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INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT  
PROGRAM DOCUMENT FOR A PROPOSED  
LOAN IN THE AMOUNT OF EUR568.3 MILLION (US\$600 MILLION EQUIVALENT) TO  
THE REPUBLIC OF COLOMBIA  
FOR THE  
FIRST FISCAL SUSTAINABILITY AND COMPETITIVENESS  
DEVELOPMENT POLICY FINANCING

February 6, 2017

Macroeconomics and Fiscal Management Global Practice  
Trade and Competitiveness Global Practice  
Latin America and the Caribbean Region

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## COLOMBIA - GOVERNMENT FISCAL YEAR

January 1 – December 31

### CURRENCY EQUIVALENTS

(Exchange rate effective as of January 25, 2017)

Currency unit: Colombian Peso (COP)

USD 1 = COP 2,932

### ABBREVIATIONS AND ACRONYMS

CAR	Capital Adequacy Ratio
CPF	Country Partnership Framework
CONPES	National Council for Economic and Social Policy ( <i>Consejo Nacional de Política Económica y Social</i> )
DIAN	National Tax and Customs Administration ( <i>Dirección de Impuestos y Aduanas Nacionales</i> )
DNP	National Planning Department ( <i>Departamento Nacional de Planeación</i> )
EPS	Health Insurance Provider ( <i>Entidad Promotora de Salud</i> )
FOB	Free on Board
FONPET	National Pension Fund for Territorial Entities ( <i>Fondo Nacional de Pensiones de las Entidades Territoriales</i> )
FY	Fiscal Year
GDP	Gross Domestic Product
IBRD	International Bank for Reconstruction and Development
IFC	International Finance Corporation
IMF	International Monetary Fund
IPS	Health Services Provider ( <i>Institución Prestadora de Servicios de Salud</i> )
LAC	Latin America and the Caribbean
MHCP	Ministry of Finance and Public Credit ( <i>Ministerio de Hacienda y Crédito Público</i> )
MTFF	Medium-Term Fiscal Framework
NDC	Nationally Determined Contribution
NDP	National Development Plan
OECD	Organization for Economic Cooperation and Development
PDP	Productive Development Policy
PER	Public Expenditure Review
PFM	Public Financial Management
PMR	Product Market Regulation
POS	Mandatory Benefit Package ( <i>Plan Obligatorio de Salud</i> )
RAS	Reimbursable Advisory Services
ROE	Return on Equity
R&D	Research and Development
SAS	Simplified Public Company ( <i>Sociedad Anónima Simplificada</i> )
SIC	Competition Authority ( <i>Superintendencia de Industria y Comercio</i> )
STI	Science, Technology and Innovation
TFA	Trade Facilitation Agreement
TFP	Total Factor Productivity
VAT	Value-Added Tax
WTO	World Trade Organization

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**REPUBLIC OF COLOMBIA**  
**FIRST FISCAL SUSTAINABILITY AND COMPETITIVENESS DEVELOPMENT POLICY**  
**FINANCING**  
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## SUMMARY OF PROPOSED LOAN AND PROGRAM

### *Colombia First Fiscal Sustainability and Competitiveness Development Policy Financing*

Borrower	Republic of Colombia
Implementing Agency	Ministry of Finance and Public Credit, National Department of Planning
Financing Data	IBRD Flexible Loan. Commitment-linked with a fixed spread and bullet repayment. Amount: EUR568.3 million.
Operation Type	Single-tranche operation. First in a series of two Development Policy Financing operations.
Pillars of the Operation and Program Development Objective(s)	The PDOs of the operation are to: (i) support fiscal consolidation measures and improved contingent liabilities management; and (ii) foster productivity in non-extractive sectors by strengthening the policy framework for trade facilitation, investment, competition, business regulation and innovation.
Result Indicators	<ul style="list-style-type: none"> <li>- Reduction in Central Government personnel expenditures and general operating expenditures (<i>gastos generales</i>) as a share of GDP. Baseline (2015): personnel expenditures and general operating expenditures of 3.1% of GDP; target (2018): personnel expenditures and general operating expenditures of 2.9% of GDP.</li> <li>- Increase in the use of FONPET savings to finance subnational contributions to the subsidized health regime. Baseline (2015): 0; target (2016-18): COP1 trillion.</li> <li>- Improvement in the solvency margin of EPS. Baseline (June 2015): gap with the required solvency margin of COP5.33 trillion; target (2018): gap with the required solvency margin of COP4.26 trillion.</li> <li>- Increase in non-oil Central Government tax revenue. Baseline (2015): 14% of GDP; target (2018): 14.3% of GDP.</li> <li>- Increase in subnational government tax revenue. Baseline (2015): 3.3% of GDP; target (2018): 3.5% of GDP.</li> <li>- Reduction in VAT evasion. Baseline (2015): estimated VAT gap of 20.1%; target (2018): estimated VAT gap of 11%.</li> <li>- Reduction of customs clearance import times (average across all modes of transport). Baseline (2015): 25.53 hours; target (2018): 18 hours.</li> <li>- Increase in percentage of automated vs. non-automated foreign investment registrations. Baseline (2015): 0%; target (2018): 50%.</li> <li>- Increase in the number of firms applying to the leniency program and collaborating with the competition authority in antitrust investigation. Baseline (2012- June 2015): 4; target (July 2015-2018): 7.</li> <li>- Increase in the number of SAS companies registered online by the new one-stop shop. Baseline (2015): 0; target (2018): 5,000.</li> <li>- Increase in the number of programs that are revised (modified, discontinued, introduced) on the basis of the CONPES. Baseline (2015): 0; target (2018): 18.</li> <li>- Increase in the share of existing fiscal incentives granted by the National Council of Fiscal Incentives for STI to firms that come from sectors other than mining and energy. Baseline (2015): 16%; target (2018): 24%.</li> </ul>
Overall risk rating	Moderate
Climate and disaster risks (required for IDA countries)	(i) Are there short and long term climate and disaster risks relevant to the operation (as identified as part of the SORT environmental and social risk rating)? Yes <input type="checkbox"/> No <input checked="" type="checkbox"/>
Operation ID	P158739

# IBRD PROGRAM DOCUMENT FOR A PROPOSED LOAN TO THE REPUBLIC OF COLOMBIA

## 1. INTRODUCTION AND COUNTRY CONTEXT

1. **The proposed Development Policy Financing (DPF) series supports Colombia's efforts to maintain fiscal sustainability and enable the basis to accelerate productivity growth in the context of the ongoing peace process and under a less favorable external environment.** Colombia is at a historic juncture as an end may be in sight to the longest-running civil conflict in the Western Hemisphere. The ongoing peace process has the potential to boost inclusive growth and reduce regional inequities. However, this can be sustainable only if the process is accompanied by productivity-enhancing measures and fiscal reforms to enable space for critical spending while continuing the needed consolidation process. On the external front, reduced export demand from China, the fall in oil prices, and the prospects of higher borrowing costs contributed to a slowdown in growth and increased fiscal pressures in commodity-exporting countries, including Colombia. The unfavorable external environment has highlighted the shortcomings associated with the country's increased reliance on extractive industries over the last decade. The proposed DPF series recognizes and supports the Colombian authorities' reform efforts in the adjustment to this new domestic and external environment. It supports critical fiscal reforms to maintain sustainability as well as structural reforms aimed at supporting faster productivity growth, particularly in the non-extractives sectors.

2. **Sound macroeconomic and structural policies, coupled with favorable external conditions (up to mid-2014), enabled a strong broad-based growth and poverty reduction.** Between 2004 and 2014, average annual growth reached 4.8 percent, making Colombia one of the strongest performers in Latin America. Its sound macroeconomic management, based on a combination of an inflation targeting regime, floating exchange rate, and strong track record of fiscal discipline, helped the country weather the global financial crisis of 2008-9, and together with strong oil prices, enabled a remarkable bounce back between 2009 and 2013. A favorable external environment in that period also helped to boost foreign direct investment (FDI), exports and Government revenues. At the same time, the authorities implemented targeted structural reforms to gradually improve the country's regulatory system and reduce factor and product market rigidities. Extreme poverty fell from 17.7 percent in 2002 to 7.9 percent in 2015, while total poverty fell from 49.7 percent in 2002 to 27.8 percent in 2015. Although inequality remains high, between 2008 and 2014, the income of the bottom 40 percent of Colombians grew at an average rate of 6.1 percent, significantly faster than the national average rate over that period (of 4.2 percent, see Figures 1 & 2).<sup>1</sup> Higher growth rates of incomes for those in the bottom two quintiles of the income distribution translated into lower inequality, with the Gini index declining from 56.7 to 52.2 between 2008 and 2015.

3. **The Colombian authorities continue to adhere to a sound macroeconomic policy framework.** Colombia was able to face the downturn with some monetary and fiscal cushions. Its flexible exchange rate was the first line of defense against the terms of trade shock stemming from lower oil prices and softer external demand. When the depreciation passed through to the

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<sup>1</sup> Labor income growth has been the main driver of poverty reduction and shared prosperity gains (explaining 84 percent of poverty reduction between 2002 and 2013) rather than redistribution policies.

broader economy, the monetary authorities began a hike in interest rates to tame inflation, showing strong commitment to maintaining price stability. In response, inflationary pressures started to ease in August 2016. The authorities also used a mix of revenue enhancing and expenditure reducing measures to partly compensate for the loss in fiscal revenues from the oil sector, while allowing the fiscal deficit to increase within the parameters set by the Fiscal Rule (which targets the structural fiscal deficit). That moderate fiscal impulse through the higher deficit was aimed at smoothing the transition of the economy to a likely lower potential growth in the context of less favorable external conditions over the medium term.

4. **Fiscal reforms are a central priority to maintain sustainability, including in light of the potential costs of the ongoing peace process.** Oil-related fiscal revenues for the Central Government fell by 2.2 percent of GDP between 2013 and 2015. While the authorities have taken a number of measures and reforms to contain the deficit so far, additional expenditure pressures are coming to the fore. Interest payments on debt increased from 2.2 percent of GDP in 2013 to 3 percent in 2016. At the same time, there is not much space for drastic reductions in public investment, without compromising medium-term growth prospects. Moreover, the peace process will require additional public spending. Thus, while the fiscal consolidation path mandated by the Fiscal Rule requires a deficit reduction of 3 percent of GDP between 2016 and 2022 (or going from 2.1 percent of GDP to 1 percent in structural terms), the extra pressures require the creation of even more fiscal space. In this context, the authorities are committed to strong expenditure controls and measures, tax policy and administration reforms, and the prudent management of fiscal risks stemming from contingent liabilities, particularly through the reforms supported by this operation.

5. **Reducing the country's vulnerability to price fluctuations in commodities requires further reforms to enable engines of productivity growth in non-extractive sectors.** Colombia's economic growth over the last five decades was driven primarily by factor accumulation.<sup>2</sup> Moreover, FDI over the last decade was heavily concentrated in the extractive sectors. In the current external environment, these drivers of growth are facing constraints. In turn, faster productivity growth becomes an urgent priority. In recent years, the authorities made significant progress in reforms to reduce burdensome business regulation, promote a better allocation of productive skills, improve the innovation framework, and attract investment in infrastructure, among others. But further progress is needed in these and other areas, including to facilitate trade and FDI, and improve competition.<sup>3</sup> In this context, the authorities are undertaking reforms to lift rigidities that disproportionately affect the non-extractives sectors. The proposed DPF series supports critical aspects of this reform program.

6. **The two pillars supported by this DPF series are mutually reinforcing.** Both areas of reform are likely to raise investor confidence, reduce entry and operating costs for the private sector, make the country even more resilient to shocks, and help foster stability and growth over the medium term. They are also critical for Colombia to reap the growth benefits of the peace process. The short-term economic costs of the fiscal consolidation process would be, to some extent, mitigated through competitiveness-enhancing structural reforms. The fiscal space created by the reforms would enable the Government to maintain priority spending, including that needed to support private sector growth and peace-related activities. At the same time, more productive

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<sup>2</sup> World Bank (2014a).

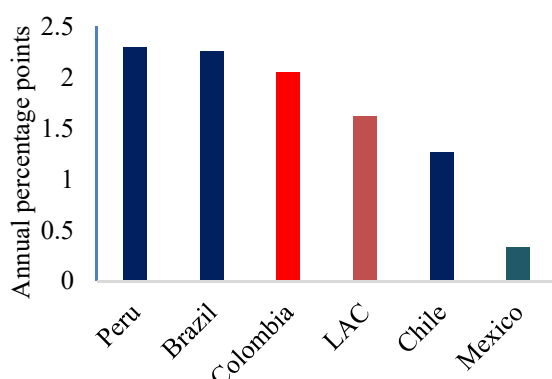
<sup>3</sup> World Bank (2014a).

and growing firms would support the expansion of the tax base that is needed over the medium term to continue improving services for the population.

7. **The authorities value the Bank’s programmatic policy-based financing for its continuity in its support to the institutional reform agenda and the technical support that is embedded in the design and preparation of this DPF series.** Moreover, reforms under the two pillars of the proposed DPF series build on the engagement under previous DPF operations, thus supporting continuity in reforms. Earlier DPF operations supported the adoption and implementation of the Fiscal Rule, a first wave of tax policy measures, the reform of the General System of Royalties, social security liability management, firms’ access to finance, innovation and productive development and trade facilitation, among others.<sup>4</sup> Furthermore, the reforms supported by a parallel DPF series on territorial development complement these measures through stronger institutions for land management and territorial planning, which will support regional development, increased property tax collections, improved financial management and investment prioritization at the subnational level.

8. **The operation also builds upon the current peace and post-conflict agenda and is well-aligned with the objectives of the World Bank Group’s Colombia Country Partnership Framework (CPF) FY2016-2021.** Since 2012, the GoC has engaged in peace talks with the country’s largest rebel group, the Revolutionary Armed Forces of Colombia (*Fuerzas Armadas Revolucionarias de Colombia*, FARC). On August 23, 2016, the GoC and FARC announced that a final agreement had been reached. Following the referendum, a revised peace agreement was approved by Congress in November 2016 and has begun its implementation.<sup>5</sup> This operation supports the CPF’s cross-cutting area of constructing peace, while contributing to Pillar 3 of the CPF, which aims at supporting fiscal sustainability and productivity.

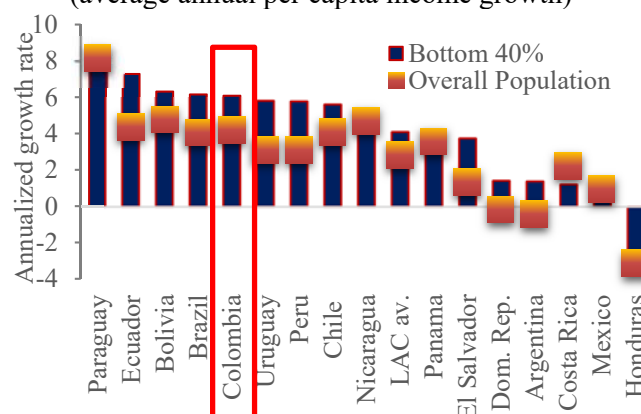
**Figure 1. Growth has been pro-poor**  
(poverty reduction in percent)



Note: Figures show the change in poverty rate, over the circa 2004-14 period, using a daily poverty line of 4 USD (PPP 2005).

Source: World Bank staff calculations based on LAC Equity Lab.

**Figure 2. Growth has been broadly shared**  
(average annual per capita income growth)



Note: Data for circa 2009-14.

Source: World Bank staff calculations based on Socio-Economic Database for LAC (SED-LAC) and LAC Equity Lab.

<sup>4</sup> Fiscal Sustainability and Growth Resilience DPF series (FY11/13); Enhancing Fiscal Capacity to Promote Shared Prosperity DPF (FY14); and Sustained Growth and Income Convergence DPF series (FY15/16).

<sup>5</sup> On October 2, 2016, Colombians voted in a national referendum to answer the question: “Do you support the final agreement for the end of conflict and building a lasting and stable peace?” The “NO” vote prevailed, with 50.2% of votes. In response, the Government and the FARC renegotiated the agreement.

## 2. MACROECONOMIC POLICY FRAMEWORK

### 2.1 RECENT ECONOMIC DEVELOPMENTS

9. **Following a decade of strong expansion, growth started to slow in 2014-15 amid falling oil prices.** The country's economy grew, on average, by 4.8 percent per year between 2004 and 2014, making it one of the strongest performers in Latin America. This expansion was underpinned by important macroeconomic and structural reforms. Growth rates were still strong in 2014 (4.4 percent), albeit down from 4.9 percent in 2013. But output growth moderated more markedly in 2015, to 3.1 percent. Growth has been led by domestic demand, primarily private consumption and investment, although gross capital formation recently slowed after many years of strong expansion. On the supply side, growth in 2015 was led by financial services, commerce and construction, partially compensating for the slump in the extractives sector. Throughout the last decade, growth was accompanied by a fall in unemployment, which dipped below 9 percent in 2015.

10. **The deterioration of the terms of trade resulted in a widened current account deficit.** Oil exports, which had accounted for over 50 percent of total exports in recent years, declined by 51 percent in US\$ terms, while total exports fell by 35 percent, in 2015. As a result, the current account deficit rose to 6.5 percent of GDP in 2015, from 5.2 percent in 2014. Colombia's flexible exchange rate regime acted as the first line of defense to the external price shock. The peso depreciated from an average of COP 2,000/US\$ in 2014 to a low of COP 3,435 in February 2016—before falling back to below COP 3,000/US\$ in January 2017. But while import compression has been significant, the export response to the depreciation has been more limited. Hydrocarbon exports continued their strong decline, while the reduction in other exports slowed and a number of manufacturing exports (such as vehicles and auto parts, glass and wood products) began to grow again. Net FDI slowed from 4.2 percent of GDP in 2012 to 2.7 percent in 2015, driven mainly by a decline in investments in the extractives sector. External loans took a more pronounced role in financing the balance of payments over the last two years. Forex buffers remain solid, with international reserves at US\$46.7 billion in November 2016, representing over 10 months of imports or 3.2 times external short-term debt.

11. **The Central Bank initiated a cycle of monetary policy tightening to rein in inflation.** The pass-through effect of the exchange rate depreciation to domestic prices, coupled with rising food prices due to the drought caused by the El Niño phenomenon and a strike of truck drivers in mid-2016, led to a strong acceleration in inflation, from an average of 2.9 percent in 2014 to 9 percent in July 2016. In an effort to gradually bring inflation back to within the target range (Colombia's monetary policy is based on an inflation-targeting regime with a target range of 2-4 percent), the Central Bank gradually raised interest rates from 4.5 percent in September 2015 to 7.75 percent in August 2016. As a result, consumer price inflation fell to 5.75 percent by December 2016. The monetary authorities remain strongly committed to price stability policies.

