only from 5.7 percent to 5.9 percent of GDP over the more recent period, while administrative expenditure actually declined by about 25 percent as a share of GDP. More important, however, municipal revenues rose substantially from 5.0 percent of GDP in 2000 to 6.1 percent in 2009. Although much of this increase was attributable to the expansion of the general revenue transfer (SGP), one-third of it came from an increase in municipal taxation, particularly from the local business tax.

Although the fiscal structure of different groups of municipalities is sharply different (Table 5), interestingly, much the same trends were apparent in all groups of municipalities, ranging from Bogotá to the smallest rural localities. Trends at the departmental level, however, were quite different, since the fiscal balance continued to deteriorate during 2003–08, although for the most part this deterioration primarily reflected the decline in transfers. Like at the municipal level, departmental expenditures declined, with the reduction again being particularly marked with respect to administrative expenditures. Law 617 thus appears to have succeeded to some degree in achieving its financial objectives.

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<sup>14</sup> The data reported were obtained from the Ministry of Finance (MHCP) in July 2011. Much the same story is told in more detail for a slightly different period in MHCP (2009). Incidentally, it is important in interpreting Colombian fiscal data (and legislation) to understand that “investment” is defined in very broad terms; in particular, payments for teachers and health personnel are defined as “social investment” rather than current expenditure.

**Table 5**  
**Municipal Revenue Structure by Category, Colombia, 2007**

Category	Number	Share of Current Revenue (%)	Share of Taxes (%)
<b>Special</b>	5	60.3	61.4
<b>1</b>	15	11.5	13.3
<b>2</b>	17	5.2	6.0
<b>3</b>	17	2.9	3.5
<b>4</b>	21	1.3	1.3
<b>5</b>	29	2.6	2.8
<b>6</b>	986	16.2	11.7

Source: González Salas 2011.

### *Revising the SGP*

Bird and Fiszbein (1998) suggested that many of the problems attributed to the post-1991 system reflected avoidable design errors in the transfer system.<sup>15</sup> However, the national government's reactions focused not on reshaping the incentives created by the transfer system but rather on cutting back on the flow of transfers and on tightening up the (already detailed) controls over subnational spending. The first important change made to reduce the burden of transfers on the national budget was taken in 2001, when a constitutional amendment was implemented through several new laws that substantially reformed the transfer system in a number of ways, changing not only the level and distribution of transfers but also the conditions under which they could be spent.

As noted earlier, a new general-revenue sharing system, the SGP, was established to replace the previous separate transfers to the departments for education and health and the transfers to municipalities. Under the SGP, the total amount to be distributed was initially set at the 2000 level (as a percent of GDP) of the previous general transfers. Subsequently, this share was to be increased annually by 2 percent in real terms until 2005 and then by 2.5 percent up to 2008, at which time the pre-2001 system was supposed to come into force again. The principal objective of this amendment was to break the previous rigid link between national revenues and transfers.

As Box 4 shows, over half of the SGP was allocated to departments (and some larger municipalities “certified” to carry out these functions)<sup>16</sup> largely on the basis of the cost of

<sup>15</sup> Bird and Fiszbein (1998) suggested that the pressures felt at the central level in the 1990s were attributable not so much to the increase in transfers per se as to the failure of the national government to decrease its own expenditures on the transferred functions sufficiently to offset the impact on the budget of the increased transfers. Something similar may also have happened in the early 2000s, although the increases in central expenditure in that period were probably more related to the (largely successful) desire to improve the security situation in part by increasing the national government's presence in large parts of the country that had, over the previous decade, come under the control of guerilla and paramilitary groups.

<sup>16</sup> The certification system—in effect, an ex-ante approach to assessing capacity—was established in 1991 with each sector (education, health, and water and sanitation) having its own requirements, and municipal certification being determined jointly by the departmental planning offices and the relevant sector ministries. Over time, however, the working of the political process resulted in almost everyone being certified. At present, the main role of this system

financing primary and secondary education (mainly teachers' salaries, which were set by the central Ministry of Education). In addition, largely in response to a long-standing problem in financing teachers' pensions, a new National Territorial Pensions Fund (Fondo Nacional de Pensiones Territoriales, FONPET) was set up with about another 3 percent of SGP revenues being explicitly earmarked to pay the pensions of subnational employees. Finally, about 25 percent of the SGP was allocated to the public health sector, which had been substantially restructured with expanded coverage beginning in the mid-1990s (Glassman et al. 2009; Salazar 2011). As with the education transfer, although most of these funds passed through the budgets of the departments (and some larger municipalities), they were not really managed or controlled by these subnational governments to any significant extent.

**Box 4**  
**The Colombian SGP Distribution System since 2007**  
 (share as percent of total)

**Special allocations:** 4 percent of total SGP:

- FONPET: 2.90 percent
- School meals: 0.50 percent (95 percent based on enrolment weighted by population dispersion and the Index of Basic Needs [*indice de necesidades básicas insatisfechas*, NBI]; 5 percent for effort in reducing drop-out rate)
- Indigenous reserves: 0.52 percent (based on proportion of indigenous population in municipality)
- Municipalities bordering the Magdalena River: 0.08 percent (based on proportion of area that is part of the municipality).

**Sectorial allocations:** 96 percent of total SGP:

- Education: 58.5 percent of 96 percent = 56.2 percent of total. In 2008, 53.4 percent of this amount went to the departments and 46.6 percent went to the municipalities<sup>a</sup>
- Health: 24.5 percent of 96 percent = 23.5 percent of total. In 2008, 28.7 percent of this amount went to departments and 71.3 percent went to municipalities<sup>b</sup>
- Water and sanitation: 5.4 percent of 96 percent = 5.2 percent (85 percent to departments and 15 percent to municipalities)<sup>c</sup>
- General purposes: 1.6 percent of 96 percent = 11.1 percent of total. All to municipalities, but 60 percent is earmarked to water and sanitation, sports, and other activities.<sup>d</sup>

**Note:** a. This share has six components: (1) per enrolled student, based on the average cost of providing service in a public school in the territorial unit as determined by a complicated procedure (only 1 percent of this amount can be spent on administrative costs); (2) complement, or additional resources to finance the gap between the amount allocated by the previous component and the payroll; (3) cancellations, which goes to certain departmental pension funds covering employees who were nationalized in 1975; (4) coverage increase, to cover the increase in enrolment over the previous year (no penalty if a decrease); (5) special costs, to cover debt incurred in standardizing administrations in certain departments; and (6) quality, to cover nonwage expenditures and distributed to all municipalities and distributed by the number of enrolled students adjusted by the ratio of the NBI to the national NBI.

b. This share has three components: (1) demand subsidies (100 percent to municipality) allocated by percent uninsured poor weight by municipal share of uninsured relative to total national uninsured; (2) public health (45 percent to departments, 55 percent to municipalities) allocated by population, a weighting

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is to permit the decertification of those territorial entities with obvious capacity problems, which are, as noted elsewhere, being increasingly assessed on the basis of an ex-post assessment of service results.

factor of poverty level and public health risk, and attainment of immunization coverage; (3) supply subsidies (59 percent to departments; 41 percent to certified municipalities; if uncertified, 100 percent to department) allocated by uninsured poor population adjusted for population dispersion and a weighting factor based on cost of services not covered by subsidized health plan.

c. This portion is allocated among municipalities taking into account the following factors: (1) the coverage deficit; (2) the nature of the population served; and (3) the increase in coverage, poverty, and the efficiency of the sectorial administration.

d. This portion is allocated among municipalities as follows: (1) 40 percent on NBI, 40 percent on proportion of urban and rural population, (2) 10 percent on fiscal efficiency, and (3) 10 percent on administrative efficiency. For municipalities in Categories 1 through 3, 41 percent of the “general purpose” portion of the SGP must be allocated to basic water and sewerage, while those in Categories 4 through 6 must allocate 41 percent of 72 percent (that is, 29.5 percent) of their “general purpose” funds to this sector.

As Acosta and Bird (2005) argue, despite what a first glance at the data on the growing importance of subnational expenditure in Colombia may suggest, there is not and never has been a serious fiscal or decentralization crisis at the departmental level.<sup>17</sup> Both education and health are nationally controlled and nationally financed services that are administered by subnational governments. These important functions have clearly been decentralized in some ways, but in no significant sense have they been “devolved” to lower levels of government. Departmental and some larger municipalities are responsible for operating their school systems, but they do so under detailed rules established, monitored, and controlled by the national Ministry of Education and with funding largely provided, monitored, and controlled by the national Ministry of Finance. Although the operation of the health system has effectively been decentralized to decentralized agencies to a much greater degree than has education, and is substantially financed by (nationally earmarked) departmental revenues (Box 1), it, too, is best thought of as essentially a national system with the principal responsibility remaining squarely with the national Ministry of Health (and, again, the Ministry of Finance). Departments may appear to be much more important spenders (about 4.5 percent of GDP) than municipalities (3.5 percent), but at least 75 percent of recorded departmental spending is in effect controlled and directed by the central government.

In contrast, the remaining—and much smaller part—of SGP funds was allocated to municipalities for general purposes. As shown in Box 4, the distributive formula for this transfer is largely driven by population on one hand and a measure of poverty (the Index of Basic Needs, NBI) on the other, so that it was obviously intended to direct relatively more funds to poorer areas. Although municipalities are much bigger revenue raisers than departments, most local revenue-raising capacity exists, and most revenues are collected, in the big cities, which are less favored by the transfer formula and hence more dependent on own resources (Table 5). That is, in most of Colombia’s more than 1,100 municipalities, almost all the funds they spend flow from above. During 2002–09, for example, although average municipal income increased by 1.1 percent of GDP compared to the 1997–2001 average (from 5.0 percent to 6.1 percent), almost two-thirds of this increase occurred in the larger cities (and almost half in Bogotá alone). Between these two periods, however, current transfers to the larger cities actually declined

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<sup>17</sup> As noted elsewhere, however, there have certainly been serious management problems in some departments that have received large royalty incomes. As MHCP (2011) shows, in 2010, 11 departments (and about 50 municipalities) were under fiscal adjustment programs as a result of breaching either Law 617 or its predecessor, Law 550 of 1999.

slightly, although “investment” transfers (including “social investment”) increased sufficiently to finance 74 percent of the expenditure increase, with the balance being financed largely by an increase in own revenues (especially in Bogotá). In contrast, since both current transfers and investment transfers as well as royalty transfers increased in the smallest municipalities—those in the three lowest categories (see box 3)—transfers financed 87 percent of the (much smaller) increase in their expenditures.<sup>18</sup>

Given the continuing fiscal pressure at the national level in the early years of this century arising in part from the major and substantially successful effort to control security problems in much of the national territory, it is not surprising that a further constitutional amendment was introduced in 2007 to ensure that the pre-2001 system would not come back into force in 2008 as originally intended. This objective was achieved by establishing a typically complex new formula that set the annual growth rate in real terms of the SGP at 4 percent in 2008 and 2009, 3.5 percent in 2010, and 3 percent until 2016. Thereafter, the SGP would be increased each year at a rate equal to the average growth of current national revenues in the preceding four years. However, the effects of this provision were considerably softened by two additional provisions.

First, the SGP would be augmented by an additional increment earmarked for education, amounting to 1.3 percent of the preceding year’s SGP in 2008 and 2009, with the figure rising to 1.6 percent in 2010 and 1.8 percent from 2011 to 2016. Second, in any year in which real GDP growth—not the growth of national current revenues—exceeded 4 percent, there would be a proportionate increase in SGP, with the additional resources being earmarked for infant care. As World Bank (2009) notes, although this formula guarantees some further relative growth in the size of the SGP, its net effect is, as was its intention, to significantly reduce the budgetary cost of transfers compared to the “do-nothing” scenario under which the pre-2001 formula would have come back into effect. Since the impact of growing transfers on the national budget was restrained but subnational governments continued to be guaranteed an increasing share of the national fiscal pie, perhaps both sides may have considered this outcome a “win-win” situation.

