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INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT

PROGRAM DOCUMENT

FOR A PROPOSED DEVELOPMENT POLICY LOAN

IN THE AMOUNT OF EQUIVALENT TO US$700 MILLION

TO

THE REPUBLIC OF COLOMBIA

FOR THE

FIRST PROGRAMMATIC SUSTAINED GROWTH AND INCOME CONVERGENCE OPERATION

November 13, 2014

Macro and Fiscal Management Global Practice
Finance and Markets Global Practice
Colombia and Mexico Country Management Unit
Latin America and the Caribbean Region

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ABBREVIATIONS AND ACRONYMS

AFP	Pension Fund Administrators (*Administradoras de Fondos de Pensiones y de Cesantía)*
ANI	National Infrastructure Agency
BID	Inter-American Development Bank *(Banco Interamericano de Desarrollo*)
CARS	Regional Environmental Authorities (*Corporaciones Autónomas Regionales*)
CAT-R	Customs Assessment Trade
CCE	National Agency for Public Procurement - Procurement Directorate (*Agencia Nacional de Contratación Pública, Colombia Compra Eficiente*)
COLCIENCIAS	Administrative Department of Science, Technology and Innovation (*Departamento Administrativo de Ciencia, Tecnología e Innovación)*
CONPES	National Council for Economic and Social Policy (*El Consejo Nacional de Política Económica y Social)*
CPS	Country Partnership Strategy
CREE	Income Tax for Equity Contribution (*Impuesto sobre la Renta para la Equidad)*
DANE	National Administrative Department of Statistics *(Departamento Administrativo Nacional de Estadística)*
DIAN	Tax and Customs Revenue Authority (*Dirección de Impuestos y Aduanas Nacionales*)
DPL	Development Policy Loan
ESW	Economic Sector Work
FARC	Revolutionary Armed Forces of Colombia (*Fuerzas Armadas Revolucionarias de Colombia)*
FCL	Flexible Credit Line
FDI	Foreign Direct Investment
FDN	National Development Bank (*Financiera de Desarrollo Nacional)*
FOB	Free-on-Board
FSAP	Financial Sector Assessment Program
G&S	Goods and services
GDP	Gross Domestic Product
GNP	Gross National Product
GoC	Government of Colombia
IBRD	International Bank for Reconstruction and Development
ICA	Agricultural Institute (*Instituto Colombiano Agropecuario)*
IDB	Inter-American Development Bank
IDF	Institutional Development Fund
IFC	International Finance Corporation
IMF	International Monetary Fund
INVIMA	Institute for Drug and Food Supervision (*Instituto Nacional de Vigilancia de Medicamentos y Alimentos)*
IS	Information Systems
LAC	Latin America and the Caribbean
LCR	Latin America and the Caribbean Region

LDP	Letter of Development Policy
LPI	Logistics Performance Index
MADS	Ministry of Environment and Sustainable Development (*Ministerio de Ambiente y Desarrollo Sostenible),*
MHCP	Ministry of Finance and Public Credit *(Ministerio de Hacienda y Crédito Público)*
MTEF	Medium Term Expenditure Framework
MTFF	Medium Term Fiscal Framework
NBFI	Non-Bank Financial Institutions
NDP	National Development Plan
NFPS	Non-Financial Public Sector
OECD	Organization for Economic Co-operation and Development
PA	Programmatic Approach
PDO	Project Development Objective
PES	Public Employment Service
PFM	Public Financial Management
PIP	Public Investment Program
PISA	Program for International Student Assessment
PND	National Development Plan (*Plan Nacional de Desarrollo*)
PPP	Public–Private Partnership
PSIA	Poverty and Social Impact Assessment
PyME	Small and Medium Enterprises *(Pequeña y Mediana Empresa)*
R&D	Research and Development
ROC	Regional Operations Committee
ROSC	Report on the Observance of Standards and Codes
SENA	National Service of Learning (*Servicio Nacional de Aprendizaje)*
SFC	Securities and Futures Commission
SIIF	Financial and Administration System (*Sistema Integrado de Información Financiera*)
SINERGIA	National Evaluation System of Management and Results (*Sistema Nacional de Evaluación de Gestión y Resultados)*
SME	Small and Medium Enterprises
SRO	Self-Regulating Securities Market - Self Regulatory Organization
TTL	Task Team Leader
UAM	Autonomous Metropolitan University (*Universidad Autónoma Metropolitana)*
UEASPE	Special Administrative Unit for the Public Employment Service (*Unidad Administrativa Especial del Servicio Público de Empleo)*
USD	Unites States Dollar
VUCE	Single Window for International Trade (*Ventanilla Única de Comercio Exterior*)
WB-IFC	World Bank – International Finance Corporation
WEO	World Economic Outlook
WTO	World Trade Organization

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COLOMBIA

DEVELOPMENT POLICY LOAN FOR THE FIRST PROGRAMMATIC SUSTAINED GROWTH AND INCOME CONVERGENCE OPERATION

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SUMMARY OF PROPOSED LOAN AND PROGRAM
COLOMBIA DEVELOPMENT POLICY LOAN FOR THE FIRST PROGRAMMATIC SUSTAINED GROWTH AND INCOME CONVERGENCE OPERATION

Borrower	Republic of Colombia
Implementation Agency	Ministry of Finance and Public Credit and the National Planning Department
Financing Data	IBRD Flexible Loan with Variable Spread. Amount: US$700 million.
Operation Type	First in a series of two programmatic Development Policy Loans (DPLs). Single tranche.
Pillars of the Operation And Program Development Objective(s)	The Programmatic Sustained Growth and Income Convergence Development Policy Series contributes to Colombia's growth and convergence agenda by supporting the implementation of policy reforms in three main areas: (Pillar 1) fostering solutions to develop infrastructure financing and increasing access to finance for firms; (Pillar 2) improving the quality and allocation of productive skills; and (Pillar 3) increasing productivity by promoting innovation and an efficient regulatory environment. The program development objective is to (i) improve the access to financial markets for road infrastructure investments and firms, (ii) improve training, build productive skills and improve its allocation and (iii) strengthen regulations that affect innovation and business efficiency, as means to support sustained growth and income convergence.
Result Indicators	*Pillar 1: Fostering solutions to develop infrastructure financing and increasing access to finance for firm:* *(*i) Amount of financing allocated to the 4G concessions program by credit institutions (increase from a baseline of 0 in 2013 to COP$10 billion in 2016); (ii) Number of registrations in the collateral registry (increase from a baseline of 0 transactions in 2013 to 1 million transactions in 2016); and (iii) Number of new issuers that entered the market through the hybrid regime (increase form a baseline of 0 issuers in 2013 to 10 issuers in 2016). *Pillar 2: Improving the quality and allocation of productive skill:* (i) Number of job placements achieved through the new system, which is expected to reach 342,000 in 2016 (from a baseline of 166,000 in 2013; (ii) Number of unemployed re-trained. (increase form a baseline of 45,000 in 2013 to 60,000 in 2016); and (iii) Number of firms providing professional training (increase form a baseline of 0 UVAEs in 2013 to 40 in 2016). *Pillar 3: Promoting innovation and an efficient regulatory environment:* (i) Share of budgeted tax benefits for science, technology and innovation effectively used by firms (increase from 16 percent of budget resources in 2013 to 50 percent of budget resources by 2016); and (ii) Number of sectors for which the regulatory evaluation is piloted has increased from 0 sectors in 2013 to 2 sectors 2016 and number of proposed regulations whose efficiency, economic and social impacts in have been evaluated has increased from 0 regulations in 2013 to at least 6 regulations in 2016.
Overall risk rating	Moderate. The main risks arise from changes in the external economic environment, such as a decline in oil and mining prices and variation in external financing conditions. The team believes that the program supported by this DPL will help strengthen the domestic economy and help attenuate the impact from larger than expected external shocks.
Operation ID	P149609

IBRD PROGRAM DOCUMENT FOR A PROPOSED DEVELOPMENT POLICY LOAN TO COLOMBIA FOR THE SUSTAINED GROWTH AND INCOME CONVERGENCE OPERATION

1 INTRODUCTION AND COUNTRY CONTEXT

1. **The First Programmatic Sustained Growth and Income Convergence Development Policy Loan (DPL) supports the Colombian government's efforts to sustain economic growth and increase productivity.** This DPL for US$700 million is the first in a series of two single tranche operations supporting a program of structural reforms to promote long-term growth. The program series seeks to address key bottlenecks to growth and productivity such as access to financing for investment in infrastructure and physical capital by firms, human capital accumulations and skill mismatches, limited innovation and managerial expertise in private firms.[1] The operation has been requested by the Colombian government and underscores the government's continued interest in engaging with the World Bank to strengthen economic activity and shared prosperity. The supported program is fully consistent with both the FY12-FY16 Colombia Country Partnership Strategy (CPS), in particular the pillar of inclusive growth with enhanced productivity, and with the government's current development strategy, in its pillar of sustainable growth and productivity.

2. **In recent years, Colombia's strong economic performance has contributed to poverty reduction and shared prosperity.** According to Colombia's official poverty line[2] poverty rates decreased significantly in the last decade (from 49.7 to 30.6 percent between 2002 and 2013). Extreme poverty rates behaved similarly (decreasing from 17.7 percent in 2002 to 9.1 percent in 2013). Poverty reduction has been accompanied by progress in shared prosperity, with the income growth of the bottom 40 percent of the population reaching 6.6 percent over the period 2008-2013 compared to 4.1 percent for the total population. Many households in Colombia joined the middle class; many others are no longer poor, but vulnerable to fall back into poverty. These trends are mostly explained by sustained economic growth. More than 60 percent of the poverty reduction over the last decade is explained by income growth and labor market participation. The unemployment rate fell (from 15.6 percent in 2002 to 9.6 percent in 2013) while the overall participation rate increased (from 62.3 to 64.2 percent in the same period). However, Colombia's labor market outcomes remain much worse than the LAC average (6.5 percent unemployment and 71 percent participation rate).

3. **In the last decade, Colombia consolidated its position among the top performers in Latin America, helped by internal and external factors.** Colombia's sound macroeconomic management, based on a combination of its inflation targeting regime, floating exchange rate, and a strong track record of fiscal reforms, has helped the country weather the global financial crisis and sustain relatively high growth rates in its wake. Colombia's performance has also benefited from a favorable external environment. The country received large capital inflows, taking advantage of abundant international liquidity. High commodity prices contributed to an expansion of extractive industries production and exports as well as fiscal revenues, having

[1] Colombia Growth and Structural Changes Policy Note, 2014.
[2] Which is nearly four times the Bank's benchmark poverty line of US$1.25 /day.

important implications for growth. Colombia had an average growth rate of 5.4 percent prior to the global crisis (2004-08) and during recovery (2010-11), helping close the country's per capita income gap with top LAC economies and high income (OECD) countries. However, growth slowed down in the last two years as the external environment started to change.

4. **Going forward, Colombia will have to rely on its ability to address existing structural bottlenecks in order to sustain high growth and speed up convergence in standards of living.** Favorable external conditions, i.e. "tailwinds", are expected to recede. As international investment conditions deteriorate and commodity prices stagnate, economic growth will depend even more on Colombian firms' ability to effectively produce and sell goods and services. In this context, addressing structural bottlenecks to economic growth will yield important dividends. In particular, closing Colombia's gap with top performers in the LAC region and OECD with respect to physical capital, labor and human capital standards, as well as productivity, particularly innovation and regulatory environment for businesses, would help sustain the high levels of growth, poverty reduction and shared prosperity enjoyed over the last decade. It would also continue promoting a convergence in living standards between Colombia and this set of countries.

5. **Colombia faces a number of structural bottlenecks limiting its long term growth performance.** These are usually areas where Colombia lags significantly behind top Latin American and OECD economies. Bottlenecks frequently mentioned in the literature include financial markets development (in particular financing for investment in infrastructure and physical capital by firms), low levels of human capital and skills mismatches, limited innovation, restrictive business and labor regulations, limited international trade, and impacts of the armed conflict.[3] Access to financing is relatively narrow and costly, and approximately 41 percent of Colombia firms identify access to financing as a major constraint to business (while the average for LAC is 15 percent).[4] Lack of adequate financing has also contributed to Colombia's large infrastructure gap; the country ranks 117 out of 148 countries in terms of infrastructure quality according to the Infrastructure Quality Index.[5] In terms of human capital, while Colombia has made progress in educational attainment and achievement, the country is still among the lowest ranking countries in the Program for International Student Assessment (PISA) student achievement test of 2012. Labor regulations are also frequently mentioned as a restrictive factor, although recent reforms[6] helped improve this dimension. Low levels of human capital and strict regulations are also reflected in labor market outcomes, where low skill workers are disproportionally represented among Colombia's large share of informal (51 percent) and unemployed workers (9.6 percent). Colombia's low human capital also has implications for productivity as advanced skills are crucial for assimilating new technologies and innovating. In fact, innovation rates and resources dedicated to innovation are low compared to countries of

[3] OECD Colombia Economic Survey (2013).
[4] Enterprise surveys 2010.According to the 2013 *Gran Encuesta PYME*, this number increases to 50 percent for SMEs.
[5] World Economic Forum 2013.
[6] The 2012 reform on non-wage labor costs was supported by the Enhancing Fiscal Capacity for Shared Prosperity DPL, approved in September 20113.

similar incomes[7]. Despite its impressive integration efforts, Colombia is still relatively closed when compared to regional peers, in part due to high trade costs. Colombia's trade as a share of GDP (38 percent) is lower than the average for LAC (50.8 percent), and is the second lowest in LAC after Brazil (21 percent of GDP). Finally, decades of armed conflict have imposed high direct and indirect costs, hindering investment in physical assets, destroying human capital (injuries and deaths), and creating distortions that affect overall productivity.[8]

6. **While the government of Colombia has been working on addressing many of these bottlenecks, the proposed operation supports a program of reforms focusing on key issues for promoting sustained growth and speeding up the income convergence process.** The Colombian government is aware of the important structural issues described above and the strategic value of addressing those issues as the possibility of less favorable external conditions become more like. For this reason, the government has defined a comprehensive program of policy reforms with implications for medium and long-term growth, that will help support continued gains in shared prosperity. This programmatic DPL series supports key reforms under this program. The first proposed operation supports a first round of reforms currently under implementation, while the second operation is expected to support follow-up actions that will help strengthen and consolidate the medium-term goal of sustaining growth and income convergence. Reform efforts have been grouped in three pillars: pillar I supports solutions to develop infrastructure financing and increase access to finance for firms; pillar II includes actions to improve the quality and allocation of productive skills; and pillar III support actions to promoting innovation and improving regulatory environment for business.

2. MACROECONOMIC POLICY FRAMEWORK

RECENT ECONOMIC DEVELOPMENTS

7. **The Santos administration, currently entering a second term, has accumulated a strong record of structural reforms to promote macroeconomic stability and social progress.** In recent years, the government was able to implement important fiscal and macro reforms (including the Fiscal Responsibility Law, the Fiscal Rule, and Comprehensive Tax Reforms to address loopholes, reduce distortions and encourage formal job creation). Reforms have strengthened the country policy management tools, promoted sustainability and resilience but increasing buffers against shocks. In parallel to macro and social reforms, the government has been advancing peace negotiations with guerrilla group FARC, reaching agreement on three out of five negotiation topics for ending the conflict[9]: illegal drugs (May 2014), rural development (June 2013), and political participation (December 2013).[10] Over more than five

[7] According to the National Innovation Survey IV (2007-2008), only 11.8 percent of Colombian firms over 10 workers innovate in product or process compared to 30 percent on average for countries at its level of development.

[8] Estimated growth losses associated with the conflict range from 0.6 percentage point to 1.77 percentage points a year. A. Saavendra (2013), M. Santa Maria, N. Rojas, G. Hernandez (2013).

[9] The remaining topics are the end of the armed conflict (pending) and the preparation of a strategy for the victims.

[10] The first agreement on rural development aims to transform the living conditions in rural areas, reversing the negative effects of violence. The second agreement reached established the basis of an eventual participation of the FARC in Colombian politics. It included rights and guarantees for new political parties that may emerge after a final peace deal, mechanisms of citizen participation, and measures to promote engagement in politics. Finally, the FARC

decades, the conflict has imposed severe economic and social cost, and the dividends from reaching peace are expected to be significant.

8. **Colombia's sound economic performance, backed by the solid macro reforms and favorable external context, helped consolidate the country's position among LAC's strongest performers**. As a result of an enhanced macroeconomic framework, a commodity price boom, and better security conditions, Colombia's economy has grown strongly since the early 2000's. The country weathered the financial crisis robustly, sustaining high growth rates (above 5 percent) in the year before and after. This performance helped Colombia close the country's per capita income gap with top LAC economies and high income (OECD) countries. Growth moderated in 2012 (to 4 percent), in line with emerging markets' slowdown trend and less favorable external conditions. Government actions to support economic activity, including some of the prior action supported by the DPL, helped accelerate growth in the end of 2013 and beginning of 2014. Colombia's growth reached 4.7 percent in 2013, above LAC's average (3.5 percent) but still below the performance in the previous decade. In recognition of its important economic achievements, Colombia was invited to start its accession process to OECD membership (October 2013) and the country's risk rating was upgraded by all major rating agencies in the past 18 months.[11]

9. **Unlike the last decade, the recent growth spell has been led by domestic demand.** From a sectorial point of view, growth has been led by the construction sector (mainly due to infrastructure projects and a rebound in housing construction), social services (mostly public administration and defense), and the primary sector (favorable conditions in coffee production). Breaking the trend during the decade, manufacturing industries resumed growth, taking advantage of local consumption and relatively low exchange rates. In contrast, extractive activities remain stagnant following low prices and disruptions in production linked to the conflict. From the demand point of view, gross capital formation, household and government consumption were the main drivers of growth. Growth has been accompanied by improvements in labor market outcomes. During the last four years unemployment has dropped consistently reaching a record low of 9.6 percent in 2013, the lowest annual figure in this century.

10. **Monetary policy management has been adequate, the peso's appreciation cycle has stopped and inflation has remained within the target band.** The Central Bank has appropriately managed monetary policy tools, in response to fluctuations in economic activity, while maintaining inflation within the target range. In addition, sustained accumulation of international reserves helped relieve exchange rate pressures. Between August 2012 and March 2013, the interest rate was reduced by 200 basis points, reaching 3.25 percent. The rate remained constant until May 2014, when the Central Bank started a gradual increase in the policy rate following a pickup in economic activity and price increases. By July 2014, the rate had increased 100 basis points to 4.25 percent. The Colombian peso (in terms of both nominal and the real

agreed through the third point of the agenda to break any relationship with the illegal drugs business, while the GoC compromised to continue fighting illegal drug and give greater priority to crop substitution and drug treatment programs.

[11] Moody's upgraded Colombia debt rating on Jul 2014 (to Baa local currency, Baa2 foreign currency); Fitch upgraded on Dec 2013 (to BBB+ and BBB, respectively), while S&P upgraded on Apr 2013 (also to BBB+ and BBB, respectively).

effective rate) grew stronger for almost a decade in response to significant capital inflows (primarily FDI). However, the dollar retracted in 2013 from an average of COP$1772 in January to around COP$1931 in December. This retraction was a result from both changes in policies and in the external environment. More recently, an increase in investment inflows led to a moderate appreciation, but the dollar remain close to COP$1900. Fluctuations in Colombia's flexible exchange rate and accumulated international reserves (US$45 billion) act as a shock absorber in times of crisis and uncertainty, strengthening Colombia's external buffers.

11. **Colombia's external accounts remain broadly balanced, despite a recent drop in overall trade.** In 2013, both exports and imports decreased as a share of GDP, leaving the current account deficit almost unchanged at 3.3 percent of GDP. Falling exports are mainly explained by the reduction in coal and gold exports (14 and 34 percent drop between 2012 and 2013). The decline in import primarily reflects a decrease in capital goods purchased from abroad. Nevertheless, terms of trade remained somewhat favorable and investment inflows reached record levels. Gross FDI flows—most of which targeted the oil and mining sector—increased by more than 8 percent in 2013, to US$16.7 billion (4 percent of GDP). While FDI outflows also increased significantly, net FDI flows (2.3 percent of GDP) financed most of the current account deficit. Other financing sources include portfolio investment and public sector net inflows.

12. **Colombia enjoys a relatively strong fiscal position and comfortable room to conduct countercyclical fiscal policy, with a low public debt level and manageable gross public financing needs.** Fiscal results in 2013 remain aligned to Colombia's medium term consolidation goals: the Central Government fiscal deficit is almost unchanged at 2.4 percent of GDP, in line with the fiscal rule's target. The Consolidated Public Sector (CPS) balance dropped to minus 1 percent of GDP in 2013, from a surplus of 0.3 percent of GDP in 2012, but remained consistent with medium term goals. The drop was due to lower than expected revenues from the last tax reform, accelerated budget implementation across regions, and increased transfers to finance the unification of health benefit plans for the contributory and subsidized regimes. While better debt management helped lower interest payments, currency devaluation and an anticipation of bond issuance pushed the overall public debt from 32 percent in 2012 to 35.8 percent of GDP in 2013. Colombia's fiscal position has helped reduce the sovereign risk premium and strengthen the economy's resilience to external shocks. The fiscal account could still be temporarily affected by shocks, for example by a sharp decline in oil prices (oil related revenues represent 17 percent of total Central Government revenues), but the country has enough buffers and tolls (such as stabilization fund and the renewed US$5.8 billion IMF flexible credit line) to prevent strong impacts in the rest of the economy.