12. **The Colombian financial sector is dominated by banks which report adequate financial indicators despite the economic slowdown.** Colombia's financial system has a banking sector comparable to countries of similar per capita GDP, size, and demographics—although capital markets intermediation to the private sector remains below potential. Overall, financial soundness indicators remain adequate, despite some deterioration in the last year. The banking system remains well-capitalized, with a Capital Adequacy Ratio (CAR) of 15.5 percent



in September 2016, albeit down from 17 percent in 2014. In recent years, Colombia has introduced capital and liquidity regulations that are aligned with international standards, although the key issue of supervision of conglomerates remains a challenge to be addressed. With monetary tightening over the last year, credit growth to the private sector slowed from 18.1 percent (year-on-year) in December 2015 to 5.3 percent in August 2016. Non-performing loans have increased slightly in recent months, to 3.3 percent (September 2016), and the impact of rising unemployment and lower real income (owing to high inflation) could trigger further deterioration in the quality of consumer loans and mortgages during 2016-2017. While still relatively high, profitability declined slightly in the past months with Return on Equity (ROE) at 18 percent (September 2016), partly reflecting the concentration of the banking sector. In February 2016, Standard and Poor's (S&P) revised to negative the outlook rating of Colombia's three biggest banks (*Bancolombia*, *Banco de Bogotá* and *Davivienda*) in line with their negative outlook on the sovereign. A downgrade could adversely affect the sector, including funding costs and profitability.

**13. The drop in oil revenues has created significant fiscal pressures.** Oil-related fiscal revenues for the Central Government fell by 2.2 percent of GDP between 2013 and 2015. At the same time, additional expenditure pressures have come to the fore, with interest payments on debt increasing from 2.2 percent of GDP in 2013 to 3 percent in 2016. Efforts to maintain the fiscal deficit at manageable levels have come partly from the public investment side, but there is not much space for further reductions in this category over the medium term without harming growth prospects. The ongoing peace process also implies additional public spending. Thus, while the fiscal consolidation path mandated by the Fiscal Rule requires a deficit reduction of 3 percent of GDP between 2016 and 2022 (equivalent to a reduction from 2.1 percent of GDP in 2016 to 1 percent by 2022 in structural terms), the added fiscal pressures related to compensations and reparations under the Victims' Law<sup>6</sup>, restoration of lands and other agreements reached through the post-conflict process require the creation of even more fiscal space.

**14. To maintain adherence to the Fiscal Rule<sup>7</sup>, the Colombian authorities initiated revenue and expenditure reforms in 2014-16.** The country enacted an initial wave of tax reforms in 2014, which introduced a corporate income surcharge and extended a number of temporary taxes, thereby raising non-oil revenues by an estimated 0.6 percent of GDP in 2015. On the expenditure side, the Government reduced the budget envelope by COP 6.2 trillion (a 0.8 percent of GDP reduction vis-à-vis the approved budget) in 2014. Similar budget cuts were implemented in 2015, reaching COP 9 trillion (1.1 percent of GDP). These measures helped to contain the deficit of the Central Government at 3 percent of GDP (2.2 percent in structural terms) in 2015 (Table 1). The Non-Financial Public Sector deficit reached an estimated 3.4 percent of GDP in 2015, as sub-national governments stepped up spending and ran small deficits. The Government introduced another set of measures in early 2016. These included efforts to reduce tax evasion<sup>8</sup> and a reduction of COP 6 trillion (0.7 percent of GDP) in the 2016 budget envelope, with a 2.5 and 2 percent reduction in the wage bill and general expenditures compared to the

<sup>6</sup> Law 1448 of 2011, which stipulates measures to attend, assist and provide reparations to victims of Colombia's conflict.

<sup>7</sup> The Fiscal Rule requires a deficit of 1 percent in structural terms by 2022. This implies a reduction of 3 percent of GDP between 2016 and 2022, or going from 2.1 percent of GDP to 1 percent in structural terms.

<sup>8</sup> Mainly through the enactment of the Anti-Contraband Law and the implementation of VAT electronic invoicing.

approved budget (the former are wage containment measures since the aggregate spending in this line item is slightly higher than in 2015).

**Table 1: Estimated fiscal impact of recent expenditure and revenue measures  
(% of GDP)**

	2014	2015	2016
<b>Expenditure containment*</b>			
Reductions in the General National Budget	-0.8	-1.1	-0.7
Budget as approved by Congress	26.4	26.8	25.2
Budget after reductions	25.6	25.7	24.5
<b>Revenue increase ^</b>			
2014 tax reforms		1.2	1.4
Improvements in tax administration (Anti-Contraband Law and electronic invoice)			0.5

\*Expenditure containment is measured as the reduction in the total spending envelope vis-à-vis the approved budget. Numbers refer to the General National Budget, which includes the executive, legislative and judicial branches of the national government; Attorney General's and Auditor General's office; and the election organization. ^Revenue increase is measured as the additional revenue collected over the baseline (i.e. no policy change, including phasing out of temporary taxes). *Source:* World Bank staff estimates based on MHCP data.

15. **The authorities followed through on their commitment to fiscal consolidation with a structural tax reform that was approved at the end of 2016.** The structural tax reform that was signed into law on December 29, 2016, includes reforms to income taxes, the VAT, and selected excise and subnational taxes, among others. The Government estimates that the reform proposal would generate 0.7 percent of GDP in additional revenues for the Central Government in 2017, to increase to 2.4 percent of GDP by 2022 (see Table 5 for detailed projections). These measures, and some of those highlighted earlier in this document, are supported by the proposed DPF series and are incorporated into the projections presented in Tables 2 and 3.

16. **External debt has risen in recent years, driven by the larger fiscal deficits and the depreciation effect on foreign currency denominated debt.** Gross public debt fluctuated between 30 and 40 percent of GDP for much of the last decade, before increasing to 44.2 percent of GDP in 2014 and 50.6 percent in 2015 in the wake of the oil price decline and the peso depreciation (Figure 3). Private external debt was also affected by the depreciation, increasing by 4 percent of GDP between 2014 and 2015. Total external debt reached 37.9 percent of GDP by end-2015, with public debt accounting for about two-thirds of it (Figure 4).

Figure 3: COL: Gross public debt (% of GDP)

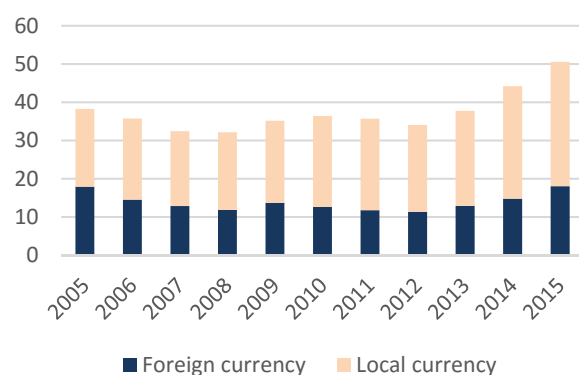
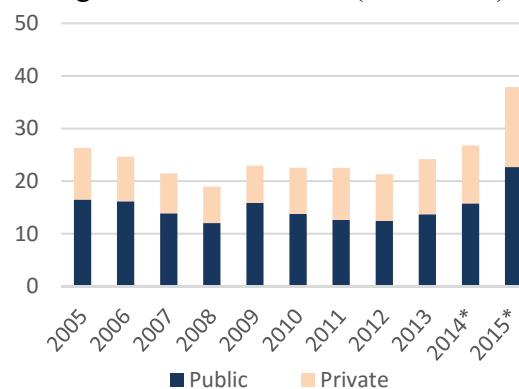


Figure 4: External debt (% of GDP)



\*Preliminary. *Source:* Central Bank, IMF and World Bank staff calculations.

**Table 2: Colombia: Key Macroeconomic Indicators, 2012-2018**

	2012	2013	2014	Est. 2015	Proj. 2016	2017	2018
<b>Real sector</b>	Annual percentage change, unless otherwise indicated						
Real GDP	4.0	4.9	4.4	3.1	1.7	2.5	3.0
Contributions:							
Consumption	3.9	3.7	3.5	3.0	1.5	1.8	2.4
Investment	1.3	1.8	2.7	0.8	-1.2	0.5	0.7
Net exports	-1.4	-0.7	-2.4	-1.2	1.4	0.2	-0.1
Unemployment rate (nat. def.)	10.4	9.6	9.1	8.9			
GDP deflator	3.0	2.0	2.1	2.6	5.3	3.6	3.3
CPI (average)	3.2	2.0	2.9	5.0	7.5	4.8	3.2
<b>Fiscal accounts (Central Government)</b>							
Revenues	16.1	16.9	16.6	16.2	15.0	15.1	15.6
Expenditures	18.4	19.2	19.1	19.1	19.0	18.5	18.3
Fiscal balance (CG)	-2.3	-2.3	-2.4	-2.9	-4.0	-3.3	-2.7
<b>Fiscal accounts (Non-Financial Public Sector)</b>	Percent of GDP, unless otherwise indicated						
Revenues	28.3	28.1	27.7	26.7	26.3	26.6	27.0
Expenditures	28.2	29.1	29.4	30.1	29.0	29.2	29.1
Fiscal balance (NFPS)	0.1	-1.0	-1.7	-3.4	-2.7	-2.6	-2.1
Gross public debt*	34.1	37.8	44.2	50.6	50.5	50.2	49.4
<b>Selected monetary accounts</b>	Annual percentage change, unless otherwise indicated						
Base money	10.0	15.3	7.0	18.4			
Credit to private sector	16.3	12.1	14.7	15.5			
Policy interest rate	4.25	3.25	4.50	5.75			
<b>External sector</b>	Percent of GDP, unless otherwise indicated						
Current account balance	-3.1	-3.2	-5.2	-6.5	-4.8	-4.3	-3.9
Imports GNFS (% change, real)	9.1	6.0	7.8	3.9	-4.0	0.8	2.3
Exports GNFS (% change, real)	6.0	5.2	-1.3	-0.7	1.5	2.4	3.4
Foreign direct investment (net)	4.2	2.3	3.3	2.7	3.9	2.8	3.0
Gross reserves (US\$ billion, eop)	37.5	43.6	47.3	46.7			
In months of next year's imports	6.4	7.0	9.2	10.5			
As % of short-term external debt	363	362	331	320			
External debt	21.3	24.2	26.8	37.9			
Terms of trade (% change)	3.1	-2.0	-3.4	-16.9			
Exchange rate (COP/US\$, average)	1,798	1,869	2,000	2,744			
<b>Memo items</b>							
Nominal GDP (US\$ million, current)	369,385	380,169	378,624	288,490	273,832	277,670	290,049
Nominal GDP (COP billion, current)	664,240	710,497	757,506	800,849	843,677	892,154	950,566
Oil production (hundred thousand barrels/day)	944	1,010	990	1,004	921	913	908
Oil price (Brent spot price, US\$/barrel)	112.0	108.9	98.9	52.4	51.4	54.6	57.9

\*Includes Ecopetrol. *Source:* Banco de la Republica, MHCP, Departamento Administrativo Nacional de Estadísticas (DANE), IMF and World Bank staff estimates.

**Table 3: Colombia: Key Fiscal Indicators for the Central Government, 2012-2018 (% of GDP)**

	2012	2013	2014	Prelim. 2015	Proj. 2016	2017	2018
<b>Total revenues</b>	<b>16.1</b>	<b>16.9</b>	<b>16.6</b>	<b>16.2</b>	<b>15.0</b>	<b>15.1</b>	<b>15.6</b>
Tax revenues	14.3	14.2	14.3	14.5	13.7	14.4	14.9
Net income tax and profits	6.6	6.3	5.0	4.6	4.4	4.4	4.6
Value-added tax	5.5	4.9	5.1	5.2	5.1	5.5	5.8
International trade	0.5	0.5	0.5	0.5	0.4	0.4	0.4
Financial transactions tax	0.8	0.8	0.9	0.9	0.8	0.8	0.8
Stamp and other taxes	1.0	1.6	2.8	3.3	3.2	3.3	3.3
Non-tax revenues	0.2	0.1	0.1	0.1	0.3	0.3	0.2
Capital revenues	1.6	2.5	2.2	1.6	1.0	0.4	0.5
o/w Ecopetrol dividends	1.1	1.9	1.4	0.5	0.1	0.0	0.0
<b>Total expenditures</b>	<b>18.4</b>	<b>19.2</b>	<b>19.1</b>	<b>19.1</b>	<b>19.0</b>	<b>18.5</b>	<b>18.3</b>
Current expenditures	14.5	14.6	14.8	15.1	15.8	15.3	15.1
Wages and salaries	2.1	2.1	2.3	2.3	2.4	2.4	2.3
Goods and services	0.8	0.9	0.8	0.8	0.7	0.6	0.5
Interest	2.4	2.2	2.2	2.6	3.0	3.0	3.0
Current transfers	8.7	9.2	9.4	9.4	9.5	9.4	9.4
Other	0.5	0.1	0.0	0.0	0.1	0.0	0.0
Capital expenditures	3.9	4.5	4.3	4.0	3.2	3.1	3.2
Fixed capital formation	2.8	3.2	3.0	2.7	1.8	1.5	1.8
Capital transfers	1.1	1.3	1.3	1.3	1.4	1.6	1.4
Primary balance	0.1	-0.1	-0.2	-0.3	-1.0	-0.3	0.3
<b>Overall fiscal balance</b>	<b>-2.3</b>	<b>-2.3</b>	<b>-2.4</b>	<b>-2.9</b>	<b>-4.0</b>	<b>-3.3</b>	<b>-2.7</b>
<b>Financing needs</b>	<b>6.5</b>	<b>5.7</b>	<b>7.1</b>	<b>7.5</b>	<b>7.8</b>	<b>6.7</b>	<b>5.5</b>
Overall fiscal balance	2.3	2.3	2.4	2.9	4.0	3.3	2.7
Amortizations	3.0	2.8	2.9	3.3	2.0	2.4	2.3
Other*	1.2	0.6	1.7	1.3	1.8	1.0	0.5
<b>Memo items</b>							
Non-oil Central Government tax revenue	12.7	12.7	13.1	14.0	13.7	14.1	14.3
NFPS revenues	28.3	28.1	27.7	26.7	26.3	26.6	27.0
NFPS expenditure	28.2	29.1	29.4	30.1	29.0	29.2	29.1
Non-financial Public Sector (NFPS) balance	0.1	-1.0	-1.7	-3.4	-2.7	-2.6	-2.1

\* Includes arrears, judicial claims, and savings. ^As defined by the Fiscal Rule which became effective in 2012.

Source: Ministerio de Hacienda y Crédito Público, IMF and Bank staff estimates.

**Table 4: Balance of Payments Financing Requirements and Sources, 2013-2018 (US\$ million)**

	2013	2014	2015	2016	2017	2018
<b>Financing requirements</b>	<b>35,854</b>	<b>45,587</b>	<b>42,858</b>	<b>37,039</b>	<b>36,894</b>	<b>35,999</b>
Current account deficit	12,326	19,593	18,925	13,193	12,042	11,219
External debt amortization	16,582	21,557	23,518	23,732	24,910	24,780
Medium and long term	6,272	9,584	9,278	9,162	12,470	10,115
Short term	10,310	11,973	14,240	14,570	12,440	14,665
Gross reserve accumulation	6,946	4,437	415	114	-58	0
<b>Financing sources</b>	<b>35,854</b>	<b>45,587</b>	<b>42,858</b>	<b>37,039</b>	<b>36,894</b>	<b>35,999</b>
FDI (net)	8,557	12,426	7,891	10,221	7,624	8,670
External debt disbursements	29,173	31,190	32,531	28,805	30,824	28,922
Medium and long term	17,200	16,950	17,960	16,365	17,659	16,183
Short term	11,973	14,240	14,570	12,440	13,165	12,738
Other capital flows (net)	-1,876	1,971	2,436	-1,987	-1,554	-1,593

Source: Banco de la Republica, MHCP, IMF and World Bank staff estimates.

## 2.2 MACROECONOMIC OUTLOOK AND DEBT SUSTAINABILITY

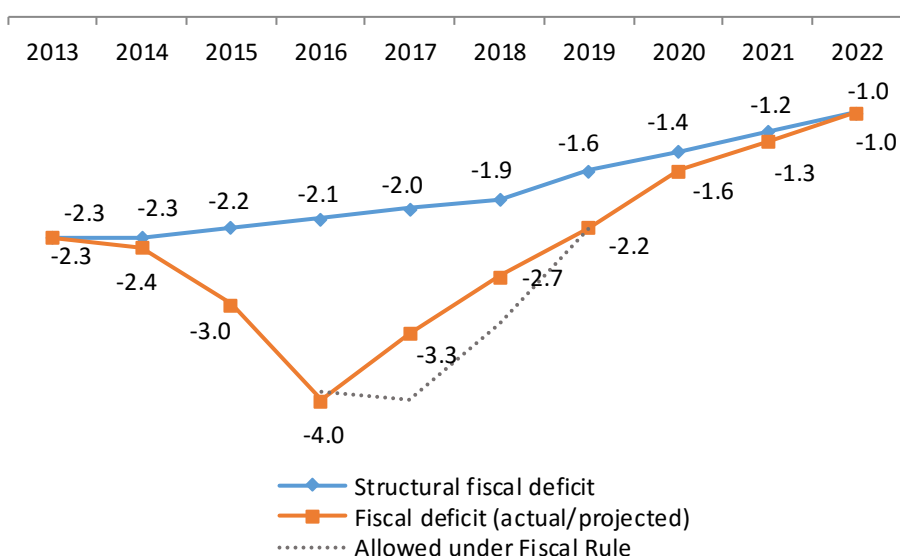
17. **Colombia is expected to experience a gradual but steady recovery starting in 2017.** The reduction in exports due to low oil prices will continue to weigh on growth in the short term. The Government's expenditure rationalization and interest rates may keep investment demand tamed. But the 4<sup>th</sup> generation (4G) infrastructure program will support investment recovery in late 2017 and 2018. The recently approved Peace Agreement could provide a further boost to economic activity over the projection period. Structural reforms to support competitiveness and diversification would help the recovery accelerate over the medium term. As a result, growth is expected to gradually recover from 1.7 percent in 2016 to 2.5 percent in 2017 and 3.0 percent in 2018.

18. **The current account will gradually improve.** In the short term, improvements in the current account deficit will come from further import compression, although a gradual export response in non-traditional exports will take hold over the projection period, especially in manufacturing and agricultural products. The current account deficit is expected to be partly financed by net FDI and portfolio inflows, with the gap filled with external loans. Colombia also continues to have access to a precautionary Flexible Credit Line (FCL) arrangement with the International Monetary Fund (IMF), which encompasses about US\$11.5 billion in contingent financing.

19. **Inflationary pressures will continue to subside.** Price increases have begun to slow down in response to three factors: (i) the interest rate hikes; (ii) the end of the El Niño-induced drought; and (iii) the stabilization of the exchange rate. While inflation remained above the Central Bank target in 2016, it will converge towards 4 percent by the end of 2017. The Central Bank will continue its strong commitment to price stabilization and act as needed.