Without delving further into the full complexity of the way in which funds were transferred under the SGP either before or after the 2007 amendment, a few general remarks may suffice to illustrate the current system (Box 4).<sup>19</sup> Like the pre-2007 system, small fixed percentages of the total SGP go to FONPET,<sup>20</sup> to indigenous reserves (for health, education, and other good things), to municipalities in the Magdalena River region (for reforestation and water services), and to—of all things—a school lunch program. The larger part of the SGP, however, 96 percent of the total,

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<sup>18</sup> Calculations based on unpublished data obtained from DAF in July 2011.

<sup>19</sup> This description is based largely on World Bank (2009). The more detailed description below of the new SGR system illustrates many of the same characteristics—special treatment for some regions, earmarking to FONPET, differing treatment of departments and municipalities, and a long list of other supposedly good things to which funds are supposed to flow. For a more detailed account of some of the differences—and complexity—of Colombian fiscal decentralization in particular sectors (health, education, roads, water), see World Bank (2009). To see how little reality has changed in many important respects despite the many changes in fiscal and legal arrangements discussed in the text and the security upheaval in the decade intervening between the two studies, compare the discussion of the health and education sectors (and the briefer treatment of investment in, for example, water, sanitation, and roads) in World Bank (2009) with the similar discussions in World Bank (1996).

<sup>20</sup> As mentioned, this fund is intended to cover the pension liabilities of territorial employees, predominantly in education and health. These liabilities are largely funded from national revenues for reasons that, while historically understandable, are neither particularly persuasive nor logical.

is divided between the departments and the municipalities. The departmental share is entirely earmarked to, in order of importance, education, health, and water and sanitation. Much of the municipal share is similarly earmarked to the same services. However, municipalities also receive about 11 percent of their share for “general purposes” (*de libre disposición*)—although in fact about 60 percent of this amount is also earmarked, so that in total less than 5 percent of SGP funds can be spent freely by municipalities.

The small municipal general purpose share is distributed in accordance with a redistributive formula intended to give more to more rural and lower-income (as measured by the NBI) municipalities. On balance, however, it does not seem inaccurate to say that, combining the departmental and municipal shares on a departmental basis, the SGP has, over time, been distributed surprisingly evenly on a per capita basis (table 4). Finally, a new and important feature of the 2007 constitutional reforms in the SGP (Decree 028), however, authorizes the central government to suspend (intercept) revenue sharing and even to assume the management of subnational governments that are judged not to perform adequately. This additional authority, although simply an extension of the tendencies already evident in Law 550 of 1999 and Law 617 of 2001 would appear, if exercised to the full, to move decentralization in Colombia even further in the direction of delegation rather than devolution.

### ***Revising Subnational Revenues***

As mentioned, following an early report (Misión 1981), some efforts were made to strengthen municipal revenues, in particular through Law 14 of 1983. Thereafter, however, not much was done at the national level until the 2008 report of a commission on departmental finance (Comisión 2008). In the end, however, that report recommended only relatively minor changes in the existing (weak) departmental revenue system (see box 5), and no actions have yet been taken to implement them. In short, both departments and municipalities still have essentially only the taxing powers—and, hence, own-source revenues for which they are politically responsible to their constituents—that they had 40 years ago.

#### **Box 5**

#### **Recommendations of the Colombian Commission on Departmental Taxes, 2008**

- Eliminate the concept of “ceding” national taxes (for example, on alcohol and tobacco)
- Establish a new departmental tax code defining tax bases and establishing ranges of rates
- Tax vehicles not only on value but also on engine size
- Replace the present gasoline surcharge by a specific indexed tax, unify the surcharges on gasoline and diesel at the same level, and give all proceeds (not just 50 percent) to departments
- Over time, unify the present taxation of cigarettes at the highest existing rate
- Unify the tax rates on the alcohol content of liquor and beer and convert to a specific indexed tax and apply an additional graduated ad-valorem tax to higher-priced liquors
- Update the cadastral values of real property (the base of the registry tax)
- Replace the antique tax on animal slaughter (which departments have ceded to municipalities) by a tax on nonalcoholic beverages.

*Source:* Comisión 2008.

Departments have few real “own” taxes other than those on tobacco and vehicle ownership, and even then the rates are set nationally (Box 1). Most other departmental taxes are either really national taxes (for example, on diesel fuel) or are, by national law, not really within departmental control in the sense that all or a significant fraction of their proceeds are earmarked to specific sectors. For example, much of the revenue from excises on alcohol (as well as lottery revenue) goes mainly to the health sector. Even tobacco tax revenues are earmarked in part (16 percent) to sports. In contrast, most municipal own revenues come from a property tax over which municipalities (particularly the big cities) have much more control, including some over rates (Box 1).

Although 94 percent of Colombian municipalities have done little to update the property tax base and impose very low rates, with the result that they remain almost completely dependent on transfers,<sup>21</sup> despite the absence of any clear national policy or effort to support local revenues, Bogotá and some other cities have done a considerable amount to help themselves, by both improving and strengthening their property tax systems through updating the cadastre and enforcing the tax more effectively (Acosta and Bird 2005). In addition, the larger cities have also obtained substantial revenue from the more elastic base provided by the rather antiquated local business tax on gross receipts (*industria y comercio*). On the whole, however, as the next section discusses, both municipal and departmental revenues can and should be improved in a number of respects.

### ***Reforming Royalties***

In contrast to the SGP, the large and growing amount of royalties distributed to subnational governments has, for the most part, been very unequally distributed (Table 4). The royalty rate structure is complex, with different rates ranging from 1 percent of the value of production on construction materials to up to 25 percent on oil when production exceeds 600,000 barrels a day (box 2). During 1994–2009, 82 percent of royalties came from oil and 12 percent from coal (Hernandez 2011). Most public discussion of royalties in Colombia has focused on how to distribute and control royalties rather than on the logically prior question of whether the basic royalties structure is the best possible and is administered properly.

Since 1994, in principle up to 32 percent of royalties could be directed to the National Royalty Fund. In practice, however, between 1994 and 2009, 79 percent of all royalties went directly to the “producing” departments and municipalities with shares varying with both the resource and (for coal and oil) the amount of production (Hernandez 2011). About 60 percent of these direct royalties went to the departments, with the balance going mainly to municipalities. The remaining royalties—“indirect” royalties—were divided among all departments. The result of this system was that four small departments, with less than 5 percent of total population, accounted for over 55 percent of all royalties during 1994–2009 (Table 4). “Direct” royalties were earmarked to FONPET and (rather loosely in many cases) to such good things as education, health, water and sanitation, and projects dealing with infant mortality and intended to help the

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<sup>21</sup> Information obtained from the DAF in July 2011.

poor.<sup>22</sup> A study by the Comptroller-General (Contraloría 2006) concluded that not only was the distribution of royalties highly inequitable, but the revenue was not well spent. In addition, World Bank (2009) provides evidence suggesting that in most producing regions, the growing royalty transfers appear to have discouraged local tax effort.

This system is about to be drastically changed. On July 18, 2011, an important constitutional amendment to the treatment of nonrenewable resource royalties came into effect. This section first outlines what this important—and exceptionally detailed—constitutional amendment appears to do. At the time of writing, however, since the law required to implement this amendment was still being drafted, some details of the proposed new General Royalty System (*Sistema General de Regalías*, SGR), including the structure and functioning of the new National Royalty Agency (*Agencia Nacional de Regalías*, ANR), to be created within the National Planning Department, were not entirely clear and may be subject to change in the near future.<sup>23</sup>

Not only are all royalties from nonrenewable resource royalties to flow through the new SGR, but the revised constitution specifies in great detail how they are to be used. Specifically, the amendment states that SGR revenues can be used for only the following purposes:

- Financing projects in territorial entities (the departments, municipalities, and districts)
- Pensions for territorial employees (FONPET)
- Physical investment in education
- Investment in science, technology, and innovation
- Public sector saving
- Oversight, inspection, and audit (*fiscalización*) of exploration, exploitation, and geological survey
- To increase the general competitiveness of the economy in order to improve the social conditions of the population.

While the last item in this list might appear to open the door rather widely, in reality this list has little impact on how funds are distributed or how they may be spent. Like many other parts of the new law, it is perhaps best interpreted as simply reflecting some of the language emerging from the long political debate prior to the adoption of the amendment. The real meat of the new system lies in the detailed prescription of (a) how the royalty pot is to be divided, and (b) what the recipients can do with the money.

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<sup>22</sup> The degree of control exercised over this spending depends to a considerable extent on whether subnational governments comply with certain “minimum” requirements. If a department does not meet specified coverage ratios, it must allocate at least 60 percent of its royalty funds to doing so, with at least 1 percent of this amount for investment in food security and nutrition; similarly, at least 30 percent of royalty funds must go to other priority sectors within departmental and municipal plans, with at least 50 percent of this amount going to priority projects in municipalities that do not receive direct royalties themselves. Municipalities that do receive such royalties but have not achieved coverage targets must spend 75 percent of their royalties on doing so and 15 percent on other priority projects in their plans. Conditionality is reduced for those jurisdictions that have achieved coverage targets; all they have to do is to spend 90 percent of the funds received on planned priority projects.

<sup>23</sup> Note, however, that if the implementing law is not passed by congress prior to the scheduled date (January 1, 2012), when the SGR is to begin to operate, under special constitutional provisions the draft law (on which this section is largely based) will come into effect.

*Splitting up the Pot*

The amendment to the constitution abolishes the existing National Royalty Fund and replaces it with four new funds (Table 6):

- The Savings and Stabilization Fund (Fondo de Ahorro y Estabilización)<sup>24</sup>
- The Regional Compensation Fund (Fondo de Compensación Regional)
- The Regional Development Fund (Fondo de Desarrollo Regional)
- The Science, Technology and Innovation Fund (Fondo de Ciencias, Tecnología y Innovación).

The Innovation Fund is to receive 10 percent of SGR revenues (although, as discussed later, this does not mean it really gets 10 percent). The full complexity of the royalty allocation structure under the new law is set out in more detail in Box 6.

**Table 6**  
**Estimated SGR Distribution, Colombia, 2012–20**  
(billions of pesos)

Item	2012	2012 as % of Total	2012–20	2012–20 as % of Total
Total	9,180	100.0	94,811	100.0
Oversight, inspection, and audit	184	2.0	1896	2.0
Administration	46	0.5	474	0.5
Direct to producers	3,133	34.1	14,054	14.8
FONPET	895	9.75	9,244	9.75
Science, Technology, and Innovation Fund	895	9.75	9,244	9.75
Savings and Stabilization Fund	1,790	19.5	24,728	26.1
Regional Development Fund	895	9.75	14,068	14.8
Regional Compensation Fund	1,343	14.6	21,102	22.3

*Source:* Calculated from preliminary estimates by Departamento Nacional de Planeación as of July 2011.

*Note:* SGR = General Royalty System.

<sup>24</sup> Confusingly, the Stabilization Fund to which SGR resources are to flow is not the same as the somewhat similarly named Fondo de Ahorro y Estabilización Fiscal y Macroeconómica (as recently modified by Law 1473 of 2011), to which part of national general revenues are supposed to flow, although both funds are to be maintained and operated by the central bank.

### **Box 6** **The New Royalty Allocation System**

As mentioned in the text, FONPET is to receive 10 percent of SGR revenues—an amount which is not really 10 percent, for the reasons discussed below. Although it has been traditional to earmark certain national transfers to this fund, the rationale for earmarking resources from a particularly volatile revenue source like royalties to a peculiarly stable expenditure need like pensions remains unclear. In addition, 2 percent of SGR revenues are to be set aside for *fiscalización*. The following important points should be noted about this allocation.