13. **Colombia's macroeconomic and financial stability have not been dented by increased volatility in international financial markets.** Assets of the supervised financial system reached 75 percent of GDP at end–2013, with the banking sector accounting for over half of all financial system assets. Pension Fund Administrators (AFPs) are the most important non-bank financial institutions (NBFI), holding around 20 percent of financial system assets in 2013. Insurance premiums are still small (2.4 percent of GDP) but have been growing, while mutual funds are slowly growing to be the second largest player in capital markets (6.8 percent of GDP). Credit growth to the private sector has increased at an annualized rate of around 15 percent,

among the highest in the region, but financial soundness indicators are robust. Capitalization is adequate (16.9 percent); provisions remain well above 100 percent, with non-performing loan levels below 3 percent. Today, Colombia's financial system is much better supervised and resilient, as demonstrated during the last global financial crisis. Capital markets have been rapidly increasing and are among the most developed in the Latin American region.

14. **Despite solid fundamentals, Colombia's economy still faces various challenges to achieve sustainable, inclusive, and higher potential growth.** During most of the 2000's, Colombia benefited from growing external demand, high commodity prices, and abundant FDI. These "tailwinds" have started to stall and -progressively- economic growth is likely to be driven by structural factors. Additional growth dividends from macro stability reforms are limited. However, the country faces considerable challenges to boost and sustain growth: (i) access to finance for firm and infrastructure investment is low and narrow compared to regional peers, limiting effective capital accumulation, and infrastructure provision; (ii) lack of adequate education and professional skills and skill matching mechanisms contribute to low levels of labor productivity, and weak labor market outcomes; (iii) the country lacks a coherent and integrated innovation financing system that will encourage productivity gains and sophistication of firms over time; and (iv) regulations and procedures increase business costs, limiting trade activities. Box 1 discusses in more details key structural challenges for sustaining growth and income convergence in Colombia.

Box 1. Challenges for Sustained Growth and Income Convergence in Colombia

Colombia sustained historically high growth rates in the last decade, which contributed to a convergence in income levels with top LAC and OECD economies. The Colombian economy sustained an average GDP growth of 4.8 percent in the last decade, more than one percentage point above the average for the previous three decades (3.5 percent). In per capita terms, growth was around 2.9 percent, contributing significantly to poverty reduction and shared prosperity (compared to 1.7 in the previous decades). In 2000, LAC's per capita income was 1.8 times Colombia's, while OECD countries had an average per capita income that was 10.9 times Colombia's level. But by 2012 these differences had diminished to 1.6 times and 8.7 respectively.
Following historical patterns, growth was heavily based on factor accumulation; productivity gains were relatively modest. Physical capital accumulation contributed 1.5 percentage points to growth and the combined effect of employment growth and human capital accumulation contributed another 2.4 p.p. A slowdown in population growth (-1.5 p.p.) also contributed to higher per capita income. Finally, TFP growth only contributed 0.3 p.p. of the total.[12] This contribution is higher than in the previous decade, but well below the average for LAC (0.6 p.p.) and fast growing Asian economies (1.62 p.p.).

Despite the importance of factor accumulation to growth, Colombia still lags behind with respect to physical capital, particularly infrastructure. Colombia has a large infrastructure gap. The country places at 117 out of 148 countries in terms of infrastructure quality[13], more than one point below the world average. This gap is the largest in the transport sector, where Colombia is ranked well below Latin American peers and other emerging economies. Both the quality (i.e. paved roads out of total roads) and quantity (i.e. length of roads per km^2)) of roads are low; road length scaled by land area is less than a tenth of the OECD average. As a result, the country's costs of internal freight transport are one of the highest in the world with important consequences on competitiveness. Investing in physical capital can also be a challenge for Colombian firms particularly SMEs. Domestic credit to the private sector more than doubled in the last decade but remains well below OECD and other emerging economies. The access to financing and high financing costs currently represent major constraints to investment as cited by firms. High intermediation margins can

[12] Colombia Growth and Structural Changes Policy Note, 2014.
[13] Infrastructure Quality Index, World Economic Forum 2012.

also constrain entry of new businesses in the real sector and undermine productivity High levels of informality and lack of collateral adds additional challenges to financing of SMEs.

Colombia also lags behind with respect to human capital, education and labor market outcomes. Colombia's performance in the last decade was largely driven by growth in the employed population and gains in primary and secondary education attainment. However, Colombia's skill formation and labor market outcomes still lag behind regional peers. Colombia continues to be among the lowest ranking countries in PISA 2012, underscoring the country's underperformance relative to its middle-income status. Enrolment rates in pre-school and tertiary education are also low when compared to some regional peers such as Argentina and Chile.[14] The post-secondary school National Training Service (SENA - *Servicio Nacional de Aprendizaje*) attempts to fill the general education and technical training gaps, but studies find that the SENA curriculum is not aligned with employer skill demands and the quality of training is mixed, at best.[15] Lack of adequate skill affects employment prospects and income generation opportunities. According to the World Bank Enterprise Survey, 44.5 percent of Colombian employers identify inadequately educated labor force as a constraint to growth, as compared to 36 percent of Latin American firms and 25.8 percent of global firms.[16] One in three firms surveyed report that they do not fill vacancies because of a lack of the skills needed.[17] Lack of adequate skills is aggravated by lack of efficient matching mechanisms. Nearly 70 percent of workers rely on informal job search mechanisms, finding their jobs through the help of family and friends. Only 3 percent used labor intermediation systems, which are mostly small and local private labor services. These intermediation services operate independently. As a result, Colombia's informality and unemployment rates are among the highest in the region. Low education individuals are disproportionally more likely to be unemployment, work informally or being out of the labor force.

Many factors have contributed to Colombia's historically slow productivity growth. First, in addition to its direct effects on growth,[18] Colombia's low human capital has implications for productivity. Quality education helps develop advanced skills that are crucial for an economy to assimilate new technologies and consistently innovate. In fact, innovation rates are low and Colombia's management practices are among the worst in the region.19 Total national research and development expenditures are 0.18 percent (2011) of GDP, roughly half that expected for a country at this level of development. According to the National Innovation Survey IV (2007-2008), only 11.8 percent of Colombian firms over 10 workers innovate in product or process compared to 30 percent on average for countries at its level of development. Second, despite its trade integration efforts, Colombia has remained relatively closed (relatively low levels of trade to GDP for the region). The economic literature has identified positive productivity spillovers from competing with, buying from, selling to, and receiving investment from foreign firms. By facing high costs to trade and investment for decades, partially due to burdensome regulations and procedures, Colombia's low levels of international integration have limited opportunities for technology adoption. In fact, Colombia's small improvements in TFP growth in the last decade coincide with a continued effort to open the economy.[20]

Addressing these gaps is a key requirement for sustaining high long-run growth rates and speed up the income convergence process with high income economies. A simple growth decomposition exercise[21] can provide some intuition on the requirements to sustain GDP per capita growth rates of around 3.2 percent (equivalent to baseline potential GDP growth rate of 4.5 percent). The employment growth required to implement such rate is consistent with an increase of 1.8 percent of the economically active population combined to a reduction in unemployment rate to 7 percent (from 9.6 percent in 2013). In terms of capital accumulation, the country is expected to sustain investment rates above 30 percent (close to the maximum historical levels), to maintain the levels of productivity gains of the last decade (also close to historical maximum). Closing gaps in each of the areas described describe above can help implement this scenario. While labor market performance is directly mentioned in the exercise, other elements have implication to

[14] OECD 2013.
[15] World Bank (2012). "Public Training Reform Issues in Colombia: The Case of SENA," Report No. 27752
[16] Enterprise Surveys 2010.
[17] Source: Manpower Talent Shortage Survey, 2013.
[18] The economic literature has mixed. While Hanushek and Woessmann, 2011 find very large effects, Caselli and Ciccone, 2011 find positive but modest impacts.
[19] World Bank (2013).
[20] Eslava, Haltiwanger, Kugler, Kugler, (2012).
[21] Tendencia Economica 144, Jun 2014.

capital accumulation and productivity and are only indirectly link to the estimate. In an attempt to measure their individual contribution to income convergence and growth, we present a second counterfactual exercise based on growth regression models[22]. The exercise suggests that closing Colombia's gap in financial development (proxied by credit to GDP) with the top 10 percentile performer in LAC, i.e. double the level of credit/ GDP, would lead to an increase of 11.5 percent Colombia per capita GDP in 5 years – on average 2.2 percent a year. Closing Colombia's gap in trade openness (equivalent to level of trade to GDP 3 times larger), would lead to an increase of 8.6 percent per capita GDP in 5 years – on average 1.6 percent a year. Closing Colombia's infrastructure gap with the top 10 percentile performer in LAC (i.e. significantly improve 9 positions on a infrastructure index combining roads and telecommunications), would lead to an increase of 4.3 percent Colombia per capita GDP in 5 years – on average 0.84 percent a year. Finally, Colombia's gap in education (increase secondary school enrolment rate from 78 percent to 100 percent), would lead to an increase of almost 2 percent Colombia per capita GDP in 5 years – on average 0.39 percent a year.

The proposed Sustained Growth and Income Convergence DPL series supports program of reforms aimed at addressing the structural bottlenecks mentioned above and providing concrete initial steps towards closing Colombia's performance gap. For example, reforms supported under pillar I of the operation address some of the existing bottlenecks and market failures on private financing of infrastructure projects, contributing to improvements in Colombia infrastructure in the medium term. This pillar also supports access to finance for firms by facilitating the use of collateral and broadening the reach of capital markets. Reforms on pillar II support skill formation and a better matching of skills and jobs, with direct and indirect dividends for growth. Pillar III combines reforms that are expect to contribute to innovation financing, access to more efficient operational and managerial practices, helping increase productivity gains and reforms that reduce the cost of trading internationally, improving access to markets and goods.

MACROECONOMIC OUTLOOK AND DEBT SUSTAINABILITY

15. **LAC's economic outlook is projected to strengthen over the medium term, with GDP growth around potential level, but below the boom years before the crisis.** Following a stable growth performance in 2013, the 2014 outlook for LAC is expected to be positive. Growth in high-income economies appears to be firming up, but developing countries showed a more mixed performance, largely due to differences in domestic factors. Against this backdrop, global assumptions about the near-term outlook have generally improved. Yet, significant uncertainty remains about how smoothly the recovery can play out in an environment where policy stimulus needs to be reversed. The expected withdrawal of global monetary stimulus therefore continues to pose a key risk to the global outlook. In addition, a slowdown in the economic growth of large developing economies like China and India might contribute to stagnant commodity prices. In this context, LAC faces a number of downside risks with possible implications to the external, social, and fiscal sectors, as well as in the monetary and exchange rate front. The ability to mitigate those risks varies from country to county. Colombia is among the group best prepared to respond to such shocks due to a combination of strong macroeconomic buffers and a sound medium-term strategy to address structural bottlenecks affecting long-term growth.

16. **Colombia's sound macroeconomic framework helps build resilience against external shocks, while ongoing structural reforms help sustain growth in the medium term.** As discussed, Colombia's policy framework is based on: (i) a credible medium-term fiscal framework, supported by a fiscal rule; (ii) an independent Central Bank leading monetary policy based on an inflation-targeting regime alongside a floating exchange rate with moderate interventions; and (iii) sound macro and micro prudential policies combined with a robust financial system. This framework provides a solid basis for countercyclical policy responses and

[22] Brueckner (2014).

stability. In the medium-term, economic prospects will be also benefit from structural reforms carried out by the government, including the actions supported by this operation. For example, reforms to increase financing will allow for new infrastructure investments, training and better matching of workers to firms will improve labor outcomes, among others. The reforms should compensate for a less favorable external environment.

17. **Owing to strong fundamentals, a sound policy framework, and some degree of policy flexibility, Colombia's economic prospects in the baseline scenario are expected to be solid.** While the economic outlook is clearly subject to the downside risks discussed above, the most likely scenario for Colombia is described as follows:

- **Growth and inflation:** As growth accelerates in developed economies and structural reforms are implemented, real GDP is projected to increase to 4.8 percent in 2014, slightly above the estimated long-term rate of 4.5 percent. Private consumption and investment are expected to sustain domestic demand growth, led by the gradual implementation of infrastructure investment projects.[23] Inflation will stay on target at 3.4 percent in 2014 and 3 percent over the rest of the projection period, kept in check by timely Central Bank interventions.
- **Fiscal accounts:** Consolidated public sector expenditures are estimated to decrease in the coming years from a pick of 29.8 percent of GDP in 2014 to 28 percent in 2018. This decrease will slightly exceed that of revenues, which are estimated to drop from 28.2 percent of GDP in 2013 to 27.2 percent in 2018. Consequently, the NFPS fiscal deficit is projected to decline from a pick of 1.6 percent of GDP in 2013 to 0.8 percent in 2018. The Government is projected to meet the fiscal rule interim target for the central government structural deficit of 2.3 percent of GDP by 2014 and gradually decrease it afterwards to reach 2 percent of GDP by 2017. In light of Colombia's solid track record of fiscal management, the authorities are expected to take the necessary corrective policy measures needed to meet this target.
- **External accounts:** The external current account deficit remained unchanged in 2013 as a reduction in the trade balances was compensated by lower factor income outflows. In the medium term, the trade balance is expected to gradually narrow following a small but continued deterioration in terms of trade. The external deficit is expected to continue to be primarily financed by inflows of net foreign direct investment, although an increase in portfolio inflows is expected in the near term.

18. **The debt sustainability analysis indicates that public debt is expected to follow a declining path in the baseline case and in alternative scenarios.** This analysis is consistent with the macroeconomic assumptions outlined in Table 1. In the baseline scenario, the combined public debt-to-GDP ratio is projected to decline from 35.1 percent of the gross combined public sector debt in 2013 to 29.8 percent in 2018 (Annex 4). This scenario is largely based on the government's consolidation plans supported by the medium term fiscal framework. Because a large share of central Government debt is in local currency and on fixed terms, shocks to the interest rate (a one standard deviation shock) and exchange rates (20 percent devaluation) have

[23] The government is starting the implementation of a fourth generation of infrastructure projects (4G) with will be implemented through PPP, and is expected to help close Colombia's infrastructure gap.

only a modest impact on the debt trajectory. At the same time, the debt outlook is not severely affected by shocks to economic growth (a one standard deviation shock) or if the primary balance is left unchanged. Contingent fiscal liabilities represent a potential risk to fiscal accounts, but after a simulated increase of 10 percent in debt creation flows, the public debt continues to decline. Even when historical figures are taken into account, the debt path still falls. These results suggest that public debt sustainability is not a major concern in the medium term.

19. **In sum, Colombia's macroeconomic policy stance is deemed adequate for the purpose of this operation although a downside risk persists.** Medium-term fiscal policy remains prudent, with proposed fiscal adjustments already well underway. Monetary and exchange rate policies are also supportive of macroeconomic and financial stability. Colombia is exposed to downside risks such as:(i) a sharper-than-expected decline in commodity prices which could affect fiscal accounts; (ii) a sharp slowdown in global growth, particularly in main trading partners such as the United States; and (iii) uncertainties in international financial markets that could reduce capital flows. As discussed, Colombia is well positioned to mitigate the impacts of these shocks. In contrast, the Colombian economy could benefit from positive shocks that are not accounted for in the baseline scenario, including a faster than expected implementation of the peace agreement or an acceleration in the execution of new infrastructure projects.

Key economic indicators

	2010	2011	2012	2013	2014	2015	2016	2017	2018
Real GDP growth (%)	4.0	6.6	4.0	4.7	4.8	4.5	4.5	4.5	4.5
GDP Deflator (avg. %)	3.9	7.0	2.7	1.6	4.6	2.3	2.6	2.8	2.8
Oil price, Colombian mix (US$/bl)	73.1	99.3	104.2	100.3	102.2	99.1	94.9	92.4	91.1
Gross national savings	22.1	23.8	24.0	24.2	24.4	24.4	24.7	24.7	25.1
Gross dom. investment	19.1	20.9	20.8	20.9	21.2	21.2	21.6	21.4	21.6
Export growth (FOB+, %)	22.2	35.7	8.7	0.8	5.8	4.6	5.6	5.6	5.2
- Oil exports growth (%)	60.9	72.3	10.8	1.6	2.4	2.5	1.9	1.8	1.2
Import growth (FOB, %)	-3.7	13.8	4.2	3.7	4.2	6.6	7.3	6.3	5.5
Current account balance	-3.0	-2.9	-3.1	-3.3	-3.8	-3.6	-3.5	-3.5	-3.4
Foreign direct investment (net)	0.5	1.4	4.3	2.3	3.0	3.0	3.2	3.1	2.9
Gross reserves (months of G&S++)	7.1	6.1	6.5	7.5	7.6	7.5	7.4	7.2	7.0
Total external debt +++	23.2	23.3	20.8	24.7	24.2	23.8	23.1	22.2	21.5
Combined public Sector (% of GDP):									
Total Revenue	26.1	26.7	28.3	28.3	28.2	27.2	27.3	27.2	27.2
Tax Revenue	18.7	19.1	20.0	19.9	20.1	19.5	19.7	19.7	19.8
Non-tax	7.4	7.6	8.3	8.4	8.1	7.7	7.6	7.5	7.3
Total expenditures	29.2	28.5	27.9	29.2	29.8	28.7	28.6	28.2	28.0
Current expenditures	22.4	20.4	20.8	21.6	22.2	21.6	21.5	21.5	21.5
- Wages and salaries	5.8	5.2	5.2	5.2	5.2	5.2	5.2	5.2	5.2
- Other Consumption	2.4	2.2	2.7	2.7	3.0	2.5	2.5	2.5	2.5
- Goods and services	3.3	2.9	2.9	3.2	3.2	3.1	3.0	3.0	3.0
- Interest	2.9	2.8	2.7	2.6	2.8	2.8	2.8	2.7	2.7
-Transfers	8.1	7.4	7.3	7.8	8.0	8.0	8.0	8.0	8.0
Capital Expenditures	6.8	8.1	7.2	7.6	7.6	7.1	7.1	6.7	6.5
NFPS, Overall Balance	-3.3	-2.0	0.1	-0.9	-1.6	-1.5	-1.3	-1.0	-0.8
CPS, Overall Balance	-3.3	-2.0	0.2	-0.9	-1.5	-1.4	-1.1	-0.8	-0.6
Primary balance	-0.4	0.7	2.8	1.7	1.3	1.4	1.6	2.0	2.2
Public debt	37.0	35.7	32.0	35.8	34.0	33.3	32.4	31.1	29.8
o/w foreign currency	12.7	11.9	11.3	12.9	12.4	12.3	12.1	11.3	11.1
GDP (US$ billions)	287.0	336.3	369.8	378.1	401.1	428.3	453.8	482.3	512.8

Source: World Bank Staff projections based on DANE (official statistics agency), Banco de la Republica, Ministry of Finance and Public Credit, and the IMF numbers from June, 2013. Note that figures presented in this table may differ from official figures owing to differences in methodology and definitions.
Note: +FOB = Free-on-board; ++G&S = Goods and services imports; +++Public and private external debt.

IMF RELATIONS

20. **In June, 2014, the IMF concluded its first review of the two-year US$5.84 billion flexible credit line for Colombia.** The review concluded that Colombia has maintained robust economic performance in recent years due in large part to its very strong policy framework. Well-anchored inflationary expectations, a flexible exchange rate, a structural fiscal balance rule, and effective financial supervision and regulation have contributed to the resilience of the Colombian economy to global uncertainty. The Flexible Credit Line (FCL), approved on June 24, 2013 as a two-year arrangement in an amount equivalent to SDR 3.87 billion (about US$5.84 billion), has also allowed Colombia to restore orderly financial market conditions despite increased volatility in financial markets over the past year by providing a buffer against future external shocks. The Colombian authorities indicated that they intend to treat the new arrangement as precautionary and not to draw on the FCL resources. The review confirms the findings of the last Article IV Consultation held on May, 2014.

3. THE GOVERNMENT'S PROGRAM

21. **The National Development Plan 2010-2014 "*Prosperity for All*" recognizes the importance of growth as a mean to shared prosperity.** The National Development Plan (NDP) proposed a framework base on three pillars: (1) Sustainable Growth and Competitiveness, (2) Equality of Opportunities for Social Prosperity, and (3) Consolidation of Peace – and four cross-cutting principles relevant to all pillars: (1) innovation, (2) good governance, (3) international relevance, and (4) environmental sustainability.