20. **Additional fiscal efforts are needed to ensure the continued process of consolidation and compliance with the Fiscal Rule.** Compliance with the Rule requires a reduction in the fiscal deficit by 3 percent of GDP (1.1 percent in structural terms) between 2016 and 2022 (Figure 5). The tax reform passed in December 2016 is a central piece of this effort and its full implementation will be critical (table 5). The Government is expected to continue to control and rationalize current expenditures, as needed, especially considering the fiscal costs of the unfolding peace process and the need to maintain a healthy level of public infrastructure investments.

**Figure 5: Adjustment path under the Fiscal Rule, 2013-2022 (% of GDP)**



Source: MHCP.

**Table 5: Revenue impact of the comprehensive tax reforms, Central Government (% of GDP)\***

	2017	2018	2019	2020	2021	2022
VAT and consumption tax	0.7	0.8	0.8	0.8	0.8	0.9
Financial transactions tax <sup>^</sup>	0.0	0.0	0.2	0.4	0.7	0.9
Income taxes	-0.1	-0.2	0.0	0.0	0.0	0.0
Carbon tax	0.1	0.1	0.1	0.1	0.1	0.1
<b>Subtotal</b>	<b>0.7</b>	<b>0.7</b>	<b>1.2</b>	<b>1.4</b>	<b>1.6</b>	<b>1.9</b>
Improvements in tax administration	0.0	0.0	0.4	0.5	0.6	0.6
<b>Total</b>	<b>0.7</b>	<b>0.7</b>	<b>1.5</b>	<b>1.8</b>	<b>2.1</b>	<b>2.4</b>

\*Preliminary government estimates based on Law 1819 of 2016, signed into law on December 29, 2016.

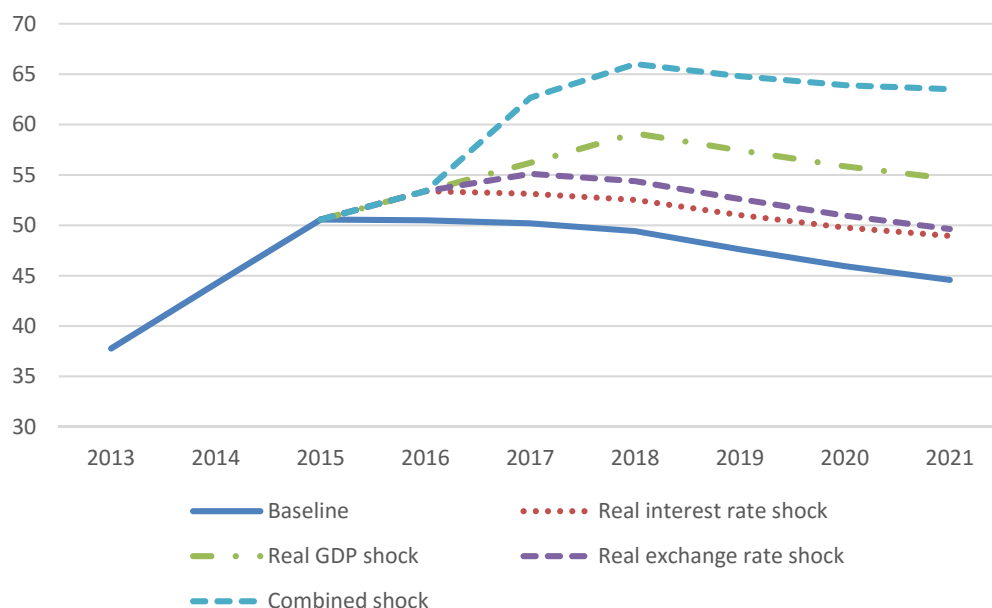
<sup>^</sup>The financial transactions tax was supposed to be phased out beginning in 2019, but the proposed reform would make it permanent. The additional revenue impact is therefore only shown for 2019 onwards.

Source: MHCP.

21. **The debt sustainability analysis indicates that public debt reached a peak in 2015 and is expected to follow a declining path thereafter in the baseline case.** In the baseline scenario, the public debt-to-GDP ratio is projected to remain around 50 percent in 2016, then decline gradually to 44.6 percent in 2021. Because a large share of public debt is in local currency and on fixed terms, shocks to the interest (to maximum historical levels) and exchange rates (24 percent real devaluation) will have a modest impact on the debt trajectory. A stress scenario, with lower GDP growth in 2017 and 2018—equivalent to half of the projected rate, would lead to an increase of public debt to 59.1 percent of GDP by 2018. A combined macro-fiscal shock scenario could push public debt up to 66 percent of GDP in 2018, before declining to 63.5 percent by the end of the projection period. On the other hand, if historical growth and fiscal trends continued, public debt would decline more rapidly than under the baseline scenario. These results suggest

that public debt sustainability is resilient to a range of different shocks, and that debt levels would return to below 50 percent of GDP during the projection period (Figure 6).

**Figure 6: Debt Sustainability Analysis (public debt, % of GDP)**



Source: World Bank staff estimates

22. **The risks to the economic outlook stem from both external and domestic factors.** Despite the emerging signs of a recovery in manufacturing exports, Colombian exports remain sensitive to oil price developments. It is estimated that a decline in the oil price to US\$25, combined with a 10 percent decline in volumes, would result in a reduction in the value of exports of 35 percent.<sup>9</sup> A faster than expected hike in policy rates in the U.S. or additional capital markets uncertainty could generate further volatility for emerging economies like Colombia. While Colombia has maintained its investment grade rating, market perceptions of Colombia's sovereign risk have deteriorated since the beginning of the oil price fall (Standard and Poor's downgraded its outlook to negative in February, and Fitch followed in July 2016). A significant reduction in FDI or portfolio investment due to added uncertainty in international markets could increase balance of payments pressures. While the approval of the tax reform has reduced macroeconomic risks, failure to effectively implement the reforms would result in further expenditure cuts, the brunt of which would be borne by public investment, thus affecting medium-term growth. It would also jeopardize compliance with the Fiscal Rule, which would negatively affect market confidence. Domestically, the needed fiscal and monetary tightening may dampen economic activity more than expected, and thus a continued implementation of structural reforms will be needed to create conditions for steady recovery over the medium term. Reforms to improve productivity and competitiveness are important in this respect. Finally, a successful conclusion of the ongoing peace process will be critical.

23. **Reasonable macroeconomic buffers, access to international financial markets, and a strong track record in macroeconomic management place Colombia in a strong position to**

<sup>9</sup> IMF (2016).

**mitigate the potential impact of further economic shocks.** Colombia's macroeconomic policy framework is sustainable over the medium term and adequate for the proposed operation.

## 2.3 IMF RELATIONS

24. **In June 2016, the IMF Board approved a new precautionary Flexible Credit Line (FCL) for Colombia.** This is a successor arrangement to the 2015 FCL, which was cancelled ahead of its expiration to accommodate higher access in the face of increased global risk.<sup>10</sup> The FCL is a two-year arrangement in an amount equivalent to SDR 8.18 billion (about US\$11.5 billion), and is treated by the authorities only as a precautionary measure. The IMF Board's review concluded that Colombia has a track record of very strong policy frameworks, and that the authorities are firmly committed to undertaking further initiatives to strengthen the resilience of the economy and boost competitiveness and growth. This view was also reflected in the May 2016 Article IV staff report, which acknowledges the role of the Government's monetary and fiscal tightening efforts, the soundness of the financial system and the resilience of corporate and household balance sheets in the smooth adjustment, while also recognizing the downside risks to the outlook. The IMF and World Bank maintain close collaboration.

## 3. THE GOVERNMENT'S PROGRAM

25. **The National Development Plan (NDP), covering the period 2014–2018, recognizes the importance of growth as a key ingredient for shared prosperity.** The NDP has a framework based on three pillars: Peace, Equality, and Education; and six cross-cutting strategic areas relevant to all pillars: (i) competitiveness and strategic infrastructure; (ii) social mobility; (iii) rural transformation; (iv) security, justice and democracy to build peace; (v) good governance; and (vi) green growth.

26. **Moreover, the NDP places these priorities within a consistent macroeconomic framework, anchored on fiscal responsibility.** Specific measures to strengthen fiscal sustainability include the strengthening of tax and customs policy and administration; the reduction of tax compliance costs; the strengthening of transparency in public accounts and the fight against fraud and corruption; enhancements in the social security system to reduce uncertainties over public liabilities, especially in the pension system; and the alignment of the multiannual investment plan with the Medium-Term Fiscal Framework (MTFF).

27. **The NDP recognizes that competitiveness directly contributes to poverty reduction and inclusive growth.** The NDP highlights the improvement of the country's competitiveness as a key strategy to reduce poverty through the creation of jobs and the increase of household income, leading to a more equitable, more educated and more peaceful country. The NDP defines, as part of its strategy, measures to increase productivity, diversify the economy and enable a business environment conducive to growth by reducing regulatory costs, eliminating barriers that prevent access to markets and strengthening the innovation capacity of firms. Specifically, the NDP proposes to (i) rationalize administrative processes to reduce transaction costs; (ii) reduce

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<sup>10</sup> Colombia has had access to FCL arrangements since 2009, renewed every 2 years.



market barriers for entry of firms and trade in goods and services; and (iii) increase the efficiency of public spending on Science, Technology and Innovation (STI).

## **4. THE PROPOSED OPERATION**

### **4.1 LINK TO GOVERNMENT PROGRAM AND OPERATION DESCRIPTION**

28. **The Fiscal Sustainability and Competitiveness DPF series aims to support Colombia's efforts to maintain fiscal sustainability and enable the basis to accelerate productivity growth in the context of the ongoing peace process and under a less favorable external environment.** The proposed DPF series recognizes and supports the Colombian authorities' reform efforts in the adjustment to this new domestic and external environment and it is closely aligned with the priorities identified in the NDP. The series' Program Development Objectives (PDOs) are to: (i) support fiscal consolidation measures and improved contingent liabilities management; and (ii) foster productivity in non-extractive sectors by strengthening the policy framework for trade facilitation, investment, competition, business regulation and innovation. The reforms under these two objectives mutually reinforce each other. Both areas of reform are likely to raise investor confidence, reduce costs for the private sector, make the country even more resilient to shocks, and foster fiscal sustainability and growth over the medium term. They are also critical for Colombia to reap the growth benefits of the peace process.

29. **The design of the proposed operation incorporates lessons learned from previous DPFs.** The experience of the Fiscal Sustainability and Growth Resilience DPF series<sup>11</sup> (FY12/13) and the Enhancing Fiscal Capacity to Promote Shared Prosperity DPF<sup>12</sup> (FY14) suggests that (i) the Bank's ability to provide cross-sectoral support through a DPF is an effective tool to address the client's cross-cutting challenges; (ii) DPFs can serve as a vehicle for deepening the policy dialogue on fundamental issues, even beyond the scope of the program supported by the operation; and (iii) the Bank's role as a provider of technical knowledge can further add to the value of a DPF. These three lessons are reflected in the proposed operation, which (i) supports a cross-cutting but interlinked set of reforms; (ii) has led to a number of related technical assistance activities; and (iii) is being supported by knowledge activities beyond the scope of the DPF, such as the Innovation PER. Moreover, a key lesson learned from other DPFs supporting fiscal and competitiveness reforms is that country ownership and commitment are essential to achieve the program's objectives and appropriately define results indicators.

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<sup>11</sup> P123267 and P129465

<sup>12</sup> P154213

## 4.2. PRIOR ACTIONS, RESULTS AND ANALYTICAL UNDERPINNINGS

### Pillar 1: Support fiscal consolidation measures and improved contingent liabilities management

#### *Public expenditure and contingent liabilities*

30. **Restraining current expenditures and reducing fiscal risks from contingent liabilities are important for safeguarding fiscal sustainability.** As discussed in Section II, part of the reduction in the fiscal deficit over the next 6 years will need to come from the expenditure side. In order to limit the impact of fiscal adjustment on investment spending, tight limits on recurrent expenditures are required. Fiscal sustainability will also depend on sound management and monitoring of contingent liabilities, with the aim of reducing their risk of materialization and the resulting fiscal costs. In this context, obligations related to the provision of social security and health represent some of the most substantial long-term fiscal risks.

**Prior action #1:** *The Government has adopted measures to reduce its Executive Branch's recurrent expenditures in the context of the 2016 national budget, including: (i) the implementation of cutbacks in general operating expenses (gastos generales) and communication costs; and (ii) the establishment of a set of limitations for hiring new personnel, including a freeze in overall personnel numbers.*

31. **Rationale.** As oil prices began to fall in 2014, reducing oil-related fiscal revenues, the Colombian authorities embarked on measures to ensure compliance with the Fiscal Rule, while allowing the fiscal deficit to increase. That moderate fiscal impulse through the deficit was aimed at smoothing the transition of the economy to a likely lower potential growth. The initial measures implemented included (i) the approval by Congress (in December 2014) of tax policy measures to support revenue collections; and (ii) cuts in the budget of COP6.2 trillion (equivalent to 0.8 percent of GDP). Later, the authorities announced in November 2015 cuts of COP9 trillion (1.1 percent of GDP) to the originally approved 2015 budget. The authorities also included in the 2016 budget a COP1 trillion set aside as a “Fiscal Rule Guarantee” kept under the Ministry of Finance as well as a reserve of 1 percent of the total budget of each institution (equivalent to COP1.8 trillion) to cover a potential shortfall in revenues. But considering the greater than expected reduction in oil prices, it became clear in early 2016 that further expenditure rationalization measures were needed, within the constraints imposed by constitutional mandates (such as the link of public sector wage increases to inflation).

32. **Substance of the prior action.** The first set of adjustments supported by this operation came in February 2016, with the issuance of Presidential Directive No. 1 of 2016, which sets a target of 10 percent savings in recurrent spending (*gastos de funcionamiento*) compared to the 2016 budget envelope approved by Congress in November 2015. It was followed by Decree No. 378 of 2016, issued in March, which announced a cut of COP6 trillion (0.7 percent of GDP) in the aggregate budget envelope, including (i) COP660 billion in personnel costs through a measure that called for a freeze of the existing personnel numbers as of December 31, 2015<sup>13</sup> and the reduction of indirect personal services by 5 percent; and (ii) COP149 billion in expenses for the

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<sup>13</sup> Further decreases in this category were prevented by the agreement reached with public sector labor unions for 2015-16 to increase public sector wages by CPI inflation plus one percentage point for productivity growth. A Constitutional Court ruling prevents the government from raising public sector wages by less than CPI inflation.

purchase of goods and services (*gastos generales*) (equivalent to 5 percent). Other measures taken to contain spending in 2016 include a COP1.7 trillion reduction in transfers that are not part of the general participation system or allocated to universities, pensions and reconciliations (equivalent to 10 percent of such transfers); and a reduction of COP3 trillion in investment, focusing on non-priority projects and maintaining the coverage of social programs.

33. **Triggers.** The Government is committed to ensuring compliance with the Fiscal Rule and will continue to limit public spending accordingly. In this context, it is planning to control personnel spending and cut spending on goods and services in the 2017 budget. The 2017 budget, the draft of which was submitted to Congress on July 29, 2016, will establish a policy measure that continues the freeze on personnel numbers as of February 2016, limits the public sector salary increases to inflation and cuts spending on goods and services. Together with the measures taken in 2014-2016, these additional expenditure measures will contribute to a containment in current spending over the medium term.

34. **Expected results.** It is expected that the measures supported by the DPF series will contribute to a reduction in the Central Government recurrent expenditure categories targeted by the controls. It is expected that the sum of Central Government personnel and goods and services expenditures will fall from 3.1 percent of GDP in 2015 to 2.9 percent of GDP by 2018.

**Prior action #2:** *The Government has established a set of rules to improve the funding of public pension liabilities at the subnational level, including: (i) the requirement of registering public pension liabilities in FONPET on a regular basis and by administration sector; (ii) the procedure for transferring funds across said sectors to ensure adequate funding coverage; and (iii) the conditions for using any excess sectoral savings.*

35. **Rationale.** Prior to the establishment of the national (unified) pension system in 1993, there were over 1,000 separate pension funds, many administered by subnational governments. Subnational governments continued to be responsible for the pension liabilities incurred prior to 1993, but had no reliable mechanisms in place to estimate these liabilities and to provision for them. In the wake of the subnational fiscal crisis in the late 1990s, the Government created the *Fondo Nacional de Pensiones de las Entidades Territoriales* (FONPET) as a long-term savings vehicle to ensure the adequate funding of the subnational pension liabilities. The law requires subnational governments to collect and submit information on the working history of current and/or former employees, on the basis of which the Ministry of Finance conducts actuarial calculations of the outstanding liabilities. The FONPET is financed by three main sources: (i) a share of the general participation transfers, royalties transfers and transfers from the national lottery; (ii) a share of Central Government earmarked financing from privatization receipts and the national stamp tax; and (iii) a share of municipal and departmental own source revenues. Savings accumulation in the FONPET has been significant in recent years, reaching 76 percent of overall subnational pension liabilities in 2015 (in net present value terms), up from 14 percent in 2006. Within the FONPET, subnational governments maintain sub-accounts, reflecting obligations under three different pension regimes for public workers: general administration, education, and health.<sup>14</sup> Data on outstanding liabilities in the general administration is good and comprehensive, but information to estimate pension liabilities in the other sectors, particularly

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<sup>14</sup> Some of the financing sources of the FONPET are earmarked specifically for pension liabilities in the education and health sector, respectively.

health, is of much lower quality, adding to the subnational governments' fiscal risks associated with unfunded obligations in this sector.<sup>15</sup>

36. The issues related to subnational pension liabilities are closely related to the broader challenges Colombia faces in its social security system, including health insurance. Subnational governments carry significant financial obligations in the financing of the Colombian health system. However, the rapid expansion in health insurance coverage in the last two decades, especially in the subsidized regime, coupled with the growth in expenditures outside the mandatory benefit package (POS), is straining the financial sustainability of the system. While reforms in the last five years<sup>16</sup> have eased pressures in the short term, the NDP recognized the need for measures with a longer term impact, including: (i) the clarification of, and provisioning for, liabilities between health insurance providers (*Entidades Promotoras de Salud*, EPS), health services providers (*Institución Prestadora de Servicios de Salud*, IPS) and subnational governments; (ii) the approval of new revenue sources, including “vice taxes” (such as taxes on tobacco and alcohol – see also prior action #3 on the tax reform); (iii) a strengthening of the financial stability and solvency of EPS and public IPS<sup>17</sup>; and (iv) a re-definition of the POS itself.

37. **Substance of the prior action.** The Government issued Decree No. 630/2016 which stipulates (i) the registration of subnational pension liabilities in the FONPET by sector; (ii) the mechanisms to move funds between sectors in the FONPET in order to achieve the required sectoral funding coverage of liabilities; and (iii) the conditions under which excess sectoral savings in the FONPET can be withdrawn or used. The Decree also sets out the conditions under which FONPET savings in the health account can be used to make ongoing pension payments to retired health workers.<sup>18</sup> Finally, the Decree also establishes that those subnational governments that have reached full savings coverage at the sectoral level use their excess savings to finance expenditures in the subsidized public health regime.<sup>19</sup> These measures help reduce the risk associated with unfunded subnational pension liabilities and with subnational governments' financial obligations in the health sector.