First, since this function is to be undertaken by the Ministry of Mines and Energy, all or at least some—perhaps half—of this amount will go to the budget of that ministry (although it is not clear if it will be included in the general national budget, for reasons discussed later).

Second, since the amendment specifically states that this 2 percent is to be taken “off the top” of SGR distributions, only 98 percent is allocable for other purposes. This means that the 10 percent shares to FONPET and the Innovation Fund are in fact shares of what might be labeled the residual (or the distributable total, DT) of the SGR, and hence amount to only 9.8 percent each of that total. In fact, under the draft implementation law, these shares will be only 9.75 percent of the total because an additional amount of (up to) 0.25 percent of SGR revenues is to go to the new National Royalty Agency (*Agencia Nacional de Regalías*, ANR) to be created within the National Planning Department to cover the costs of the monitoring system discussed below, and another (up to) 0.25 percent to the Fiscal Support Agency (DAF) within the Ministry of Finance to finance the operation (including monitoring) of the SGR.

Third, while no definite share is set for the new royalty Stabilization Fund, the maximum share that can go to this fund is set at 30 percent (of the DT). As table 3.6 shows, however, this figure is far from firm, since the actual share of royalties flowing to the Stabilization Fund depends on a number of factors discussed below.

Fourth, after deducting the shares for FONPET and the Innovation and Stabilization Funds, the balance of the DT is then to be distributed as follows:

- 20 percent goes to those territorial entities that previously received “direct” royalties—essentially those jurisdictions in which natural resources are produced. These departments and municipalities will apparently be able to spend this transfer relatively freely, more or less like under the previous royalty distribution system. If the Stabilization Fund received the maximum 30 percent specified in the law, this share would thus amount to 10 percent of the DT—or the same amount as received by FONPET and the new Innovation Fund.
- Of the remaining balance (24 percent of the DT if 30 percent goes to the Stabilization Fund), 60 percent is to flow to the new Regional Compensation Fund and the remaining 40 percent to the new Development Fund.

This allocation is complex. In addition, it is subject to change over time in several ways:

- The sum of the direct share of the Compensation Fund and the Development Fund is to increase annually at one-half the rate of growth of total SGR resources.
- As time goes on, the difference between total SGR resources and the sum of the shares going to the Development Fund, the Compensation Fund, FONPET, and the direct recipients is to go to the Stabilization Fund. This important provision is clearly intended to increase the extent of national control over SGR resources over time, subject of course to the 30 percent maximum noted above. However, if the share of the Stabilization Fund exceeds 30 percent, the excess is to be distributed to the other recipients in accordance with the formula presented above.
- There is also an important transitory provision that further weakens the stabilization aspect of the SGR. In the first year (2012) of the SGR—when distributions will be based on SGR revenues in 2011—not only is the Stabilization Fund’s share of SGR revenues fixed at a maximum of 25 percent (of the DT), but it is further provided that 20 percent of this amount will go to the direct

recipients—the territorial entities receiving royalties under the previous system—for 2012, 2013, and 2014.

- Moreover, as yet another buffer for the current royalty recipients, an additional transitory provision requires that in the first year of the SGR, 50 percent of the total of the direct resources plus those of the Compensation Fund and Development Fund will go into the direct pool, with this percentage being reduced to 35 percent in 2013 and 25 percent in 2014.
- In a final “hold-harmless” provision, the new law also provides that if the revenues thus allocated to the direct recipients are below the average received (in constant 2010 pesos) for 2007–10, the direct recipients may use the resources allocated to them through the Compensation Fund and Development Fund—as discussed further below—to make up the amount until either the target percentage is received or the funds are used up (whichever comes first). A similar transitory provision, but at a lower percentage of 40 percent, is provided up to and including 2020.

To sum up this complex allocation system, depending on the rate at which resource revenues increase over time, as Table 6 shows, the SGR system is not expected to be in full operation until 2021, since the transition period may extend up to 10 years. As currently planned, 2.5 percent of total SGR revenues will be directed to cover the (presumed) costs of operating the system, with 2 percent going to the Ministry of Mines and up to 0.25 percent each to the DAF (for monitoring the system) and to the DNP (for operating the system). Of the remaining 97.5 percent, only two shares are definitely fixed: 10 percent (9.75 percent of total SGR) each to FONPET and to the new Innovation Fund. Of the remaining 78 percent of the SGR, up to 29.25 percent may go to the Stabilization Fund, although this maximum is set at only 24.375 percent initially and will then be reduced by 20 percent—that is, to 19.5 percent—for the next three years. Moreover, in subsequent years, the share of this fund is to be determined as a residual after deducting not only the two fixed share funds (FONPET and the Innovation Fund) but also the amounts allocated to the Compensation Fund, the Development Fund, and the direct recipients. In short, the amount to go to the Stabilization Fund is subject to considerable uncertainty and depends on how all the different factors mentioned above change over time.

Table 7 sets out the estimated royalty distribution by category in 2012, the year in which the scheme set out in Box 6 is first to be applied. The distribution by department, however, is far from certain since it depends on the details of the allocation formulas used for the Compensation Fund and the Development Fund. For example, as Table 7 shows, if the Development Fund is distributed entirely on a population basis, as is 75 percent of the Compensation Fund, with the balance varying with the NBI (15 percent) and unemployment (10 percent), the sparsely populated but resource-rich Department of Casanare would receive five times as much in per capita terms but about the same share as the much larger Department of Nariño. However, (although this is not shown in Table 7), if the Development Fund formula is changed so that 40 percent of this amount is allocated to the inverse of per capita GDP, Nariño’s share would become a bit larger relative to that of Casanare, and the difference in per capita would be slightly reduced. Within the range of factors currently under consideration, however, one outcome is clear: resource-rich regions will continue to get far more in royalties than other regions, although the imbalance will be much less than under the previous system. During 2007–10, four small departments (Arauca, Casanare, La Guajira and Meta) with less than 4 percent of the national population received 53 percent of all royalties; under the new SGR, however, those departments will receive only an estimated 16 percent of the total (Table 6).

**Table 7**  
**Distribution of the SGR by Department in Colombia, 2007–10 and 2012–20: An Illustration**  
 (billions of 2010 pesos)

Department	Average Royalties 2007–10	As share of Total Royalties (%)	2012	As Share of Total Royalties (%)	2012–20	As Share of Total Royalties (%)
Guaviare	0	0	54	0.6	799	0.8
San Andrés	0	0	48	0.5	681	0.7
Amazonas	0	0	50	0.5	739	0.8
Vaupés	0	0	52	0.5	755	0.8
Guainía	0	0	59	0.6	857	0.9
Quindío	0	0	38	0.4	503	0.5
Caquetá	0	0	97	1.0	1,437	1.5
Risaralda	0	0	92	0.9	1,331	1.4
Vichada	0	0	63	0.6	912	1.0
Caldas	2	0	90	0.9	1,265	1.3
Atlántico	0	0	183	1.9	2,707	2.9
Bogotá	0	0	308	3.1	4,652	4.9
Cauca	8	0.2	212	2.2	3,103	3.3
Valle	1	0	278	2.8	4,081	4.3
Norte Santander	29	0.7	178	1.8	2,319	2.4
Chocó	23	0.6	184	1.9	2,041	2.2
Nariño	15	0.4	273	2.8	3,925	4.1
Magdalena	53	1.3	234	2.4	2,985	3.1
Cundinamarca	19	0.5	227	2.3	3,041	3.2
Putumayo	78	1.9	155	1.6	1,514	1.6
Bolívar	121	2.9	375	3.8	4,413	4.6
Tolima	143	3.4	300	3.1	2,999	3.2
Sucre	124	3.0	293	3.0	3,163	3.3
Boyacá	125	3.0	301	3.1	3,142	3.3
Antioquia	118	2.8	601	6.1	7,749	8.2
Córdoba	242	5.8	529	5.4	5,569	5.9
Huila	288	6.9	437	4.5	3,594	3.8
Arauca	406	9.8	478	4.9	3,060	3.2
Santander	235	5.6	427	4.4	3,919	4.1
Cesar	345	8.3	481	4.9	3,779	4.0
La Guajira	455	10.9	625	6.4	4,806	5.1
Casanare	720	17.3	771	7.9	4,334	4.6
Meta	615	14.8	724	7.4	4,638	4.9
National Total	4,165	100.0	9,180	100.0	94,811	100.0

*Source:* Author's calculations using preliminary DNP estimates as of July 2011.

*Note:* These estimates are based on the following (in part arbitrary) assumptions: (a) the Stabilization Fund will in effect be financed by every department in proportion to the departmental share in the SGR as a whole; (b) the Innovation Fund will be allocated in proportion to the departmental distribution of the Compensation Fund and Development Fund; (c) the Compensation Fund will be allocated 60 percent on population, 30 percent on relative poverty (as measured by NBI), and 10 percent on departmental unemployment; (d) the Development Fund will be allocated on the basis of population; (e) FONPET will be allocated in proportion to the uncovered pension liabilities registered in the fund; and (f) the direct share to producers will be allocated in proportion to production. Percentage columns are subject to rounding errors.

In short, if one objective of the new SGR is to provide either more certainty or more equity in the distribution of royalties, it seems unlikely to be fully successful. This conclusion is only strengthened by considering how the funds are to be spent and the SGR organized.

### *Spending the Money*

As mentioned, SGR funds are constitutionally limited to spending on certain activities. As is common with most intergovernmental transfers in Colombia, for example, they are (leaving aside the question of the fungibility of money) definitely not to be spent on such recurrent expenditures as wages, salaries, or supplies. Moreover, all funds accruing to the Innovation Fund and the two regional funds (Compensation Fund, Development Fund) and to the direct recipients must be spent as determined in the national and territorial plans.<sup>25</sup> In addition, both the Innovation Fund and the Development Fund are to be spent only on regional projects agreed to between the national and the relevant territorial governments. This raises the question of what is a “regional” project.

While it might be tempting to link this regional emphasis with the current National Development Plan (DNP 2009), how all this works appears to depend on how the new Organic Law for Territorial Regulation [a better translation than mine!], discussed below, is implemented. Under this law, Colombia can adjust its existing territorial structure—departments and districts, in particular—in a way that might alleviate some of the problems that have arisen from its marked decentralization of expenditure responsibilities in an unchanged structure. However, it remains to be seen to what extent and in what manner this new potential for more effective decentralization of service delivery is realized.

Curiously, spending by the Innovation Fund—which (unlike expenditures by the Compensation Fund and Development Fund) may go to both “programs” and “projects”—must be explicitly distributed among the departments (though not other territorial entities) in the same proportions as Compensation Fund and Development Fund (as discussed above). No doubt it is a good thing for Colombia to direct more funding to science and technology. However, questions may be raised about doing so in the context of the SGR. Not only is the logic of making such funding dependent on volatile resource revenues far from clear, but directing that such resources must be spent only on regional projects and that they must be distributed in the same way as the explicitly regional funds has no obvious rationale. Knowledge is a plant that grows best when water and fertilizer are applied in the right proportions to seeds that have been planted in the right places; it seems less likely to flourish when seeds are let fall where the political winds take them.

Although the Compensation Fund, unlike the Development Fund, may finance both regional and local projects, it may do so only in poor territorial entities as defined by three criteria: (a) the NBI; (b) population; and (c) unemployment, with priority given to projects in coastal, frontier, and peripheral regions. Although the details of how these funds are to be allocated had not been

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<sup>25</sup> The implicit assumption here is presumably that national and territorial plans agree, that is, that the latter are simply the local counterpart of the National Development Plan, which indeed seems likely since the National Planning Department must approve the territorial plans.

finalized at the time of writing, as table 7 suggests, this feature seems unlikely to alter the continuing substantial allocation of SGR resources to the producing regions.