22. **The NDP's sustainable growth and competitiveness pillar combines three main areas: innovation, policies for competitiveness and productivity, and stimulation of growth and job creation engines.** It includes strategic guidelines for promoting innovation as an instrument to shared prosperity including allocation of financing resources to innovation, creating fiscal incentives for innovation related projects, and strengthening property rights instruments. Policies for competitiveness and productivity growth includes developing competences as part of the educational system to better prepare students for jobs, aligning skill formations with firms' needs, encouraging the formalization of workers and firms, reducing logistics costs, increasing access to financial services and capital markets, and improving the business climate and firm efficiency. Finally, in order to stimulate growth and job creation engines, strategic guidelines supporting new innovative sectors, agriculture and housing, transport infrastructure, and extractive and energy activities are needed.

23. **The core sectors covered in the proposed DPL series are well-aligned with the areas targeted by the Colombia NDP 2010-2014.** The strategic policy areas supported by the plan are critical to address Colombia's structural bottlenecks for growth. In particular, strategies under the sustainable growth and competitiveness pillar and the crosscutting themes of innovation and international relevance, such as access to finance and capital markets development, skill formation, innovation and efficiency policies are closely associated with the policy areas and actions supported by this operation.

4. THE PROPOSED OPERATION

LINK TO GOVERNMENT PROGRAM AND OPERATION DESCRIPTION

24. **The PDO and pillars supported by the proposed DPL series are closely linked with the strategic priorities sets by the NDP 2010-2014, which reflect critical needs for promoting growth and shared prosperity.**[24] The program development objectives of this DPL series are to: (i) improve the access to financial markets for road infrastructure investments and firms; (ii) improve training, build productive skills and improve its allocation; and (iii) strengthen regulations that affect innovation and business efficiency, as means to support sustained growth and income convergence. Table 2 presents a mapping between the government

[24] Participation of the private sector in financing and development of public, economic and social infrastructure is still scarce within Colombia. This is due to: (i) the deficient structuring of projects, (ii) weakness in the legislative framework regulating projects, (iii) institutional weakness within different sectors, and (iv) the lack of adequate incentives that allow linking long-term investors offering quality services.

goals and strategic areas and the pillars supported by this operation. The government goal of sustainable growth and competitiveness is directly linked to the PDO, and some of the strategic policy areas supported by this goal are perfectly in line with the three pillars of the operations. The government goal of equity and opportunities for shared prosperity also includes areas linked to the operation through pillar II. Finally, two of the cross-cutting principles set as priority for the government, innovation and international relevance, are closely associated to pillars III of the DPL series.

Table 1: Links between the DPL series and NDP 2010-2014

Colombia NDP 2010-2014		**Associated Pillar of the DPL series**
Pillar/ Cross-cutting principles	*Selected Strategic Areas*	
Sustainable Growth and Competitiveness	i. Access to financing and capital market development ii. Knowledge and innovation iii. Business entrepreneurship iv. Development of competencies v. Logistics costs,	i. Pillar I ii. Pillar III iii. Pillar III iv. Pillar II v. Pillar III
Equality of Opportunities for Social Prosperity	vi. Education of human resources vii. Employability, entrepreneurship and income generation	Pillar II
Consolidation of Peace		None directly
Innovation		Pillar III
Good governance		None directly
International relevance		Pillar III
Environmental sustainability.		None directly

25. **The design and preparation of this DPL series takes into account lessons learned during several years of engagements through DPLs in Colombia.** A key lesson is that DPLs should be seen as one strategic tool of engagement for policy dialogue with a sophisticated client, within a broader program of technical and analytical support that responds to the countries needs and demands. Consultations between the Bank and the GOC during preparation and implementation of the program have helped expand the dialogue in the area such as financial inclusion, professional training, competitiveness, innovation and trade facilitation, and create opportunities to build on ongoing engagement and develop new areas for technical support.

PRIOR ACTIONS, RESULTS AND ANALYTICAL UNDERPINNINGS

26. **The program of reforms supported by the proposed DPL series is organized around three main pillars, reflecting on four critical policy areas for supporting growth and income convergence.** The Colombian government is aware of the important structural bottlenecks to sustained economic growth faced by the country and the strategic value of addressing those issues in an increasingly unfavorable external environment. For this reason the government has defined a comprehensive program of policy reforms with implication to growth, income convergence and ultimately shared prosperity in the country. The proposed DPL series is designed as programmatic, focusing on the areas that have been identified as critical under the CPS and NDP and which are implementable in the foreseen time frame. This first DPL of the programmatic operation supports a set of initial reforms which are expected to contribute to long term-growth. In particular, DPL1 supports key reforms that are grouped in three pillars: actions under pillar I foster solutions to develop private infrastructure financing and increase access to finance for firms; pillar II includes actions aimed at improving the quality and allocation of

productive skills; and pillar III support actions to promote innovation and improving business regulations.

Pillar 1: Fostering solutions to develop infrastructure financing and increasing access to finance for firms

27. **The program supported by this operation recognizes the central role of finance for economic growth and competitiveness.** The GoC is carrying out a reform program to foster the development of the local capital markets to provide firms with more efficient financing mechanisms and promote infrastructure financing.

Fostering the financing of key infrastructure projects

28. **As discussed in Box 1, Colombia's infrastructure gap is a key bottle neck to sustained growth and lack of adequate financing mechanisms has been a limiting factor for infrastructure development.** Aware of the country's tremendous needs in this area and the impact of infrastructure development on economic growth, the GoC has set infrastructure development as a national priority**.** In order to implement an ambitious infrastructure program, the government needs effective long-term financing solutions. The participation of the private sector in financing and development of public, economic and social infrastructure is still scarce within Colombia. This is due to, among other things, the lack of adequate incentives that allow long-term investors to participate in the market. The latter could have a significant impact in the securities market given Colombia's existing infrastructure gap and infrastructure investment plans, which includes US$26 billion of planned investments in an ambitious concessions road program (4G). In this context, a comprehensive approach has been developed across several government agencies. The most important changes are being led by the Ministry of Finance, the National Infrastructure Agency (ANI) and the National Development Bank (FDN). [25] [26]

29. **Available market instruments and regulations are lacking and do not provide incentives for institutional investors to participate in the financing of large projects such as 4G infrastructure investments.** Allowing for the investment and development of such instruments, would help foster investment in 4G projects and contribute to close the country's infrastructure gap with high potential dividends for growth. Moreover, an improved enabling environment created for infrastructure financing could facilitate, in a later stage, access to finance by private corporations, which are now subject to the inertia of bank financing that would take longer to overcome and which require different areas of support where the World Bank has been engaged.

DPL1 Prior Action 1: *The GoC has increased the individual credit limit of credit institutions to invest in projects under the 4G Concession Program (Decree No. 816, April 28, 2014).*

[25] FDN is a semi-public company under the Ministry of Finance of Colombia, with its own legal regime, whose main purpose is to promote, finance and support companies and investment projects in all sectors of the economy.

[26] Authorities have been working on strengthening the institutional setup to structure and finance infrastructure projects. For this purpose, FDN was created in 2013 and has taken the lead in funding 4G, leaving ANI as the head of the structuring and contracting of the actual projects. FDN has undertaken an initiative to design different types of guarantees the financing and maintenance of the constructions.

30. **Regulatory amendments have been done to significantly incentivize credit institutions, to participate in the long term-financing of infrastructure, particularly under the 4G concessions program.** On April 28, 2014, the Government of Colombia issued Decree #816[27] amending the regulatory framework relating to individual credit limits and investment regimes of institutional investors. In particular, the decree increases the individual borrowing limit of credit institutions from 10 percent to 25 percent of regulatory capital, provided that the excess is used to finance infrastructure projects of the fourth generation highway concessions (4G) under the PPP scheme described in Act 1508 of 2012. This recognizes the fact that the 4G contract concessions incorporate a number of conditions that mitigate the financing risks both during construction and in operation and maintenance.

31. **This prior action is a concrete initial step towards expanding infrastructure financing, but the government strategy contemplates additional short and medium term steps that will be considered as triggers for the second operation in the series.** In particular, the GoC will review the definition and simplify the framework for the issuance of credit guarantees in order to further support 4G projects investments. (*DPL2 Indicative Trigger #1*).

32. **Expected results:** Combined, these actions are expected to increase the amount of financing allocated to the 4G concessions program by credit institutions (increase form a baseline of 0 in 2013 to COP$10 billion in 2016).

Improved Access to Credit by firms

33. **Credit for investment remains limited among Colombian firms, particularly small and medium enterprises (SMEs), and as discussed, it is an important bottleneck to economic activity.** According to Asobancaria, the number of firms with at least one financial product reached 600,000 in June 2013 (growing at 9.4 percent annually on average 2008-2013), with just 1 percent of these firms having a microcredit. The 2013 *Gran Encuesta PYME* (GEP) survey indicated that over 50 percent of SMEs reported no access to the financial sector, in particular, SMEs cannot access sufficient long-term finance to modernize their operations and they lack alternative non-bank financing sources. Thus, the GoC has been recently supporting reforms to improve access to credit and foster the capital markets as an additional source of finance. Initiatives to deepen capital markets would grant long term access to finance to a more diversified pool of investors, specially supporting more access for small and medium sized firms.

DPL1 Prior Action 2: *The GoC has authorized the use of movable assets as collateral in financial operations to improve access to credit (Law No.1676, August 20, 2013; and Decree No. 400, February 24, 2014).*

34. **This prior action reflects an important reform of the secured transactions regime.** On August 20, 2013 Colombia adopted a modern secured transactions law (Law 1676) and on February 24, 2014, modern registry regulations to complement the law (Decree 400). The Law

[27] The decree sets the financial regulation to incorporate the particular characteristics of PPPs scheme described in Act 1508 of 2012.

expands the universe of securities that are available for contracting credit obligations, creates an electronic collateral registry for movable assets and establishes a centralized and more efficient registration and consultation scheme. The Law is based on international best practices and it has been adapted to the specific circumstances of Colombia. It has implemented a more efficient and flexible collateral registry, articulated through a centralized and electronic notification registration system, with a reduced cost and an organization based on the criterion of identity of the guarantor (personal record base).

35. **The new framework is a significant milestone to promote financial inclusion and access to credit to the Colombian private sector, particularly SMEs, and is expected to contribute to shared prosperity in the country.** This law broadens the universe of guarantees available to get credit obligations, becoming an essential tool for improving the business environment and competitiveness in the country and broadening the opportunities of SMEs to access a loan. The reform has incorporated innovative norms and principles in the treatment of security interests, and thus is expected to be effective in their role of credit protection and facilitating cheaper credit and access to finance for SMEs. Additional regulation to coordinate the exchange of information between the collateral registry and the registry of vehicles at the Ministry of Commerce/Ministry of Transport would be necessary to continue improving (*DPL2 Indicative Trigger #2*).

36. **Expected results:** The government strategy is expected to significantly improve access to credit in the medium run. With this new legal and regulatory framework, a significant increase in the number of registrations in the collateral registry is expected (increase from a baseline of 0 transactions in 2013 to 1 million transactions in 2016).

DPL1 Prior Action 3*: The GoC has expanded access to capital markets to a more diversified group of issuers and investors through: (i) the reform of the alternative issuance scheme (Segundo Mercado); (ii) the provision of specific guidelines related to the administration and management of mutual funds; and (iii) the establishment of stronger custody schemes for securities markets (Decree No. 1019, May 28, 2014; Decree No. 1242, June 14, 2013; and Decree No. 1243 June 14, 2013).*

37. **The GoC is committed to continue fostering capital market development and to facilitate access to bond financing for a larger and more diversified group of companies, including SMEs.** A decree was issued (May 28 2014) with the purpose of reforming the alternative securities issuance scheme ("Segundo Mercado" or second market) for institutional investors, which is a hybrid regime between public offering and private placements. The decree introduces more flexible requirements, lower costs of issuance, and faster approval times than in standard public offerings. Low origination of securities in the previous Segundo Mercado framework and the high credit quality requirements for the public offering regime for corporate bond markets in Colombia are some of the main motivations to propose reforms in the new hybrid issuance regime. This reform is expected to contribute to increase access to the bond market, with a particular focus on three types of issuers: (i) issuers outside Colombian blue chip companies that are less well-known or have lower credit ratings, while still being investment grade; (ii) one-time issuers for infrastructure projects; and (iii) small and medium enterprises (SMEs). The new regulatory framework takes into account the limited use that has been given to

the original scheme of the "second market" to date, in order to boost the participation of new issuers into the market and generate an increase in the supply of new investment alternatives for investors.

38. **Reforms also seek greater efficiency for the industry of mutual funds so that it will stimulate and further channel savings and financing of new businesses.** The mutual fund industry in Colombia is bank dominated both in terms of management as well as distribution channels. The GoC has supported an improved environment for diversification of the institutional investor base by reforming investment fund regulations, which include measures to lower entry barriers to allow independent/smaller portfolio managers to enter the mutual fund industry and stronger custodial arrangements. The entry of new players is expected to introduce competition and a movement towards increased diversification of investments, beyond government debt, including alternative assets like infrastructure related instruments. In this sense, Decree 1242 and Decree 1243 were issued in mid-2013 providing specific guidelines related to the administration and management of mutual funds, reinforcing the figure of the independent manager and including the establishment of separate custody and distribution schemes, and establishing a progressive separation of brokers from managing collective investment schemes-thus limiting conflicts of interest.

39. **These prior actions to improve firm long-term financing are a part of a medium term government strategy that includes triggers for the second operation in the series.** The issuance of detailed regulation to implement and operationalize mutual funds and Segundo Mercado decrees *(DPL2 Indicative Trigger #3),*contemplated under the work program of the Ministry of Finance, should help ensure consistency in policy measures and implementation of further reforms to continue fostering financing for investment.

40. **Expected results:** The number of new issuers[28] that entered the market through the hybrid regime *Segundo Mercado* is expected to increase from a baseline of 0 issuers in 2013 to 10 issuers in 2013.

Pillar 2: Improving the quality and allocation of productive skills

41. **As discussed in Box 1, Colombia's inadequate supply of, poor quality of, and misallocation of skills has limited labor productivity and growth.** Although Colombians are more educated than ever, Colombia's achievements compare poorly with the LAC average and OECD member countries.[29] Education gap is even large among ethnical groups. Data from the 2005 population census shows that 30 percent of those with indigenous ethnicity have received no schooling, as compared to 10 percent of the general population, and only 2.7 percent have reached higher education versus 37.2 percent of all Colombians.[30] Education quality is also lagging relative to Colombia's level of development. Lack of adequate skill affects employment prospects and income generation opportunities. This problem is aggravated by the lack of

[28] A new issuer is considered an issuer for the 1st time or an issuer that has not accessed the market in the past 5 years.
[29] OECD (2013), *OECD Economic Surveys: Colombia 2013: Economic Assessment,* OECD Publishing.
[30] Source: DANE, General Census 2005.

efficient matching mechanisms. As a result, Colombia's informality and unemployment rates are among the highest in the region. In response to these challenges, the GoC has been implementing an employment strategy aimed at improving skills and employment opportunities. Actions supported under this operation are part of the employability strategy and aim at providing public services such as higher quality job training, and matching workers and vacancies, in order to further develop professional skills.

Improving the matching between jobs and skills

42. **In 2011 a new Ministry of Labor was created with the mandate of coordinating, articulating and implementing labor market policies to improve employment opportunities.** In order to achieve this goal, Colombia's new Ministry of Labor has started to: (i) strengthen public labor intermediation services (*Servicio Público de Empleo* - Public Employment Service PES) to serve a broader clientele of job seekers and employers; and (ii) integrate the information systems of all public and private labor intermediation services by creating a National Employment Network (*Red de Prestadores de Servicios de Empleo*).[31]

DPL1 Prior Action 4*:* *The GoC created the Public Employment Service (PES) within its Ministry of Labor, including an upgraded unified national registry for unemployment and a system to match workers and vacancies (Law No. 1636, June 18, 2013; Decree No. 2521, November 15, 2013; Decree No. 2852, December 6, 2013; Decree No. 722, April 15 2013).*

43. **Law 1636 was issued in July 2013 creating a national employment system (Sistema de Gestión de Empleo para la Productividad - SGEP) to articulate, coordinate and focus active and passive labor market instruments aiming to increase employability.** The system includes the Public Employment Service (PES), expected to replace the more limited service offered by the National Training Service (SENA - *Servicio Nacional de Aprendizaje*) to its graduates; to allow the integration of public and private operators to offer income generation programs, job training and other services. As regulated in the Decree 2852, December 2013, the PES is an instrument of the SGEP with the objective to "achieve the best possible organization of the labor market, which will help workers to find good jobs and employers to contract appropriate workers that meet firm needs." (Ley 1636/2013), including responsibility for organizing, implementing, and managing an integrated registry of unemployed individuals and vacancies and a system for assigning individuals to potential job opportunities.

44. **The Unidad Administrativa Especial del Servicio Público de Empleo (UAESPE) is in charge of the administration of the PES, including its Information System (IS) of the employment network:** it is mandatory for all employers to register their vacancies and for unemployed individuals to subscribe to the unemployment insurance (*Mecanismo de Protección al Cesante*) and to register their CVs, creating the national unique register of vacancies and suppliers. This aims to improve the information nationwide, increasing the possibilities for a better job match and reducing information lags about job availability at the local level.

[31] The objective of the Network is to "integrate and connect activities related to management and job placement that are carried out by public, private, and public-private partnership entities. (Ley 1636/2013).

45. **The PES still faces challenges for its operability, which will be supported by triggers for the next operation.** UAESPE is in its design phase and is a key element of the PES. The Agency needs to define itself by better stipulating the regulation that creates the Unit and identifying its role in the Public Employment System. Some of its challenges are to identify the range of services it provides, the results it aims to achieve, the actors that will feed into the system, its budget distribution, and its IT systems. The PES also faces other challenges in its operation and supervision that require close follow up. Among those challenges the country needs to ensure sustainability of the service in all territorial levels, find the correct incentives to encourage registration of vacancies by employers, coordinate agencies in charge of the employment centers, and develop a results-base payment for agencies. These issues are expected to be addressed by the approval of the regulatory framework defining the institutional arrangement and responsibility for processing the registry of information and managing the system and the approval of the regulatory framework of information flow, and basic PES indicators *(DPL2 Indicative Trigger #4).*

46. **Expected results:** The effective implementation of the system will be assessed by the number of job placements achieved through the new system, which is expected to reach 342,000 in 2016 (from a baseline of 166,000 in 2013).

Building professional skills

DPL1 Prior Action 5: *The GoC has strengthened professional training and skill formation by: (i) developing training courses for unemployed individuals that match labor market needs; and (ii) expanding the provision of training services through the authorization of non-profit entities as training providers (Decree 681, April 4, 2014; and Decree 2852, December 6, 2013).*

47. **The PES will provide basic matching services to unemployed and to firms, but will also ensure job training for unemployed individuals.** The PES system is expected to offer income generation programs, and training services for unemployed individuals. As part of the services, the agencies behind the operation of the PES shall collect the information needed to identify the most demanded profiles by the local productive sector. This analysis is aimed to design the more relevant human capital training for the area (Decree 2582, December 2013). In parallel to the development of PES, and in order to improve access to continued technical and technological training for the population at large, the GoC has also issue a decree regulating the private provision of this services through financing resources from SENA (Decree 681, April 2014), creating bridges with the private sector, and providing incentives for a higher investment in human capital from the private sector.

48. **Since the tax reform of 2012 (Law 1607) and the creation of the CREE tax[32] that in part replaces payroll taxes and finances SENA's operation, SENA can only use these**

[32] CREE is the income tax for equity contribution created in favor of workers, employment generation and social investment. The specialized training program can continue to operate with the resources coming from payroll taxes that still perceives the SENA since the Law maintains the contribution of 2 percent of payroll for employers of one person, Employers of employees earning more 10 monthly minimum wage whether or not subject of the CREE tax, nonprofit entities, certain Societies declared free zones.

resources for social projects[33], via the *Programa de Reentrenamiento y Formación a lo largo de la vida* (Retraining and Life-long Learning Program) through Decree 681/2014. The *Programa de Reentrenamiento y Formación a lo Largo de la Vida* provides counterpart funding to NGOs, employer associations, and Unidades Vocacionales de Aprendizaje Empresarial (UVAEs). Via this mechanism, SENA is bringing closer together employers and training programs, with an emphasis of job competences and on-the-job training while encouraging firms to become trainers of their own workforce. The law regarding use of CREE resources complements an existing program funded by payroll tax (*parafiscales*) - the *Formación Especializada y Actualización Tecnológica del Recurso Humano* program (Law 344/1996) - which transfers resources from SENA to private sector firms that provide training (i.e. not via UVAEs, but directly to firms).