38. **Triggers.** The government is planning to adopt a number of critical regulations to implement the Statutory Health Law approved in 2015 (Law No.1751 of 2015). For example, the Law changes the concept of POS, introducing instead the concept of explicit exclusion, or “negative list”, of services that are not financed. Regulations on the criteria to be used to exclude certain health technologies will also be issued. The second DPF in the series will support these implementing regulations. The fiscal savings and/or reductions in fiscal risks resulting from these changes will need to be carefully evaluated. In addition, the second DPF will support measures to

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<sup>15</sup> Total subnational pension liabilities currently represent close to 7 percent of GDP.

<sup>16</sup> These include the requirement for EPS to operate under similar financial solvency conditions as those of other insurance companies (including minimum capital, solvency margin, technical reserves, investment regime), with a transition period of 7 years. The Government also closed SaludCoop, one of the largest EPS in the contributory system after a 3-year public intervention.

<sup>17</sup> In an important step towards addressing the financial sustainability of EPS, the government closed down, in December 2015, the largest public EPS (Caprecom) in the subsidized regime, which is estimated to result in fiscal savings of 0.2-0.3 percent of GDP compared to the projected COP3.2 trillion cost of recapitalizing Caprecom in compliance with EPS financial requirements between 2015 and 2021.

<sup>18</sup> In aspects related to pension liabilities in the health sector, Decree No. 630/2016 implements Article 147 of Law 1753 of 2015 (National Development Plan).

<sup>19</sup> In the case of savings in the education and general administration account, excess savings are earmarked for investment projects.

regulate the pharmaceutical market to generate fiscal savings through centralized purchasing, price controls, and promotion of competition and transparency.

39. ***Expected results.*** It is expected that the measures supported by this operation will lead to an increase in the sectoral coverage of subnational pension liabilities, especially in the health and education sectors. Achieving full savings coverage would eliminate the remaining contingent liabilities for the Central Government related to subnational pensions (estimated at 1.6 percent of GDP).<sup>20</sup> It would also help increase subnational resources for investment and free up resources for subnational financing of the public (subsidized) health system, in the case of subnational governments that have achieved full coverage. This result would be measured by the increase in the use of FONPET savings to finance subnational contributions to the subsidized health regime. The redefinition of the POS and the improvements in the regulation of the pharmaceuticals market would help reduce costs and improve the solvency margin of EPS.

### ***Tax policy and tax administration***

40. **Given that Colombia's tax collection levels remain low relative to peers, fiscal sustainability will also depend on greater revenue mobilization.** Colombia has one of the lowest tax-to-GDP ratios in the region, with the Central Government collecting just above 14 percent of GDP in taxes in 2015 (the OECD average in this ratio is 20.5 percent). Some of the shortcoming of the tax system include: (i) high marginal rates on narrow bases, with many loopholes and limited progressivity (e.g., on income taxes); (ii) some under-taxed bases (particularly on consumption items); and (iii) high rates of tax evasion across the board.

**Prior action #3:** *The Government has adopted a tax reform, which, inter alia, (i) increases the general sales tax (VAT) rate from 16% to 19%; (ii) establishes a single corporate income tax (Impuesto sobre la Renta de Personas Jurídicas), and lowers overall corporate tax rates; (iii) applies the Personal Income Tax to dividends; (iv) establishes a single tax ("monotributo") for small traders; and (iv) increases the rates of the tobacco and liquors and wine taxes.*

41. ***Rationale.*** Tax reforms approved in 2014 helped to maintain revenue collections through the economic downturn and the decline of oil-related fiscal revenues. But in order to ensure compliance with the critical anchor that is the Fiscal Rule, address new spending pressures arising from the peace process and maintain fiscal sustainability, the Government needed to adopt a structural reform of its tax system as well as a number of critical tax administration reforms. The reforms also needed to fulfill the increased revenue collection objective, while improving efficiency and maintaining equity in the system. These objectives were consistent with the recommendations of a Government-convened Commission to conduct a comprehensive review of Colombia's tax system, which benefited from inputs of many stakeholders across the country (including from international organizations such as the World Bank, IMF, IADB and OECD).

42. ***Substance of the prior action.*** With the approval of Laws 1816 and 1819 in December 2016, the Government adopted a range of tax reforms aimed at simplifying the tax system, incentivizing employment, protecting public health, and increasing tax revenue to protect social spending and public investment. In order to improve tax enforcement, the Law also includes measures to strengthen tax administration, including stronger control over the Special Tax Regime

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<sup>20</sup> Equivalent to the current shortfall between FONPET savings and subnational pension liabilities.

for Non-Profit Organizations, and higher sanctions for tax evaders.<sup>21</sup> The reforms will support the government's objective of boosting growth in the context of lower oil prices, while generating an estimated 1.9 percent in additional tax revenue<sup>22</sup> by 2022 which will help comply with the fiscal consolidation path set by the Fiscal Rule. Among the tax policy reforms, the most critical include the following:

- *An increase in the VAT general rate from 16 to 19 percent*, and a change in the classification of some goods and services (such as high-end housing). The change in tax rates and classification does not affect the basic food basket or medicines, which will remain excluded from the VAT to protect the poor;
- *The establishment of a single Corporate Income Tax (CIT)*, replacing the various taxes currently levied on corporations, and *the reduction of the overall tax rate for corporations*. Under the previous regime, the tax burden would have risen to 43 percent by 2018 for the largest corporations, which paid the CIT, the tax for equity (CREE) and CREE surcharge. All other corporations would have paid a CIT of 34 percent. With the changes introduced by Law 1819, the CIT rate will be lowered to 33 percent, with a temporary surcharge for the largest corporations of 6 percent in 2017 and 4 percent in 2018. The law also eliminates a number of exemptions, to broaden the base while reducing marginal rates;
- The unification of the three existing personal income tax (PIT) regimes and a change in the definition of income for the PIT, by nature of income rather than type of activity pursued. This includes *the taxation of dividends* at progressive rates, from 5 percent for dividend income above 600 *Unidades de Valor Tributario* (UVT) and at 10 percent for dividend income above 1,000 UVT. Total exemptions for labor income are capped at 40 percent;
- *The introduction of a single tax (monotributo) for small traders* under the new PIT regime. The *monotributo* is available for taxpayers with gross income of between 1,400 and 3,500 UVT and combines income tax and retirement savings contributions (under the *Beneficios Economicos Periodicos* regime). The revenue from the *monotributo* is earmarked for the financing of the social security, health and labor risk systems;
- *An increase in the tax rates on alcoholic beverages (liquors and wine) and tobacco*. Law 1816 includes changes to the structure of the tax levied on liquor and wine, as well as measures aimed at improving departmental control of the production and distribution of liquor and at strengthening efforts to fight smuggling and falsification. The new tax consists of two parts: (i) a specific component, determined by alcohol content of beverage, of COP220 (liquors) and COP150 (wine) per ABV percentage point for each 750cc unit<sup>23</sup>; and (ii) an ad valorem component, equivalent to 25 percent (liquors) and 20 percent (wine) of the value of the product for a 750cc unit. In addition, liquors and wine are subject to a 5 percent VAT rate on the sales price of the product. Law 1819 raises the tax rate on tobacco in two parts: a specific component (COP1,400 per pack in 2017, rising to COP2,100 from 2018 on<sup>24</sup>) and an ad valorem component (10 percent). Revenues from

<sup>21</sup> Higher sanctions and other disincentives can help deter noncompliance (IMF 2015).

<sup>22</sup> Compared to the no-reform scenario.

<sup>23</sup> Tax rates will from thereon be adjusted annually in line with CPI inflation

<sup>24</sup> After 2018, tax rates will be adjusted annually in line with CPI inflation plus 4 percentage points.

these departmental taxes are earmarked for spending on health, education and sports (in the case of the liquor tax) and on health (in the case of the tobacco tax).

**Prior action #4:** *The Government has adopted the following environmental taxes: (i) a carbon tax on fossil fuels proportional to their CO<sub>2</sub> emissions, and (ii) a tax on plastic bags.*

43. **Rationale.** Under the 2015 Paris Agreement on Climate Change, Colombia has committed to taking actions to reduce greenhouse gas emissions, and tax policy is one of the tools to help achieve this goal. Fossil fuels account for the bulk of greenhouse gas emissions in Colombia. However, tax rates of the gasoline and diesel taxes (the main existing tax on fossil fuels) are comparatively low, representing about one-fifth of the OECD average for gasoline, and one-third for diesel. In addition, the tax only applies to fossil fuels used for transportation, not for heating, process or electricity generation. Overall, Colombia ranks, among the OECD and Latin American countries, as one of the countries with the lowest revenue collections from environmentally-related taxes (0.9 percent of GDP in 2012)<sup>25</sup>, suggesting that there is scope to increase the use of tax policy to address negative environmental externalities.

44. **Substance of the prior action.** Law 1819 introduces two new environmental taxes. First, it establishes a Carbon Tax on all fossil fuels used for energy purposes, following the example of other countries in the region (including Mexico and Chile). The rate is COP 15,000 per ton of CO<sub>2</sub> emissions, thus incentivizing fuel efficiency and a switch to cleaner fuels and renewable energy sources. As the new carbon tax applies to all fuels, it also contributes to greater tax collections (see Table 5). Second, the law introduces a tax on the use of plastic bags, with a rate of COP20 per bag in 2017, increasing to COP50 by 2020.<sup>26</sup> Similar taxes have been adopted in many countries and have led to a significant decrease in plastic bag use and litter.<sup>27</sup>

45. **Trigger.** The second operation in the DPF series supports the implementing regulations of the recently approved tax reform and of the new environmental taxes.

46. **Expected results.** The tax policy reforms (Prior Actions #3 and #4) are expected to have a positive impact on non-oil tax revenues of the Central Government, which would increase from 14 percent of GDP in 2015 to 14.3 percent of GDP by 2018. Subnational tax revenues are expected to increase from 3.3 to 3.5 percent of GDP in the same period.

**Prior action #5:** *The Government has adopted measures for preventing, controlling and sanctioning contraband, money laundering and tax evasion.*

**Rationale.** While it is difficult to quantify the impact of contraband on tax collections, Government estimates suggest that losses could be as high as COP3.3 trillion (0.5 percent of GDP) per year of foregone revenues from the VAT, import tariffs and income taxes at the central level.<sup>28</sup> Illegal rents from contraband also negatively affect the competitiveness of firms that abide by the rules, in some particular sectors (hydrocarbons, pharmaceuticals, alcohol and tobacco). The Government issued in 2015 its “Shock Plan” against tax evasion and contraband, which outlines a set of administrative reforms and measures to strengthen audits and improve customs control.

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<sup>25</sup> OECD (2015)

<sup>26</sup> Tax rates will from thereon be adjusted annually in line with CPI inflation.

<sup>27</sup> OECD (2008)

<sup>28</sup> Estimate is for the year 2011. DIAN (2014).

47. **Substance of the prior action.** The Anti-Contraband Law (Law No. 1762 of 2015), adopted in July 2015, toughens penalties on smuggling and related offenses, by establishing the act of smuggling as money laundering and increasing the maximum prison sentences for smuggling goods and hydrocarbons. It also toughens penalties for public officials involved in smuggling. The law also strengthens the unification of the sanctions applied to the evasion of excise taxes administered by subnational governments (especially alcoholic beverages and tobacco), and the strengthening of the institutions involved in the fight against smuggling. As such, it is a critical measure to support the increase in collections from these taxes resulting from the higher rates on liquor, wine and tobacco products (Prior Action #3). The Anti-Contraband Law became effective upon its enactment and its implementation is already showing effects, as evidenced by the increase in confiscations of smuggled goods since mid-2015. The implementation of the Anti-Contraband Law will also be aided by the approval of the *Estatuto Aduanero* and the introduction of scanners at customs stations, supported under Pillar 2 of this DPF series.

**Prior action #6:** *The Government has established the regulatory framework which lays the foundations for the subsequent adoption and usage of electronic invoices, including, inter alia: (i) conditions and procedures for issuing, receiving and processing electronic invoices; and (ii) rules for their circulation as legal title.*

48. **Rationale.** The level of development of information systems in Colombia's tax administration (*Dirección de Impuestos y Aduana Nacional*, DIAN) lags behind that of other countries in the region. Even though initiatives to adopt electronic invoicing began in the mid-1990s, its implementation did not advance significantly. Similarly, the share of tax refund and tax payment transactions made through electronic means is only a fraction of that in upper middle income countries in LAC as well as in the OECD.<sup>29</sup> The persistence of paper-based systems not only affects compliance and administration costs, but also complicates efforts to control tax evasion.

49. **Substance of the prior action.** In an effort to lay the foundations for the full adoption and usage of electronic invoicing, the Government has issued Decree 2242, which regulates the conditions of issuance and interoperability of electronic invoicing in Colombia. The main objective of e-invoicing is to reduce compliance costs while strengthening fiscal controls. It will also improve efficiency by streamlining the tax credit and refund process, benefiting taxpayers while reducing administrative costs. The decree introduces a number of benefits to participating businesses to incentivize the wide-spread adoption of electronic invoicing. The implementation of this new system will be taking place gradually over the next few years, starting with a pilot with large taxpayers. Participants in the pilot will have six months to comply with the requirements and testing before issuing electronic invoices, either directly or through technology suppliers that are approved by law. In addition, the Government issued Decree 1349 on the transfer of electronic invoices as title, which facilitates factoring as an alternative source of funding for companies, especially SMEs, and thereby also creates additional incentives for the adoption of the electronic invoice.<sup>30</sup>

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<sup>29</sup> Tax Commission report (2016).

<sup>30</sup> The decree complements the creation of the central registry of electronic invoices, which was supported by the Sustained Growth and Income Convergence DPF series.



50. **Triggers.** Once the pilot is completed, the Government will issue resolutions to make the use of electronic invoicing mandatory, initially for specific taxpayer groups.

51. **Expected results.** The Government expects all businesses to be operating under the new system of electronic invoicing by 2018. The main expected result of the Anti-Contraband Law and the implementation of the electronic invoice is an increase in revenue in the medium to long term, thanks to improved control.<sup>31</sup> Within the period of the DPF series, it is expected that the VAT gap<sup>32</sup> would be reduced by 9 percentage points as a result of these two measures.

## **Pillar 2: Foster productivity in non-extractive sectors by strengthening the policy framework for trade facilitation, investment, competition, business regulation and innovation**

52. **In the context of a less favorable external environment, growth will have to rely much more on productivity improvements.** Addressing the binding constraints to productivity growth requires policy reforms across various areas. Over the period 1991-2008, annual TFP growth in Colombia was only 0.7 percent, compared to 1.7 percent in Chile and 4.8 percent in China. The poor productivity growth in Colombia can be decomposed into two components: (i) low average productivity growth at the firm-level; and (ii) misallocation of resources where lower productivity firms employ a share of worker that is disproportionately larger than their productivity, while higher productivity ones employ a disproportionately low share of workers. Accordingly, there are several binding constraints for productivity growth and need to be addressed in a systemic manner. First, it is important to improve incentives for firms to innovate and integrate into global markets, which are crucial in spurring average firm-level productivity growth. Second, burdensome regulations need to be simplified and competition policy strengthened in order to improve efficient functioning of markets and address the constraints behind the current productivity misallocation.

### **Trade facilitation**

**Prior action #7:** *The Government has adopted: (i) a customs regulatory framework (“regulación aduanera”) to, inter alia, improve risk management practices in connection with custom controls and establish standard procedures for the electronic processing of customs documents; and (ii) procedures for using scanners to inspect goods transiting at the country’s maritime terminals.*

53. **Rationale.** Colombia trades well below what its per capita income level would predict, and trade as a share of GDP remains lower than the LAC average.<sup>33</sup> One of the key obstacles limiting trade integration are the costs associated with trading across borders activity, and especially the time and cost of border compliance: the Doing Business ranking puts Colombia at

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<sup>31</sup> Anti-contraband measures can be expected to reduce foregone revenue from illicit trade by approximately 0.25 percent of GDP.

<sup>32</sup> Defined as the difference between potential and actual VAT collections, expressed as a share of potential collections

<sup>33</sup> Trade openness remains low with trade to GDP ratio at 31.5% in 2014 relative to 39% LAC average and 75% in fast-growing Asia (World Bank, 2015a).

rank 121 out of 189 economies on the ease of trading across borders,<sup>34</sup> and Colombia only scores 2.64 over 5 in the World Bank's Logistic Performance Index (LPI). The policy of increasing global integration through preferential trade agreements with key trading partners (e.g., United States, EU and Canada) and by joining regional partnerships such as the Pacific Alliance (which includes Colombia, Chile, Mexico and Peru) will need to be accompanied by strong behind-the-border trade facilitation measures to render the expected results.

54. **Substance of the prior action.** The *regulación aduanera* (also known as the *Estatuto Aduanero*), approved in March 2016, will enable a reduction in time and costs of border compliance through the following policy and institutional reforms by (i) providing a legal framework for aligning customs and border practices to those included in the World Trade Organization's Trade Facilitation Agreement (TFA), and simplifying the guarantee system for customs procedures to allow a prompt and immediate disposal of goods at borders and ports, particularly for perishable goods, and by establishing a system of advance rulings on customs, which provides predictability to traders; (ii) strengthening the control role of DIAN in line with the Anti-Contraband Law (see Pillar 1); (iii) improving risk management by categorizing traders according to their risk profile; and (iv) establishing a mandatory paperless processing for customs documents. This legislation is complemented by a reform that operationalizes the use of scanners in the main ports of the country (Resolution No. 0084 of July 31, 2015). It also establishes the obligation of maritime port administrators<sup>35</sup> to install scanners and to connect the scanners with the information systems of the anti-narcotics police unit and DIAN. The scanners will potentially reduce the amount of physical examinations of goods, which in some cases can take over a day per container. The use of scanners also has a positive effect on the inspection of perishable goods, because it avoids exposing them to high temperatures encountered in Colombian ports. These measures complement a number of reforms supported by the Programmatic Sustained Growth and Income Convergence Development Policy Financing series (FY15-16).

55. **Trigger.** The Government will issue regulations that implement the *regulación aduanera*, including on the introduction of a risk-based inspection system and the implementation of paperless customs in the course of 2017. Risk-based systems reduce red tape and clearance times at the borders, which in turn reduce costs for the private sector and fosters trade.

56. **Expected results.** Customs clearance import times (average across all modes of transport) decrease from 23.53 hours in 2015 to 18 hours in 2018.<sup>36</sup>

## **Investment**

57. **Rationale.** Foreign Direct Investment (FDI) inflows decreased in Colombia from 3.3 percent of GDP in 2014 to 2.7 percent in 2015. A key driver of this decline was FDI in the mining and oil sectors that declined by 66.3 percent and 46.9 percent, respectively, over that period. The extractive sectors had accounted for 39 percent of total FDI in 2014. Given the high competition among countries to attract FDI in non-extractive sectors, the authorities are placing significant importance on simplifying the regulatory framework for foreign investors. This aims specifically

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<sup>34</sup> World Bank, 2016. Doing Business 2016: Measuring Regulatory Quality and Efficiency.