Even with respect to the new Stabilization Fund, the law requires that when spending is authorized from this fund, it must be allocated to various uses in the same way as any additional SGR funds. Similarly, any excess over 30 percent (of the DT) that would otherwise accrue to the Stabilization Fund must be distributed in the same way. In other words, although in many ways the residual recipient of resource rents through the SGR is, quite logically, the Stabilization Fund, when it comes to how these resources are to be spent, the national budget priorities of the day will play no role, and most of the money will flow to the major recipients of royalties, that is, the producing departments and municipalities.<sup>26</sup>

### *Controlling the System*

Given this complex structure for spending the SGR, some system clearly must be established to approve all these projects and to monitor the spending. The organizational structure proposed to do all these things is, like the SGR itself, quite complex, as shown in some detail in box 7.

To start with the simplest point, although, as mentioned earlier, the Ministry of Mines and Energy will continue to play a key role in the royalties system, the new royalty monitoring and control system to be established for the SGR will be run by the DAF of the Ministry of Finance, parallel to (but apparently not integrated with) its existing role in supervising the SGP. This raises two questions.

First, and most obviously, it may be difficult to expand the technical capacity (and political weight) of this unit sufficiently to take on this major new task, especially in view of the way it is apparently intended to organize the planning and administrative system for SGR spending (as outlined below).

Second, although the DAF currently does a good job both in the information-gathering part of its present task and, to the extent it receives sufficient political support, appears to do about as well as can be expected in monitoring the financial aspects of the SGP, it does not as yet appear to do very much in terms of evaluating the extent to which the spending is either efficient or effective in delivering services although, under Decree 028 of 2008, it is apparently expected to do so.

This raises a more general question. Colombia has, in recent years, developed such a complex budgetary system that it is perhaps time again for a general reconsideration of the efficacy of its current public financial management system. In addition to the apparent need for more “value for money” evaluation of transfers just mentioned, the creation of a new National Royalty Agency in the National Planning Department to supervise the SGR system, together with the biennial budgetary structure of the SGR, including the various funds mentioned earlier and the existing

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<sup>26</sup> In yet another example of how noncomprehensive budgeting has become in Colombia, when the existing National Royalty Fund is suppressed on the implementation of the SGR in 2012, any uncommitted resources left in that fund are to go to the special emergency fund for reconstructing roads and environmental restoration in the areas damaged by the severe winter floods of 2010.

critical role of the DNP in approving investment projects in the annual investment budget for the national government, as well as its similar role (discussed below) with respect to the biennial SGR budget, implies not only that the role of the DNP in controlling investment spending in Colombia will be substantially strengthened, but also that Colombia's already unduly fragmented public financial management system will be put under yet more strain.

Limited though it is, the creation of the Royalty Stabilization Fund, (which is managed by the central bank), may improve Colombia's already fairly good intertemporal macroeconomic management. However, unless great care is taken to ensure that it functions correctly, the new management system for the SGR runs the risk of making the already difficult task of sensibly allocating public sector funds within any budgetary period even more difficult. In particular, it is unclear how the increased power of DNP will mesh, if at all, with the long-standing dominance of sectorial ministries in shaping infrastructure provision and service delivery, let alone what the effective role of the regional, departmental, and local representatives will be in the whole complex process.

#### Box 7

##### The Organizational Structure of the New Royalty System

To fully understand this argument in the text, one must also understand the core organizational proposal of the most recent constitutional amendment—the creation of a new, complex, and perhaps unworkable set of new “Collegial Organs for Administration and Decision” (*Organos colegiados de administración y decisión*, OCADs), which must approve the various projects to be funded through the SGR before they can be included in budgets. Perhaps on the principle that one can never have too much of a good thing, several varieties of OCADs are to be created:<sup>27</sup>

- For the “direct” recipient departments, the OCAD consists of two national ministers (unspecified), the relevant governor, and a representative of the mayors.
- For direct recipient municipalities, the OCAD consists of a national delegate, the governor, and the relevant mayor.
- For Compensation Fund and Development Fund regional projects, the OCAD includes four national ministers, a representative of the DNP, the governors concerned, and representatives of the mayors.
- For the Innovation Fund, a particularly complicated OCAD is specified, including three ministers, one DNP representative, one representative from the national administrative department of science, technology, and innovation (generally known as Colciencias) who will act as Technical Secretary, (interestingly, no similar post appears to be established for other OCADs), a governor, four representatives of public universities, and two representatives of private universities.

Although in all OCADs mentioned in Box 7 the constitution states clearly that the representatives of the territorial entities must outnumber those of the national government, it is unclear how well these new entities will (or can) function. Given the problems in the past in getting different departments to agree even on relatively simple “regional” projects such as highways (World Bank 2009), it is difficult to be optimistic in this respect, despite the developments discussed briefly in the next section. In any case, subsequent discussions suggest that much of this apparatus may in practice be bypassed to some extent by a central control board

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<sup>27</sup> In addition, in October 2011, the Minister of Finance announced that the National Development Fund (*Fondo Financiero de Proyectos de Desarrollo*, FONADE), which is a dependency of the DPN, will be responsible for assuring that projects funded through the SGR are eligible. It is not clear exactly how this relates to the OCAD structure set out in the law.

(DNP and the Presidency) that is to maintain a “balance score card” showing the “scores” by municipality with respect to service delivery goals. While such a system obviously strengthens central control, it may be easier for subnational governments to deal with than the present confusing and complex system that varies by sector and source of financing, let alone the even more complex OCAD system set out in the new royalty legislation. However, since it seems that policy is being made—and administrative structures developed—virtually “on the fly” with respect to the SGR in order to get something in place in 2012, it is difficult at the time of writing to envisage exactly how the new system is supposed to work, let alone to appraise it.

### **Regional Policy, Fiscal Transfers, and the New Territorial Law**

An important subtheme that has long run through the Colombian decentralization story is the relation—actual and intended—between fiscal transfers and regional policy. Even the most cursory review of decentralization initiatives in recent decades shows repeated concern for strengthening the finances of the many smaller (and often largely rural) municipalities in the country. This long-standing concern is politically important because of the territorially based politics that characterize the national legislature (Alesina 2002). It clearly lies behind the initiation and much of the design of the first municipal transfers introduced in 1968; it became even more marked with the election of mayors and governors and the major constitutional changes of 1991, and especially during the subsequent difficult years of internal rebellion and the loss and then regaining of national control over much of rural Colombia. Over more or less the same period, Colombia’s rising coal and oil exports resulted in a substantial flow of royalty revenues to a number of sparsely populated and peripheral departments, some under the influence of disaffected groups. All these factors accentuated the importance of regional politics, so that regional development became an even more important factor in influencing national policy in general, particularly with respect to transfers.

This issue seems likely to become even more important in the near future both because of the new SGR and its strong regional policy component, as discussed in the preceding section and because of the introduction of Law 1454 of 2011, the Organic Law for Territorial Regulation (*Ley Orgánica de Ordenamiento Territorial*, LOOT). The LOOT is discussed briefly in this section, following a brief general consideration of the convoluted question of the relationship between regional policy and fiscal transfers.

### ***Transfers, Regional Policy, and Poverty Reduction***

The question of the appropriate relationship between regional “balance,” the appropriate design of intergovernmental transfer systems, and poverty alleviation often comes up in discussions of decentralization. From one perspective, the best way to approach these three concerns is as three separate problems. Although policies carried out with any of these concerns in mind may, of course, have implications for other policies, treating them separately is the best way to keep the objectives of particular policy measures clearly in mind and at the same time ensure that the measures in question are not significantly offset by other measures.

The fiscal (and financial) relations between central and subnational governments inevitably affect the relative economic position of different regions and thus affect regional economic disparities in terms of both regional development and interregional redistribution.<sup>28</sup> Although regional balance, like fiscal sustainability, is a term often heard in discussions of intergovernmental fiscal relations, achieving complete regional balance in terms of either equal regional growth rates or equal regional per capita incomes is always and everywhere a virtually impossible goal in heterogeneous environments. Nonetheless, “balance” sounds a lot better than “imbalance,” and in Colombia, as elsewhere, much public discussion of transfers understandably focuses on the relationship between transfers and regional disparity, whether understood in terms of differences in per capita income between states or localities or in terms of differential regional growth rates, unemployment rates, or some other economic variable.

Reducing such regional disparities may not always be a sensible policy objective, but countries may attempt to do so if they wish, and they may choose to use intergovernmental transfers as one policy instrument to achieve this objective. For this reason, it is common, as in Colombia, to see that an important indicator of need in transfer formulas is some measure of the level of regional economic well-being (NBI). However, it is important to distinguish the aim of reducing regional disparity from the narrower, but important, concept of fiscal equalization in terms of ensuring that governments with different fiscal capacities have equal ability to provide public services at some desired level.

Some degree of what is often called “vertical fiscal imbalance” seems inherent in countries with more than one level of government (Bird and Tarasov 2004). It is not only in Colombia that central governments tend to collect most taxes, while regional and local governments are responsible for more expenditures than they can finance from sources of revenue directly under their control. Indeed, as discussed earlier, many of the recent revisions in transfers in Colombia have been motivated by the desire to reduce this imbalance in favor of the central government, essentially by reducing the size of transfers. More relevant to the present discussion, however, is the fact that in Colombia, as elsewhere, some subnational jurisdictions are much richer than others (table 3.4).

An important consequence of this wealth disparity is that the resources available to subnational governments to provide public services are also unequal. Despite the considerable political rhetoric heard in Colombia with respect to regional balance it is not clear from Colombian policy over the years that the “horizontal fiscal imbalance” (as it is often called) due to such regional inequality is actually seen as much of a problem. If it is, there are some relatively straightforward ways, at least in technical terms, to deal with it by, first, designing transfers properly (Bird and Smart 2002), and, second, by providing sufficient “own-revenue” flexibility to subnational governments, along the lines sketched in the next section. Before engaging in that discussion, however, it is important to distinguish the task of rectifying horizontal fiscal imbalance (to the extent considered desirable) from the quite separate objective of dealing with regional imbalance

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<sup>28</sup> Regional income differences in Colombia are indicated in Table 4. See also Bonet (2006) and the more general discussion in Benzaquen et al. (2010). For interesting recent perspectives on these issues in a number of developed countries that both discuss the measurement and interpretation problems that arise in dealing with such issues and make it clear that no country has yet managed to deal with them satisfactorily, see Bosch, Espasa, and Solé Ollé (2010), Lessman (2011), and Sacchi and Salotti (2011).

in the more general (and vague) sense of regional disparities or the further separate objective of reducing income inequality or reducing poverty, in general.

These topics are often confused. For example, discussions of intergovernmental transfers sometimes assume that the principal objective of such transfers is to reduce disparities in per capita incomes among regions. However, interregional equity is not interpersonal equity, and it is important to keep the two concerns distinct. Sometimes transfers to poor regions may help poor people and sometimes they may not. Although it may be argued that regional transfers in Colombia appear to be motivated more by concern with poverty reduction (and restoring state control in conflict regions) than by differences in fiscal capacity, it is well known that if the principal objective of policy is to alleviate poverty, intergovernmental transfers are unlikely to be either the most appropriate or the most efficient way to achieve that aim (Rao and Das-Gupta 1995). If the target is poor families, the best way to help such families is to do so as directly as possible, not by channelling more resources to subnational governments and then attempting to rechannel them to the poor. Intergovernmental fiscal transfers have their own rationales and should not be judged solely or primarily in terms of their effects on individuals at different income levels, although, of course, these effects may nonetheless be important.<sup>29</sup>

In principle, countries that wish to devolve important expenditure functions to subnational governments may wish to level the playing field between heterogeneous subnational governments through transfers intended to equalize the fiscal capacity of territorial entities to some level, thereby putting all closer to the same footing with respect to incentives. At the same time, such transfers may also be intended to provide sufficient resources to enable all local governments, even the smallest and poorest, to provide a basic package of local services. Since the evidence (Faguet 2011) is that there is little or no correlation between the lack of resources and good management, it may make good economic sense to help even the smallest rural areas that have virtually no local fiscal resources to provide at least a minimal standard of basic local services.