49. **The following indicative triggers should help ensure progress in the implementation of the government strategy develop and improve allocation productive skills**: (i) approval of a Decree regulating the operation of Firms' Vocational and Learning Units (UVAEs) that includes general guidelines of a national learning service (non-formal training): assurance of minimum quality standards; (ii) approval of a basic and socio-emotional skills curriculum in SENA training program: Approval of the national occupational standards (*DPL 2 Indicative Trigger #5);* and (iii) enactment of the Decree-Law regulating the transfer of SGP resources for inter-alia education and human capital formation for indigenous communities (*DPL 2 Indicative Trigger #6*).

50. **Expected results:** The government strategy is expected to increase the number of unemployed re-trained (form a baseline of 45,000 in 2013 to 60,000 in 2016) and the number of firms providing professional training (form a baseline of 0 UVAEs in 2013 to 40 in 2016). Measurable improvements in skills formation for indigenous communities are expected to take longer than the time frame of this DPL series.

Pillar 3: Promoting innovation and improving business regulation

Promoting innovation and technological progress

51. **As discussed in Box 1, Colombia's low levels of Research and Development (R&D) investments and innovation limit productivity gains and sustained growth.** Only 11.8 percent of Colombian firms over 10 workers innovate in product or process compared to 30 percent on average for countries at its level of development. Weak quality of firm management generates low technological "absorptive capacity". A recent LSE-World Management Survey indicates that Colombian firms have among the worst management quality measured to date. Finally, total national R&D expenditures as a share of GDP at 0.18 percent (2011) are roughly half that expected for a country at this level of development.[34] Low levels of R&D in Colombia

[33] The law uses the language "social projects", which is being interpreted by SENA as training services for individuals and does not include current SENA programs such as business incubation or reimbursement to firms for in-firm training.
[34] Colombia Policy Notes, The Urgent Innovation Agenda— Governance, Knowledge, and Firms, 2014.

have been linked to low competition and incentives as well as lack of adequate financing for these activities.

52. **While Colombia counts with a few innovation financing mechanism, regulatory ambiguities and difficulties on execution, has led to low take up and ineffective use of resources.** Currently, Colombia possesses two main instruments to finance science and innovation: (i) the system of tax benefits for firm's investment in science, technology, and innovation; and (ii) the science, technology and innovation fund financed with oil and mining royalties' resources. In both cases, resources have been underused due to regulatory gaps related to granting the benefit and ambiguities in the definition of eligible expenditures, particularly regarding innovation spending and seed capital. In the case of tax benefits, take up has been less than half of the amounts contemplated in the national budget. Some of the reasons for low take up are the vague definitions of eligible spending and difficulties on the process of application and selections of firms to access the benefit. In the case of royalties[35] fund, questions have been raised regarding the nature and relevance of projects selected, and execution rates continue to be very low.

53. **The GoC has taken important initial steps to address this issue, which are supported by this operation**:

DPL1 Prior Action 6: *The GoC has strengthened its system of tax credits for innovation, science and technology by: (i) defining the roles and responsibilities of its National Council of Tax Credits for innovation; and (ii) clearly identifying expenditure eligible for tax credits as well as mechanisms for monitoring and evaluation of tax credit resources (Decree No. 121, January 28, 2014; and Agreement No. 09, July 31, 2014).*

54. **The government is aware of the challenges with innovation system and in particular with the effectiveness of the tax benefits for science, technology and innovation. The proposed prior action support initial efforts to address regulatory gaps associated with the system of benefit**. The action supports the regulation, definition of roles and responsibilities of National Council Tax Benefits (CNBT), composed by DNP, the Ministry of Information Technologies and Communications, DIAN and the Administrative Department of Science, Technology and Innovation – *Colciencias*, and the approval of the committee first unified agreement clearly defining expenditure eligible for tax credits as well as criteria for monitoring and evaluation of resources allocated.

55. **In order to continue addressing bottlenecks on Colombia's innovations system the government strategy also contemplates improvement on the allocation of royalty's resources to science technology and innovation.** In particular, the government expects to approve two important regulations: one, clearly defining rules for execution of royalty's resources dedicated to Science, Technology and Innovation, and the other clearly defining procedures for monitoring and evaluation of the use of these resources (*DPL2 Indicative Trigger #7*).

[35] Since the royalty's reform in 2012, 10 percent of royalty annual receipts are earmarked to finance science, technology and innovation projects.

56. **Expected results:** These actions are expected to lead to a higher and more effective allocation of resources to innovation in the medium term. During the term of this operation, the use of tax benefits for science, technology and innovation is expect to increase from 16 percent of budget resources in 2013 to at least 50 percent of budget resources by 2016.

Improving regulatory efficiency

57. **As previously discussed, the country's regulatory and business environment can generate inefficiencies and distortions that hinder productivity gains.** According to the doing business indicators, Colombia has made continuous progress in improving the business environment. While the country ranks well in the region, it has a significant gap with respect to top developing countries. In particular, there is substantial room to improve when compared with the regional top performer (i.e. Chile) and even more when compared with OECD countries. Regulations and incentives for entry of dynamic young firms are particularly important. Recent work has shown that the vast majority of jobs and income growth in Colombia is generated by the very top 10 percent of young firms.[36] The need to facilitate entry, support, and allow exit if necessary of such young firms is therefore crucial.[37]

58. **Improving individual business regulations is a necessary condition but may not be sufficient if a country lacks a coherent regulatory production strategy.** Improving the regulation that supports allocative efficiency is crucial. However, while strengthening the regulatory environment and making it more efficient is a necessary condition this may not be sufficient for improving the quality of regulations and reduce excessive regulatory burden in the long term. As discussed by a recent OECD report (2013)[38], while Colombia has made important progress in introducing various regulatory reforms, it still lacks a comprehensive policy that promotes regulatory quality. Such policy would introduce a systemic approach that requires evaluating the rationale behind specific regulations and evaluate their costs as well as their benefits. This issue is expected to be addressed by the actions supported by this DPL series.

DPL1 Prior Action 7: *The GoC has established a procedure for the drafting of regulations, in line with OECD best practices, which reduces potential distortions and inefficiencies from regulatory reforms (CONPES 3816, October 2, 2014).*

59. **The main purpose of this CONPES is to define a concrete policy for improving the quality of regulatory policy in Colombia, and as a consequence increase the levels of trust, effectiveness and transparency of the process of issuing regulations.** For this, the present CONPES develops strategies to strengthen economic and social efficiency of future regulatory reforms. This process requires a comprehensive evaluation of externalities and implicit costs for State and citizens and businesses imposed by regulatory change in order to ensure the quality of regulations produced. As part of this strategy, public officials should learn how to develop such assessment and what methodologies to use. With this objective the CONPES set steps to the full implementation of the policy including rules to be issued, in addition methodologies that

[36] Eslava and Haltiwanger (2013)
[37] See Sub-national Doing Business data.
[38] OECD (2013). Regulatory Policy in Colombia: Going Beyond Administrative Simplification.

guarantee not only the evaluation has taken place and the effective participation of citizens and stakeholders are established and information about economic, fiscal, environmental and social impacts of potential regulatory changes are shared. The final step of implementation of CONPES, expected to take place within 3 years of its approval, is the approval of a decree defining mandatory evaluation requirements.

60. **An important step in the implementation of this policy is the creation of Committee for Improving the Production of Regulations, considered as indicative trigger for the second DPL.** More specifically, the committee, composed by the Presidency, Minister of Technology, Ministry of Commerce, and the Planning Department, will be the main body responsible for coordination and technical decisions regarding the requirements for producing new regulations in Colombia (*DPL2 Indicative Trigger #8*).

61. **Expected results:** This prior action and follow up indicative trigger are part of the government support the implementation of mandatory evaluation of impact and efficiency of policy reforms and regulatory changes in economic areas. Its medium-term objective is to mitigate distortion and adverse economic effects of reform, while introducing efficiency considerations. Intermediary results expected to be achieved during the term of this operation include, and increase in the number of sector for which the regulatory evaluation is piloted to reach 2 in 2016 (from a base line of 0 sectors in 2013) and in the number of proposed regulations whose efficiency, economic and social impacts have been evaluated reach at least 6 in 2016 (from a baseline of 0 in 2013).

Trade Facilitation

62. **Colombia has to advance in trade facilitation – for legal and economic reasons.** The Ministerial Conference of the WTO reached an 'Agreement on Trade Facilitation' in December 2013 which requires Colombia to align its trade facilitation framework with international standards. The country currently lags behind in this area with regard to regional and income peers: it ranks 97 (of 160) in the 2014 World Bank's trade logistics performance index—behind Mexico, Brazil, Peru, Chile, Ecuador, Venezuela and Argentina—and a recent World Bank Customs Assessment revealed that Colombian custom authorities apply only 40 percent of benchmark practices with respect to trade facilitation. This underperformance may restrain competitiveness-inducing effects of international trade and may be especially detrimental to integration into global value chains in high-tech sectors where reliable and cost-effective transportation is essential. Furthermore, the persistent current account deficit that has built up in Colombia over the last decade will require increased exports in the future to pay back resulting liabilities. This can only be achieved by overcoming export bottlenecks, e.g. trough trade facilitation.

63. **Given the relevance of this reform area, the programmatic operation supports government efforts of trade facilitation reform.** The GoC has expressed its intention to address the existing lag in trade logistics performance. It outlined the role of enhanced public sector management for competitiveness and sustainable growth in its development plan and regards trade facilitation as an important component of this goal. Among other reform efforts, it designed a strategy of customs modernization and a new Customs Statute which are on the verge

of being enacted, and strengthened its Single Window for International Trade (VUCE) in various aspects.

64. **Bank involvement in this area is supportive to reform success.** The reforms envisaged for trade facilitation have proven difficult in many other countries because they usually involve many different agencies and asymmetrically affect different interest groups. In the case of Colombia, the GoC has outlined the political will for these reforms and it is committed to their implementation, particularly for streamlining of customs procedures and increasing efficiency.

65. **Organizational restructuring paves the way for the government's customs modernization efforts, makes custom management more efficient and increases transparency.** The restructuring of the National Tax and Customs Administration (DIAN) aims for more in-house coordination and broadening of services for custom clients. Some of the specific reforms could include the creation of an integrated system of customs risk management and increase transparency, increase coordination between tax and customs sections to potentially help mitigate misalignments in customs legislations and practices, and a reform of institutional career paths that includes an initial training period which should help improve skills and effectiveness of DIAN officials. A new head of the (DIAN) has been appointed in August 2014 and is reviewing the draft decree that was proposed and would recommend next steps to follow. As a commitment to further progress, the operation thus includes, as an indicative trigger for the next operation in the programmatic series, the restructuring of the DIAN (*DPL2 Indicative Trigger #9*), with the purpose of streamlining processes and improving efficiency and effectiveness.

66. **In addition, it is relevant to note that a new Customs Statute is at the core of the governments' customs modernization strategy.** Against the background of a rather complex institutional setup and political economy with respect to trade issues, Colombia's current customs' legislation is scattered across various decrees, often patched and not aligned to international norms (such as the Revised Kyoto Convention on the Simplification and Harmonization of Customs and the recent WTO Agreement on Trade Facilitation). Therefore, the GoC is working on the legal reform (implemented through a Decree) to create a New Customs Statute (*Estatuto Aduanero*)[39]. Once it is finalized, it will directly impact internationally trading firms and their competitiveness by alleviating the burden of excessive customs paperwork but also have a longer-term impact on further trade facilitation measures by establishing a legal basis for future reforms such as IT-based custom procedures and an integrated and efficient risk administration system, that are expected to reduce processing time. The new customs statute is expected to modernize and simplify Colombia's customs regulation while harmonizing with international practices.

67. **Simultaneous inspections are another important step towards achieving an integrated Single Window for International Trade.** Despite substantial achievements so that inspection of maritime exports for customs, sanitary, and narcotics control can be performed simultaneously, further commitment to trade facilitation is needed for the simultaneous inspections of imports**.** Simultaneous import inspection is important for consistency in the

[39] The old statute was approved in the early 1990s and is outdated.

Single Window and global value chain integration and it is contemplated as an indicative trigger for the second DPL. The Ministry of Commerce, Industry, and Tourism currently leads an initiative of strengthening the Single Window for International Trade on the import side[40]. More specifically, the government will further strengthen the Single Window for International Trade by extending simultaneous inspection methods to imports (*DPL2 Indicative Trigger #10*). Progress in this area would be desirable for making the Single Window more consistent and would potentially help overcoming Colombia's issues concerning the timely arrival of shipments at destination. This would in turn be important for the establishment of competitive value chains in the country.

68. **The policy actions supported under this first programmatic DPL are grounded in analytical evidence; selected findings from the relevant analytical studies are outlined in Table 3 below:**

Table 3: DPL Prior Actions and Analytical Underpinnings

Prior actions	Analytical Underpinnings
Pillar 1: Fostering solutions to develop infrastructure financing and increasing access to finance for firms	
Prior Action 1: The GoC has increased the individual credit limit of credit institutions to invest in projects under the 4G Concession Program (Decree #816, April 2014).	WB Colombia FSAP Update Capital Markets Technical Note (2014) analyzed that pension funds could be the main source of demand for infrastructure fixed income instruments given their long term investment horizons. It also highlighted the relevance of infrastructure financing for the 4G program and the country's economic growth. In addition, CONPES 3760 of 2013, recommended to the Ministry of Finance to consider alternative sources of financing for projects of the 4G program.
Prior Action 2: The GoC has authorized the use of movable assets as collateral in financial operations to improve access to credit (Law No.1676, August 20, 2013, Decree No. 400, February 24, 2014).	Insolvency ROSC (2014) states that the Secured Transactions Act, adopted in August 2013, represents the modernization and reform of Colombian credit protection law.
Prior Action 3: The GoC has expanded access to capital markets to a more diversified group of issuers and investors through: (i) the reform of the alternative issuance scheme (Segundo Mercado); (ii) the provision of specific guidelines related to the administration and management of mutual funds; and (iii) the establishment of stronger custody schemes for securities markets (Decree No. 1019, May 28, 2014; and Decrees 1242 and 1243, June 2013).	Government Policy Note (2013) "Documento Conceptual Reforma Normativa Segundo Mercado". Ministry of Finance presents and analyzes statistics regarding the current situation of small and medium enterprises in the country and access to funding sources and to the capital markets. The reforms proposed are based on experiences and international developments documented in studies by the World Bank and local regulatory agencies such as the Ministry of Finance and the Self-Regulating Securities Market (SRO). Government Policy Note (November 2011) "Documento Conceptual Reforma Normativa Fondos de Inversion en Colombia" describes the proposed regulations and explains the rationale behind the changes.

[40] The GoC has received support from the IFC to reduce the time and cost required by Colombian traders to import and export goods in and out of the country by means of streamlining trade procedures.

Pillar 2:Improving the quality and allocation of productive skills	
Prior Action 4: The GoC has created the Public Employment Service (PES) within its Ministry of Labor, including an upgraded unified national registry for unemployment and a system to match workers and vacancies (Law No. 1636, June 18, 2013; Decree No. 2521, June 18, 2013; Decree No. 2852, December 6, 2013; Decree No. 722, April 2013).	CEER (*Centro de Estudios Económicos Regionales*) (2007), "Bases para reducir las disparidades regionales en Colombia", OECD (2013), Colombia Economic Survey (OECD 2013); Reviews of National Policies for Education: Tertiary Education in Colombia (World Bank 2012).
Prior Action 5: The GoC has strengthened professional training and skill formation by: (i) developing training courses for unemployed individuals that match labor market needs; and (ii) expanding the provision of training services through the authorization of non-profit entities as training providers (Decree 681, April 4, 2014; Decree 2852, December 6, 2013).	
Pillar 3: Promoting innovation and improving business regulation	
Prior Action 6: The GoC has strengthened its system of tax credits for innovation, science and technology by: (i) defining the roles and responsibilities of its National Council of Tax Credits for innovation; and (ii) clearly identifying expenditure eligible for tax credits as well as mechanisms for monitoring and evaluation of tax credit resources (Decree No. 121, January 28, 2014; and Agreement No. 09, July 31, 2014).	World Bank's Innovation Programmatic Approach (2013), Innovation Policy Note (2014), Colombia Economic Survey (OECD 2013).
Prior Action 7: The GoC has established a procedure for the drafting of regulations, in line with OECD best practices, which reduces potential distortions and inefficiencies from regulatory reforms (CONPES 3816, October 2, 2014).	Regulatory Policy in Colombia: Going Beyond Administrative Simplification (OECD 2013).

LINK TO CAS AND OTHER BANK OPERATIONS

69. **The DPL series is fully aligned with the Country Partnership Strategy's (CPS) FY12-FY16 (discussed in July 2011) and with the CPS Progress Report (discussed in May 2014).** In particular, the series contribute to the strategic pillar 1: "Expanding Opportunities for Social Prosperity" and pillar 3: "Inclusive Growth and Enhanced Productivity". Specifically, it supports the development objectives of: (i) improving coverage and monitoring of select social services, in particular for the poor; (ii) increasing education for students from disadvantaged households; and (iii) improving instruments to mobilize capital. While the DPL series has not been contemplated in the CPS, it directly supports a number of intended outcomes and result indicators. In particular, the program of reforms supported by the DPL is expected to contribute to the following revised CPS results indicators: (i) increase in the coverage of municipalities that offer active labor market policies (including *Servicio Publico de Empleo* Centers); (ii) percentage of students enrolled in first year tertiary education; (iii) strengthened capital markets oversight and institutions; (iv) new financial products for low-income population and SMEs launched; and (v) number of new instruments for infrastructure finance launched in the market.

70. **This DPL is supported by the technical work developed under different thematic Programmatic Approach (PA) for Colombia.** For example, reforms under pillar one are closely related to the work of the Sound Financial Sector Development PA, which contributes to

the sound development of the Colombian financial system with a view to support inclusive economic growth, through strengthening financial sector oversight, developing the capital markets and supporting financial inclusion. Reforms under pillar two have close links with the IDF Grant "Strengthening the Ministry of Labor's capacity to design interventions and manage for results", which among other things supports the strengthening of the labor intermediation system and the Ministry of Labor's capacity to Respond to Crisis through the design and implementation of a temporary employment program and cyclical tools. Reforms under pillar three are supported by the Innovation and Competitiveness PA. Additionally, reforms under pillar III are closely related to the technical work carried out by the Public Sector PA and the RAS on for the Modernization of the Colombian Tax Administration and Customs System. The definition of the PDO and the overall diagnostic that supported the design of the operation were based on the work under the Strengthening Fiscal Policy for Sustained and Inclusive Growth PA and the Colombia Policy Notes. Finally, it is worth highlighting that this DPL series follows a long engagement with Colombia through DPLs, including the Fiscal Sustainability and Growth Resilience DPL I (2011) and II (2012) and the Fiscal Policy for Shared Prosperity DPL (2013), and builds on the engagement developed during these operations.

71. **This DPL also builds on to a previous DPL series on business productivity and efficiency[41] implemented between 2006 and 2011.** The DPL series focused on (i) facilitating the operation of businesses and promoting investment to boost productivity and employment levels, and (ii) consolidating the financial sector and capital markets as pillars of economic growth to address the needs of individuals and the productive sector. Many of the reforms supported by the proposed operation builds on or provide continuity to early reforms supported by the previous DPL series.

CONSULTATIONS, COLLABORATION WITH DEVELOPMENT PARTNERS

72. **The government's long term reform program included a process of consultations.** Consultations and socialization of the National Development Plan took place[42] in 2010, including consultations of the GoC's goals of long-term development and growth, which this DPL supports. In addition to the consultation and participatory measures associated with the National Development Plan 2010-2014, some of the prior actions were subject to additional consultations and to the development of technical policy notes.

73. **The Bank's country team has collaborated very closely with the IMF, notably on the review of macroeconomic developments, including fiscal projections and the analysis of debt sustainability.** Overall, the proposed DPL program is consistent with IMF policy advice. The program supported by the operation is also consistent with the recommendation of the OECD accession process and recent IDB activities. Within the World Bank Group, the DPL

[41] The DPL series comprise IBRD 73340 (P094301), IBRD 74130 (P095213) and IBRD 75340 (P105029) for a total of US$1.1MM.

[42] The legal institution for consultation and socialization of the National Development Plan (and, therefore, the goals of long-term development) is the National Planning Council. The Organic Law on Planning, in Articles 8, 9 and 10 provides the composition and responsibilities of the Council.

team has coordinated with the IFC on areas related access to finance, firm's efficiency and trade facilitation.

5. OTHER DESIGN AND APPRAISAL ISSUES

POVERTY AND SOCIAL IMPACT

74. **The Government policies supported in this DPL are expected to have a positive poverty and social impact.** Income growth and labor markets outcomes help explain 60 percent of Colombia's poverty reduction in the last decade. The actions supported by this operation intended to further increase growth and productivity and likely to have similar impacts on poverty reduction and share prosperity. The Poverty and Social Impact Assessment has been carried out, documenting these expected positive impacts from a social, gender and distributional perspective. This assessment, explained in more detail in Annex 5, explains the potential positive outcomes of these policy actions on overall growth, employment and welfare of the poor and those in the bottom 40 percent of the income distribution.