<sup>35</sup> Maritime terminals play a key role in Colombia as in 2015 97.7 percent of imports and 99 percent of exports transited through maritime terminals.

<sup>36</sup> Data collected by Sinergia/DNP ([www.sinergia.dnp.gov.co](http://www.sinergia.dnp.gov.co))

at improving the attractiveness of Colombia to FDI beyond natural resource-intensive sectors that can contribute to the diversification of exports and integration into global value chains, as well as to generate spillovers to local firms and promote productivity gains through technological upgrading. One important constraint to attract and retain FDI identified by the Ministry of Finance<sup>37</sup> are the cumbersome rules under Decree 2080 of 2000 and its amendments, which resulted in a large number of sanctions and delays for foreign investors when registering their foreign investment transactions at the Central Bank.

58. **Trigger.** The Government will issue a decree that simplifies regulations faced by foreign investors when investing in Colombia. The simplification will entail increasing the use of automated processes for registering investors, and clarifying the rights of permitted foreign investors. This decree will revise the current rules under Decree 2080, which resulted in a large number of sanctions to foreign investors when registering their foreign investment transactions at the Central Bank, an issue identified by the Ministry of Finance as an important constraint to attract and retain FDI. The reform, by clarifying the rights of foreign investors, making the registration processes more automatic,<sup>38</sup> and limiting the instances when foreign investors could be subject to sanctions, will aim to make entry of FDI simpler and more transparent, and reduce discretion in the sanctioning of foreign investors. This is especially important for investors in non-traditional sectors (i.e. energy and mining) which are especially sensitive to entry conditions and typically consider alternative locations in different countries.

59. **Expected results.** The percentage of automated (vs. non-automated) foreign investment registrations is expected to increase from 0 percent in 2015 to 50 percent in 2018.

## **Competition**

**Prior action #8:** *The Government has adopted measures to foster competition including, inter alia: (i) incentives to promote collaboration of cartel members in detecting and investigating anti-competitive agreements; and (ii) a fixed term and objective criteria for the selection and appointment of the director of the Superintendence of Industry and Commerce (Superintendencia de Industria y Comercio) whose responsibilities include, inter alia, the carrying out of competition oversight activities.*

60. **Rationale.** Colombia has a legal framework for competition, but more effective implementation and enforcement are critical to enhance competition pressures in the markets and deter price-fixing cartels. Although Colombia was one of the first countries to introduce a competition law in 1959, today it ranks 37<sup>th</sup> out of 54 OECD and non-OECD countries as measured by the OECD Product Market Regulation (PMR) Indicators of 2013.<sup>39</sup> Data on PMR, jointly collected by the WBG and OECD, suggests that while Colombia compares well with regional peers (third-least restrictive following Chile and Peru in Latin America), regulations in key sectors of the economy (such as telecom, energy and transport) are more restrictive to competition than on average in the OECD countries with a 30 percent difference in the overall PMR indicator that measures restrictiveness. The Colombian competition authority has detected

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<sup>37</sup> Ministry of Finance (2014)

<sup>38</sup> With the new decree, the sole submission of the registration form to the Central Bank will be sufficient for an investment to be considered registered and therefore covered under the set of guarantees that the decree provides (except for some special cases to be defined by the Central Bank).

<sup>39</sup> <http://www.oecd.org/eco/growth/indicatorsofproductmarketregulationhomepage.htm#indicators>

and sanctioned only 20 cartels in the past seven years.<sup>40</sup> Firms were found to fix prices in key consumer goods such as sugar, cocoa, diapers, paper notebooks and toilet paper, as well as in the transport sector, which tend to disproportionately affect the poor.<sup>41</sup> Strengthening leniency programs to destabilize and deter cartels and increasing the powers and independence of the competition in establishing commensurate fines for anti-competitive behaviors is key to tackle cartels. Leniency programs allow the competition authority to exempt cartel members from sanctions in exchange for information on the cartel, thus destabilizing and deterring cartels by creating a permanent threat that any of its members may reveal the cartel in order to avoid fines.

61. ***Substance of the prior action.*** The Government will increase significantly the incentives to report and cooperate with investigations against cartels by enhancing the attractiveness of the program of benefits to collaboration (“whistleblower program”). The new decree establishes an enhanced position (in terms of reduction of fines) for the first informant as opposed to the second one, which increases the incentives to become the first informant and thereby break the cartel. The decree also mandates the exclusion of the leniency benefits for cartel leaders/coercers and more incentives for potential applicants to collaborate after the initiation of the procedure. These are aimed at increasing the incentives of cartel members to apply for leniency, as well as legal certainty at each step of the procedure which are key elements for the overall success of the leniency program.<sup>42</sup> The reform also enables the competition authority to deter cartels with more significant sanctions by increasing the independence of the Superintendent as it sets a fixed term that does not overlap with the President of Colombia’s mandate.<sup>43</sup> This is crucial for enhancing the capacity of the competition authority to take independent technical decisions (such as imposing the highest overall fines against politically connected cartels) without fear of political retaliation.

62. ***Trigger.*** The Government is currently preparing a reform of the competition law. This reform will further strengthen the leniency program and increase the dissuasive effect by raising the ceiling for fines against anticompetitive practices. The policy reforms will (i) set the sanction limit for cartels based on company sales or margins and not as a fixed amount; and (ii) improve the regime of ex-ante control of mergers.

63. ***Expected results.*** The number of applicants to the antitrust program of benefits to collaboration (firms breaking a cartel and collaborating with the competition authority) is expected to increase by 75 percent, from four during the period before the reform (from 2012 to mid-2015) to seven in the period after the reform (from mid-2015 to 2018).

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<sup>40</sup> Even compared to countries at a similar income level, the perceived extent of market dominance in Colombia is higher.

<sup>41</sup> See Connor (2014). Based on worldwide average estimates these types of cartel on average lead to an increase in prices by 50% over the long-run above what would be the normal market price

<sup>42</sup> The lessons emerging from other countries show that an effective leniency program has led to an increase in the number of cartels investigated and punished by 60 percent and deterrence on the formation of cartels in the same proportion.<sup>42</sup> Also, Klein (2011) revises data from 23 OECD countries and finds that leniency policies were associated with a decrease in the industry-level price-cost margin of 3 to 5% and Chen and Harrington (2007) identify that leniency can also reduce the level of prices that cartels decide on charging.

<sup>43</sup> This reform followed the recommendations of the OECD Colombia Peer Review of Competition Law and Policy (2009) which highlighted as an institutional weakness that the Superintendent could be removed by the President of Colombia at pleasure.

## ***Business regulation***

64. **Rationale.** Young companies and startups play a key role in contributing to job creation and economic dynamism. Existing research shows that, for any size level, young establishments in Colombia grow much faster and create more jobs than old firms.<sup>44</sup> However, the number of procedures and days it takes to register a business is well above the average of OECD countries. In addition, many procedures related to tax registration and social security contributions need to be completed outside the Chamber of Commerce, which is responsible for business registration in Colombia.<sup>45</sup> These barriers to entry limit the creation of new dynamic young firms that can put competition pressure on incumbents, inhibit an important job creation engine, and foster informality.<sup>46</sup>

65. **Trigger.** In order to lower the barriers to entry and support economic dynamism through new startups, the second DPF in the series will support the Government in simplifying the procedures to create a company by merging these procedures under a single window for registering new companies. This will imply a substantial change and simplification with respect to current processes and procedures, centralizing all procedures under a single entry point and formally establishing a single window for business creation. This will not only reduce costs and save time, but it will also make procedural requirements more transparent and easier to access. The reform also aims to create a new coordination mechanism, under an existing agency of the Ministry of Commerce, Industry and Tourism, to better articulate business simplification initiatives among the 57 chambers of commerce in Colombia.

66. **Expected results.** The reforms supported by this DPF series are expected to increase the number of companies (*Sociedades Anónimas Simplificadas*, SAS) registered online in Bogotá by the new single window from 0 in 2015 to 5000 in 2018.<sup>47</sup>

## ***Innovation***

**Prior action #9:** *The Government has approved a national development policy for productivity development aimed to, inter alia, promote an efficient use of public resources by recommending a number of measures, including: (i) a cost-benefit analysis for new public projects; and (ii) a periodic review of public expenditures relating to projects in the areas of science, technology and innovation.*

67. **Rationale.** Measured by TFP growth, productivity growth in Colombia has averaged a low 0.5 percent over the past 60 years. This level is not only relatively low, but there are large differences in productivity levels across firms and regions in Colombia, hinting inefficiencies in the economy. A recent study found an 850 percent difference in productivity between manufacturing firms in the 90th vs. the 10th percentile of the productivity distribution, pointing toward the existence of higher level of productivity misallocation relative to the United States.<sup>48</sup>

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<sup>44</sup> Eslava and Haltivanger (2013).

<sup>45</sup> This reform builds on a reform approved in 2016 which electronically linked the databases of DIAN (tax authority) and the business registries housed at the chambers of commerce and eliminated the requirement for opening a bank account in order to register a new firm.

<sup>46</sup> Bruhn (2011).

<sup>47</sup> The *Dirección de Registro Mercantil* of the Chamber of Commerce of Bogotá keeps real-time electronic records of all business registrations in the city of Bogotá.

<sup>48</sup> Brown et al (2015).

In the context of low commodity prices, unleashing productivity has become an essential objective, and a key channel to achieve this is through promoting innovation. Innovation is one of the key factors driving within-firm productivity and is influenced by the incentives set by the institutional and policy context. Further, when innovation inputs are not equally accessible it can also lead to a misallocation of factors across firms and sectors. Thus, shortcomings in the national innovation system can hamper productivity in some sectors and, through them, in the whole economy.

68. **Substance of the prior action.** The Government adopted a new National Policy (“CONPES for Productive Development Policies”) to increase productivity and promote the diversification through a strategy<sup>49</sup> associated with knowledge and technology transfer, innovation and entrepreneurship, human capital, financing and production chains. Specifically, the CONPES recognizes the differences between regions in Colombia, in terms of their comparative advantages and potential demand, to promote productive development priorities at the regional level. Additionally, the CONPES emphasizes the importance of minimizing the risks of distortions and capture in public interventions to promote firms’ productivity. It promotes this objective by developing a set of specific and objective criteria for Government interventions, and by mandating that policy interventions at the sectoral level should be limited to the provision of public goods. In this framework, productive development programs are justified only to address specific market failures and distortions that hinder productivity growth, sophistication and diversification of production.<sup>50</sup> Crucially, this reform also aims at improving the efficiency and effectiveness of public expenditure by eliminating duplication and improving the allocation of resources across public institutions, by, for example, (i) structuring Subnational Strategic Plans and Agreements (*Planes y Acuerdos Departamentales de Ciencia, Tecnología e Innovación - PAED*) towards specifically contributing to the objectives and strategies of the current science, technology and innovation (STI) policy; (ii) adopting the Subnational Innovation Index for Colombia (*Índice Departamental de Innovación para Colombia.IDIC*) as a regional reference in order to prioritize the choice of specific STI instruments; (iii) incorporating the participation of various regional bodies for competitiveness and STI into a unique channel of communication, represented by the regional committee of competitiveness, science, technology and innovation; (vi) mandating a periodic Public Expenditure Review of STI programs to eliminate programs that have limited effectiveness and merge overlapping ones; and (v) requiring a cost-benefit analysis for new programs starting in 2017.

69. **Triggers.** With a view to improving the effectiveness of innovation programs, the Government will adopt the legal framework to articulate and operationalize the merger of the competitiveness and STI systems. The decree will define how to operationalize and articulate the merger of these two governance systems, implementing one of the key recommendations of the NDP. This reform aims to improve the efficiency and the effectiveness of public programs to promote innovation and competitiveness.

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<sup>49</sup> This strategy is built around a framework that emphasizes the importance of evidence-based policy decisions takes a long-term development perspective.

<sup>50</sup> Crespi et al (2016).

70. **Expected results.** As a result of the measures supported by the DPF series, the number of programs that are revised (modified, discontinued or newly introduced) on the basis of the PER recommendations will increase from 0 in 2015 to 18 in 2108.<sup>51</sup>

**Prior action #10:** *The Government has established the criteria and procedures for identifying projects entitled to access specific tax incentives under the existing fiscal legislation and within the established fiscal deductions' cap.*

71. **Rationale.** Colombia's investment in science, technology and innovation is well below other OECD and Latin American countries. The relatively low investment is also reflected in a low Research and Development (R&D) investment per capita (US\$ 16), 4.5 times smaller than the average for Latin America.<sup>52</sup> Furthermore, while in Colombia only around 30 percent of R&D resources come from private companies, countries like Mexico and Brazil have managed to leverage between 37 and 45 percent, respectively, of investment in STI from the private sector, while OECD countries such as the United States or Germany have a participation of the private sector in R&D expenditure of about 70 percent.<sup>53</sup> One of the biggest challenges for Colombia is to create the right incentives to increase private sector investment in STI, particularly in the non-extractive sectors, to reach a share more in line with the Latin American average of 45 percent.

72. **Substance of the prior action.** The policy change entails a reform of the system of tax incentives for innovation. The reform aims at increasing private sector investment in innovation and thus reduces the dominance of the public sector in innovation investment. A recent meta-analysis evaluating the effectiveness of such incentives across 37 studies suggests that these incentives tend to consistently have a positive effect with an additionality coefficient ranging between 17 and 25 percent.<sup>54</sup> The reform also aims at expanding and diversifying the type and number of companies with access to these incentives, all within the existing fiscal envelope (without an additional cost to the budget).<sup>55</sup> Specifically, the reform: (i) establishes a new system that recognizes "highly innovative"<sup>56</sup> firms that get fast-tracked to access fiscal benefits, and (ii) expands emphasis on sectors beyond extractives and young SMEs.<sup>57</sup> As part of the reform a pilot that identified 91 additional companies as "highly innovative" was conducted, providing them with access to fiscal incentives. 37 percent of these companies are SMEs, mostly in the manufacturing and IT industries<sup>58</sup>. In addition, the National Council for fiscal incentives on STI

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<sup>51</sup> This information will be collected and reported every six months by the *Dirección de Desarrollo Empresarial* in DNP through a technical document.

<sup>52</sup> *Red de Indicadores de Ciencia y Tecnología*.

<sup>53</sup> World Bank (2015b).

<sup>54</sup> Correa et al (2013).

<sup>55</sup> The reform does not focus on altering the size of the fiscal envelope which is defined by the National Council for fiscal incentives on STI yearly on the basis of criteria such as: (i) sufficiency of the envelope to accommodate projects presented in the previous year, (ii) sufficiency to accommodate multi-annual innovation projects, (iii) its effective use. Until 2015 only 70 percent of the existing envelope (i.e. COP 500,000 million) was used and 84 percent of this by mining and energy companies.

<sup>56</sup> The definition of highly innovative companies according to the CONPES 3834 is: "firms that can proof to systematically perform activities that foster innovation, through established processes, allocated resources and results that can be verified".

<sup>57</sup> These young SMEs are typically startups that are not yet able to generate positive profits and for which tax incentives would not be attractive unless, as the system allows now, they would be granted future tax credits.

<sup>58</sup> From these 91 highly innovative companies, 57 percent work in the manufacturing industry, in particular pharmaceutical, while 13 percent belong to the IT industry (Source: *Dirección de Desarrollo Tecnológico y de Innovación de Colciencias* 2016).

specified through a formal document<sup>59</sup> a clear set of specifications and requirements for firms to be able to access fiscal incentives on STI related projects, making the process of applying for fiscal incentives more transparent. This reform complements actions supported under the Second Programmatic Sustained Growth and Income Convergence Development Policy Loan (FY16).<sup>60</sup>

73. **Expected results.** The reforms supported by the DPF series are expected to increase the share of fiscal incentives granted by the National Council of Fiscal Incentives for STI to firms that come from sectors other than mining and energy from 16 percent in 2015 to 24 percent in 2018.

**Table 5: Prior Actions and Analytical Underpinnings**

Prior actions	Analytical Underpinnings
<i>Pillar 1: Support fiscal consolidation measures and improved contingent liabilities management</i>	
Prior action #1: The Government has adopted measures to reduce its Executive Branch's recurrent expenditures in the context of the 2016 national budget, including: (i) the implementation of cutbacks in general operating expenses ( <i>gastos generales</i> ) and communication costs; and (ii) the establishment of a set of limitations for hiring new personnel, including a freeze in overall personnel numbers.	Fiscal Rule (2011), MTFF (2015)
Prior action #2: The Government has established a set of rules to improve the funding of public pension liabilities at the subnational level, including: (i) the requirement of registering public pension liabilities in FONPET on a regular basis and by administration sector; (ii) the procedure for transferring funds across said sectors to ensure adequate funding coverage; and (iii) the conditions for using any excess sectoral savings.	OECD (2016): To strengthen health system performance and sustainability, it is important to develop more demanding and transparent performance frameworks around insurers (EPS), providers (IPS) and territorial authorities responsible for public health, focused on population health outcomes, quality of care, financial sustainability and good governance.
Prior action #3: The Government has adopted a tax reform, which, inter alia, (i) increases the general sales tax (VAT) rate from 16% to 19%; (ii) establishes a single corporate income tax ( <i>Impuesto sobre la Renta de Personas Jurídicas</i> ), and lowers overall corporate tax rates; (iii) applies the Personal Income Tax to dividends; (iv) establishes a single tax (" <i>monotributo</i> ") for small traders; and (iv) increases the rates of the tobacco and liquors and wine taxes.	Tax Commission Report (2016): Colombia's tax system generates relatively little revenue compared to its potential; does not contribute to a more equitable distribution of revenue; exhibits horizontal inequity between persons and companies; is complex and difficult to administer; and penalizes investment, employment and competitiveness. OECD (2015): The Colombian corporate tax system is highly complex and distortive. The effective tax burden on businesses is very high due to the combined effect of the corporate income tax, the corporate surtax (CREE), the net wealth tax on business assets and the value added tax (VAT) on fixed assets.
Prior action #4: The Government has adopted the following environmental taxes: (i) a carbon tax on fossil fuels proportional to their CO <sub>2</sub> emissions, and (ii) a tax on plastic bags.	OECD (2015): Environmentally related tax revenues in Colombia, at 0.9% of GDP, are low compared to OECD and Latin American countries. In particular, lower taxation of diesel than gasoline has environmental costs given that diesel has higher carbon emissions per liter of fuel used.