Attempts to provide similar public services regardless of location, however, may conflict with the growth-related objective of increasing migration from less (privately) productive to more productive locations. Even in cases like Colombia, in which the 1991 constitution frequently refers to regions, and regional issues are often at the forefront of discussions of intergovernmental fiscal matters, it is striking how often migration, which is always a major factor in reducing poverty and increasing growth, is ignored as though it either did not exist or is in some way inherently undesirable. Given the state of conflict that has existed for decades in some regions, however, not least those near national borders, policies such as interregional transfers intended to improve the living standards of persons in those areas may have a clear rationale. On the whole, however, issues such as those touched on in this section and the many and complex ways in which they are related appear to need more discussion than they have received in Colombia.

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<sup>29</sup> For further discussion of the need to disentangle the question of designing intergovernmental transfers from the conceptually (and often practically) distinct question of alleviating poverty (or improving interpersonal income distribution), see Bird and Rodriguez (1999).

### ***The New Territorial Law***

Despite the obvious importance of regional issues in Colombia, it is not surprising that 18 different draft laws intended to define and regulate regions were introduced in the Congress over the last two decades. However, none succeeded (González Salas 2011). The confluence of the new Organic Law for Territorial Regulation (LOOT), the SGR, and even the current National Development Plan with its regional focus (DNP 2009) perhaps indicates that the regional policy issue may once again become the focus of considerable discussion in Colombia and perhaps play a substantial role in shaping future decentralization policy. It is thus important to understand what “regions” mean in the Colombian context, how they relate to the existing departmental and municipal structure, and why it is critical in developing a sound intergovernmental finance system in Colombia not to permit this issue to dominate the field.

This is the key issue raised by the LOOT, the new territorial law. The LOOT creates a new organization at the national level (the Territorial Regulation Commission (*Comisión de Ordenamiento Territorial*, COT). This organization, which is to be headed by the Minister of the Interior but with its technical base in the DNP, has the initial task of developing a full legal framework for regionalization in various dimensions, including the establishment of appropriate regional COTs at both the departmental and municipal levels.

Although distinct from the OCADs intended to implement the SGR, such COTs, when established, may over time come to play an increasingly important role in shaping not only how the SGR works but also, more generally, how decentralization works in Colombia. The law envisages a variety of ways in which subnational entities may voluntarily form new types of regional entities, ranging from simple associations of existing departments to both intradepartmental and interdepartmental associations of special districts, metropolitan areas, and municipalities for various specific purposes. The LOOT also specifies that departments may, at the request of contiguous municipalities, form administrative and planning “provinces” (*provincias*) to provide services of mutual interest, subject to the relatively mild restraint that at least 10 percent of the relevant residents agree.

Although all these potential new entities will be able to enter into contracts, they are not permitted either to increase administrative expenditures or to expand public employment. However, they would be able to deal with the central government on investment projects. Indeed, the new administrative and planning regions the law establishes are explicitly envisaged as the executing agents for projects under the Regional Development Fund funded through the SGR. In addition, the LOOT provides for yet another new entity, the Special Investment to Overcome Poverty Zone (*Zona de Inversión Especial para Superar la Pobreza*) to serve, in effect, as the executing agency for projects under the Regional Compensation Fund. In other words, much of the legal and institutional basis needed to implement an important part of the new SGR described earlier appears to be provided by the LOOT.

In addition to setting out a framework for regionalizing service provision, and especially investment planning at various levels, the new territorial law also provides both for differentiated devolution of administrative and fiscal responsibilities to departments in accordance with their differing circumstances, and for revising the categorization of municipalities (see box 3.3) and

again specifying different regimes and functions as appropriate. Both of these activities had already been carried out to some extent under previous laws, as illustrated by the certification of departments (and some larger municipalities) under the SGP, and the categorization of municipalities in terms of fiscal resources. Over time, however, the operational significance of such distinctions has generally been eroded by political pressure to treat everyone the same way.<sup>30</sup> In economic (and administrative) terms, asymmetrical treatment may be needed to yield uniform (or at least acceptably minimal) outputs from the very heterogeneous departments and municipalities, but politics often rules with respect to this, as with respect to most aspects of decentralization policy.

The LOOT also attempts to revive the idea of establishing metropolitan areas as special districts with a clear fiscal base and, interestingly, explicitly suggests that the existing Special District of Bogotá should combine with Cundinamarca and neighboring departments in a new administrative and planning region. Unfortunately, the special district concept has been severely distorted in Colombia: apart from the Special District of Bogotá, which, with a population of almost 7 million (in 2005) is both the national capital and the capital of the Department of Cundinamarca and has a special administrative and fiscal regime, other major cities like Medellín and Cali are simply municipalities with the same powers as any other. Although Barranquilla, a city of a little over 1 million at the center of a metropolitan area of about 1.5 million, has also been labeled a Special District—as are the smaller port cities of Buenaventura, Cartagena, and Santa Marta—Bogotá remains the only one that is really “special” in administrative and fiscal terms.

To some extent, LOOT may thus perhaps provide an appropriate new starting point from which to tackle the problem of providing a more adequate structure for metropolitan development in Colombia, by eventually establishing properly defined metropolitan areas around the major cities with characteristics similar to those of Bogotá, that is, combining to a substantial extent within a single metropolitan government the spending and revenue-raising powers of departments and municipalities. Whether this happens or not, Colombia, like most countries in the region, has to rethink how it governs and delivers services to its increasing urbanized (and metropolitanized) citizens.<sup>31</sup>

### **Has Expenditure Decentralization Delivered the Goods?**

A recent detailed outline of the complex legal and organizational structure of the education and health sectors in Colombia identified 23 national powers, 15 departmental powers, and 15 municipal powers with respect to education; and 21, 29, and 19 powers, respectively, for health, with some differences with the municipal sector with respect to districts and certified localities, both of which have some additional powers (González Salas 2011). In short, the assignment of

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<sup>30</sup> For instance, the appropriately asymmetrical certification and cofinancing systems of the 1990s (Bird and Fiszbein 1998) had ceased to have any practical significance by the early years of the 21st century (Acosta and Bird 2005).

<sup>31</sup> For a discussion of the problems of metropolitan governance and finance in Latin America, see Rojas, Cuadrado-Roura, and Fernandez Guell (2008).

expenditure functions in Colombia is not clear-cut. However, full clarity in expenditure assignment is seldom possible and is not always desirable.

For example, three or more levels of government may properly play distinct but related roles in delivering education. The central government may set national standards for graduates and for teachers, and establish the basic curriculum. Regional governments may, within this framework, develop their own policy goals—for instance, with respect to the use of school facilities—and train and certify teachers. Local governments may be responsible for paying teachers and maintaining facilities. And, since education is delivered in the end by local schools, outcomes may be better outcomes if they, too, have a substantial degree of budgetary autonomy and face incentives leading them to react appropriately to teachers, parents, and the local community (Burki and Perry 2000).

Is it meaningful to consider a particular service to be “assigned” to the local level, when much of the relevant policy and regulatory framework, and indeed much of the financing, may come from higher levels of government—and the actual service delivery may be at a lower institutional level? Clarity as to who is responsible for what is indeed important, but many different public sector actors may appropriately be involved in the provision of any particular public service. What matters is not so much that each expenditure function, broadly understood, is clearly assigned to one level of government or another, but rather that it is clear to all *exactly* who is responsible for doing *precisely* what.

Fortunately, for present purposes it is not necessary to go into the myriad details of how the Colombian intergovernmental system really works in any sector, let alone in any particular region or locality.<sup>32</sup> Instead, this section considers only one key question: how well has Colombia’s decentralization worked in achieving what have been traditionally assumed to be the two central aims of decentralization policy—improving the provision of public services, particularly education and health, and, more generally and perhaps in the long run more importantly, improving subnational governance? The verdict is, unsurprisingly, mixed in both respects.

In Latin America, decentralization has been closely associated with democratization. It is thus not surprising that in many ways, as Faguet (2011) emphasizes, the most important question about decentralization policy is really the same question to be asked about democracy: to what extent does it make government more accountable and responsive to the governed?<sup>33</sup> Although this question does not appear to have been examined rigorously in Colombia, the evidence seems to suggest that the extensive decentralization of expenditures that has taken place in recent

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<sup>32</sup> For a more detailed discussion of some important aspects of the major sectors, see, for example, Glassman et al. (2009) on health; World Bank (2006) on education; and González Salas (2011) and World Bank (2009), more generally.

<sup>33</sup> As mentioned, an alternative view is that, over time, and particularly over the last decade, the focus of decentralization policy in Colombia has gradually shifted to an increasingly centrally controlled poverty reduction strategy implemented through a variety of subnational agencies. We return to this point in the conclusion.

decades has succeeded in increasing the coverage of public services and may even, at least in some instances, increased the efficiency of service delivery.<sup>34</sup>

Indeed, the evidence suggests that the two questions are closely related. The more responsive governments are to the governed, the more likely they are to provide services that the people value. From the early study of Fiszbein (1997) to more recent studies such as Acosta and Bird (2005), Chaparro, Smart and Zapata (2005), Faguet and Sanchez (2007, 2009), and Granados and Sanchez (2008), Colombian evidence suggests that, at least in some places at some times, the combination of political and expenditure decentralization has resulted in people not only getting better public services in terms of both coverage and quality than they had under the previous, more centralized delivery system, but in also having more direct input into what services they receive. Indeed, success in terms of improving the local governance experience appears to have been critical in at least some cases in improving service delivery (see Box 8).

### **Box 8 Decentralizing Water**

A 2008 empirical study of water provision in Colombia by Granados and Sanchez shows that the outcome of decentralization in terms of service delivery depends not only on the extent to which service provision has been “devolved” rather than simply “delegated” to subnational governments, but also, and more importantly, on the precise structure of the incentives that face those in charge of final service delivery, regardless of whether they are national, regional, or local public agencies or private providers.

Although, historically, most water was provided at the local level in Colombia, over time both national funding and national regulation increased, and the local role was greatly diminished. However, in the 1980s, concern about the inadequate level and quality of water and sanitation services eventually led to the full restoration of the responsibility for water service to the local level, although this activity continued to be funded largely with national resources. With the introduction of the SGP, available funding increased so substantially that by 2007 the resources available for investment in water and sanitation were four times greater in real terms than they had been in 1993.

In addition to this major change in financing, important changes were also introduced in how the water system was managed. Although it was apparently intended to replace direct municipal provision by a more businesslike enterprise model, in fact only about half of the almost 800 local providers, including most of the larger ones, followed this path, with many of them also privatizing the water enterprise in whole or in part. The careful comparison by Granados and Sanchez (2008) of the outcomes of these reforms, after controlling for municipal characteristics, found that while the adoption of the enterprise model was associated with some increase in sewerage coverage, it had little if any effect on water coverage and was actually associated with an apparent decline in water quality, as measured by child mortality data. In other words, this study suggests that the provision of water services directly by local governments had better effects in terms of reducing child mortality, suggesting that, contrary to conventional views, making the provision of water service more responsive to local political structures may have produced better outcomes.

These results, Granados and Sanchez suggest, appear to reflect the inappropriateness of the incentives facing water enterprise managers compared to those facing local government water departments. Interestingly, very similar results emerged in an earlier empirical study comparing

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<sup>34</sup> For relevant discussions on this issue, see Alesina (2002) and Konrad Adenauer Stiftung (2010), although in the latter, it should be noted that Gutierrez (2010) paints a much gloomier picture of the effectiveness of service decentralization than that suggested by the studies cited in the text.

water provision through municipal enterprises and municipal departments in Canada (Kitchen 1975). At the very least, such results suggest that much closer attention needs to be paid to the details of precisely how decentralization of services is accomplished and, in particular, to the regulatory and incentive regimes shaping the actions of service managers. In particular, it is important not to allow concerns about the technical capacity of local governments to override the importance of ensuring that the real concerns of local residents are met by the services provided.