75. **The PSIA is structured to follow the policy areas outlined under the Proposed Operation.** Specifically, within Pillar I, policies that support infrastructure financing and increase access to credit are expected to have a positive impact by increasing employment (and formalization), reducing consumer prices (lower costs of transport and logistics), and smoothing consumption of the poorest households. In terms of Pillar II, the recently implemented system for matching workers and vacancies is expected to increase the employability of the bottom 40 percent since they rely more on these services rather than their own networks to find a job. Moreover, strengthening the professional training system targeted to the unemployed is expected to increase the probability of employment of the poorest. Within Pillar III, tax credits for innovation will likely increase formalization and earnings in those economic sectors where the funds will be allocated and reduce entry barriers for firms.

ENVIRONMENTAL ASPECTS

76. **The proposed operation is not likely to have any direct effects on the environment, forest, and other natural resources.** Colombia has a system of environmental licensing dating back to the 1974 Code on Renewable Natural Resources and Environmental Protection. The requirement to carry out environmental assessments for projects with possible environmental impacts in its current form in Colombia is regulated by the Law 99 adopted in 1993 and series of subsequent modifications. As stipulated by the law, the Ministry of Environment and Sustainable Development (MADS), the regional environmental authorities (CARs) and municipalities, depending on the nature of the works, are responsible for issuing environmental licenses. However, the enforcement and compliance monitoring capacity varies by region and by municipality and in some cases requires strengthening. It is relevant to note that an increase of access to finance for 4G infrastructure investments and SMEs that is expected to be stimulated by the policy reforms supported by the DPL, and any other works with possible environmental impacts, will be subject to the national environmental regulations. Moreover, the 4G CONPES sets guidelines for the allocation of environmental risks (particularly the responsibility for obtaining and managing environmental licenses) in the new pipeline of road concessions.

PFM, DISBURSEMENT AND AUDITING ASPECTS

77. **The public financial management systems are adequate to support development policy lending.** The national-level Public Financial Management (PFM) systems show advanced levels of performance that are moving toward good international practices, according to the most recent reports from the IMF and World Bank.[43] Notwithstanding, there remains areas for further strengthening of public financial management systems, such as information systems and budget management. In 2012, a new financial and administration system (SIIF II) was put into operation, and an effort is under way to adopt a Unified System of Investment and Public Finance. The Government has increased the coverage of SIIF II, and is working in its integration with the different PFM tools.[44] Colombia has an effective track record of implementing PFM reforms, which the Bank has supported. Salient features of the PFM systems are summarized below:

- **The budget is comprehensive, well documented, and implemented as planned, with actual expenditures deviating only slightly from planned levels.** Budget planning is based on a multiyear perspective,[45] and annual formulation reflects a mostly well-functioning policy-based system.[46] Execution of budgeted expenditures suggests a largely credible budget. The Borrower has published its annual budget in a timely fashion.[47]
- **Revenue and expenditure controls are comprehensive, and there is a continuous effort to improve them.** Of significant relevance are strong measures to safeguard the overall integrity and accuracy of revenue data by integrating or reconciling the different accounting systems used by the tax administrator, ensuring consistency between the information from accounting and statistical records, and guaranteeing timely recording of transactions. Records and controls on cash flows, balances, and public debt support sound fiscal management and provide public institutions with the tools for predicting funding to execute their budgets in an orderly manner.
- **The consolidated public accounts are prepared within six months after the end of the fiscal year.** They include full information on revenues, expenditures, and financial assets and liabilities. Year-end accrual-based financial statements are issued by the Accountant General and presented by May 15 of the following year to the Controller General for audit purposes. The Controller General's auditing policies and procedures provide for the application of financial, compliance, and performance procedures consistent with the National Government's auditing standards. Audit reports are submitted before July 1 of the following fiscal year to the Congress and the President.

[43] See IMF (2012) and World Bank (2013), and Public Financial Management and Procurement Report (PEFA 2009).
[44] These include the National Development Plan (PND), the fiscal rules, the Public Investment Program (PIP), the MTFF, the MTEF, the Operative Annual Investment Plan, and the financial plan.
[45] The country has developed key PFM multiannual instruments since 2003, such as MTFF and MTEF. However, they are presently not used adequately since, instead being prepared sequentially with the budget, they are developed in parallel.
[46] See IMF (2012) and World Bank reviews (2013) for more information.
[47]Law 1687 of December 11, 2013.

78. **The GoC is implementing an accounting and auditing reform agenda to adopt and implement international accounting and auditing standards.** In the last two years, there have been significant developments towards implementing this reform, including new legislation, and an inter-institutional commission involving key government authorities to operationalize transitional arrangements towards completing implementation. Going forward, there are still a few challenges for the GoC to overcome in the reform process.

79. **Disbursement arrangements.** Once the DPL becomes effective and the Borrower complies with any withdrawal tranche release conditions, and following the Borrower's request, the Bank would deposit the funds into an account denominated in US dollars of the Central Bank (Banco de la República) for subsequent credit into the Treasury Single Account of the MHCP, thus becoming available to finance budgeted expenditures. The MHCP will provide the Bank with a written confirmation of the transaction after the funds are disbursed by the Bank.

80. **The various assessments show that the banking control environment into which the DPL proceeds would flow are adequate.** This assessment is based on a review of the 2013 and 2012 external audit report of the Banco de la República, the latest IMF Central Bank safeguards assessment (2012), and the 2014 IMF Article IV Consultation. Because the Borrower's PFM systems and the fiduciary arrangements for this financing are assessed as adequate, the Bank will not require an audit of the designated account, and no additional fiduciary arrangements are considered necessary at this time.

MONITORING AND EVALUATION

81. **MHCP, DNP, and DANE are responsible for coordinating actions among the concerned agencies.** MHCP's Department for Public Credit will collect the necessary data to assess the implementation progress for which the MHCP is responsible and report it to the Bank. Similarly, DNP will collect and report to the Bank the information related to the implementation progress of the program. Finally, DANE will be responsible for online release of national accounts, household survey micro-data for replicating poverty and other social indicators.

6. SUMMARY OF RISKS AND MITIGATION

82. **This DPL is subject to risks related to a deteriorating external economic environment, possible changes in government, and delays in reform program implementation.** Despite solid fundamentals, Colombia's near-term macroeconomic outlook could be adversely affected by external shocks, with temporary implications for growth and productivity. This risk is mitigated by the country's high policy response capacity. In addition, the government has made important regulatory changes to help mitigate risks associated with implementing the reform program, but delays may happen given the natural transition process of the new administration.

Economic Risks

83. **Despite its relatively high exposure, Colombia has developed capacity to counter external shocks.** Colombia is exposed to two main types of external shocks: a decline in oil and mining prices and financial turmoil associated with a possible tapering of U.S. monetary policy. This risk is mitigated by the fact that the country's macro resilience is based on solid initial conditions and policy buffers to respond. In addition, structural reforms supported by this operation will contribute to growth and partially compensate for adverse changes in the external environment. The absence of significant domestic or external imbalances helps shore up stability. Prudent fiscal and monetary management – with room for countercyclical policy responses, substantial foreign direct investment inflows, comfortable levels of foreign reserves, and a Flexible Credit Line with the IMF help protect Colombia's external position.

84. **The appreciation of the Colombia peso, which has been an issue of concern, has halted since 2013**. The Colombian peso (the nominal as well as the real effective rate) has grown gradually stronger in recent years because of significant capital inflows (primarily FDI) and improved fiscal policy. Recently, however, a combination of lower interest rates, currency purchases by the Central Bank, and change in the international financial environment have contributed to a nominal depreciation of the peso during 2013, and a relatively stable position during 2014. This helped alleviate Dutch disease concerns.

Implementation Risks

85. **While direct risks associated with the implementation of the prior actions are low, indirect risks might affect the ability of reaching desired results in some cases.** The government has made important regulatory changes to help mitigate risks associated with implementing reforms, but Colombia's track record suggests that delays and interruptions could arise. Implementation risks could be related to environmental and social as well. As raised in the environmental assessment, even though Colombia regulatory system is relatively strong, it is possible that some of the potential projects partially financed by instruments supported by this operation end up having indirect adverse environmental impacts if environmental regulations and consultation processes are not enforced well.

ANNEX 1: POLICY AND RESULTS MATRIX

Prior actions and Triggers		Result Indicators
Prior Actions under DPL 1	**Indicative Triggers for DPL 2**	
Pillar 1-- Fostering solutions to develop infrastructure financing and increasing access to finance for firms		
Prior Action 1: The GoC has increased the individual credit limit of credit institutions to invest in projects under the 4G Concession Program (Decree #816, April 2014).	(**Indicative) Trigger #1** The GoC reviews the definition and simplifies the framework for the issuance of credit guarantees in order to further support 4G projects investments.	Amount of financing allocated to the 4G concessions program by credit institutions (increase from a baseline of 0 in 2013 to COP$10 billion in 2016).
Prior Action 2: The GoC has authorized the use of movable assets as collateral in financial operations to improve access to credit (Law No.1676, August 20, 2013, Decree No. 400, February 24, 2014).	**(Indicative) Trigger # 2** Additional regulations to coordinate the exchange of information between the collateral registry and the registry of vehicles at the Ministry of Commerce/Ministry of Transport.	Number of registrations in the collateral registry (increase from a baseline of 0 transactions in 2013 to 1 million transactions in 2016).
Prior Action 3: The GoC has expanded access to capital markets to a more diversified group of issuers and investors through: (i) the reform of the alternative issuance scheme (Segundo Mercado); (ii) the provision of specific guidelines related to the administration and management of mutual funds; and (iii) the establishment of stronger custody schemes for securities markets (Decree No. 1019, May 28, 2014; and Decrees 1242 and 1243, June 2013).	**(Indicative) Trigger # 3** Detailed regulations issued to implement and operationalize mutual funds and Segundo Mercado decrees.	Number of new issuers that entered the market through the hybrid regime (increase form a baseline of 0 issuers in 2013 to 10 issuers in 2016).
Pillar 2-- Improving the quality and allocation of productive skills		
Prior Action 4: The GoC has created the Public Employment Service (PES) within its Ministry of Labor, including an upgraded unified national registry for unemployment and a system to match workers and vacancies (Law No. 1636, June 18, 2013; Decree No. 2521, November 15, 2013; Decree No. 2852, December 6, 2013; Decree No. 722, April 2013).	**(Indicative) Trigger # 4** Approval of the regulatory framework defining the institutional arrangement and responsibility for processing the registry of information and managing the system and approval of the regulatory framework of information flow, and basic PES indicators.	Number of job placements achieved through the new system, which is expected to reach 342,000 in 2016 (from a baseline of 166,000 in 2013.

DPL1 Prior Action 5: The GoC has strengthened professional training and skill formation by: (i) developing training courses for unemployed individuals that match labor market needs; and (ii) expanding the provision of training services through the authorization of non-profit entities as training providers (Decree 681, April 4, 2014; Decree No. 2852, December 6, 2013).	**(Indicative) Trigger # 5** Approval of a Decree regulating the operation of Firms' Vocational and Learning Units (UVAEs) that includes general guidelines of a national learning service (non-formal training) and approval of a basic and socio-emotional skills curriculum in SENA training program. **(Indicative) Trigger # 6** Enactment of the Decree-Law regulating the transfer of SGP resources for inter-alia education and human capital formation for indigenous communities.	Number of unemployed re-trained (increase form a baseline of 45,000 in 2013 to 60,000 in 2016). Number of firms providing professional training (increase form a baseline of 0 UVAEs in 2013 to 40 in 2016).
Pillar 3 - Promoting innovation and an efficient regulatory environment		
Prior Action 6: The GoC has strengthened its system of tax credits for innovation, science and technology by: (i) defining the roles and responsibilities of its National Council of Tax Credits for innovation; and (ii) clearly identifying expenditure eligible for tax credits as well as mechanisms for monitoring and evaluation of tax credit resources (Decree No. 121, January 28, 2014; and Agreement No. 09, July 31, 2014). **Prior Action 7:** The GoC has established a procedure for the drafting of regulations, in line with OECD best practices, which reduces potential distortions and inefficiencies from regulatory reforms. (CONPES 3816, October 2, 2014).	**(Indicative) Trigger # 7** Approval of a regulation clearly defining rules for execution of royalty ("*regalia")* resources dedicated to Science, Technology and Innovation, and approval of regulation clearly defining procedures for monitoring and evaluation of the use of these resources. **(Indicative) Trigger # 8** Creation of Committee for Improving the Production of Regulations. **(Indicative) Trigger # 9** The GoC reorganizes the National Tax and Customs Administration, with the purpose of streamlining processes and improving efficiency and effectiveness. **(Indicative) Trigger #10** The GoC further strengthens the Single Window for International Trade by extending simultaneous inspection methods to imports.	Share of budgeted tax benefits for science, technology and innovation effectively used by firms (increase from 16 percent of budget resources in 2013 to 50 percent of budget resources by 2016). Number of sectors for which the regulatory evaluation is piloted has increased from 0 sectors in 2013 to 2 sectors in 2016 and number of proposed regulations whose efficiency, economic and social impacts have been evaluated has increased from 0 regulations in 2013 to at least 6 regulations in 2016.

ANNEX 2: LETTER OF DEVELOPMENT POLICY

República de Colombia

Libertad y Orden

Ministerio de Hacienda y
Crédito Público

Departamento
Nacional
de Planeación

Bogotá D.C., - 7 NOV 2014

Doctor
JIM YONG KIM
Presidente
Grupo Banco Mundial
Washington, D.C.

Asunto: Carta de Politica – DPL de Crecimiento y Convergencia del Ingreso

Estimado Doctor Kim,

La solidez de la economia colombiana se ha erigido gracias al buen manejo de la política económica, explicada por un circulo virtuoso del cual es responsable el Gobierno Nacional. Un menor déficit fiscal y unas finanzas públicas sanas se traducen en menores tasas de interés. Esta reducción en los costos del financiamiento de la economia permite mayores niveles de inversión, lo que a su vez impacta positivamente el crecimiento económico. Un mayor crecimiento impulsa la dinámica del recaudo tributario, dando espacio a una nueva reducción del déficit fiscal y reiniciando así el circulo.

Así mismo, la estabilidad macroeconómica observada se ha fortalecido sobre las bases de la coherencia en el manejo económico del país, el cual se ha sustentado en la coordinación de la política monetaria y fiscal, apoyadas en la solidez del sistema financiero y en un régimen de tasa de cambio flexible.

En efecto, dicha estabilidad macro le ha permitido al pais, entre otros: 1) reducir el déficit fiscal del Gobierno en más de un punto porcentual del PIB en corto tiempo (pasó de 3,9% en 2010 a 2,4% en 2013); 2) financiar las tasas más altas de inversión de su historia reciente (durante el primer semestre del 2014, la tasa de inversión fue de 30,2% del PIB); 3) liderar el crecimiento de la región (en el segundo trimestre de 2014 Colombia presentó el crecimiento más alto dentro de las 6 economias más grandes de la región); y 4) lograr importantes avances en términos de reducción de la pobreza (desde 2010 han salido de la pobreza 3,6 millones de colombianos, con lo cual se logró una reducción de la incidencia de pobreza de 37,2% a 29,3% en el 2014).

Sin embargo, y con el fin de que el pais logre consolidar una senda de crecimiento y desarrollo económico sostenido en el largo plazo, el Gobierno es consciente de que aún persisten importantes retos en materia de política pública que debe asumir en el corto plazo.

Teniendo en cuenta lo anterior, el Gobierno de Colombia solicita al Banco Mundial un Préstamo Programático de Política que le permita continuar impulsando el crecimiento económico. Los logros derivados de dicho préstamo complementarían aquellos propiciados por las tres operaciones programáticas de desarrollo empresarial contratadas en la década anterior, que fomentaron el proceso de aumento de competitividad del aparato productivo colombiano impulsado por el Gobierno Nacional[1].

Las áreas de política que soportan el cumplimiento de los objetivos del Programa de apoyo que se está solicitando son: i) la promoción del financiamiento y el incremento del acceso al crédito para las empresas privadas y el desarrollo de la infraestructura, ii) el mejoramiento de la calidad y la focalización de los esfuerzos estatales para el desarrollo de las capacidades productivas de la población, y iii) el aumento de la productividad mediante la promoción de la innovación y un entorno regulatorio eficiente.

En cumplimiento con lo definido en la matriz de política del préstamo programático solicitado, a continuación se describen de forma detallada las acciones relacionadas y los avances del Gobierno en la materia.

En cuanto a la primera área de trabajo, el Gobierno nacional viene avanzando en la revisión del marco regulatorio para mejorar el financiamiento a proyectos de infraestructura de cuarta generación, 4G. En este sentido, se revisaron los cupos individuales de los establecimientos de crédito, lo que redundará en un incremento en las alternativas de financiación de dichos proyectos.

De igual forma, se ha mejorado el acceso al crédito para las empresas. En efecto, se ha avanzado en la implementación del Registro de Garantías Mobiliarias, permitiendo un mayor acceso a financiación para las empresas utilizando sus activos muebles como garantías de dichas operaciones. Adicionalmente, se ha apoyado el desarrollo de los mercados de capitales a través de: i) la creación de un esquema de emisión alternativa (Segundo Mercado) que facilita el acceso a los mercados de capital a un grupo más diversificado de emisores, incluyendo pequeñas y medianas empresas; ii) la provisión de guías específicas relacionadas con la administración y el manejo de los fondos mutuos; y iii) el establecimiento de esquemas más robustos de custodia para los mercados de valores. Igualmente, cabe resaltar que dentro de la Estrategia Nacional de Inclusión Financiera lanzada recientemente se ha incluido como uno de los pilares fundamentales el acceso a financiación para las pequeñas y medianas empresas, el cual se instrumentará a través de la consolidación del mencionado registro, así como de la promoción del *factoring* como fuente fundamental de capital de trabajo para estas entidades.

Con respecto a la segunda área de trabajo, una de las principales líneas de acción del Gobierno, y especialmente del Ministerio del Trabajo, ha sido fomentar la adquisición, desarrollo y

[1] En síntesis, los logros impulsados por las tres operaciones mencionadas estuvieron relacionados con: i) la mejora del ambiente de negocios, del comercio internacional y de la competitividad; ii) el fortalecimiento y profundización del Sistema Financiero y del Mercado de Capitales; iii) el mejoramiento de los estándares de calidad y el fomento de la innovación tecnológica; y, iv) el fortalecimiento de la infraestructura y la logística nacional.

reconocimiento de competencias de los trabajadores en el marco de un sistema integral de políticas (activas y pasivas) de empleo. En este sentido, los lineamientos que defina el Gobierno para establecer programas de formación, especialmente aquellos que impliquen políticas y programas de atención a la población en situación de vulnerabilidad, contarán con parámetros básicos de calidad y pertinencia respecto a las necesidades del sector productivo y de la sociedad en general.

Asimismo y atendiendo los principios de las sociedades del conocimiento (como el de formación a lo largo de la vida), se requiere acompañamiento en la expedición de la normatividad necesaria que sirva de marco de referencia, tanto a los servicios formativos que se ofrezcan en el nuevo servicio público de empleo, como para establecer un sistema de certificación de competencias de alcance nacional.

En cuanto a la tercera área de trabajo el gobierno ha alcanzado importantes avances como: i) la definición de los roles y responsabilidades del Consejo Nacional de Beneficios Tributarios en Ciencia, Tecnología e Innovación; ii) la aprobación de un Acuerdo Unificado del Consejo Nacional de Beneficios Tributarios en Ciencia, Tecnología e Innovación, que facilitará la comprensión y acceso de las empresas a estos beneficios; y iii) la aprobación del documento de Política de Mejora Normativa CONPES.

Finalmente, cabe resaltar la importancia de este programa para el país, en la medida en que contribuirá significativamente al cumplimiento de las estrategias del Plan Nacional de Desarrollo 2014-2018 relacionadas con el desarrollo empresarial. En particular, las acciones relacionadas con este programa contribuirán a consolidar la *Política de Desarrollo Productivo basado en Innovación* en la que viene trabajando el Gobierno Nacional, las iniciativas específicas que se impulsarán en materia de innovación, y el diseño e implementación de nuevos instrumentos de inversión focalizados para atender las necesidades de los sectores productivos y las regiones – incluyendo la financiación proveniente del Sistema General de Regalías.

Agradeciendo su atención, reciba un cordial saludo.

Mauricio Cárdenas Santamaría
Ministro de Hacienda y Crédito Público
Ministerio de Hacienda y Crédito Público

Simón Gaviria Muñoz
Director General
Departamento Nacional de Planeación

<u>Translation of Letter of Development Policy</u>

Bogotá, D.C.,

Dr. **JIM YONG KIM**
President
World Bank Group
Washington, D.C.