<sup>59</sup> "Tipología de proyectos calificados como de carácter científico, tecnológico e innovación: criterios y condiciones para su caracterización". Colciencias, 2016

<sup>60</sup> P154821



Prior action #5: The Government has adopted measures for preventing, controlling and sanctioning contraband, money laundering and tax evasion.	Fedesarrollo (2012): Strengthening the control of contraband, including better coordination among departments as well as with Central Government agencies, is critical in order to reap the benefits from higher tobacco taxation. IMF (2015): Legal changes, including stronger sanctions, are needed in many countries to enable administrations to better deter non-compliance.
Prior action #6: The Government has established the regulatory framework which lays the foundations for the subsequent adoption and usage of electronic invoices, including, inter alia: (i) conditions and procedures for issuing, receiving and processing electronic invoices; and (ii) rules for their circulation as legal title.	Tax Commission Report (2016): The adoption of the electronic invoice should be accelerated in order to strengthen control and reduce tax evasion. World Bank Policy Notes (2014): The effective implementation of the Guarantees Law (1676) and creation of an enabling framework for factoring would support the Government's objective of easing credit access for SMEs.
<i>Pillar 2: Foster productivity in non-extractive sectors by strengthening the policy framework for trade facilitation, investment, competition, business regulation and innovation</i>	
Prior action #7: The Government has adopted: (i) a customs regulatory framework ("regulación aduanera") to, inter alia, improve risk management practices in connection with custom controls and establish standard procedures for the electronic processing of customs documents; and (ii) procedures for using scanners to inspect goods transiting at the country's maritime terminals.	World Bank (2015): Despite a wide array of public policies designed to foster trade openness and global insertion, Colombia is still far from fulfilling its trade potential given its development stage. Its export basket is highly concentrated and dependent on extractive industries.
Prior action #8: The Government has adopted measures to foster competition including, inter alia: (i) incentives to promote collaboration of cartel members in detecting and investigating anti-competitive agreements; and (ii) a fixed term and objective criteria for the selection and appointment of the director of the Superintendence of Industry and Commerce ( <i>Superintendencia de Industria y Comercio</i> ) whose responsibilities include, inter alia, the carrying out of competition oversight activities.	Colombia SCD (2015): More intense competition in domestic market relies on more effective anti-monopoly policies and a regulatory framework more prone to competition. OECD Peer Review of the Colombia Competition Framework (2009) and follow up (2012): An effective leniency program relies on the incentive to forego fines. The ability to impose dissuasive fines, in turn, depends on the independence of the institution. Klein (2011): Leniency policies were associated with a decrease in the industry-level price-cost margin of 3 to 5%.
Prior action #9: The Government has approved a national development policy for productivity development aimed to, inter alia, promote an efficient use of public resources by recommending a number of measures, including: (i) a cost-benefit analysis for new public projects; and (ii) a periodic review of public expenditures relating to projects in the areas of science, technology and innovation.	WB Colombia Policy Notes (2014): Poor growth performance in Colombia is largely explained by lackluster productivity, associated to low innovation levels. Reforming the National Innovation System will be key to address this issue given its fragmented and inefficient governance. Brown et al (2015): There is a 850 percent difference in productivity between manufacturing firms in the 90th vs. 10th percentile and there is a high level of market misallocation relative to the United States.
Prior action #10: The Government has established the criteria and procedures for identifying projects entitled to access specific tax incentives under the existing fiscal legislation and within the established fiscal deductions' cap.	Parra (2011): Tax incentives for innovation in Colombia are highly concentrated and used only by few companies primarily in the mining and energy sectors. Correa et al (2013): The effect of R&D public subsidies is predominantly positive and significant with an additionality effect ranging between 17 and 25 percent.

#### 4.3 LINK TO CPF, OTHER BANK OPERATIONS AND THE WBG STRATEGY

74. **The proposed DPF series is consistent with the World Bank Group’s Country Partnership Framework (CPF) for FY2016-21.** The CPF<sup>61</sup>, which was discussed by the Board in April 2016, is built on three pillars: (i) fostering balanced territorial development; (ii) enhancing social inclusion and mobility through improved service delivery; and (iii) supporting fiscal sustainability and productivity. Cutting across all pillars, the CPF aims to “Assist in Constructing the Peace” in response to Colombia’s historic opportunity to reach a Peace Accord. The proposed DPF series is fully aligned with the third CPF pillar and supports two of its four objectives: improved fiscal management in support of fiscal consolidation; and improved business environment and innovation to boost productivity. It also contributes to the cross-cutting theme of peace-building considering that maintaining fiscal sustainability in the face of increased spending pressures will be critical. It complements a parallel DPF series on territorial development and subnational financial management and investment prioritization, as well as the DPF series on green growth, both of which support the first pillar of the CPF. All three DPF series also contribute to the cross-cutting theme of peace-building.

75. **The series is supported by technical work under a range of instruments.** The reforms under Pillar 1 are linked to the activities conducted under the previous and ongoing programmatic knowledge services on fiscal issues, including on tax policy and contingent liabilities. Pillar 2 is closely linked to the programmatic approach of knowledge services on innovation and competitiveness, including the Reimbursable Advisory Services (RAS) supporting the innovation public expenditure review. In addition, the reforms related to trade facilitation will be accompanied by a Trust Fund from the Trade Facilitation Support Program.

#### 4.4 CONSULTATIONS, COLLABORATION WITH DEVELOPMENT PARTNERS

76. **Many of the reforms supported by the DPF series were included in the NDP 2014–2018, which underwent extensive public consultations.** The NDP 2014–2018 was developed in consultation with the civil society and a wide range of governmental and nongovernmental agencies. According to Article 12 of Law 152 of 1994 the National Planning Council (*Consejo Nacional de Planeación*) is the responsible entity for conducting the public consultation process associated with Colombia’s NDP. The council must comprise national and local agencies and organizations that provide suggestions and recommendations on the most important chapters and building blocks of the NDP. The council is in charge of ensuring that a broad-based consultative process is conducted, representing a wide range of non-state organizations such as academia, religious groups, private sector, minorities, and so on. Between October 2014 and January 2015, 33 regional and 27 thematic forums were held around the country including over 7,000 participants. In December 2014, a National Congress of Participatory Planning (*XVIII Congreso Nacional de Planeación Participativa*) in the city of Ibagué, Tolima was also conducted. Official consultations with minorities were concluded in mid-January 2015.

77. **The tax reforms underwent extensive consultations.** The Commission’s recommendations were widely discussed in public fora and reflected inputs from many different

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<sup>61</sup> Report No.101552-CO

actors. Following the preparation of the draft law, the Government also conducted meetings with private sector representatives and members of Congress to discuss the proposed reforms. This feedback informed the final version of the law approved in December 2016.

78. **In addition, the reforms supported by this program followed Colombia's existing system for consultations on specific regulations.**<sup>62</sup> Colombia has several instruments that promote public consultation, as outlined in the CONPES 3816 and Decrees No. 1595 and 1609 of August 2015. However, how these processes are carried out varies across different institutions and different reform proposals.<sup>63</sup> For example, in the case of the CONPES on productivity and innovation and the *Estatuto Aduanero*, a thorough and extensive process of public consultations was conducted. The Government received about 700 comments from different stakeholders on the draft CONPES, including from 14 Government institutions, 22 representatives of academic institutions and 12 representatives of the private sector.<sup>64</sup>

79. **During the process of preparing the DPF series, the World Bank collaborated with the IMF and IFC.** Overall, the proposed DPF program is consistent with IMF policy advice, as outlined in 2016 Article IV staff report. Particularly, the Bank has collaborated with the IMF on the review of macroeconomic developments, including fiscal projections and the analysis of debt sustainability. Within the T&C Global Practice, which is a joint World Bank-IFC Practice, the team received inputs both from the World Bank and the IFC arms of T&C.

## 5. OTHER DESIGN AND APPRAISAL ISSUES

### 5.1 POVERTY AND SOCIAL IMPACT

80. **Most of the prior actions supported by this operation are not likely to have significant poverty, social or distributional effects in the short term, while contributing to positive effects in these areas over the medium to long term.** All prior actions were screened for likely effects and a poverty and social impact analysis was conducted (Annex 4). The measures for expenditure containment, improved contingent liabilities management and enhanced tax administration are overall expected to strengthen the fiscal position of the government and positively affect economic growth in the medium term, which in turn will help prevent poverty increases due to the economic downturn and further reduce poverty. Similarly, the prior actions aimed at strengthening trade, investment, competition and innovation are expected to support productivity and growth over the coming years. While these actions are not expected to have direct effects on poverty or inequality in the short term, their overall impact on welfare is expected to be positive.

81. **The only prior actions that are likely to have distributional effects (either positive or marginally negative) in the short run, but also be beneficial in the medium term, are those related to the tax reforms.** A tax simulation suggests that while the reform of indirect taxes

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<sup>62</sup> The Government is currently working on a new Administrative Act that aims to establish a unique system for public consultation to strengthen the public consultation process. This reform will establish clear procedures and timelines to be followed in the process of consulting the public on new regulations.

<sup>63</sup> OECD (2014a).

<sup>64</sup> This includes the comments provided for both the CONPES on productive development and the CONPES for innovation, which were merged into a single document.

would reduce disposable income across the expenditure distribution, the absolute and relative incidence effects of the reform would seem to be progressive (Annex 5). It should be noted that essential items that account for a larger share of poor households' expenditure, such as the basic food basket and medicines, remain excluded from the VAT. It is also important to highlight that, according to the tax reform Law 1819 of 2016 supported, tax revenues from the carbon tax will be used to provide aid in areas affected by the Colombian conflict and could bolster the progressiveness of the impacts of the reform. Moreover, the income tax reform places higher tax burdens on the richest households, even as taxes on dividends could discourage investments from the wealthiest. On the other hand, changes to corporate taxes are expected to increase firms' variable cost in the short run. Furthermore, tax benefits in areas previously affected by conflict could kick start employment in these regions and become a mechanism to reduce regional inequality; but they may also produce undesired incentives such crowding out and relocation of productive investments. Finally, the single tax (*monotributo*), a new tax aimed at small businesses, has the potential of increasing formal employment and enhancing the access to welfare augmenting social services to workers. A more detailed Poverty and Social Impact Analysis can be found in Annex 5.

## 5.2 ENVIRONMENTAL ASPECTS

82. **The prior action on the introduction of environmental taxes is likely to have significant positive effects on the environment, forests and other natural resources.** The Carbon Tax on fossil fuels is aimed at reducing CO<sub>2</sub> emissions and contributing to Colombia's commitments under the Paris Agreement. This carbon tax on fossil fuels may bring key climate change mitigation co-benefits through adoption of more efficient and cleaner transport and renewable energies. Under Colombia's Nationally Determined Contribution (NDC), the government committed itself to reducing its carbon emissions levels by 20 percent by 2030. Carbon taxes, along with emissions caps and emissions trading systems, are among the policy instruments that achieve the greatest reduction in greenhouse gas emissions at the lowest cost.<sup>65</sup> Similarly, the experience in other countries that have adopted taxes on plastic bags, given their devastating consequences on ecosystems, shows that taxes lead to a reduction in the use of such bags and, as a result, in the amount of plastic waste and pollution of the environment.

83. **The other prior actions supported by this operation are not likely to have significant environmental effects.** Under the fiscal pillar, the only prior action that may have an effect, albeit indirect, is the reduction in public expenditure vis-à-vis the approved 2016 budget that affects all institutions of the public sector, including the Ministry of Environment and Sustainable Development (*Ministerio de Ambiente y Desarrollo Sostenible*), although its budget decreased less than that of other institutions. Other agencies in charge of environmental management, such as the Institute for Hydrology, Meteorology and Environmental Studies and the National Environment Fund, also experienced below-average reductions of their approved spending envelopes. It is therefore unlikely that the public spending measures will have significant effects on environmental management in Colombia. The other reforms under Pillar 1 are unlikely to have significant, if any, environmental effects. The prior action related to the FONPET supports improvements in the management of subnational pension liabilities and frees up resources for increased health financing by subnational governments, thus not affecting the resources or

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<sup>65</sup> OECD (2013).

incentives related to the environment. Improved control over contraband, stronger tax administration and the reforms in tax policy will contribute to increased government revenue, which can help finance public goods, including environmental ones. But any potential effects would be indirect and medium- to long-term. Under the growth and competitiveness pillar, the measures related to the innovation system and productive development, tax incentives for innovation, trade facilitation, investment regime and competition policy are also not expected to have significant environmental effects. Any effects related to these prior actions would be of an indirect nature, resulting from increased investment and economic activity. However, considering that the reforms related to innovation incentives and the investment regime are likely to benefit primarily companies in the non-extractives sector, their environmental effects (if any) may be positive compared to the status quo.

### 5.3 PFM, DISBURSEMENT AND AUDITING ASPECTS

84. **Colombia's public financial management (PFM) systems are generally strong.** The national-level PFM systems show advanced levels of performance that are moving toward good international practices. A new Public Expenditure and Financial Accountability Assessment for Colombia was finalized in 2016<sup>66</sup>. Overall, Colombia's PFM system exhibits reasonable alignment with international best practices at the National Government level. The policy-based fiscal strategy and budgeting has had a particularly positive performance in terms of the institutional capacity to establish a credible fiscal strategy and ensure compliance with it. The same can be said of the management of assets and liabilities, with room to strengthen the fiscal risk reporting. Performance on fiscal transparency is generally aligned with international best practices, except for budget classification and the inclusion of performance information in the budget allocated to the direct delivery of public services to the population. This finding supports the decision of the GoC to focus a substantial part of the reform effort in these areas. Practices regarding the predictability and control of budget execution have been adjusted to international standards in Treasury Management, and Internal Control Management, in contrast with Payroll controls. The GoC has also initiated actions to strengthen the instruments required to foster improvements in these processes, with an aim to consolidate them over the medium term. The performance on accounting and reporting and external scrutiny and audit suggests opportunities for improvement, which gaps in relation to international best practices. If the ongoing reforms (especially those aimed at strengthening the consolidation of government financial information on the National Balance Sheet and inter-agency coordination of regulators and oversight agencies) are pursued diligently, they may reverse these shortcomings over the medium term. 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,<sup>67</sup> and annual formulation reflects a mostly well-functioning

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<sup>66</sup> Public Expenditure and Financial Accountability Assessment (PEFA) of Colombia's Public Financial Management Systems, October 14, 2016.

<sup>67</sup> The country has developed key PFM multiannual instruments since 2003, such as the MTFF and Medium-Term Expenditure Framework. However, they are presently not used adequately because they are developed in parallel with the budget instead of sequentially.

policy-based system.<sup>68</sup> Execution of budgeted expenditures suggests a largely credible budget. The Government has published its annual budget in a timely fashion.<sup>69</sup>

- **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.

85. **The Government is implementing an accounting and auditing reform agenda to adopt and implement international accounting (International Financial Reporting Standards and International Public Sector Accounting Standards) and auditing standards (International Standards on Auditing).** In the last three years, there have been significant developments toward implementing this reform, including issuing the new regulation for public sector entities (October 2015) to be adopted in January 2018. The new accounting framework will be used to consolidate the Government public accounts for the year ending December 31, 2018, and will enhance the Government's fiscal and financial reporting for decision making.

86. **Disbursement arrangements.** Once the DPF becomes effective and the Government complies with any withdrawal tranche release conditions, following the borrower's request, the Bank will deposit the funds into an account denominated in U.S. dollars at 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 within the 30 days after the funds are disbursed by the Bank. If the Bank determines at any time that an amount of the loan was used to make a payment for an excluded expenditure, the Borrower shall promptly, upon notice from the Bank, refund an amount equal to the amount of such payment to the Bank; and amounts refunded to the Bank upon such notice shall be cancelled from the loan.

87. **There is no evidence that the banking control environment into which the DPF proceeds would flow is inadequate.** This assessment is based on a review of the 2015 external audit report of the *Banco de la República*, the latest IMF Central Bank safeguards assessment (2012), and the 2016 IMF Article IV Consultation. Because the Government's PFM systems and the fiduciary arrangements for this financing are assessed as adequate, the Bank will not require

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<sup>68</sup> See PEFA 2015, IMF 2012 and the World Bank reviews 2013 for more information.

<sup>69</sup> Law 1815 of December 2, 2016.

an audit of the designated account and no additional fiduciary arrangements are considered necessary at this time.

## 5.4 MONITORING, EVALUATION AND ACCOUNTABILITY

88. **MHCP and DNP are responsible for collecting and monitoring information related to program implementation and progress towards the achievement of the results.** MHCP and DNP are responsible for coordinating necessary actions among the agencies involved in the reform program supported by this DPF series. The World Bank has worked closely with the two agencies in order to define results indicators that are clearly spelled out and measurable, giving preference to those that are collected on a regular basis in order to avoid an additional reporting burden. For example, several of the indicators are included in the NDP, which has a robust results framework that is closely monitored by DNP. Other indicators, such as those related to the annual Doing Business exercise, will be produced externally.

89. **Grievance Redress.** Communities and individuals who believe that they are adversely affected by specific country policies supported as prior actions or tranche release conditions under a World Bank Development Policy Operation may submit complaints to the responsible country authorities, appropriate local/national grievance redress mechanisms, or the WB's Grievance Redress Service (GRS). The GRS ensures that complaints received are promptly reviewed in order to address pertinent concerns. Affected communities and individuals may submit their complaint to the WB's independent Inspection Panel which determines whether harm occurred, or could occur, as a result of WB non-compliance with its policies and procedures. Complaints may be submitted at any time after concerns have been brought directly to the World Bank's attention, and Bank Management has been given an opportunity to respond. For information on how to submit complaints to the World Bank's corporate Grievance Redress Service (GRS), please visit <http://www.worldbank.org/GRS>. For information on how to submit complaints to the World Bank Inspection Panel, please visit [www.inspectionpanel.org](http://www.inspectionpanel.org).

## 6. SUMMARY OF RISKS AND MITIGATION

90. **The overall risk associated with the proposed DPF is assessed as moderate.** Most of the reforms supported by the operation form part of the NDP and benefit from strong ownership of the Government. The most relevant risks (albeit assessed as moderate) are related to the political and governance, macroeconomic and institutional capacity categories.

91. **Political and governance risks are related to the uncertainty associated with the ongoing peace process.** While the overall political context is stable, with national elections not due until 2018, the Government's top priority remains the successful advancement of the peace process with the main rebel group, the *Fuerzas Armadas Revolucionarias de Colombia* (FARC). Implementation issues in the peace process could have effects on other policy reform areas, including those supported by this DPF series. However, mitigating factors include Colombia's track record in implementing structural reforms and its aim to advance with the process of OECD accession. Overall, risks in this category are assessed to be moderate.

92. **Macroeconomic risks arise from the uncertainty in the external outlook and domestic developments.** A further fall/added volatility in oil prices and depressed demand from export partners could deepen Colombia's economic slowdown and fiscal pressures. A faster than expected hike in policy rates in the U.S. could generate further volatility for emerging economies like Colombia. A reduction in FDI or portfolio investment due to added uncertainty in international markets could generate some balance of payments pressures. There is also the possibility that domestic factors, such as the impact of El Niño and the tightening of monetary and fiscal policy, could have a greater than expected dampening effect on economic growth. Slower than expected (or partial) implementation of the structural tax reforms could also have a negative impact. These scenarios could result in slower progress towards the PDO than currently foreseen. Mitigating factors include the Government's internationally recognized strong track record on macroeconomic management, its commitment to price stability and to adhere to the Fiscal Rule. Risks in this category are moderate.