While it is often easy to criticize particular local “political” decisions and to argue that more “technical” solutions would be preferable, it is equally easy to lose sight of the critical importance of providing local people services that they want and need and not those that others think they “should” have (Fiszbein 1997). The implications of this argument with respect to the long-term desirability of devolving rather than simply delegating the local provision of services are developed at some length in Bird (1980).

Of course, not all the news about expenditure decentralization is good. There have been all too many instances of corrupt and wasteful subnational expenditures. While many of the more dramatic instances along these lines are associated with the huge amounts of royalty revenue received by some subnational governments, similar concerns have long been raised with respect to SGP system transfers. As discussed earlier, in order to reduce such highly visible problems, not only has the level of transfers been reduced, but tighter and tighter controls have also been imposed on subnational spending. Reducing the freedom of subnational governments to spend, however, although it may indeed deter some bad spending, is also all too likely over time to deter some spending that the local community wants and would be willing, to at least some extent, to pay for. More important, however, tighter national control over subnational governments moves in exactly the wrong direction with respect to the long-term goal of developing more responsible and responsive subnational government. There is seldom much learning without the risk of real failure. Colombia thus faces a policy dilemma: whether to devolve some real responsibility with respect to deciding on and providing local public services at the risk of possibly facilitating considerable waste and corruption, or to attempt to prevent such problems by recentralizing in the form of delegation at the risk of hampering the development of effective local governments.

Delegation is and always has been the only appropriate way to describe the large share of the SGP that is channeled through the departmental governments and directed to cover the (nationally determined) wage bills of most employees in the education and health sectors. However, so many of the changes in the SGP made in recent years have been aimed at reducing the degree of discretion that can be exercised by subnational governments that it seems fair to suggest that, from the perspective of the national government, the only good peso spent by a subnational government is one spent exactly as the national government wants it to be spent. What began, in principle, as a devolved system, which gave some real spending power (and some matching responsibility) to municipal governments in particular, has thus gradually evolved into something that is much closer to an almost completely delegated system—one in which the principal responsibility of local service providers is less to those they supposedly govern than to the national agencies that increasingly govern them.

Apart from the important special cases of education and health, discussed earlier, the major national agencies directly involved in controlling decentralization are—since most transfers must be spent on investment—the DNP, whose role will become even more important with the new SGR, and the DAF at the Ministry of Finance, whose role is also about to increase with the SGR.

Neither of these agencies seems sufficiently staffed (or perhaps oriented) to provide the essential capacity-building support that most municipalities and many departments almost certainly need to be able to perform adequately either their service delivery or governance functions. Partly in recognition of this problem, though probably more to tighten central control, the central government apparently intends to establish as part of the Office of the President (Presidencia) a powerful new central administrative department intended to manage the decentralization—or delegation—process more effectively. Regardless of how the central management is restructured, however, it is important to ensure that the incentives facing both departments and municipalities, particularly the 1,000 or so smaller localities that are almost entirely dependent on SGP funding, are well designed, since the problems seem likely to be exacerbated in the complex and confusing new world of the SGR outlined earlier.

### **Improving Public Financial Management**

World Bank (2009) correctly emphasizes the difficulty that subnational governments in Colombia have had in managing the “two budgets” that are in effect separately funded from SGP resources and own resources. In fact, the public finance management problem is and always has been worse than this and promises, with the inception of the SGR, to become even worse in the future. To begin with, in addition to the unusually broad concept of “social investment” mentioned earlier, the central government itself has always had to manage two distinct budgets in terms of expenditures—the annual operating budget controlled by the Ministry of Finance and the annual investment budget the allocation of which is essentially controlled by the DNP. To this, the new SGR adds yet another capital budget which, subject to the as yet untested complex governance system described earlier, is also to be controlled by the new tripartite (DAF-DNP-Presidencia) structure, but separately from the regular investment budget and within a two-year rather than an annual framework.

At the subnational level, matters will obviously be even more complicated. Not only will departments and municipalities now have to manage their own resources and the separate procedures with respect to various components of the SGP, but they will also have to cope with the complexities of the new SGR, including, presumably, the array of new COTs, OCADs, and other “regional” entities envisaged in the SGR and LOOT. The problems of managing a third budget (from SGR funds) will add to the present complexities of managing the SGP and own-revenue budgets, with all being subject to an array of national regulations and controls. At some level, of course, presumably all these complex activities will be coordinated in both a macroeconomic and a planning sense, since they take place within the framework of both the medium-term financial plan and (at least loosely) within the National Development Plan and are hence monitored and evaluated by the central government.

As noted above, however, how effectively the present DAF monitoring and evaluation system functions with respect to improving the outcomes of the SGP transfer is questionable. Adding a new (though presumably similar) system with respect to the SGR to the task of this small agency is a good idea from the perspective of improving the information available to the central government, and may help curb some of the more egregious examples of fraud and incompetence. However, it seems unlikely to be able to do much in terms of yielding “value for money” in terms of better policy outcomes. Substantial efforts are already needed to improve

monitoring and evaluation with respect even to such relatively simple services as water, in part because of the fragmented and unclear nature of both service responsibilities and resource provision. A good example of the unnecessarily confusing way in which Colombia has, to date, decentralized is provided by the relatively simple road sector (Box 9).<sup>35</sup> Channeling the SGR transfers through an expanded version of the existing monitoring and control system will test it severely, especially since it will almost certainly prove extremely difficult to assign responsibilities clearly within the complex new OCAD decision process outlined earlier.<sup>36</sup>

### **Box 9** **Decentralizing Roads in Colombia**

Following the 1991 constitutional amendment, roads in Colombia were assigned to different levels of government in what seemed a quite logical fashion, with the national government responsible for the main interdepartmental roads, the departments responsible for the main intermunicipal roads, and the municipalities responsible for road linkages to their urban centers. The previous National Road Fund (for main roads) was replaced by the National Roads Institute (*Instituto Nacional de Vías*), and the separate National Fund for Local Roads was supposed to be liquidated within three years, with the secondary roads being transferred to the departments and the tertiary roads to the municipalities. A new cofinancing fund was established to allocate national budget funds to local road projects that met technical guidelines and also received local funding. It all seemed sensible, but it has not worked as planned.

At the departmental level, all roads were indeed transferred to the departments by 1995. However, the only money that came with them was one-time money, thus throwing the entire burden for maintenance on departmental budgets, which had little free revenue for this purpose. At the municipal level, even today only about one-third of roads have been transferred. One reason was, as in the case of the departments, because most municipalities simply did not have any additional money with which to maintain the system. However, another reason was because it proved politically useful to both sides to keep the National Fund for Local Roads in operation as a way for both local politicians and national congressmen to, so to speak, “deliver the goods” to their constituents. Largely for fiscal reasons, however, the cofinancing funds were eliminated at the end of the 20th century, with the result that road money ceased to flow despite some attempts to earmark both taxes (part of the diesel tax) and some transfers to the sector. Not much was done with respect to roads until, as part of the general “peace” package, some significant direct national investments were made in local roads early in the 21st century.

This tale illustrates a number of fairly common problems with decentralization in Colombia.

First, although the initial assignment of functions seemed logical, in fact it turned out to be very unclear in practice, resulting in unending disputes about which level of government was responsible for what when it came to roads.

Second, when all three levels of government are involved in financing an activity but two of them receive most of their funding from the third, but through several different channels, not only is the “ownership” of (and hence responsibility for) roads further confused, but the diverse and volatile set of funding sources makes it exceptionally difficult to either invest sensibly or, of equal or greater importance, to maintain investments properly once made. This problem is exacerbated by

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<sup>35</sup> This account is largely based on World Bank (2009) and the earlier discussion in World Bank (1996).

<sup>36</sup> In reality, matters are even more complex than noted in the text owing to the existence of centrally appointed Regional Competitiveness Commissions to implement a program of industrial policy called the Program for Productive Transformation. How these bodies affect both public investment programs and the allocation of central subsidies at the regional level is not clear.

the general lack of any sensible rationale for most earmarking in Colombia and the related lack of any sound connection between the amounts earmarked and expenditure needs.

The problems outlined in Box 9 extend well beyond the road sector. Indeed, they permeate all the main decentralized expenditure programs (World Bank 2009). It thus seems more than time for Colombia to once again look closely at how well the national and subnational budgetary, planning, and evaluation systems are functioning—preferably before making everything even more confused and intractable by adding all the complexities of the new SGR to its present overly elaborate set of fiscal decentralization policies.

### Improving Subnational Revenues

Deciding on an appropriate system of subnational taxation is important because in many ways it lies at the heart of both the taxation and decentralization puzzles. The issue is difficult to resolve because it is inextricably related to many of the same complex and conflicting political, social, administrative, and economic issues that need to be resolved not only in decentralizing expenditures and revenues but also in raising public revenues generally. The right answer to subnational taxation is thus not something that may be quickly or easily discerned, let alone resolved, in any country. One approach, suggested in Bird (2010a) is to follow four basic principles in assigning revenues to subnational governments:

- Ideally, own-source revenues should be sufficient to enable at least the richest subnational government to finance from its own resources the services that they provide that directly benefit their residents.<sup>37</sup>
- To the extent possible, taxes imposed by subnational governments should burden *only* their residents, preferably in relation to the benefits they receive from the services provided.
- Governments at all levels should bear clear public responsibility at the margin for financing expenditures for which they are politically responsible.
- Subnational taxes should not unduly distort the allocation of resources.

Among the characteristics that appear to be desirable in a subnational tax structure designed to satisfy these requirements, the public economics literature suggests the following:

- The tax base should be relatively immobile to permit subnational authorities some leeway in varying rates without losing most of their tax base.
- The tax yield should be both adequate to meet local needs and relatively stable and predictable over time.
- At the same time, tax yields should be sufficiently buoyant over time to maintain fiscal sustainability; that is, broadly, taxes should expand at least as fast as expenditures.<sup>38</sup>
- Subnational governments should not be able to export to nonresidents much of the burden of the taxes that they impose.

<sup>37</sup> Note that this does not include national expenditures (like paying teachers' salaries in Colombia) that subnational governments are carrying out as decentralized agents of the central government.

<sup>38</sup> For further discussion of what might be meant by fiscal sustainability, see Bird (2006).

- The tax base and tax rate should be visible, to ensure accountability.<sup>39</sup>
- The tax should be perceived to be reasonably fair by taxpayers.<sup>40</sup>
- The tax should be relatively easy to administer efficiently and effectively. The cost of efficient administration should be a reasonable proportion of revenue collections.<sup>41</sup>

How does Colombia's present subnational tax structure stack up against these criteria?

### *Departments – Excise Taxes*

As Table 2 shows, the current departmental tax system depends heavily on excise taxes. A 2008 report (Comisión 2008) recommended a number of changes in this system but would not have changed this basic characteristic (see Box 5). There are good arguments in support of this system. For example, McLure (1997) suggests that excise taxes may be a potentially significant source of regional revenue. Such taxes are, he argues, easily administered by regional governments and permit regionally differentiated rate determination. Moreover, in terms of efficiency, regional excise taxes applied on a destination basis should have little distortionary effect. In addition, there is at least some benefit argument for certain excises—for example, on alcohol and tobacco to the extent regional governments are responsible for health expenditures, and on vehicles and fuel to the extent they are responsible for roads.

In reality, however, despite their popularity, the benefit case for “sin” taxes is weak (Cnossen 2005), although such taxes may certainly provide a significant and steady source of revenue. Nor, as earlier Colombian experience shows, is it always simple to impose regionally differentiated taxes without incurring substantial administrative and compliance costs and giving rise to resource misallocation and evasion (Bird 1984). Moreover, it does not seem particularly desirable to tie regional finances to inelastic excise taxes when regional treasuries are under pressure from increasing expenditures for health and education.