Subject: Letter of Development Policy on Growth and Income Convergence DPL

Dear Dr. Kim,

The health of the Colombian economy has been built on sound economic policy management based on a virtuous circle created by the National Government. A lower fiscal deficit and sound public finances lead to lower interest rates. This reduction in the cost of financing the economy results in higher levels of investment, which in turn have a positive impact on economic growth. Higher growth results in higher tax collections, creating space for a further reduction of the fiscal deficit and thus restarting the virtuous circle.

Similarly, the macroeconomic stability observed has been built on consistency in the economic management of the country, which has in turn been based on the coordination of monetary and fiscal policy, supported by a sound financial system and a flexible exchange rate.

This macroeconomic stability has allowed Colombia to: (1) reduce the fiscal deficit by more than one percentage point of GDP in a very short period of time (it declined from 3.9 percent in 2010 to 2.4 percent in 2013); (2) finance the highest levels of investment in recent memory (during the first half of 2014, the investment rate was 30.2 percent of GDP); (3) lead growth in the region (in the second quarter of 2014, Colombia recorded the highest growth among the six largest economies in the region); and (4) make significant progress the area of poverty reduction (since 2010 3.6 million Colombians have risen out of poverty, reflecting a reduction in the incidence of poverty from 37.2 percent to 29.3 percent in 2014).

Nevertheless, the government knows that there are still important public policy challenges that must be tackled in the short term if Colombia is to establish itself firmly on a path of growth and economic development that can be sustained over the long term.

Bearing in mind the above, the Government of Colombia is asking the World Bank for a Programmatic Development Policy Loan that will enable it to continue to promote economic growth. The successes attained with the help of that loan will supplement the achievements of the three programmatic business development operations over the past decade, which helped to increase the competitiveness of the Colombian productive system.[48]

The policy areas underpinning the achievement of the objectives of the support program requested are: (i) promotion of access to finance and increased access to credit for private enterprises and the development of infrastructure; (ii) improvement in the quality and targeting of government efforts to develop the productive capacity of the population; and (iii) boosting of productivity by promoting innovation and an efficient regulatory environment.

To supplement the policy matrix for the Programmatic Development Policy Loan requested, the associated actions and progress made by the government in this area are described in detail below.

In the first area of work, the National Government has made progress in revising the regulatory framework to improve the financing of fourth-generation (4G) infrastructure projects. Thus, the individual credit limits of the credit institutions to invest in infrastructure have been revised and will lead to an increase in the financing alternatives available for such projects.

Similarly, access to credit for businesses has been improved. Progress has been made in the implementation of the Collateral Registry, allowing for better access to financing for business using their movable assets as collateral in such operations. As well, the development of the capital markets has been supported by means of: (i) the creation of an alternative issuance scheme (Second Market) that facilitates access to the capital markets for a more diversified group of issuers, including small and medium-sized businesses; (ii) the provision of specific guidelines for the administration and management of mutual funds; and (iii) the establishment of more robust custody arrangements for the securities markets. In addition, it should be noted that one of the fundamental pillars of the recently launched National Strategy for Financial Inclusion is access to financing for small and medium-sized businesses, which will be achieved through the consolidation of the afore-mentioned registry, as well as the inclusion of factoring as a fundamental source of working capital for these entities.

In the second area of work, one of the main activities of the Government, particularly the Ministry of Labor, has been to promote the acquisition, development and recognition of the competencies of workers in the context of a comprehensive system of (active and passive) employment policies. The guidelines defined by the Government for the establishment of training programs, especially those that involve policies and programs targeting vulnerable segments of the populations, include basic quality and relevance parameters with respect to the needs of the productive sector and society in general.

[48] In summary, the achievements resulting from the three operations mentioned included: (i) improving the business environment, international trade and competitiveness; (ii) strengthening and deepening the financial system and capital market; (iii) improving quality standards and promoting technological innovation; and (iv) strengthening infrastructure and national logistics.

Similarly, taking into account the principles of knowledge societies (such as lifelong learning), assistance is required in the development of the necessary regulations that can serve as the reference framework, both for the training offered in the new public employment service and for the establishment of a national system of skills certification.

In the third area of work, the government has made significant progress, including: (i) the definition of the roles and responsibilities of the National Council on Tax Benefits in Science, Technology and Innovation; (ii) the approval of a Consolidated Agreement of the National Council on Tax Benefits in Science, Technology and Innovation, which will help firms understand and access these benefits; and (iii) approval of the CONPES policy on Regulatory Improvement.

Finally, the importance of this program for Colombia should be emphasized, given that it will contribute significantly to the achievement of the strategies of the 2014-2018 National Development Plan in the area of business development. In particular, the actions under this program will help consolidate the Innovation-Based Productive Development Policy on which the National Government is working, the specific initiatives that will promote innovation, and the design and implementation of new investment instruments targeting the needs of the productive sectors and the regions, including the financing from the General System of Royalties.

Sincerely yours,

Mauricio Cárdenas Santamaría	**Simón Gaviria Muñoz**
Minister of Finance and Public Credit	Director General
Ministry of Finance and Public Credit	National Planning Department

ANNEX 3: FUND RELATIONS ANNEX

Press Release No.14/288
June 18, 2014

IMF Executive Board Completes Review of Colombia's Performance under the Flexible Credit Line

The Executive Board of the International Monetary Fund (IMF) today completed its review of Colombia's qualification for the arrangement under the Flexible Credit Line (FCL) and reaffirmed Colombia's continued qualification to access FCL resources. The Colombian authorities have indicated that they intend to continue treating the arrangement as precautionary.

The current two-year SDR 3.87 billion (about US$5.96 billion) FCL arrangement was approved on June 24, 2013 (see Press Release No 13/229). Colombia's first FCL arrangement was approved on May 11, 2009 (see Press Release No. 09/161), and two successor arrangements were approved on May 7, 2010 (see Press Release No. 10/186) and May 6, 2011 (see Press Release No. 11/165).

Following the Executive Board discussion of Colombia, Mr. David Lipton, Deputy Managing Director and Acting Chairman of the Board, made the following statement:

"The Fund's Flexible Credit Line (FCL) arrangement with Colombia has helped reduce the perception of risks by providing Colombia with a buffer against adverse external shocks, and allowed Colombia to restore orderly financial market conditions despite increased volatility in financial markets over the past year. Today, the Executive Board reaffirmed that Colombia continues to meet the qualification criteria for access to FCL resources.

"Colombia has maintained a robust economic performance in recent years. This is underpinned by a very strong policy framework, anchored by an inflation-targeting regime, a flexible exchange rate, a sound fiscal rule, and effective financial supervision and regulation.

"At the same time, important downside risks remain for emerging market economies and they continue to present challenges even for strong and well-managed economies like Colombia. While Colombia has ample policy space to contain the fallout from normal external shocks, the additional buffer provided by the FCL arrangement would continue to play an important role in mitigating tail risks. The authorities remain committed to strengthening buffers, including international reserves, and plan to take further steps toward exit from the FCL arrangement when external conditions allow."

Press Release No. 14/234
May 19, 2014
IMF Executive Board Concludes Article IV Consultation with Colombia

On May 19, 2014, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation[49] with Colombia.

[49] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board.

Colombia has maintained a robust economic performance in recent years. A strong policy framework—anchored by an inflation-targeting regime, a flexible exchange rate, a structural fiscal balance rule, and effective financial supervision and regulation—has allowed the authorities to respond adequately to shocks and pursue effective demand management. The authorities have continued to improve the policy framework in recent years, by including a fiscal sustainability principle in the constitution; introducing a structural fiscal balance rule; overhauling the oil and mining royalties system; and implementing a comprehensive tax reform that replaced payroll taxes with a corporate income tax. Amid increased volatility in financial markets, the Flexible Credit Line arrangement has also allowed Colombia to maintain orderly financial market conditions by providing a buffer against tail risks.

Real GDP growth rebounded strongly in the second half of 2013. After slowing down to 2.9 percent y/y in the second half of 2012 and the first half of 2013, growth accelerated to 5.2 percent y/y in the second half of 2013, driven by higher public investment and a solid expansion in private consumption. Overall, real GDP growth in 2013 as a whole averaged 4.3 percent, up from 4 percent in 2012. Employment also increased, particularly in the formal sector of the economy, and unemployment declined to 9.7 percent in 2013, the lowest mark in the last decade. At the same time, inflation was subdued at 1.9 percent y/y at end-2013, slightly below the 2–4 percent target range.

Monetary and fiscal policies supported growth in 2013. The central bank held the policy interest rate constant at 3.25 percent between April 2013 and April 2014 in light of soft growth during the first half of the year and inflation at or below the lower bound of the target range throughout the year. The reallocation of central government spending to provide targeted stimulus (e.g., through mortgage interest subsidies) and the use of royalties for investment spending by subnational governments also supported growth in 2013. In April 2014, the central bank increased the policy interest rate by 25 basis points to 3.5 percent. Going forward, the authorities have reaffirmed their commitment to adjust the policy rate as necessary as conditions warrant to keep inflation within the target range, to adhere to fiscal plans consistent with the medium-term fiscal framework, and to use the flexible exchange rate as a shock absorber.

The banking system remained stable. Financial soundness indicators remained strong, with low and well-provisioned non-performing loans, strong profitability, and adequate liquidity. New capital requirements became effective in August 2013, significantly enhancing the quality of banks' capital. The financial system is expected to continue deepening, and the participation of nonresidents in both the local government debt market and the equity market is also projected to rise in the near term.

Growth is projected to remain robust in 2014 and beyond, although risks are tilted to the downside. With the output gap nearly closed as of end-2013, real GDP is projected to grow at around potential (about 4½ percent) in 2014 and beyond, with inflation remaining within the target range. However, Colombia remains vulnerable to external risks, including: a sharp decline in commodity prices, especially oil; deterioration in global financial conditions; and volatility from the normalization of monetary policy in the U.S., especially if not accompanied by a corresponding increase in U.S. growth.

Executive Board Assessment[50]

Executive Directors commended the continued strong performance of the Colombian economy, with faster economic growth, low inflation, robust job creation, particularly in the formal sector of the economy, and declining unemployment. Nonetheless, while economic prospects are favorable, risks remain tilted to the downside. The uncertain global outlook, including the increase in geopolitical and emerging market risks, could present challenges even for strong and well-managed economies like Colombia. Directors stressed the importance of continued prudent policies to safeguard macroeconomic and financial stability and sustained structural reforms to promote more inclusive growth.

Directors commended the authorities' adherence to the fiscal rule and commitment to medium-term fiscal consolidation. They noted, however, that meeting the fiscal goals will require greater revenue mobilization, and called for decisive action to broaden the tax base, reduce informality, and strengthen tax administration. Adjustments on the expenditure side would also be needed to improve the efficiency of spending, including by reducing costs from healthcare provision. Directors considered the authorities' plans for a comprehensive reform of the pension system to broaden coverage and increase the equity of the pension system as a step in the right direction. Directors took note of the staff's assessment that the external position of the Colombian economy is strong, with the current account balance and the real exchange rate broadly in line with fundamentals. They emphasized that continued efforts to enhance productivity is crucial to raise competitiveness. Directors noted that risks to external stability are mitigated by a stable source of financing of the current account deficit, an adequate level of international reserves, and the additional line of defense offered by the Flexible Credit Line arrangement. Directors welcomed the authorities' recognition of the need to weigh the opportunity costs of further reserves accumulation vis-à-vis the benefits of ensuring sufficient buffers.

Directors noted that the financial system is sound and financial supervision broadly effective. Nonetheless, they saw room to enhance supervision of complex conglomerates and their exposure to concentration risk. They also highlighted that the expansion of the largest institutions across the region will require a deeper framework to monitor and stress-test cross-border risks.

Directors emphasized the need to foster more inclusive growth through structural reform. They encouraged the authorities to continue to reduce informality by further reducing non-wage costs and addressing labor market rigidities. They also recommended fostering financial inclusion by reducing the cost of access to finance and developing products tailored to low-income households. Directors noted that addressing infrastructure needs is critical to boosting competitiveness and growth and welcomed the authorities' infrastructure program.

IMF COMMUNICATIONS DEPARTMENT

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[50] At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities. An explanation of any qualifiers used in summing up can be found here: http://www.imf.org/external/np/sec/misc/qualifiers.htm.

ANNEX 4: DEBT SUSTAINABILITY ANALYSIS[51]

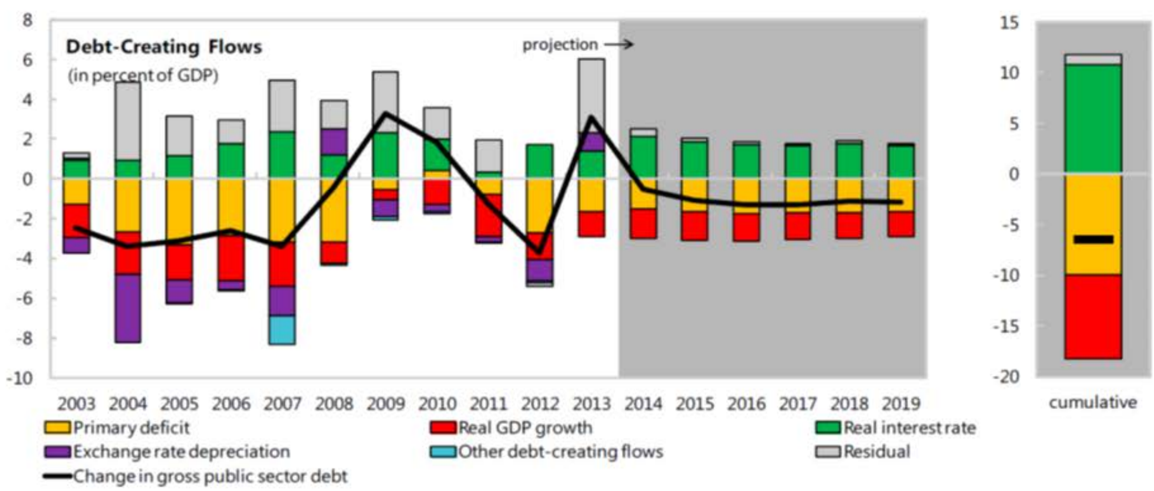
Debt, Economic and Market Indicators [1/]

	Actual			Projections					
	2003-2011 [2/]	2012	2013	2014	2015	2016	2017	2018	2019
Nominal gross public debt	36.9	32.0	35.1	34.6	33.5	32.2	30.9	29.8	28.7
Public gross financing needs	8.4	3.2	4.3	6.0	5.5	4.6	3.8	5.2	3.8
Real GDP growth (in percent)	4.8	4.0	4.3	4.5	4.5	4.5	4.5	4.5	4.5
Inflation (GDP deflator, in percent)	5.8	2.7	3.9	1.8	2.4	2.7	2.9	2.8	3.1
Nominal GDP growth (in percent)	10.9	6.9	8.3	6.3	7.0	7.4	7.5	7.5	7.8
Effective interest rate (in percent) [4/]	10.3	8.0	8.8	8.2	8.3	8.3	8.5	9.2	9.3

As of Aug 20, 2014		
Sovereign Spreads		
EMBIG (bp)		146
Ratings	Foreign	Local
Moody's	Baa2	Baa
S&Ps	BBB	BBB+
Fitch	BBB	BBB+

Contribution to Changes in Public Debt

	Actual			Projections							
	2003-2011	2012	2013	2014	2015	2016	2017	2018	2019	cumulative	debt-stabilizing primary balance [9/]
Change in gross public sector debt	-1.3	-3.7	3.1	-0.5	-1.1	-1.3	-1.3	-1.1	-1.1	-6.5	
Identified debt-creating flows	-3.2	-3.5	-0.6	-0.9	-1.2	-1.4	-1.4	-1.2	-1.3	-7.5	
Primary deficit	-1.9	-2.7	-1.7	-1.5	-1.7	-1.7	-1.7	-1.7	-1.6	-10.0	0.4
Primary (noninterest) revenue and grar	26.3	28.3	27.8	27.5	27.0	26.9	26.7	26.7	26.6	161.5	
Primary (noninterest) expenditure	24.3	25.6	26.1	25.9	25.3	25.2	25.0	25.0	25.0	151.4	
Automatic debt dynamics [5/]	-1.1	-0.7	1.1	0.6	0.4	0.3	0.3	0.5	0.4	2.6	
Interest rate/growth differential [6/]	-0.3	0.4	0.1	0.6	0.4	0.3	0.3	0.5	0.4	2.6	
Of which: real interest rate	1.4	1.7	1.4	2.1	1.9	1.7	1.7	1.8	1.7	10.8	
Of which: real GDP growth	-1.7	-1.4	-1.3	-1.5	-1.4	-1.4	-1.3	-1.3	-1.3	-8.2	
Exchange rate depreciation [7/]	-0.8	-1.0	0.9	...	...	...	...	...	...	...	
Other identified debt-creating flows	-0.2	-0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Privatization proceeds (negative)	-0.2	-0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Contingent liabilities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Residual, including asset changes [8/]	2.0	-0.2	3.7	0.4	0.1	0.1	0.1	0.1	0.1	1.0	



Source: IMF staff.

1/ Public sector is defined as general government.

2/ Based on available data.

3/ EMBIG.

4/ Defined as interest payments divided by debt stock (excluding guarantees) at the end of previous year.

5/ Derived as $[(r - \pi(1+g) - g + ae(1+r)]/(1+g+\pi+g\pi))$ times previous period debt ratio, with r = interest rate; π = growth rate of GDP deflator; g = real GDP growth rate; a = share of foreign-currency denominated debt; and e = nominal exchange rate depreciation (measured by increase in local currency value of U.S. dollar).

6/ The real interest rate contribution is derived from the numerator in footnote 5 as $r - \pi(1+g)$ and the real growth contribution as -g.

7/ The exchange rate contribution is derived from the numerator in footnote 5 as $ae(1+r)$.

8/ Includes asset changes and interest revenues (if any). For projections, includes exchange rate changes during the projection period.

9/ Assumes that key variables (real GDP growth, real interest rate, and other identified debt-creating flows) remain at the level of the last projection year.

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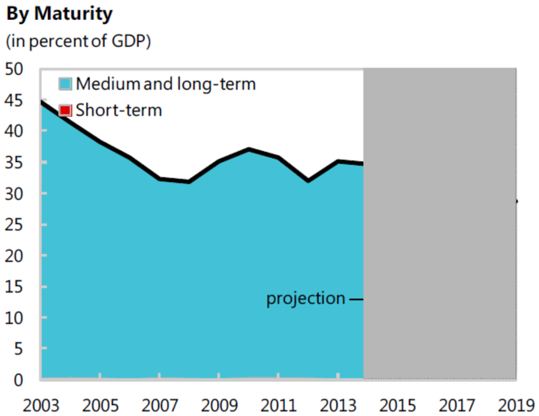
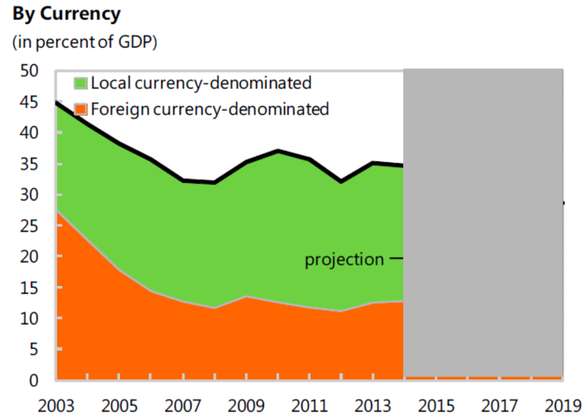
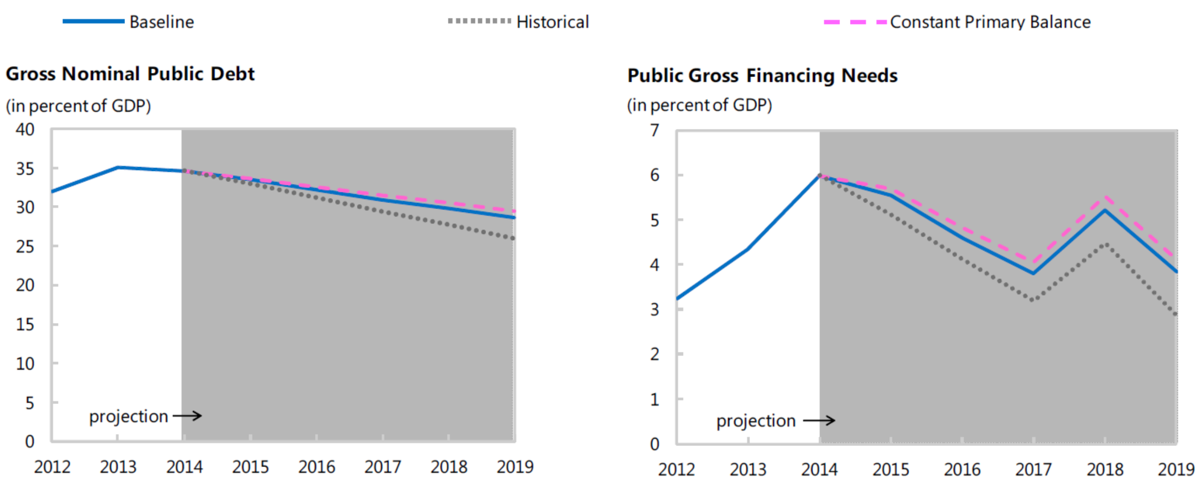
[51] This section will be updated when second quarter GDP figures are released in Sep 18, 2014.