93. **Colombia's institutional capacity is generally strong, but the implementation of some of the supported reforms will require additional strengthening.** In particular, the reforms associated with the fight against contraband and the facilitation of trade will only be effective with adequate staffing, training and supporting IT systems. In an environment of budget cuts, there is a risk that the financial resources for this institutional strengthening will not be available. However, the Government recognizes the criticality of effective tax administration (and especially anti-evasion) measures for fiscal sustainability, as shown by the permission granted to DIAN to hire additional audit staff in 2016. Overall, risks in this category are moderate.

<b>Risk Categories</b>	<b>Rating (H, S, M or L)</b>
1. Political and governance	M
2. Macroeconomic	M
3. Sector strategies and policies	L
4. Technical design of project or program	L
5. Institutional capacity for implementation and sustainability	M
6. Fiduciary	L
7. Environment and social	M
8. Stakeholders	M
9. Other	
<b>Overall</b>	<b>M</b>



## ANNEX 1: POLICY AND RESULTS MATRIX

Prior actions (DPF1)	Indicative triggers (DPF2)	Results (2018)
<b>Pillar 1: Support fiscal consolidation measures and improved contingent liabilities management</b>		
PA#1: The Government has adopted measures to reduce its Executive Branch's recurrent expenditures in the context of the 2016 national budget, including: (i) the implementation of cutbacks in general operating expenses ( <i>gastos generales</i> ) and communication costs; and (ii) the establishment of a set of limitations for hiring new personnel, including a freeze in overall personnel numbers, as evidenced by Presidential Directive No. 1 dated February 10, 2016 and published in the Official Gazette on February 10, 2016.	Trigger #1: The Government has (i) maintained the freeze in Central Government personnel numbers; and (ii) reduced general operating expenditures in the 2017 budget to help support the fiscal adjustment process.	Reduction in Central Government personnel expenditures and general operating expenditures ( <i>gastos generales</i> ) as a share of GDP  Baseline (2015): personnel expenditures and general operating expenditures of 3.1% of GDP  Target (2018): personnel expenditures and general operating expenditures of 2.9% of GDP
PA#2: The Government has established a set of rules to improve the funding of public pension liabilities at the subnational level, including: (i) the requirement of registering public pension liabilities in FONPET on a regular basis and by administration sector; (ii) the procedure for transferring funds across said sectors to ensure adequate funding coverage; and (iii) the conditions for using any excess sectoral savings, as evidenced by Decree No. 630 dated April 18, 2016 and published in the Official Gazette on April 18, 2016.	Trigger #2: The Government has issued the regulations implementing the general principles set forth in the Statutory Health Law (Law 1751 of 2015).  Trigger #3: The Government has issued the implementing regulations to centralize procurement of medicines and other measures to promote competition in the pharmaceuticals market.	Increase in the use of FONPET savings to finance subnational contributions to the subsidized health regime  Baseline (2015): 0 Target (2016-2018): COP1 trillion  Improvement in the solvency margin of EPS

		<p>Baseline (June 2015): Gap with the required solvency margin<sup>70</sup> of COP5.33 trillion</p> <p>Target (2018): Gap with the required solvency margin of COP4.26 trillion</p>
<p>PA#3: The Government has adopted a tax reform, which, inter alia, (i) increases the general sales tax (VAT) rate from 16% to 19%; (ii) establishes a single corporate income tax (<i>Impuesto sobre la Renta de Personas Jurídicas</i>), and lowers overall corporate tax rates; (iii) applies the Personal Income Tax to dividends; (iv) establishes a single tax (“<i>monotributo</i>”) for small traders; and (v) increases the rates of the tobacco and liquors and wine taxes, as evidenced by Law No. 1816 and Law No. 1819, dated December 19 and December 29, 2016, and published in the Official Gazette on December 19 and December 29, 2016, respectively.</p>	<p>Trigger #4: The Government has issued implementing regulations for the tax reform and for the environmental taxes.</p>	<p>Increase in non-oil Central Government tax revenue</p> <p>Baseline (2015): 14.0 % of GDP Target (2018): 14.3% of GDP</p> <p>Increase in subnational government tax revenue</p> <p>Baseline (2015): 3.3% of GDP Target (2018): 3.5% of GDP</p>
<p>PA#4: The Government has adopted the following environmental taxes: (i) a carbon tax on fossil fuels proportional to their CO<sub>2</sub> emissions, and (ii) a tax on plastic bags, as evidenced by Law No. 1819, dated December 29, 2016 and published in the Official Gazette on December 29, 2016.</p>		

<sup>70</sup> According to Decree 2702/2014, the solvency margin is defined as the difference between required assets (*patrimonio adecuado*) and actual assets (*patrimonio técnico*). A reduction in the gap indicates convergence towards the solvency requirements.

PA#5: The Government has adopted measures for preventing, controlling and sanctioning contraband, money laundering and tax evasion, as evidenced by Law No. 1762 dated July 6, 2015 and published in the Official Gazette on July 6, 2015.		Reduction in VAT evasion  Baseline (2015): Estimated VAT gap <sup>71</sup> of 20.1% Target (2018): Estimated VAT gap of 11%
PA#6: The Government has established the regulatory framework which lays the foundations for the subsequent adoption and usage of electronic invoices, including, inter alia: (i) conditions and procedures for issuing, receiving and processing electronic invoices; and (ii) rules for their circulation as legal title, as evidenced, respectively, by Decree No. 2242, dated November 24, 2015 and published in the Official Gazette on November 24, 2015, and Decree No. 1349, dated August 22, 2016 and published in the Official Gazette on August 22, 2016.	Trigger #5: The Government has issued resolutions on the mandatory use of electronic invoicing for selected taxpayer groups.	
<b>Pillar 2: Foster productivity in non-extractive sectors by strengthening the policy framework for trade facilitation, investment, competition, business regulation and innovation</b>		
PA#7: The Government has adopted: (i) a customs regulatory framework (“regulación aduanera”) to, inter alia, improve risk management practices in connection with custom controls and establish standard procedures for the electronic processing of customs documents; and (ii) procedures for using scanners to inspect goods transiting at the country’s maritime terminals, as evidenced, respectively, by Decree No. 390 dated March 7, 2016, published in the Official Gazette on March 7, 2016 and Resolution No. 84 issued	Trigger #6: The Government has issued implementing regulations for the <i>regulación aduanera</i> including the introduction of a risk-based inspection system for customs and the implementation of paperless customs.	Reduction of customs clearance import times (average across all modes of transport)  Baseline (2015): 25.53 hours Target (2018): 18 hours

<sup>71</sup> Defined as the difference between actual and potential collections, expressed as a share of potential collections.

by the Intersectoral Committee for the Implementation and Monitoring of Non-Intrusive Inspection Systems ( <i>Comisión Intersectorial Para la Implementación y Seguimiento de Los Sistemas de Inspección No Intrusiva</i> ) and dated July 31, 2015.		
	Trigger#7: The Government has approved a decree that simplifies the rules and procedures for registering foreign investments by introducing new procedures for automatic registration of said foreign investments; and clarifies permitted investments and foreign investors' rights.	Increase in percentage of automated vs. non-automated foreign investments registrations.  Baseline (2015): 0% Target (2018): 50%
PA#8: The Government has adopted measures to foster competition including, inter alia: (i) incentives to promote collaboration of cartel members in detecting and investigating anti-competitive agreements; and (ii) a fixed term and objective criteria for the selection and appointment of the director of the Superintendence of Industry and Commerce ( <i>Superintendencia de Industria y Comercio</i> ) whose responsibilities include, inter alia, the carrying out of competition oversight activities, as evidenced, respectively, by Decree No. 1523, dated July 16, 2015 and published in the Official Gazette on July 16, 2015, and Decree No. 1817, dated September 15, 2015 and published in the Official Gazette on September 15, 2015.	Trigger #8: The Government has adopted new competition legislation.	Increase in the number of firms applying to the leniency program and collaborating with the competition authority in antitrust investigation.  Baseline (2012-June 2015): 4 Target (July 2015-2018): 7

	Trigger #9: The Government has issued an administrative act establishing the single window for registering new companies under a coordination agency to better articulate business simplification initiatives among the 57 chambers of commerce in Colombia.	Increase in the number of SAS companies registered online by the new one-stop shop  Baseline (2015): 0 Target (2018): 5,000
PA#9: The Government has approved a national development policy for productivity development aimed to, inter alia, promote an efficient use of public resources by recommending a number of measures, including: (i) a cost-benefit analysis for new public projects; and (ii) a periodic review of public expenditures relating to projects in the areas of science, technology and innovation, as evidenced by Section 5.3.3 of CONPES No. 3866, dated August 8, 2016 and published in the web page of DNP.	Trigger #10: The Government has issued the legal framework to articulate and operationalize the merger of the competitiveness and STI systems/programs with a view to improve effectiveness of innovation and productivity programs (Decree for operationalizing the integration of system of STI and Competitiveness).	Increase in the number of programs that are revised (modified, discontinued, introduced) on the basis of the CONPES  Baseline (2015): 0 Target (2018): 18
PA#10: The Government has established the criteria and procedures for identifying projects entitled to access specific tax incentives under the existing fiscal legislation and within the established fiscal deductions' cap as evidenced by Decisions No. 13, 14 and 15 of the National Council of Tax Benefits for Science, Technology and Innovation ( <i>Consejo Nacional de Beneficios Tributarios en Ciencia, Tecnología y Innovación</i> ), dated, respectively, December 31, 2015, February 26, 2016 and March 22, 2016.		Increase in the share of existing fiscal incentives granted by the National Council of Fiscal Incentives for STI to firms that come from sectors other than mining and energy  Baseline (2015): 16% Target (2018): 24%

## ANNEX 2: LETTER OF DEVELOPMENT POLICY



Bogotá D.C., 25 de enero de 2017

Doctor  
**Jim Yong Kim**  
Presidente  
Grupo Banco Mundial  
Washington, D.C.

Asunto: Carta de Política. DPL Sostenibilidad Fiscal y Competitividad

Estimado Dr. Kim:

Como ha sido de conocimiento del Grupo Banco Mundial (WBG por sus siglas en inglés), el Gobierno colombiano se ha caracterizado históricamente por su permanente compromiso por generar y promover crecimiento económico, salvaguardando la sostenibilidad de las finanzas públicas. Gracias a este esfuerzo permanente, la economía colombiana goza de una buena credibilidad en los mercados nacionales e internacionales, hecho que demuestran las calificaciones de riesgo crediticio de las que goza hoy la deuda de largo plazo en moneda extranjera del Gobierno Nacional: BBB por Standard & Poors y Fitch Ratings, y Baa2 por Moody's Investors Service.

En virtud de lo anterior, Colombia hoy es un país que gracias a su grado de inversión y a su programa de políticas públicas ha logrado consolidar cada vez más los fundamentales de su economía, así como su resiliencia a choques internos o externos. A pesar de que el reto en esta materia es permanente, y a que aún tenemos enormes desafíos por delante para entre otros reducir la desigualdad, disminuir brechas territoriales e incrementar nuestra competitividad y productividad, desde el Gobierno Nacional estamos satisfechos con el trabajo realizado hasta el momento, para el cual ha sido fundamental el permanente apoyo que hemos recibido del WBG.

Entre 2010 y 2016, la economía colombiana mantuvo un crecimiento económico promedio anual de 4,1 %. Gracias a esta dinámica, en este mismo periodo el desempleo se logró mantener en un solo dígito (cerrando el 2016 con un tasa promedio de 9,2 % y 22,2 millones de ocupados, siendo este el nivel más alto en los últimos 16 años) y el PIB per cápita ajustado por el poder de paridad de compra de los colombianos se incrementó de manera importante (según el Fondo Monetario Internacional este se ubicó en US\$ 13.846 en el 2015, frente a US\$ 10.776 del 2010). En consecuencia, avanzamos de manera importante en mejorar el bienestar de los colombianos, tal como lo evidencia la reducción en la tasa de pobreza de 37,2 % en 2010 a 27,8 % en el 2015.

Sin embargo, a partir del 2014 Colombia tuvo que enfrentar varios choques internos y externos que alteraron la dinámica económica antes descrita, y que obligaron al Gobierno Nacional a efectuar ajustes macroeconómicos que garantizaran crecimiento económico sostenido, pero que al mismo tiempo preservaran los principios y límites de responsabilidad fiscal que nos hemos impuesto como país a través de la que hemos denominado 'Regla Fiscal' (Ley 1473 de 2011).

El país no fue ajeno a la caída internacional de los precios del petróleo, situación que generó presiones sobre la tasa de cambio nominal y sobre el déficit en cuenta corriente, el cual en 2015 llegó a su máximo de 6,5 % del PIB. Sin embargo, la economía ha logrado adaptarse a esta nueva realidad de precios del petróleo razón por la cual en 2016 se redujo considerablemente la vulnerabilidad de la economía, cerrando con un déficit externo de 4,5 % del PIB.

Por otro lado, la inflación en 2016 se ubicó en 5,75 %, inferior en 1,02 puntos porcentuales a la cifra de 2015 y significativamente por debajo al máximo de 8,96 % que se observó en julio de 2016. Este resultado confirma la senda de corrección que han tenido los precios en los últimos meses, una vez desaparecidos los choques temporales provenientes de la depreciación del peso y del Fenómeno El Niño.

En consecuencia, para nosotros el 2016 fue un año de transición. La economía se ajustó más rápido de lo que se esperaba al principio del año, lo cual fue una buena noticia, pues es un claro indicio de que lo peor ya pasó y que hacia adelante soplarán vientos más favorables. Los pronósticos apuntan a que la economía habría cerrado el año con un crecimiento de 2,0 %, lo cual es un buen dato si se tienen en cuenta los fuertes choques externos que recibimos; prueba de ello es que una vez se excluye al sector minero-energético, Colombia y México son los líderes de crecimiento en la región, expandiéndose a tasas de 2,9 % y 2,5 %, respectivamente.

En respuesta a todo lo antes descrito, y gracias a la fortaleza institucional de nuestra economía y de nuestra democracia, el Gobierno Nacional puso en marcha un ambicioso y ordenado plan de ajuste macroeconómico de corto, mediano y largo plazo que hoy podemos decir con certeza que le ha permitido al país sobrellevar hasta este momento y de manera responsable los choques que se presentaron, del cual vale la pena destacar que incluye medidas estructurales para fortalecer la productividad de la economía doméstica y la recuperación de la inversión agregada y de la inversión extranjera directa, las cuales nos permitirán generar un crecimiento económico sostenido en el tiempo.

El programa de créditos bajo la modalidad DPL con el Banco Mundial en el que se enmarca esta carta de política, ha acompañado y apoyado este plan de ajuste al que hemos hecho referencia, el cual esperamos seguir implementando a lo largo del 2017 y el 2018. Tenemos confianza en las decisiones de política que hemos estado tomando para beneficio de nuestra economía; ya hemos empezado a ver evidencia de recuperación en nuestros indicadores (reducción en el déficit de la balanza comercial, el cual fue de US\$ 11.378 millones FOB en el periodo enero-noviembre de 2016, vs US\$

14.477 millones para el mismo periodo del 2015), así como en la reactivación de la actividad económica y de la productividad.

Adicionalmente, y de gran valor para nosotros, seguimos viendo signos de credibilidad, respaldo y buenas perspectivas por parte de los inversionistas, los mercados y nuestros socios de desarrollo como el WBG, el Banco Interamericano de Desarrollo y el Fondo Monetario Internacional, aspectos que siguen sustentando por qué la economía colombiana sigue siendo una de las más estables y activas de la región de América Latina y el Caribe.

El mencionado plan de ajuste macroeconómico se puede presentar en dos pilares, los cuales coinciden con el programa de apoyo que se presenta a través de este DPL: un primer pilar que hace referencia a la dimensión fiscal, y un segundo pilar que se refiere a la dimensión de crecimiento.

#### Pilar Fiscal

Entre 2013 y 2016, los ingresos petroleros del Gobierno Nacional Central descendieron en COP\$ 22,8 billones, equivalentes a 3,2 % del PIB; adicionalmente, debido a una depreciación nominal fruto de los menores precios del petróleo, el pago de intereses del Gobierno en su deuda externa incrementó en cerca de 0,7 puntos porcentuales del PIB.

En consideración a lo anterior, el Gobierno puso en marcha un conjunto de medidas de ajuste tanto en sus ingresos como en sus gastos con el ánimo de compensar el choque, cuyo orden de magnitud total fue del 3,9 % del PIB (2013-2016), medidas que seguiremos implementando durante el próximo año.

En materia de gasto, incrementamos el déficit fiscal en 1,7 % del PIB con respecto a 2013 con el respaldo técnico que el Comité de la Regla Fiscal nos permitía, debido a que la flexibilidad y dinamismo de nuestra Regla Fiscal define el déficit total permitido con base en el ciclo petrolero y económico observado en el país. Por otro lado, hicimos esfuerzos importantes por reducir nuestro gasto fiscal en el equivalente a 1,0 % del PIB, a través de varios decretos de recorte presupuestal que expedimos entre 2013 y 2016, así como con la decisión de congelar la nómina salarial; de esta manera, el gasto total del Gobierno Nacional pasó de 16,6 % del PIB en 2015 a 16,1 % en 2016. A este respecto es importante mencionar que protegimos el gasto de inversión social con especial cuidado, al considerarlo como uno de las inversiones más relevantes para la sostenibilidad económica y social de nuestro país, razón por la cual denominamos esta medida como de 'austeridad inteligente'.

Por el lado de los ingresos, trabajamos en dos niveles, uno nacional y otro territorial:

Con el fin de incrementar los ingresos de los 32 departamentos y 1.103 municipios del país:



- (i) definimos reglas para que los excesos de ahorro de estas entidades públicas en el Fondo Nacional de Pensiones de las Entidades Territoriales – FONPET pudieran ser liberados para financiamiento de su gasto en salud, así como para fortalecer este fondo con definición de requisitos para el registro regular de las obligaciones de pensiones públicas, y de procedimientos para transferencia de fondos (Decreto No. 630 de 2016);
- (ii) tramitamos las Leyes 1816 y 1819 de 2016 a través de las cuales, entre otras, las administraciones locales podrán incrementar sus ingresos tributarios a 2018 a niveles equivalentes al 3,5 % del PIB, provenientes de mayores tarifas al consumo de licores y un nuevo impuesto al consumo de cigarrillos.