In both theory and practice, the strongest economic and administrative case for regional (and perhaps local) excises is undoubtedly with respect to vehicle-related taxes (Bahl and Linn 1992). Such taxes could definitely be exploited more fully at the subnational level than is now the case in Colombia. From a revenue perspective, the most important tax on the vehicle sector is the fuel tax, which is also the simplest and cheapest form of automotive taxation to administer. Of course, to the extent automotive taxation is intended to price either the use of publicly provided services or externalities, taxing fuel is at best a crude instrument, since although fuel taxes are undoubtedly related both to road usage and to such external effects of vehicles as accidents, pollution, and congestion, the relationships are usually too complex to capture in any precise way through a simple tax (Newbery 2005).

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<sup>39</sup> For a discussion of the importance of “visibility” for accountability in the context of national taxes, see Bird (2010b).

<sup>40</sup> On the importance of perceived fairness (and of the visible benefits from public spending) for tax compliance, see Torgler (2007).

<sup>41</sup> It is not easy to be precise as to what is “reasonable” in this respect. For further discussion of this point, see Gallagher (2005). Of course, compliance costs must also be reasonable, as emphasized by Evans (2003). World Bank (2011) shows wide—and not always easily understandable—deviations in the compliance burden placed on taxpayers in different countries. Little is known about either of these cost dimensions with respect to subnational taxation.

In principle, toll roads (or electronically monitored road access to congested areas) and an appropriate set of annual automobile (and driver) license fees may serve the benefit tax function much better. For example, fees might be based on such features as the age and engine size of vehicle (older and larger cars generally contribute more to pollution), the registered location of the vehicle (cars in cities add more to pollution and congestion), driver records (20 percent of drivers are responsible for 80 percent of accidents), and axle weight (heavier vehicles do exponentially more damage to roads and require roads that are more costly to build). If technology permits, even more refined pricing schemes could be applied, at least in the most heavily congested urban areas or at border crossings. As a rule, however, when automotive taxation is differentiated, the aim is distributive rather than to approximate a benefit tax, and takes the form of imposing higher rates on higher-valued vehicles. However, such luxury taxes are unlikely to make sense at the subnational level.

Since automotive (and fuel) taxation appears to be the only regional revenue source likely to prove consistently income elastic, thus matching this aspect of some of the key services (education, health) for which regional governments are at least nominally responsible, some simple form (or forms) of subnational taxation of road users is a fundamentally good idea. Although careful study of the appropriate design of any system of automobile taxation (national, regional, or local) is needed to generate both more revenue and better economic effects through a revised system of automotive taxation (Smith 2006), this question deserves more attention than it seems to have received in Colombia.<sup>42</sup>

### ***Municipalities – The Property Tax***

Colombia's larger cities, like those in many developing countries, have grown in population in recent decades, an expansion exacerbated, in Colombia's case, by the accelerated rural outmigration resulting from the extended armed conflict in much of the country. Cities like Bogotá and Medellín have done much to adjust and accommodate to this new influx, but of course none has managed to do enough. Bogotá is a particularly interesting case because so much of its expansion has taken place at its extremities, with increasing growth occurring outside the boundaries of the city itself. The outward push of development within the city itself was facilitated by the successful development of a major urban transit system (the Transmilenio).

Unfortunately, the expansion of the fringes was accompanied by noticeable deterioration in much of the old central core of the city, with a consequent decrease in the potential city tax base. One result has been to increase the fiscal pressure on the remaining property and business base, thus making expansion outside of the city limits an even more attractive prospect. Excessive decentralization already appears to be occurring in the Bogotá area, and perhaps also in some other large cities. Rapid rises in land prices frequently signal large shifts in land use, reflecting underlying fiscal and regulatory distortions. An essential element in resolving both local fiscal and land use problems is a sound local property tax system. For cities to develop efficiently, both public and private decision makers need to pay correct prices for land, which means they need

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<sup>42</sup> Although Comisión (2008) recommended that the vehicle tax should be based on both cylinders and value, it neither devoted much analysis to this potentially important revenue source nor considered the possibility of regionally differentiated fuel taxes.

both an appropriate regulatory structure and, importantly, an appropriate land tax system to ensure that the best use is made of scarce urban space.

Colombia is fortunate in having had a well-established national cadastral institute (the Geographic Institute Agustín Codazzi, *Instituto Geográfica Agustín Codazzi*, IGAC) for many years. The IGAC establishes the framework for valuing property and carries out the task itself in most of the country. However, the four largest cities—Bogotá, Barranquilla, Cali, and Medellín—have their own cadastres, so they have considerably more control over the determination of the property tax base than do other municipalities.<sup>43</sup> In particular, these cities can independently take measures to keep that base up to date. Bogotá has undertaken two such major updating exercises in recent years. The first, at the beginning of the 21st century, was surprisingly successful: it resulted in updating the value of over a million properties, was generally accepted by the public, and produced a significant increase in revenue (Acosta and Bird 2005).

In contrast, the second updating effort in 2006 was considered to be of such low quality that the valuations produced for 2007 were rejected by the mayor. One result was that IGAC was called in to supervise the updating operation. Unfortunately, in doing so it insisted, perhaps understandably given the problems with the earlier effort, on returning to the old system of “walk-in” physical inspections. As a result, the updating process was substantially delayed at a time of rapid rises in property values. By 2008, for this and other reasons, much of the city’s tax base was five or six years out of date. A renewed effort under a new mayor, however, managed to update all valuations by 2010, essentially by bringing together information from property registers and other sources, while at the same time substantially reducing the per property costs of assessment and raising the assessed value to an estimated 70 percent of market value. While similar efforts to improve and integrate data flows among relevant offices at the national level have been less successful in bridging the gap between different organizational silos, Bogotá’s recent experience again demonstrates that where there is sufficient political will and administrative capacity, a way to establish a solid local property tax system can be found at least in big cities able to control their own tax base.

Other land-based financing schemes, such as *valorización* (in effect a generalized special assessment intended to capture property value increases due to public investment) and the *plusvalía* (the land value increment tax),<sup>44</sup> have been used successfully in some cities, and others, such as tax increment financing, are under consideration in Bogotá, and perhaps to some extent in other cities (Vázquez-Caro 2010). However, in the absence of a sound cadastral and property tax system, such schemes have little firm foundation and are unlikely to provide a sustainable financial basis for the badly needed increase in urban infrastructure. Indeed, the effort devoted to designing land-based taxes intended primarily to achieve nonfiscal purposes or to finance specific large-scale urban investments may at times detract from the more important task of implementing an effective and efficient revenue source for local governments (Bird and Slack 2009).

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<sup>43</sup> The Department of Antioquia also has its own cadastre covering all its municipalities other than Medellín. The Colombian cadastre is a legal and fiscal register, but only the latter aspect is touched on here.

<sup>44</sup> This levy is similar to *valorización* except that it is imposed when regulatory changes increase property values by changing how land may be used or the permitted intensity of use.

For example, the *plusvalía*, which is found in a number of Latin American countries (Smolka and Furtado 2001), is a good idea in principle. But experience suggests that it takes substantial technical and political investment to make such schemes viable. No one, anywhere, has been able to get very far with this approach, in practice.<sup>45</sup> Like rural land reform and the control of urban land speculation, reaping land value increments for public purpose can be a worthy aim. However, attempting to achieve such objectives through the clever design of such fiscal instruments rather than simply improving the property tax has seldom proved to be worth the effort.

A few years ago, Colombia considered a major reform of rural property taxes as part of its attempt to reincorporate parts of the countryside long dominated by various guerrilla and paramilitary forces into the normal governance system (Garzón and Vázquez-Caro 2004). When public funds are as hard to find as they are in most of rural Colombia, additional revenues from property taxes are obviously desirable, not least because local property taxes may play a critical role in helping develop the institutional social capital necessary for good governance and sustainable economic development (Sokoloff and Zolt 2006). An important conclusion drawn from reviewing property tax reforms in countries such as Colombia, however, is that to implement property tax reform successfully—where success is defined as raising more revenue in a relatively efficient, equitable, and sustainable way—several basic elements need to be in place (Bird and Slack 2004).

The preconditions for reform depend, to some extent, on the type of reform to be implemented. If the reform focuses on the assessment base, for example, a precondition for the successful implementation of that reform is the availability of adequate technical expertise. Other preconditions include the existence of a cadastre, a land registration system, adequate local government capacity, and a solid administrative infrastructure. In addition, considerable and sustained political will is needed to ensure that the reform is implemented. Colombia has some of these ingredients in place, as the Bogotá experience mentioned earlier suggests, although that case was exceptional both in the level of administrative capacity available and in the relative freedom the city had to shape its fiscal future. What is needed to improve municipal fiscal performance in the country as a whole is more of both of these elements—that is, strengthened local administrative capacity and providing sufficient freedom to succeed (which, of course, also means to fail) to local governments.

Sometimes, of course, shortcuts to success may be possible. With respect to expanding and keeping up to date the property tax base, for example, Bogotá began with a kind of self-declaration and to some extent a self-assessment system, under which property owners place their properties on the assessment roll and may even assign an assessed value. Such systems are always an appealing procedure to poor countries with little administrative capacity: they do not appear to require expert assessment staff, and owner-driven systems are easy to understand and

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<sup>45</sup> For a classic example of how difficult such schemes can be, see the account in Hood (1976) of Britain's futile attempts to tax land value increments in the 1950s and 1960s. It is true, as Smolka and Furtado (2001) note, that modern assessment technology makes it easier to implement such schemes, but they cannot substitute for a sound local property tax system. Indeed, to function properly they really need such a system already in place. Nonetheless, Colombia has a long history—in some cities in some periods—of successfully using *valorización* to finance some local public works (for example, Doebele, Grimes, and Linn 1979), and it should certainly continue to do so.

implement. The initial experience in Bogotá, for example, produced increasing revenues from property taxes, albeit at a time of rapidly rising property prices. Based largely on this experience, a subsequent report recommended that this approach could also be used to a considerable extent in Colombia's rural areas (Garzón and Vázquez-Caro 2004). Perhaps this approach might indeed provide a feasible starting point for fiscal reform in other large cities. However, unless backed up by a credible official valuation system, it seems unlikely to be able to provide a sustainable fiscal base for small rural municipalities, especially given the continuing strength in many regions of the landowning elite.

### ***Municipalities – Local Business Taxes***

A good local property tax, whether in urban or rural areas, meets most of the criteria of a good subnational tax. The same cannot be said of the second pillar of Colombia's local fiscal system—the local business tax (*industria y comercio*), which is a presumptive tax levied on estimated gross turnover at rates varying from 0.41 percent to 1.38 percent in Bogotá, though lower elsewhere (box 3.1).<sup>46</sup> Such local taxes on business are often highly distorting in economic terms, and theory, empirical evidence, and common sense all suggest that in most circumstances keeping such taxes on business as low as possible makes economic sense. Business taxes depress investment and distort economic decisions and reduce economic output and hence depress the potential standard of living. Moreover, to the extent such taxation breaks the connection between those who pay taxes and those who benefit from the expenditures financed, they reduce local accountability and thereby weaken the critical hard budget constraint needed to ensure that decentralized public sector decisions are efficient. In countries like Colombia, with large informal sectors, local business taxes may also discourage formalization, thus adding another barrier to channeling resources into the more productive formal sector (World Bank 2007).

Nonetheless, local business taxes both produce substantial revenue (Table 3) and are more elastic than property taxes, particularly in larger cities. When subnational governments have to meet expanding expenditure needs from their own revenue sources, they often need a more elastic source of general revenue than that provided by property taxation. Moreover, to some extent well-designed local business taxes may also make economic sense. By giving local governments a way to reap some revenue gains directly from economic growth, a local business tax may even encourage them to adopt more market-facilitating policies that encourage such growth (Weingast 2006).