Composition of Public Debt





Alternative Scenarios



Underlying Assumptions

(in percent)

Baseline Scenario	2014	2015	2016	2017	2018	2019
Real GDP growth	4.5	4.5	4.5	4.5	4.5	4.5
Inflation	1.8	2.4	2.7	2.9	2.8	3.1
Primary Balance	1.5	1.7	1.7	1.7	1.7	1.6
Effective interest rate	8.2	8.3	8.3	8.5	9.2	9.3
Constant Primary Balance Scenario						
Real GDP growth	4.5	4.5	4.5	4.5	4.5	4.5
Inflation	1.8	2.4	2.7	2.9	2.8	3.1
Primary Balance	1.5	1.5	1.5	1.5	1.5	1.5
Effective interest rate	8.2	8.3	8.3	8.5	9.2	9.2

Historical Scenario	2014	2015	2016	2017	2018	2019
Real GDP growth	4.5	4.8	4.8	4.8	4.8	4.8
Inflation	1.8	2.4	2.7	2.9	2.8	3.1
Primary Balance	1.5	2.1	2.1	2.1	2.1	2.1
Effective interest rate	8.2	8.3	8.2	8.2	8.8	8.7

Source: Fund staff estimates.

ANNEX 5: POVERTY AND SOCIAL IMPACT ASSESSMENT (PSIA)[52]

1. **The PSIA is developed according to World Bank guidelines and is designed to provide an analysis of the potential outcomes on poverty and growth of incomes, particularly of those of the individuals in the bottom of the income distribution, of the policy actions outlined in the DPL.** It documents the expected impacts of each of the policy actions with outcomes in the key objectives of this operation: growth and income convergence, and how these outcomes have potential effects on poverty reduction and shared prosperity. In particular, the policies supported by this operation, including, facilitating investment in infrastructure, increased access to finance, improving the quality and allocation of productive skills, enhancing innovation and technology adoption, are expected to produce positive outcomes on growth and regional convergence, as well as expansion of employment opportunities for the poor. The last policy action regarding streamlining customs and border procedures has a more indirect effect on poverty and shared prosperity, but may still be an important contributor for economic growth.

2. **Quantitative analyses specific to the policies supported by this operation were performed, along with literature reviews on previous studies relevant to the prior actions.** Useful information to define parameters and assumptions to perform the quantitative analysis, as well, as to organize the literature review was gathered from policy reports of the Ministry of Finance and Public Credit (MHCP) and the Ministry of Labor, previous evaluations by the World Bank, IFC and other multilateral organizations, and from academic research papers. Several World Bank Group Global Practices also provided valuable inputs for this assessment.

3. **Colombia has experienced significant economic growth coupled with large declines in poverty reduction.** Between 2002 and 2013 Colombia experienced sustained levels of strong economic growth and large reductions in extreme and moderate poverty. Extreme poverty declined from 17.7 percent in 2002 to 9.1 percent in 2013; similarly, moderate poverty fell from 48.7 percent to 30.6 percent. Over this period, growth explained 84.1 percent of reductions in moderate poverty and 72.9 percent for extreme poverty.[53] These results highlight the importance of growth on poverty reduction over the recent years in Colombia.[54] Given that the policy areas discussed in this document impact positively fundamentals of economic growth; consequently these are expected to reduce poverty.

4. **With a recent reduction in income inequality, Colombia achieved higher levels of shared prosperity.** The World Bank measure of shared prosperity, the annualized growth rate of

[52] This PSIA was prepared by a World Bank team led by Carlos Rodríguez-Castelán (GPVDR) which included: Giselle Del Carmen (GPVDR) and Daniel Valderrama (GPVDR).

[53] Results from a Datt-Ravallion decomposition for the 2002-13 period. For more details on these methods refer to: Datt, G. and M. Ravallion. 1992. “Growth and Redistribution Components of Changes in Poverty Measures: A Decomposition with Applications to Brazil and India in the 1980s.” Journal of Development Economics, 38, pp 275–95.

[54] Between 2010 and 2013, the average annual growth elasticity of poverty in Colombia was -0.59, that is, one percentage change in per capita GDP translated into 0.59 percentage points reduction in poverty rate. However, conditional on its economic performance, this pace of poverty reduction observed in Colombia, was moderate compared with its regional peers.

the average income of the bottom 40 percent of the population, grew at 2.7 percent, below the mean growth rate of about 3.1 percent between 2002 and 2008. Since then (between 2008 and 2013), the growth rate of the incomes of the bottom 40 percent grew at 6.6 percent, significantly higher than the 4.1 percent average, which translated into lower income inequality. Still, income inequality in Colombia remains high and is constraining the potential effects on poverty reduction of the country strong economic growth performance.

5. **The Government policies supported by the Colombia First Programmatic Sustained Growth and Productivity Gains Development Policy Loan (DPL 149609) are expected to have a positive poverty reduction and social impact.** In line with the Bank's main objective of promoting shared prosperity, there are reasons to expect progressive impacts of the supported reforms. The prior actions of greater flexibility in financing infrastructure and increasing access to credit for firms are expected to promote regional convergence and expand economic opportunities for the bottom 40 through employment. The prior actions that improve the quality and allocation of productive skills are expected to expand the job-seeking channels used by the poor, which are disproportionally affected by unemployment[55]. These may in turn result in greater labor market opportunities for them and potentially result in higher paid jobs.

6. **The policies supported concerning promotion of innovation and trade may also have positive effects on growth and employment.** The prior action promoting innovation, technology adoption and efficiency among firms may enable SMEs to increase competitiveness, productivity and hence stimulate economic growth. Similarly, this can positively affect the poor through job creation. Finally, prior actions of streamlining customs and border procedures to facilitate international trade have less of a direct impact on social outcomes. Nevertheless, they are expected to indirectly reduce poverty through their positive effect on economic growth. This annex provides further details and explanations on the analyses undertaken and the documentation of impacts.

PILLAR 1: FOSTERING SOLUTIONS TO DEVELOP INFRASTRUCTURE FINANCING AND INCREASING ACCESS TO FINANCE FOR FIRMS

Prior Action 1: The GoC has increased the individual credit limit of credit institutions to invest in projects under the 4G Concession Program.

7. **Greater flexibility in financing key infrastructure projects is expected to promote growth, regional equity, employment for the low skilled, and a reduction of consumer prices by lowering costs of transport and logistics.** Investments in 4G projects are expected to improve road infrastructure in Colombia. Government estimates suggest the new highways will raise Colombia's potential GDP growth rate by 0.7 percentage points over the next four years.[56] Even though this is an upper bound estimate it sheds light to the relevance of these investments.

[55] In 2013, the unemployment rate for the poor was 15.9 percent, while for the middle class it was 5.6 percent (World Bank (2014). *Towards Shared Prosperity in Colombia*. Chapter 2 of Colombia policy notes, 2014-2018.)
[56] Marco Fiscal de Mediano Plazo. Ministerio de Hacienda y Crédito Público. Junio 2014.

Poor road infrastructure represents a significant barrier to growth and remains an important source of persistent regional disparities.

8. **Colombia suffers from high regional inequality and poor road-infrastructure development.** The persistence of regional inequality in Colombia is reflected through the large disparities in both the incidence of poverty and GDP per capita across subnational units (*Departamentos and Municipalities*). In 2010, GDP per capita in the richest state was 4.95 times that of the lowest one, and in 2011 the ratio increased to 5.48. The lack of decent quality roads in Colombia further exacerbates this disparity. According to the Global Competitiveness Report 2012-2013, Colombia ranks 126 in terms of road infrastructure quality.[57]

9. **Increased investment in road infrastructure will likely expand connectivity across Colombia, promote regional equity and accelerate shared prosperity.** The construction of 4G projects may expand market opportunities to previously isolated regions; this will boost their economic activity, increase productivity and potentially reduce regional disparities. Several theoretical and empirical studies have demonstrated the positive effects these investments have on productivity and hence on growth and poverty reduction (Antle 1983, Baffes and Shah 1993, Donaldson 2010, Martinicus, Carvallo and Cusolito 2012). There is significant room for improvement under this policy for Colombia's infrastructure development. In addition, given the heavy use of roads for cargo transportation and national travel, more investments in this sector can lift trade and competitiveness across the country (Yepes, T. et al. 2013).

10. **Even though returns to infrastructure investments are expected to benefit the entire country, they are likely to have a greater positive impact, both economically and socially, on previously secluded regions.** Perez and Rowland (2004)[58] show that in the case of Italy and Brazil, investments in infrastructure have contributed to the reduction of regional disparities. Similarly, Cortés and Vargas (2012)[59] emphasize that infrastructure investment in Colombia is a key component for regional convergence.

11. **A regional growth convergence analysis was conducted to estimate the potential impact of infrastructure investment on territorial disparities.** The analysis follows the concepts of absolute and conditional convergence proposed by Barro and Sala-i-Martin (1991).[60] First, an empirical analysis focuses on the trend of per capita GDP convergence among *Departamentos* from 2003-2012. This analysis is useful to determine whether growth rate of per-capita GDP are correlated with initial levels of this same variable over time. A negative correlation indicates that poorer regions are catching up with richer ones while a positive indicates that the dispersion between departments is increasing. Furthermore, analyses of conditional convergence using the level of public investment in road infrastructure in each

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[57] Colombia ranks 126 out of 144 countries. Information available on www.weforum.org/gcr.

[58] Perez, G. J. and P. Rowland (2004). "Políticas económicas regionales: cuatro estudios de caso" Documentos de Trabajo sobre Economía Regional No. 47. Banco de la República.

[59] Cortés, D. and Vargas, J. F., (2012). "Inequidad regional en Colombia," No. 34. Universidad de los Andes Facultad de Economía. Documentos Cede 2012-34.

[60] Barro, R. and X. Sala-i-Martin, (1991). "Convergence across states and regions", Brooking Papers on Economic Activity 1: 107–182.

Departmento is useful to identify the role of road infrastructure in the regional convergence process (see Box A5.1).

Box A5.1 Regional Convergence and prospective impacts

The objective of the study is to estimate convergence patterns, given increased road construction in Colombia. The main analytical framework of this study is based on the contribution of Barro and Sala-i-Martin (1991), although it is not limited to this work. The study analyzes regional development patterns depending on the conditions of infrastructure in each department, what is defined by Barro and Sala-i-Martin (1991) as conditional convergence.

The variable utilized to approximate the effects of road infrastructure on income convergence is public spending in road infrastructure by *Departamento* from DDTS-DNP. The values of GPD by *Departamento* were produced by DANE. Other kind of public investments related with economic growth are used as controls (public investments in health, education and public services). The period selected (2003-2012) correspond to the years of data availability of public spending in road infrastructure.

The results from these sets of models allows us to conclude there is an intrinsic trend towards conditional convergence in per capita income in Colombia; whether this process has been hampered or accelerated by the convergence in some other fundamental variables as the road infrastructure projects; there would be possible estimate the potential effects of greater flexibility to investing in infrastructure projects.

Technical details:
We conduct regression analysis of the following type to analyze absolute β-convergence:

$$\frac{y_{it}-y_{i.t-\tau}}{\tau} = \alpha - \beta\, y_{i.t-\tau} + u_{it} \qquad \textbf{(1)}$$

and of the following type to analyze conditional β-convergence:

$$\frac{y_{it}-y_{i.t-\tau}}{\tau} = \alpha_i - \beta\, y_{i.t-\tau} + \delta \cdot x_{i,t} + u_{it} \qquad \textbf{(2)}$$

Where y_{it} is the log of per capita income in state or region *i* in period *t*; $x_{i,t}$ is a vector of variables related with road investments, health, education and public services; $u_{i,t}$ is a stochastic term; α_i is a country specific fixed effect and τ is the length of the period under analysis. In both regressions$\tau = 1$, and robust standard errors are computed.

After estimate the patterns of convergence in Colombia between 2003-2012, the study analyzes the effect of 4g policy on the previous convergence results. In order to address this issue a linear projection of the per-capita GDP and investment variables is done for the period 2013-2018. Using these projections the conditional convergence model is conducted using the projected series on road infrastructure investments and the counterfactual road investment including the 4G policy.

Limitations and assumptions: (i) The period of analysis is restricted by data availability the test the long term convergence analysis was impossible; (ii) all variables continue the growth rate observed for the 2003-2012.

12. **Public spending on road infrastructure has been an important factor of the regional convergence process between rich and poor *Departamentos in* Colombia.** For the period 2003-2012, there is evidence of a negative relation between *Departamento* level growth rates of GDP per-capita and their initial level of income, which implies that the poorest *Departamentos* experienced higher economic growth than the richer ones, but this relation is not statistically significant. However, this relation becomes statistically significant after taking into account the effect on the regional convergence process of public spending in road infrastructure by *Departamento*[61]. Thus, there is evidence of regional convergence in Colombia between poor and rich *Departamentos* conditional on higher investments in road infrastructure over the last decade.

13. **The implementation of investments on road infrastructure under the 4G policy is expected to speed up the process of regional convergence in Colombia over the next five years.** When controlling by other factors that are relevant determinants of growth in GDP at the *Departamento* level, such as education, health and other public services, the results of a prospective conditional convergence model show that implementation of 4G investments is expected to increase the rate income convergence among *Departamentos* over 2013-2018.[62]

[61] This result is robust to different specifications, See Column 2 to Column 5of Table 5.1.
[62] Column 6 and 7 table 5.1.

Table 5.1. Absolute and conditional convergence (observed 2003-2012/ simulated 2013-2018)

	Unconditional convergence 2003-2012	Conditional convergence 2003-2012			Conditional Convergence 2013-2018	
					Without 4g	With 4g
log per-capita GDP at t-1	-0.0105 (0.009)	-0.091* (0.043)	-0.101* (0.047)	-0.0979* (0.047)	-0.0865*** (0.003)	-0.0890*** (0.005)
log of Public investment on road infrastructure at t-1			0.0011 (0.0007)	0.00132 (0.0007)	0.00120*** (0.00013)	0.0004 (0.0002)
log of Public investment on education infrastructure at t-1				-0.00105 (0.0006)	-0.0000428 (0.0003)	0.000575 (0.0006)
log of Public investment on health infrastructure at t-1				-0.00065 (0.0004)	-0.000607 (0.0005)	-0.00148 (0.0008)
log of Public investment on public services infrastructure at t-1				-0.00001 (0.0003)	-0.00094*** (0.00014)	-0.00059* (0.0002)
Fixed effects - department level		√	√	√	√	√
Constant	0.196	1.456*	1.583*	1.578*	1.395***	1.450***
Observations	261	261	261	261	156	156

Source: Own calculations based on DANE for GDP, population and deflators. DNP-DDTS for public investments. Note: The models include robust standard errors. T values between parentheses. Bogota was not included given that the information of public expenditure on roads for Bogota includes a different kind of investments that the 4G projects. The projections of all independent variables was done with a linear projection based on the average growth rate and the projection of growth rate was done with more complete model but with a lag of 2 for the per-capita income in order to avoid the perfect prediction.

14. **The policy action that supports the investment in road infrastructure may also lead to enhanced social inclusion through more job opportunities for the unskilled or low skilled**. Greater employability can enable marginalized populations to improve their living conditions, increase productivity and thus spur economic growth. The investment scheme proposed will create at least 180,000 jobs in the construction sector throughout the national territory. DNP-DEE (2013)[63] uses a Competitive General Equilibrium (CGE) model to estimate the effect of investment injections to be generated by 4G on employment, growth and productivity.

15. **Even under the most conservative scenario, the expected job creation of this policy may result in significant reductions in poverty and extreme poverty.** An analysis based on micro-simulation is used to estimate the effect of creating 180,000 jobs on earnings and the

[63] DNP (2013). Documento CONPES 3760. Agosto 20, 2013.

income aggregate of households of potential workers (See Box A.5.2).64 With the conservative scenario, which only considers the effects of projects that will be developed in the short run, results indicate that new jobs will lead to a reduction of moderate and extreme poverty by 0.5 and 0.3 percentage points respectively. Under the more optimistic scenario, which considers the realization of both the expected short- and medium-term infrastructure projects, moderate and extreme poverty are reduced by 1.1 and 0.5 percentage points respectively (See Table A.5.2).

Table A.5.2 Impact of 4G on poverty by term of investment

Department	Poverty			Extreme poverty		
	Baseline (%)	Short-term investments (%)	Mid-term investments (%)	Baseline (%)	Short-term investments (%)	Mid-term investments (%)
Antioquia	27.1	25.9	25.5	8.3	8.0	7.3
Atlántico	33.9	32.2	32.2	4.7	4.5	4.5
Bogotá DC.	11.9	11.9	11.9	2.1	2.1	2.1
Bolivar	42.8	41.3	41.1	12.4	12.2	12.1
Boyacá	33.8	33.0	32.5	9.6	9.6	9.6
Caldas	35.7	33.8	33.3	10.6	9.6	9.3
Caquetá	42.1	42.1	42.0	10.0	10.0	10.0
Cauca	61.1	61.1	59.5	33.6	33.6	32.7
Cesar	45.3	43.3	43.1	15.2	13.7	13.0
Cordoba	60.3	60.3	59.4	27.7	27.7	27.3
Cundinamarca	21.3	19.6	19.6	4.7	4.1	4.1
Choco	69.0	69.0	68.9	41.5	41.5	41.5
Huila	46.6	46.6	44.6	17.7	17.7	17.4
La Guajira	57.0	57.0	55.3	25.5	25.5	25.0
Magdalena	53.8	53.8	53.8	18.7	18.7	18.7
Meta	30.1	30.1	26.2	9.5	9.5	8.0
Nariño	50.2	50.2	49.1	17.4	17.4	16.6
Norte De Santander	40.7	38.6	37.8	11.2	10.7	10.5
Quindío	38.2	38.2	36.1	11.8	11.8	10.8
Risaralda	28.4	28.4	27.0	6.6	6.6	6.3
Santander	20.3	19.5	19.3	4.2	4.2	4.2
Sucre	52.1	52.1	49.9	12.8	12.8	12.4
Tolima	41.8	40.4	40.1	15.5	15.0	14.9
Valle Del Cauca	27.4	26.4	26.0	7.7	7.4	7.4
Total	**32.7**	**32.2**	**31.6**	**10.5**	**10.2**	**10.0**

Source: Own estimations based on DANE-MESEP, GEIH (2012).

[64] For the simulation, a salary is randomly assigned to individuals who are unemployed and who, by their socio-economic and demographic profile, are likely to work in the construction sector. After salaries are assigned to these individuals (i.e. added to their total income), moderate and extreme poverty are recalculated using the official national moderate and extreme poverty lines.

Box A. 5.2 Prospective impacts of 4G infrastructure projects on Employment and poverty reduction

This analysis is based on the overall results of a Computable General Equilibrium Model, calibrated by DNP (2013) which estimates that the investments planned in the 4G project will create between 180,000 and 450,0000 jobs. The micro-simulation conducted will use the lower bound-conservative estimates (180, 000 jobs).

The 4G infrastructure investments could be grouped in two sets: (i) ongoing investments, those which are expected to be developed in a 2-5 year window, these will be referred to as short-term investments, and (ii) medium-term investments. According to DNP-(2013) the first will create around 32,000 jobs while the second will create the remaining 148 thousand jobs. All simulations will be done separately by short- and medium-term investment. The results of these simulations are based on the data of the 2012 labor force survey (GEIH).

The micro-simulation model distributes the total number of jobs at the national level *(N)* by *Departamento* (n_d) using the proportion of road kilometers of 4G in each *Departamento* relative to total kilometers planned in the entire 4G policy.

In order to assign jobs to the unemployed a logistic model is computed for each *Departamento*. The model uses as a binary dependent variable that defines if an employed individual belongs to the construction sector. Based on the model's coefficients the likelihood of being hired by the construction sector is computed for the unemployed.

Finally, two variables are used to determine the draw of the n_d jobs, the first is a dichotomous variable that flags unemployed individuals that have previous experience in the construction sector, and the second one is simply the probability of being hired. The micro-simulation sorts by both variables; it will hire the first n_d unemployed who has experience in the construction sector and also has the highest probability of being hired within the same sector. Once individuals are hired, the micro-simulation imputes wages based on the hot-deck method and re-estimates the household per-capita income and poverty indicators.

Limitation and assumptions: (i) the number of workers in the construction sector is low in the labor survey. (ii) The simulation assumes that all employment is created simultaneously and is not a smoothing process. (iii) Job creation is lineal with respect of expected number of kms in each *Departamento*. The DNP result is robust in the lower bound estimations.

16. **Higher investment in road infrastructure may also have a positive welfare effect in all Colombian households by reducing consumer prices and cutting logistics costs**. Road quality strongly affects shipment times and consequently a firm's expenses and competitiveness. A reduction in logistic costs directly lowers consumer prices and positively affects all households but particularly to the poor in relative terms due to their consumption basket. In addition, these lower costs of logistics could lead to increased employment and trade flows.[65]

17. **Lack of proper infrastructure translates to extremely high transportation costs in Colombia.** According to Perez (2005)[66], 80 percent of intraregional trade is done via roads, he argues investment on roads will reduce two of the main components of transport cost that Colombian intraregional trade faces: gas and road maintenance. These cost reductions will ultimately reduce consumer prices that translate to higher purchasing power of all households in Colombia. In addition, lower logistics costs will benefit SMEs and help them expand their production capacities.

[65] Guasch, Jose L. (2011). "Logistics as a driver for Competitiveness in Latin America and the Caribbean." Inter-American Development Bank. Capital Markets and Financial Institutions Division. Discussion Paper.
[66] Pérez, Javier (2005). La infraestructura del transporte vial y la movilización de carga en Colombia. Documentos de trabajo sobre economía regional. N 64.

18. **Overall, greater flexibility in financing key infrastructure projects is expected to contribute to poverty reduction and shared prosperity.** This will be achieved through increased regional convergence, employment, and reduced consumer prices by lowering transport and logistics costs.

Prior Action 2: The GoC has authorized the use of movable assets as collateral in financial operations to improve access to credit.

Prior Action 3: The GoC has expanded access to capital markets to a more diversified group of issuers and investors through: (i) the creation of an alternative issuance scheme (Segundo Mercado); (ii) the provision of specific guidelines related to the administration and management of mutual funds; and (iii) the establishment of stronger custody schemes for securities markets.

19. **Improved access to credit by firms and the creation of an alternative issuance scheme *(Segundo Mercado)* has the potential to expand economic opportunities for the poor and promote shared prosperity through the creation, survival and growth of small and micro enterprises (SMEs).** These businesses employ nearly 80 percent of Colombian households in the bottom 40 (Figure A5.1). In addition, access to credit will give individuals the possibility to smooth consumption, save, borrow, and expand productive capacities. The *Segundo Mercado* is also expected to give Colombian SMEs an alternative for long-term financing, and increase competitiveness and productivity.

20. **The poor and vulnerable in Colombia have low access to financial services.** As of 2011 only 15 percent of those in the bottom 40 in Colombia had an account at a formal financial institution, whereas 45 percent in the top 60 had one.[67] Thus, there is a significant gap in access across income groups. Increased access to financial services is a crucial mechanism for poverty alleviation; it allows individuals to save, borrow, smooth consumption over time, and potentially change their employment decisions.

21. **The use of movable assets as collateral in financial operations has the potential to expand access to credit and increase the engagement in entrepreneurial activities of the poor.** Ruiz (2013)[68] examines the effects of a similar banking regulation that expands access to credit in Mexico on the decisions and welfare of households by eliminating the proof of income requirement. In the case of Mexico, after this regulation was established new banks started operating in the poorest and least populated municipalities, enabling the poorest households to smooth their consumption and accumulate more durable goods. Another study analyzes the implementation of payroll credit as a new instrument to offer credit with lower risk for the poor in Brazil, finding that the new tool increased the probability of engagement in entrepreneurial

[67] Demirguc-Kunt, Alsi, and Leora Klapper (2012). "Measuring Financial Inclusion: The Global Findex Database," The World Bank Development Research Group, Finance and Private Sector Development Team. Washington, D.C.: World Bank Policy Research Working Papers.
[68] Ruiz, Claudia (2013). From Pawn Shops to Banks, the Impact of Formal Credit on Informal Households. Policy Research Working Papers. World Bank.

activities (Madeira et al 2010).[69] There is extensive literature that analyzes different mechanisms through which access to finance can allow individuals to modify their production and employment decisions and thus exit poverty (Banerjee and Newman 1993[70]; Burgess and Pande 2005).[71]

22. **The creation of *Segundo Mercado* may increase participation of SMEs in Colombian capital markets and allow them to increase productivity and competitiveness.** As of 2012, SMEs comprise nearly 80 percent, of registered firms with the *Superintendencia de Sociedades*, thus they are a crucial component for production and job creation in the Colombian economy.[72] A financial inclusion analysis in Colombia shows that mainly small firms face constraints in accessing loans. In addition, reducing participation costs has a higher impact on inequality reduction than policies around the efficiency and depth of the financial system (Karpowicz, 2014).[73]

23. **The *Segundo Mercado* will give SMEs access to capital markets and thus expand their financial resources and lead to job creation for the poor.** This in turn will allow SMEs to invest more in their businesses, generate more jobs, become more competitive and increase productivity. These will all result in positive impacts to the Colombian economy. According to calculations from the 2013 labor force survey, about 4 in 5 of employed individuals belonging to the bottom 40 percent of the income distribution worked in small firms. These were either self-employed (49.8 percent), or in firms with less than three employees (28.5 percent) (Figure A5.1). Hence, the policy *of Segundo* Mercado is expected to have a direct positive effect on the labor conditions of vulnerable populations.

24. **In sum, improved access to finance to individuals and firms will contribute to poverty reduction and shared prosperity.** These will provide the poor and smaller enterprises a different set of financial opportunities. It will allow SMEs to increase productivity and competitiveness, which in turn can lead to job creation and sustainability of current jobs for the bottom 40. More importantly it will also give vulnerable populations an alternative to smooth consumption and increase their probability of engaging in entrepreneurial activities.

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[69] Madeira, G., Rangel, M. and Rodrigues, M. (2010). Occupational Choices and Limited Commitment: Inferential evidence from the availability of new credit instruments. Mimeo.

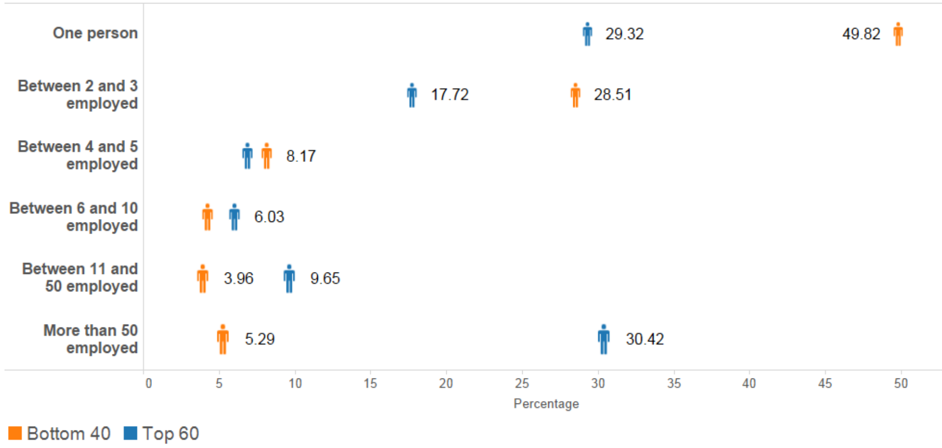
[70] Burgess, R. and Pande, R. (2005). "Do Rural Banks Matter? Evidence from the India Social Banking Experiment." American Economic Review 95 (3), pp.780-795.

[71] Banerjee, A. V. and Newman, A. F., (1993). "Occupational Choice and the Process of Development." Journal of Political Economy 101(2), pp. 274-98.

[72] Documento Conceptual: Reforma Normativa Segundo Mercado. Ministerio de Hacienda Colombia. February 28, 2013.

[73] Karpowicz, Izabela. (2014) Colombia Selected Issues. International Monetary Fund.

Figure A.5.1 Distribution of employed by per-capita household income groups



Source: GEIH 2013. Note: this includes wages employed and self-employed. Any consideration about informality was done here.

PILLAR 2: IMPROVING THE QUALITY AND ALLOCATION OF PRODUCTIVE SKILLS

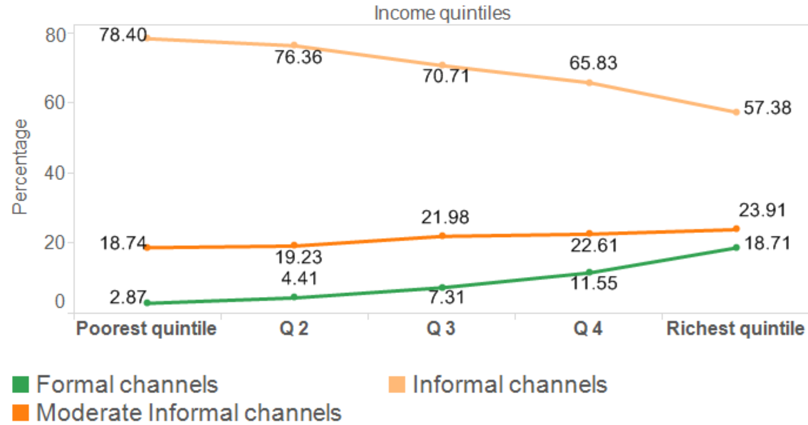
Prior Action 4: The GoC has created the Public Employment Service within its Ministry of Labor, including an upgraded unified national registry for unemployment and a system to match workers and vacancies.

Prior Action 5: The GoC has strengthened professional training and skill formation by: (i) developing training courses for unemployed individuals that match labor market needs; and (ii) expanding the provision of training services through the authorization of private firms and associations as training providers.

25. **Information asymmetries in the Colombian job market limit employment opportunities of those in the labor force, particularly to those belonging to the bottom 40 of the income distribution.** According to Uribe and Gomez (2005)[74] and Oviedo (2007)[75] both the poor and non-poor use informal channels as their main source to find a job. However, despite the poor using informal channels more intensively, they are less likely to find a job because they lack the 'better' networks in high earning jobs. In 2013, 78 percent of the labor force belonging to the poorest income quintile used informal channel to find a job. Even controlling for type of job, education, and socioeconomic characteristics, per-capita income is negatively correlated with the probability of using informal channel as a mean to find a job (Figure A.5.2 and Table A.5.3).

[74] Uribe, J. Gómez, L. (2006) "Canales de búsqueda de empleo en el mercado laboral Colombiano 2003" en: *Ensayos de Economía Aplicada al Mercado Laboral*, Programa Editorial de la Universidad del Valle, pp. 351-382.
[75] Oviedo, Y. (2007) "Canales de búsqueda de empleo y duración del desempleo en el mercado laboral colombiano 2003", Sociedad y Economía, No. 13, pp. 153-173.

Figure A.5.2 Channels to search a job by income quintile (Labor force supply)



Source: GEIH 2013. Note: The definition of channels to search job are the following: informal channels (search job with relatives, friends or networks), moderate informal (search a job by visiting the employer), formal (search a job using newspaper, employment agencies and other official institutions).

Table A.5.3. Conditional probability to select one channel to find a job

	Type of channel to find a job		
	Informal channels	**Moderate Informal channels**	**Formal channels**
Percentile of household per-capita Income	**-0.00526*** **	**0.00143** **	**0.00383*** **
Socio-demographic characteristics	√	√	√
Cohort of Born	√	√	√
Kind of job	√	√	√
Department	√	√	√

Source: *Valderrama (2009). Canales de búsqueda y duración del desempleo en Colombia. Mimeo*. The author computes are based on GEIH 2008 DANE. Note: Significant levels at 10 percent (*), 5 percent (**) and 1 percent (***). Socio-demographic controls are age, age square, education level. Cohort of birth is defined each ten years since 1960 to 1990 and uses as base the individual from 1920 to 1960. Kind of job is defined jobs as blue collar and white collar. Region use the departments. The definition of channels to search job are the following: informal channels (search job with relatives, friends or networks), moderate informal (search a job by visiting the employer), formal (search a job using newspaper, employment agencies and other official institutions).

26. **The use of informal channels to search for a job is positively correlated with lower quality jobs.** In the case of Colombia this is the case as the poor's networks tend to have less access to well-paying sustainable jobs. Diaz (2012) [76] shows that individuals that use informal channels find jobs more quickly but at the same time earn lower wages than individuals using

[76] Diaz, A. (2012). Informal Referrals, Employment, and Wages: Seeking Causal Directions, Labour, 26(1): 1-30.

other job search strategies. In fact, Garcia and Nicodemo (2013),[77] indicate this pattern is concentrated in the bottom of the wage distribution, and could be explained because the networks of the poor (friends, relatives and neighborhoods) are segmented in the labor markets.

27. **The upgrades in the national employment system have the potential to increase the number of job opportunities for the poor, both in terms of quality and quantity.** As mentioned earlier, the poor are relatively unsuccessful using informal methods to find adequate jobs. Thus, the increased information on vacancies and promotion of use of more formal mechanisms can be greater utilized by this group. The regulation may alleviate information asymmetries, match individuals better between jobs and skills, and potentially give opportunities to high quality jobs for the less fortunate.

28. **Correspondingly, strengthening professional training and skill formation may allow for greater employment opportunities for the poor.** Rosas et al (2014)[78] show that Colombia's work force does not meet labor skill requirements in the productive sector. There is a gap between labor skills demand and supply. The biggest challenge in the recruitment process across all sectors is the lack of experience and skills of candidates. In addition, the Human Capital formation and Productivity survey (EFCH)[79] shows that firms that offer training do so for skills specific to the job, thus skills are less transferable to other firms and have less impact on employability and alternative income opportunities. The system of professional training for unemployed individuals has the potential to expand economic opportunities for the bottom 40 of the income distribution.

29. **Individuals who increase their skills through professional training are expected to increase their labor earnings.** Results of a parametric model that measures the skill gap of Colombian youths who finished secondary school and had professional training (measured by technical education) with respect to those who finished secondary school but did not have professional training shows that those with technical training earned higher wages. The increases in wages range between 10.3 percent and 16.5 percent (Table A.5.4). Even though these increases may be overestimated since the model do not control for ability and other unobserved characteristics, it is important to emphasize the direction of the possible effect of training on technical skills.

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[77] Nicodemo and García (2013). Job Search Channels, Neighborhood Effects and Wages Inequality in Developing Countries: The Colombian Case. Discussion paper series. April 2013.
[78] Rosas, D. Novella, R. Gonzalez, C. (2014) La Brecha de Habilidades en Colombia. Unidad de Mercados Laborales y Seguridad Social. Banco Interamericano de Desarrollo.
[79] *Encuesta de Formación de Capital Humano y Productividad (2013.*

Table A.5.4. Returns to technical education for young people in Colombia (2013)

	OLS	OLS corrected by self-selection bias
Skill gap technical [a]	16.5***	16.2***
Skill gap technical [b]	8.13***	8.03***
Skill gap technical [c]	11.73***	10.3***
Gender	√	√
Job characteristics	√	√
Household characteristics	√	√
Urban	√	√
Observations	5,260 [a] 10,435 [b] 15,695 [c]	23,209 [a] 30,939 [b] 54,148[c]

Source: GEIH 2013 DANE. Note: Significant levels at 10 **percent** (*), 5 **percent** (**) and 1 **percent** (***). Job characteristics are firm size, self-employed. Household characteristic are the household size, condition of household head and household income quintile. A. model for youths between 19 and 20, b. youths between 21 and 23, c. youths between 19 and 23. The results are presented is percentage points.

PILLAR 3: PROMOTING INNOVATION AND EFFICIENT REGULATORY ENVIRONMENT

Prior Action 6: The GoC has strengthened its system of tax credits for innovation, science and technology by: (i) defining the roles and responsibilities of its National Council of Tax Credits for innovation; and (ii) clearly identifying expenditure eligible for tax credits as well as mechanisms for monitoring and evaluation of resources.

30. **Colombia has relatively low levels of private investment in Research and Development.** The country has experienced a decline in R&D investment of 20 percent between 2009 and 2010.[80] According to the Institute for Management Development (IMD), countries with a GDP lower than Colombia's, such as Kazakhstan, Estonia and Lithuania, have higher investments in R&D.[81] There is significant room for improvement in this sector in Colombia. Policies to promote innovation across different sectors may have a positive impact on growth and competitiveness.

[80]Consejo Privado de Competitividad. Informe Nacional de Competitividad. Ciencia, Tecnología e Innovación. (2012-2013).
[81] IMD, 2012. *World Competitiveness Yearbook*, Lausanne: Institute for Management Development - World Competitiveness Center.

31. **Promoting innovation and technology adoption can increase earnings by improving firms' productivity and sales.** Arbeláez and Parra (2011)[82] study the relationship between innovation and productivity in Colombia. They find strong evidence that innovation increases firm sales and efficiency. This in turn leads to potential job creation and stronger economic activity.

32. **Another type of investment in R&D is the Regional Systems of Innovation that helps small-medium enterprises increase their competitiveness.** In Colombia, SMEs have a lower probability to invest in innovation because they have fewer resources (Gallego et al 2013).83 Dutrenit (2009) concludes that Regional Systems of Innovation complement SMEs innovation process.[84] This policy coupled with the access to capital markets for SMEs can expand the resources available to them, and potentially incentivize innovation. Thus, allowing them to become more competitive in the Colombian market and increase productivity.

33. **The increase in labor productivity positively affects the poor.** This would occur via two channels: (i) directly through the growth in earnings and jobs in sectors where innovations are planned, and (ii) indirectly via the general effect of growth on poverty reduction. In the case of Colombia, Crespi, Maffioli and Melendez (2011)[85] contend that the Investment Fund of Technology[86] has had a positive impact on productivity, market share and the diversification of portfolio products. A clear focus of the Science, Technology and Innovation Fund associated to the National System of Regalias in regions where there is high density of poor individuals may lead to a decrease in poverty through increased employment and earning.

Prior Action 7: The GoC has established a procedure for the drafting of regulations, in line with OECD best practices, which reduces potential distortions and inefficiencies from regulatory reforms.

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34. **Improving regulatory efficiencies can support economic growth and development.** It is a strategic instrument the government can use to manage the economy and implement policy. The Colombian government can maximize its influence on regulatory policy to deliver regulations which contribute to social well-being through a more effective framework.[87] Evidence suggests the quality of regulation is strongly associated to economic growth and productivity (Djankov et al. 2006; Jacobzone et al. 2010; Jalilian et al. 2007).[88] Correspondingly,

[82] Arbeláez, M. and Parra, M. (2011) "Innovation, R&D Investment and Productivity in Colombian Firms". IADB
[83] Gallego M., Gutierrez H. and Taborda R. (2013). Innovation and Productivity in the Colombian Service Industry. Discussion Paper IDB No. IDB-DP-287.
[84] Dutrénit, G. Coord. 2009. Sistemas regionales de innovación: un espacio para el desarrollo de las PyMES. El caso de la industria de maquinados industriales. México, D.F.: Universidad Autónoma Metropolitana, UAM
[85] Crespi, Maffioli and Melendez, (2011). BID, Evaluación del Impacto de los Fondos de Desarrollo Tecnológico (FDT): El caso de COLCIENCIAS. In: http://www.iadb.org/es/temas/competitividad-tecnologia-e-innovacion/indicadores,3074.html.
[86] A strategy created by Colciencias in the past decade (1995-2007).
[87] OECD (2011). Regulatory Policy and Governance: Supporting Economic Growth and Serving the Public Interest.
[88] Djankov, S., Mcliesh, C., and Ramalho, R.M. "Regulation and Growth." Economics Letters 92.3 (2006): 395-401.

better quality of regulatory policy can also minimize corruption opportunities and reduce its negative economic and social impact (Djankov et al. 2002).[89]

35. **Transparency and inclusion in the policy design may improve credibility for the Colombian government both domestically and abroad.** Colombia is below the median under certain political indicators, there is significant room for improvement. For instance it ranks 43 out of 60 countries for government transparency.[90] A stronger regulatory framework that also considers citizen's views can enhance credibility and transparency for public policies. This in turn may allow greater foreign investment and stimulate economic growth. Through these channels the policy can indirectly contribute to poverty reduction.

Jacobzone, S., Steiner, F., Lopez Ponton, E., & Job, E. (2010). Assessing the Impact of Regulatory Management Systems: Preliminary Statistical and Econometric Estimates. OECD Working Papers on Public Governance N. 17. OECD Publishing, Paris.
Jalilian, H., Kirkpatrick, C., & Parker, D. (2007). The impact of regulation in developing countries: a cross sectional analysis. World Development. 35 (1), pp. 87-103.

[89] Djankov, S., R. La Porta, F. Lopez-De-Silanes, and A. Shleifer. "The Regulation of Entry." The Quarterly Journal of Economics 117.1 (2002): 1-37.

[90] Quality of legal and regulatory framework 33/60. Capacity of decision for the government 42/60. World Competitiveness Yearbook(WCY) por International Institute for Management Development (IMD)