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<sup>46</sup> The best short description of the local business tax in Colombia is by Vázquez Caro and Ospina (2006). Parra Ortiz (2010) describes in detail the legislation governing the industry and commerce tax in many large Colombian municipalities, noting that, although most big cities follow to varying degrees the pattern established by Bogotá in 1993 of bimonthly payments based on estimated activities in the period, many others still follow the older format of monthly payments based on gross receipts in the previous year. The tax base is often estimated on a presumptive basis and frequently, in effect, on the basis of self-reporting, and, especially outside the largest cities seems to be seldom subject to official verification. Illustrating the extent to which the tax is largely based on self-reporting, even in a city as large as Cartagena (where the tax is based on the Bogotá model), a 2011 study shows that by far the largest share of revenues comes from firms that the municipal government cannot even classify as “industrial,” “commercial,” or “financial”—even though the rates applied to each of these categories differ (Aleán, Acosta, and Matos 2011).

In addition, an economic case can often be made for a local business tax as a form of generalized benefit tax. When it is not feasible to recoup the marginal cost of cost-reducing public sector outlays through user charges, some form of broad-based general levy on business activity may be warranted. It is difficult, however, to find any support in this line of argument for taxing any one input, however, whether labor (payroll tax) or capital (corporate income tax or differential business real property tax). Instead, what this line of reasoning suggests is that a broad-based levy neutral to factor mix should be imposed, such as a tax on value added. A simple flat-rate tax on (essentially) the costs of the factors of production employed by a business appears to be a potentially promising path to pursue, particularly in more urbanized areas.<sup>47</sup>

Most possible problems from such taxes could be avoided by careful design. For example, the danger of tax exporting and “beggar-thy-neighbor” tax competition suggests that, as with local business property taxes, it may be advisable to place a floor (and perhaps also a ceiling) on local taxes and require that the same uniform rate be imposed on all types of business. Similarly, compliance and administrative costs could be kept low by imposing the tax on the basis of information available on existing business income tax returns. The tax base for individual regions and localities might be determined to a considerable extent on the basis of the payroll data already collected for purposes of social security and payroll taxation.

Although there is considerable experience around the world with variants of this sort of tax, the relative unfamiliarity of the idea of taxing factor costs appears to have discouraged its use in many countries, at least until recently.<sup>48</sup> Most countries thus have essentially presumptive forms of business levy, which is essentially how the local business tax operates in most of Colombia, although less so in the larger cities. Of course, even presumptive taxes may often be improved by better design and implementation to improve their elasticity and to reduce both their distorting effects and their vulnerability to abuse.

Many studies have highlighted the barriers to the growth of micro- and small enterprises that may be created by badly designed and implemented systems of local business taxation (World Bank 2007). The potential solution offered by the simple flat-rate tax discussed above both to this problem and to local government revenue problems, particularly in large and expanding urban areas, appears to deserve more detailed examination in Colombia, with its long history of local business taxation and the current revenue importance of such taxes.

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<sup>47</sup> Such a tax might be administered on an accounts basis or, as discussed in Bird (2003), it might in the case of the smallest businesses be levied more presumptively, provided the presumptive system is correctly designed and care is taken to deal properly with the issue of moving from one system to another (Bird and Wallace 2004). In small rural areas, often the only fiscal basis available to local governments may be a property tax, as World Bank (1996) demonstrates for Colombia.

<sup>48</sup> Factor costs are, in economic terms, value added under another name. However, the proposed tax is, as discussed in Bird (2003), distinctly different from a normal VAT. South Africa considered a local business tax along the lines suggested in the text a few years ago, but decided not to adopt it. However, Italy and Japan do have such taxes in place, and such a tax was introduced in France in 2008. More limited forms of taxes along these lines may also be found in Hungary and in a few U.S. states, notably in Michigan.

### **Taking Decentralization Seriously**

Colombians have, of course, taken decentralization very seriously for several decades, as this chapter demonstrates. Unfortunately, certain key ingredients still seem to be missing from the policy mix, in particular, more emphasis on the need to build institutional capacity and the need to further facilitate and support the development of effective governance structures at the subnational level.

#### ***Building Capacity***

For decentralization to work better, Colombia needs to build more institutional capacity in both the national and subnational governments. In particular, someone at the center must be focused on, and have clear responsibility for, shaping, monitoring, and evaluating decentralization policy. Given the highly political nature of many facets of decentralization, that person (or, better, office) must almost certainly be located very close to the president's office. If, as is apparently intended, such an office is soon to be established in Colombia, its initial task should be to set out a clear and comprehensive decentralization strategy (Bahl and Martinez-Vazquez 2006) that would serve as a framework for determining both the sequencing and the linkages among such major component parts of decentralization as the SGR, the SGP, the proposed new regional organizations, the central planning and finance ministries, the sectorial ministries and, of course, the departments, districts, and municipalities.

To take just one aspect of what such a central agency should do, from the beginning it has been clear—and not surprising—that the more uniformly decentralization measures are introduced in the highly heterogeneous Colombian environment, the less uniform outcomes are likely to be. Repeatedly, studies have shown that similar measures have produced very different results in different areas. Moreover, the evidence is that whether from a strictly financial point of view or from the perspective of service delivery, good and bad results are not highly correlated with either the size of subnational jurisdictions or their wealth. The usefulness of asymmetrical starting points has long been recognized in Colombia—witness, for example, the early contracting arrangements for departments with respect to education and health (Bird and Fiszbein 1998), and the certification process for municipalities. In the end, however, these eminently sensible attempts to differentiate between good and bad venues for bestowing more functions and finance have lost out to the unending political pressure for nominally equal treatment of jurisdictions that are legally equal. One result has been that outcomes have been markedly unequal, with some jurisdictions doing well and others—their legal (and sometimes also economic) equals—doing badly.

The key missing ingredient in this story is the need to nurse and develop adequate capacity in terms of the local political support for more and better services, the local administrative ability to develop such services, and a better and more comprehensive national and subnational monitoring and evaluation system. These are huge, complex, and difficult tasks. As the national government seems to have recognized, unless a key central government agency is considering the whole picture all the time, many billions of pesos may continue to be wasted and, much more important, millions of Colombians will not receive the services and support needed to make them full (and productive) citizens. However, it does not yet seem to be equally recognized that

substantial attention must also be paid to developing and supporting increased capacity at the sharp end—in the departmental and municipal offices that are directly responsible for service delivery. Moreover, as suggested earlier, it remains debatable whether still stronger central control over service delivery is the best way to improve outcomes. Experience elsewhere with attempts to introduce a centralized “results-oriented” approach in a heterogeneous political and economic setting suggests that doing so is both difficult and likely not only to detract from, but to conflict directly with the need, (and presumably also the desirability), of strengthening and empowering responsive and responsible local decentralized systems and democracy.<sup>49</sup>

### ***The Core of Sound Decentralization Policy***

The core of sound fiscal decentralization policy is not to strengthen central monitoring capacity—useful even necessary though that may be—but rather to develop a good transfer structure and a good subnational revenue system. Colombia has paid much attention over the years to the first of these tasks, but not nearly enough to the second. Unfortunately, unless regional and local governments are given sufficient revenues under their own control for which they are fully politically responsible to local residents, they are highly unlikely to respond properly to even the best-designed transfer system, and may hence continue to frustrate even the most sophisticated central monitoring system.

Colombia began to decentralize by providing more opportunity to at least some municipalities to become more responsible fiscal citizens by having to raise more of their own revenues. This initial effort soon got lost, however, in the pursuit of two separate, and conflicting, objectives—to download some of the responsibility (though not the financing) for the social sectors to the departments and to replace the regional *auxilios*—the percentage of the national budget that was allocated by congressmen to their constituencies prior to the 1991 reform—by transfers that ended up being spread around the country in a politically acceptable way. Unfortunately, in attempting to achieve these goals a number of perverse incentives have crept into the fiscal system that discourage most subnational governments from doing anything much other than trying to get more transfers.

To reduce such disincentives, many countries have introduced transfers with the explicit objective of equalizing the capacity of local governments to provide a specified level of designated public services, or in some cases even to equalize the extent to which such services are actually provided (Bird and Smart 2002). Capacity equalization is most commonly found in federal settings in which subnational governments have relatively clear constitutional expenditure and revenue responsibilities. With this approach, the aim is to provide each local government with sufficient funds (own-source revenues plus transfers) to deliver a centrally predetermined level of services (differentials in the cost of providing services may or may not be taken into account). Transfers are based on a measure of each jurisdiction’s potential revenue-

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<sup>49</sup> In the words of one observer of Canada’s attempt a few years ago to move to a results-oriented expenditure system, what was learned was that from the perspective of developing a system that will be not simply technically efficient but, more important, politically rational and sustainable, “...the road to ROME (results-oriented management and evaluation) is a detour; we have to seek the more challenging, complex, ambiguous, and contested road to DAMASCUS: Democracy and Markets and Socially Constructed Understanding of Science” (Dobell 1999, 102).

raising capacity, such as assessed values for property taxes or measured tax bases for other taxes, and not on actual revenues.

As long as revenue capacity is measured relatively accurately—never an easy task, in practice—the result of this approach is that the transfers create no disincentive at all for local governments to raise revenues, because at the margin the local government still bears full fiscal responsibility for expenditure and taxing decisions, essentially because transfers are lump sum (inframarginal) in nature. If a subnational government raises more than the “expected” amount, it has more to spend. However, if it raises less than the expected amount (its estimated capacity), the transfer will not be increased to make up the “deficit,” so it simply has less to spend. Of course, for this approach to make any sense, the recipient governments must have considerable revenue-raising autonomy. At least Colombia’s larger municipalities should have both the administrative and revenue capacity for such a system to work, and any effective attempt to devolve real responsibility for local service provision should give them the chance to succeed—and perhaps, over time, to map out a path for other subnational governments to follow to the extent possible.

Of course, if the recent evolution of decentralization policy in Colombia is interpreted as signaling that the country has, as it were, essentially given up on the desirability of devolving real responsibility to subnational governments and opted for the alternative approach of an extended system of delegation, with subnational governments responsible primarily to the central government for what they do and how and how well they do it, the issue of improving subnational revenues becomes much less important than improving the central budgetary, monitoring, and control systems. Even in these circumstances, however, subnational governments would, of course, still need some revenues of their own, preferably from a better-structured revenue system along the lines discussed briefly in the section on prospects and challenges.

The performance (results-based) approach, which adjusts the transfer received in accordance with the extent to which the perceived need for the aided service is satisfied (and which may also allow for cost differentials), is often more attractive to central governments, because the level of service funded is then determined centrally, and transfers can be made conditional on the provision of that level of service. This approach seems particularly attractive in Colombia with respect to the education and health sectors, which are largely financed nationally, but it also has some merit even when subnational governments are themselves actually funding those activities—provided, of course, that adequate adjustments for differential fiscal capacity are made in the transfer system. While the evidence suggests that treating decentralization policy solely as an instrument to implement national poverty reduction policy is unlikely to be either very effective or very efficient, and that pursuing centrally directed, results-oriented goals through decentralization policy in general may be not only difficult but even undesirable in the way it discourages the development of effective local democratic institutions, Colombia may, of course, do what it wishes with respect to such matters.

Whichever path Colombia chooses, however, two points seem clear.

First, Colombia should decide what it is trying to do: to create a system of responsible subnational governments with substantial expenditure responsibilities and primary accountability to local residents, or to establish a system of effective subnational agencies to deliver specified

services as determined by the national government and with primary accountability to that government.

Second, whether Colombia sticks with its long-asserted goal of strengthening subnational governments or chooses instead to focus on strengthening the capacity of the national government to, in effect, deliver services effectively through subnational agents, much needs to be done in terms of improving both the incentives provided by national transfers and the capacity of subnational governments to respond effectively to those incentives before the goal of improving locally delivered public services can be successfully achieved.

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