Por su parte, tomamos varias decisiones para mejorar la estructura y nivel de los ingresos nacionales:

- (i) pusimos en marcha un plan de choque anti-evasión para mejorar la fiscalización, expidiendo actos administrativos para fortalecer la Dirección de Impuestos y Aduanas Nacionales -DIAN con mayores auditores. Con este mismo propósito, reglamentamos el uso de la factura electrónica (Decreto 2242 de 2015); y expedimos una Ley Anticontrabando (Ley 1762 de 2015) en virtud de la cual insertamos medidas para control y sanción de la evasión, el lavado de dinero y el contrabando;
- (ii) en materia específica de aduanas, adoptamos un Estatuto Aduanero (Decreto 390 de 2016) para fortalecer nuestra institucionalidad, regulación y procedimientos de registro aduanero. En consecuencia, y entre otras, introdujimos el uso de escáneres en los puestos fronterizos marítimos como práctica de control y hoy Colombia cuenta con una 'Comisión Intersectorial para la Implementación y Seguimiento de los Sistemas de Inspección No Intrusiva';
- (iii) finalmente, tramitamos una Ley de Reforma Tributaria en virtud de la cual, entre otras, incrementamos la tarifa general del Impuesto al Valor Agregado –IVA del 16 % al 19 % y creamos nuevos impuestos como a los dividendos y a las emisiones de carbono y uso de bolsas plásticas, cuyo efecto total estimamos puede incrementar los ingresos por concepto de impuestos no petroleros del Gobierno Nacional al 14,3 % del PIB en 2018.

Adicionalmente, esta reforma tributaria tendrá otras bondades que se reflejarán a mediano y largo plazo en la estructura de ingresos del Gobierno, razón por la cual consideramos que tiene un carácter estructural. Esto debido a que simplifica impuestos, mejora la competitividad de las empresas con menor carga impositiva, aumenta la equidad con un fortalecimiento de la base tributaria y promueve la formalidad.

No obstante las medidas de índole fiscal adoptadas, somos conscientes de que las mismas deben estar acompañadas de acciones de política que promuevan un crecimiento

sostenible y competitivo; por esta razón y de manera simultánea tomamos decisiones para impulsar el crecimiento de la economía, su productividad y la generación de empleo, específicamente a través de la diversificación y sofisticación de exportaciones y la mejora en el uso eficiente y distribución de los recursos productivos. Este enfoque en entonces el que justifica el segundo pilar bajo el cual está estructurada la operación de crédito.

### Pilar de Crecimiento

Según cálculos del DNP con datos de The Conference Board (2015), la productividad (medida como productividad total de factores) restó 0,2 puntos porcentuales en promedio al crecimiento total de la economía colombiana (4,2 %) entre 2000 y 2014, esta cifra contrasta con los 5 puntos que aportó la productividad al crecimiento promedio de las economías asiáticas durante el mismo periodo.

La baja productividad está asociada a 3 principales causas. La primera de ellas es la presencia de fallas de mercado que impiden a las unidades productoras tomar las decisiones más convenientes para aumentar su productividad, y que, por lo tanto, inhiben el crecimiento de la productividad agregada de la economía. La segunda es la disminución en el número de actividades económicas y productos en los que el país es competitivo, en particular, en el número de sectores relativamente sofisticados, lo cual llevó a que el país haya concentrado sus exportaciones en pocos productos de bajo valor agregado; sumado a lo anterior, cabe mencionar que durante el periodo 2004-2014 el crecimiento del PIB fue frenado por una disminución de 1,4 % de las exportaciones netas, las exportaciones de productos no minero-energéticos se redujeron del 60 % del total de exportaciones en 2006 al 33 % en 2014, y solo cinco departamentos (Atlántico, Cundinamarca, Valle, Antioquia y Bogotá) concentran las exportaciones de manufacturas de alta y media tecnología. En tercer lugar, está la existencia de fallas de articulación entre el Gobierno Nacional y los Gobiernos regionales, entre el sector público y el privado, y entre diferentes entidades del orden nacional. En general, se percibe que no hay claridad sobre las responsabilidades de cada actor ni en la coordinación conceptual y operativa entre ellos, generando así ineficiencias y falta de foco en la definición de los programas que tienen como propósito aumentar la productividad.

Para enfrentar lo anterior, adoptamos el siguiente conjunto de medidas encaminadas a fortalecer la libre competencia, impulsar la diversificación de la economía hacia sectores más sofisticados y a promover la innovación:

- (i) expedimos el decreto 1349 de 2016, en virtud del cual definimos las reglas para que la factura electrónica se considerara título valor, con el fin de generar mejoras en los procesos de negocio en las empresas, disminuir costos, facilitar la trazabilidad y seguridad de operaciones, y mejorar la competitividad del país;
- (ii) fortalecimos los incentivos de reporte y cooperación con investigaciones contra los carteles, a través del Decreto No.1523 del 16 de julio de 2015, e incrementamos la independencia del Superintendente responsable de la autoridad de competencia

(SIC) implementando un término fijo de duración de su mandato que no se sobrepase del mandato del Gobierno (Decreto 1817 de 2015);

(iii) aprobamos el documento de política CONPES 3866, en el cual trazamos y adoptamos una Política Nacional de Desarrollo Productivo (PDP). Esta incluye principalmente:

- a. la definición de un conjunto de instrumentos de política y programas para resolver fallas de mercado asociadas, entre otros, a la adopción de nuevas tecnologías y a la innovación, que inhiben el crecimiento de la productividad y que dificultan los procesos de sofisticación y diversificación del aparato productivo colombiano;
- b. mecanismos para corregir fallas de gobierno que promuevan un entorno institucional que facilite la coordinación entre actores y garantice la sostenibilidad e implementación de dichos instrumentos en el largo plazo. De esta forma, la PDP establece estrategias tales como la identificación y priorización de apuestas productivas a nivel regional, la continuidad del análisis de gasto público en CTI cada dos años, y la mejor coordinación de los sistemas de competitividad y ciencia, tecnología e innovación;

(iv) por último, y en el marco de nuestro 'Consejo Nacional de Beneficios Tributarios en Ciencia, Tecnología e Innovación', reformamos el sistema de incentivos de impuestos para la innovación, dentro de nuestro paquete fiscal existente, incluyendo un nuevo sistema que reconoce empresas "altamente innovadoras" que obtengan de manera rápida acceso a los beneficios fiscales para la inversión e innovación, haciendo énfasis en sectores más allá de los extractivos (Decisiones No. 13, 14 y 15 de 2015 y 2016).

Este paquete de ajuste que presentamos con esta operación refleja nuestra estrategia económica actual, a través de la cual consideramos hemos logrado reaccionar de manera satisfactoria a los retos que nos impone el difícil entorno económico mundial, así como a los propios de nuestra economía doméstica. Estamos convencidos que vamos por buen camino, pero así mismo, sabemos que los esfuerzos por consolidar nuestras políticas deben continuar en pro de la estabilidad de la economía y el bienestar de los colombianos. Por esta razón, esperamos seguir contando con el WBG como un aliado para este fin.

Agradeciendo su atención, reciba un cordial saludo,

  
**Mauricio Cárdenas Santamaría**  
Ministro  
Ministerio de Hacienda y Crédito Público  
**Simón Gaviria Muñoz**  
Director General  
Departamento Nacional de Planeación

Informal translation

(National Planning Department (DNP)) (Ministry of Finance)

Bogotá D.C., January 25, 2017

Doctor

**Jim Yong Kim**

President

World Bank Group

Washington, D.C.

Re: Policy letter. DPL Fiscal Sustainability and Competitiveness

Dear Dr. Kim:

The Colombian Government has been recognized by the World Bank Group (WBG) for its unwavering commitment to the generation and promotion of economic growth, while at the same time safeguarding the sustainability of public finances. Thanks to this ongoing effort, the Colombian economy enjoys good credibility in national and international markets, as reflected in the credit risk ratings accorded to the nation's long-term foreign currency debt: BBB by Standard & Poors and Fitch, and Baa2 by Moody's Investors Service.

By virtue of the foregoing and owing to its investments and public policy programs, Colombia is today a country that has managed consistently to consolidate the fundamentals of its economy and enhance its resilience to internal and external shocks. While the challenges in this area are ongoing and enormous hurdles still lie ahead if we are to, among other things, reduce inequality, bridge territorial gaps, and increase our competitiveness and productivity, we in the National Government are satisfied with the work done to date and recognize that the ongoing support that we received from the WBG was fundamental in this regard.

Between 2010 and 2016, the Colombian economy maintained annual average economic growth of 4.1 percent. As a result of this performance, unemployment was kept at single digits over the same period (closing 2016 with an average rate of 9.2 percent and 22.2 million employed, the highest number in the last 16 years); and GDP per capita, adjusted for the purchasing power parity of Colombians, grew significantly (rising to US\$13,846 in 2015 from US\$10,776 in 2010, according to the International Monetary Fund). Consequently, we made significant strides in improving the well-being of Colombians, reflected in the reduction of the poverty rate from 37.2 percent in 2010 to 27.8 percent in 2015.

However, since 2014 Colombia has had to face a number of internal and external shocks that altered the economic dynamic described above and obliged the National Government to introduce

macroeconomic adjustments to ensure sustained economic growth, while at the same time preserving the principles and limits of fiscal responsibility that we have chosen to adopt as a country in the form of the “Fiscal Rule” (Law 1473 of 2011).

The country was not spared the effects of the international fall in oil prices. It placed pressure on the nominal exchange rate and current account deficit, which reached its highest level of 6.5 percent of GDP in 2015. Nevertheless, the fact that the economy managed to adapt to the new oil price reality meant that economic vulnerability was reduced considerably in 2016, with the external deficit registering 4.5 percent of GDP at year-end.

In addition, inflation registered 5.75 percent in 2016, down by 1.02 percentage points from 2015, and significantly below the maximum of 8.96 percent observed in July 2016. This outturn reflects the price corrections that occurred over the past few months, once the temporary shocks associated with the depreciation of the peso and the El Niño Phenomenon had passed.

Consequently, 2016 was a transition year for us. The economy adjusted more quickly than expected at the start of the year, a welcome development seen as a clear indication that the worst was over and that more favorable winds would be blowing, going forward. According to forecasts, the economy ended the year with 2.0 percent growth, considered a good result when viewed against the backdrop of the strong external shocks experienced. This is illustrated by the fact that once the mining/energy sector is excluded, Colombia and Mexico recorded the highest levels of growth in the region, expanding by 2.9 percent and 2.5 percent, respectively.

In response to the foregoing and drawing on the institutional strength of our economy and democracy, the National Government launched an ambitious, structured macroeconomic adjustment plan for the short, medium, and long terms. Today, we can state with conviction that the plan has, to this point, enabled the country to overcome in a responsible manner the shocks that occurred. In this regard, special mention must be made of the plan’s structural measures to strengthen productivity and the domestic economy and restore aggregate investment and foreign direct investment, all of which are factors that will allow us to generate sustained economic growth over time.

The loan program under the World Bank’s DPF modality is the framework in which this policy letter is presented. The program has accompanied and supported the adjustment plan referred to, a plan which we hope to continue to implement throughout 2017 and 2018. We have confidence in the policy decisions that we have taken on the economy; we have already begun to see signs of improvement in our indicators (reduction in the balance of trade deficit, which registered US\$11.378 billion FOB (Free on Board) for the January-November 2016 period, as against US\$14.477 billion for the same period in 2015), as well as an upturn in economic activity and productivity.

In addition, we place great store by the fact that we continue to see signs of confidence, support, and a positive outlook on the part of investors, markets, and our development partners such as the WBG, the Inter-American Development Bank, and the International Monetary Fund. These factors explain why the Colombian economy remains one of the most stable and active economies in the Latin American and Caribbean region.

The macroeconomic adjustment plan referred to above may be divided into two pillars that are consistent with the DPL support program: a first pillar that has to do with the fiscal dimension, and a second pillar that relates to the growth dimension.

### Fiscal Pillar

Between 2013 and 2016, oil revenues to the Central National Government fell by COP22.8 trillion, equivalent to 3.2 percent of GDP; in addition, as a result of the nominal depreciation caused by lower oil prices, the Government's external debt interest payments increased by almost 0.7 GDP percentage points.

Based on the foregoing, the Government implemented a number of revenue and expenditure adjustment measures designed to offset the shocks. These measures, equivalent to 3.9 percent of GDP (2013-2016), will continue to be implemented over the next year.

In terms of expenditure, we increased the fiscal deficit by 1.7 percent of 2013 GDP, with the technical support of the Fiscal Rule Committee, as the Fiscal Rule provides the flexibility and dynamism to establish the total allowable deficit on the basis of the country's petroleum and economic cycles. In addition, we made significant efforts to reduce our fiscal expenditure by the equivalent of 1.0 percent of GDP, issuing a number of decrees on budgetary cutbacks between 2013 and 2016 and taking a decision to freeze payroll; in this way, total expenditure by the National Government fell from 16.6 percent of GDP in 2015 to 16.1 percent in 2016. In this regard, it must be mentioned that we were particularly careful to protect expenditure on social investment, as such investments are among the most vital for the economic and social sustainability of our country – hence the denomination 'intelligent austerity.'

On the revenue side, we worked on two levels – one national and the other territorial:

The following steps were taken to increase the revenues of the 32 departments and 1,103 municipalities in the country:

- (i) We established rules to ensure that the surplus savings of these public entities in the *Fondo Nacional de Pensiones de las Entidades Territoriales* (National Pension Fund for Territorial Entities, FONPET) could be freed up for the financing of health

expenditure. The rules were also designed to strengthen the fund by establishing criteria for the regular registry of public pension liabilities, and procedures for the transfer of funds (Decree No. 630 of 2016);

- (ii) We effected Laws 1816 and 1819 of 2016, by virtue of which local administrations will be in a position to increase their tax revenues in 2018 to levels equivalent to 3.5 percent of GDP through the imposition of higher levies on alcohol consumption and a new tax on cigarette consumption.

We also took a number of decisions to improve the structure and level of national revenues:

- (i) We implemented an anti-evasion “shock plan” to improve tax auditing, and took administrative steps to strengthen the *Dirección de Impuestos y Aduanas Nacionales* (National Tax and Customs Administration, DIAN) by increasing the number of auditors. With this in view, we also regulated the use of electronic invoices (Decree 2242 of 2015); and we issued an Anti-Contraband Law (Law 1762 of 2015) with measures to monitor and sanction evasion, money laundering, and contraband;
- (ii) On the specific issue of customs, we adopted a Customs Statute (Decree 390 of 2016) to strengthen our institutional framework, regulation, and customs registration procedures. Consequently, and among other measures, we introduced the use of scanners at maritime border posts as a control measure; and today Colombia has an “Inter-sectoral Commission for the Implementation and Monitoring of Non-Intrusive Inspection Systems”;
- (iii) Finally, we put in place a Tax Reform Law with measures, among others, to increase the general rate of the Value-Added Tax (VAT) from 16 percent to 19 percent. We also created new taxes, such as those on dividends and carbon emissions and use of plastic bags, whose cumulative effect we estimate can increase the National Government’s income from non-oil streams to 14.3 percent of GDP in 2018.

In addition, the tax reform will have other positive spinoffs that will be reflected in the medium and long terms in the Government’s income structure. It is for this reason that we consider the tax reform to be structural in nature. This is because it simplifies taxes, improves the competitiveness of companies by lowering the tax burden, increases equity by strengthening the tax base, and promotes the formal economy.

In taking these fiscal measures, we do not lose sight of the fact that they must be accompanied by policy measures to promote sustained and competitive growth; for this reason, decisions were taken simultaneously to spur growth in the economy and to improve its productivity and employment generation, specifically through greater diversification and sophistication of exports

and by enhancing the efficient use and distribution of productive resources. It is this approach that underpins the second pillar under which the loan operation is structured.

### Growth Pillar

Based on DNP calculations using data from the Conference Board (2015), productivity (measured as total factor productivity) accounted for an average loss of 0.2 percentage points to the Colombian economy (4.2 percent) between 2000 and 2014. This contrasts with the five points that productivity contributed to average growth in the Asian economies over the same period.

Three principal factors account for the low productivity. The first is the existence of market failures that prevent producer entities from taking the most appropriate decisions to increase their productivity, thereby retarding the economy's aggregate productivity growth. The second relates to the reduction in the number of economic activities and products in which the country is competitive, particularly in the number of relatively sophisticated sectors. As a result, the country's exports have become concentrated in a few low value-added products. Moreover, it is noteworthy that in the 2004-2014 period, GDP growth was slowed by a 1.4 percent drop in net exports; exports of non-mining/energy products fell from 60 percent of total exports in 2006 to 33 percent in 2014; and high and medium technology manufactured exports are concentrated in only five departments (Atlántico, Cundinamarca, Valle, Antioquia and Bogotá). Thirdly, there are failures of coordination between the National Government and Regional governments, between the public and private sectors, and among various entities at the national level. In general, it seems that there is an absence of clarity regarding the responsibilities of the stakeholders, as it relates to both conceptual and operational coordination among them. This leads to inefficiencies and a lack of focus in the design of the programs that target improvements in productivity.

In order to address this situation, we adopted the following measures to strengthen free competition, promote economic diversification toward more sophisticated sectors, and stimulate innovation:

- (i) We issued Decree 1349 of 2016 establishing the rules for electronic invoices to be treated as securities to improve business operating processes, reduce costs, facilitate the traceability and security of operations, and improve the country's competitiveness.
- (ii) We strengthened incentives for informing and cooperating with investigations on cartels, by virtue of Decree No. 1523 of July 16, 2015, and we strengthened the independence of the Superintendent of the Competent Authority (SIC) by introducing a fixed term of office that will not extend beyond the mandate of the Government (Decree 1817 of 2015);



- (iii) We approved policy document CONPES 3866, outlining and adopting a National Productive Development Policy (PDP). This includes, in particular:
  - a. The design of a set of policy instruments and programs to address market failures associated with, among other things, the adoption of new technologies and innovation, and which inhibit productivity growth and complicate efforts to promote the sophistication and diversification of the Colombian productive sector.
  - b. Mechanisms to correct Government failings by promoting an institutional environment that facilitates coordination among stakeholders and guarantees the sustainability and implementation of these instruments in the long term. In this way, the PDP outlines strategies such as the identification and prioritization of productive ventures at the regional level, continuity in STI (science, technology, and innovation) public expenditure analysis every two years, and better coordination among the systems of competitiveness and science, technology, and innovation:
- (iv) Finally, and within the framework of our “National Council of Tax Benefits in Science, Technology, and Innovation,” we reformed the system of tax incentives for innovation as part of our existing fiscal package, including a new system that recognizes “highly innovative” companies and grants them rapid access to fiscal benefits for investment and innovation, with emphasis on sectors other than the extractive industries (Decisions No. 13, 14, and 15 of 2015 and 2016).

This adjustment package that we present reflects our current economic strategy. We believe that, through this strategy, we have been able to respond satisfactorily to the challenges presented by the difficult world economic environment and those of our own domestic economy. We are convinced that we are on the right track. However, we are equally aware that we must continue our efforts to consolidate our policies to promote economic stability and well-being for Colombians. For this reason, we hope to continue to rely on the WBG as a partner in this endeavor.

We thank you for your attention and extend cordial greetings.

**Mauricio Cárdenas Santamaría**  
Minister  
Ministry of Finance and Public Credit

**Simón Gaviria Muñoz**  
Director General  
National Planning Department

## ANNEX 3: FUND RELATIONS ANNEX

### COLOMBIA—ASSESSMENT LETTER FOR THE WORLD BANK

DECEMBER 12, 2016

1. **Underpinned by a strong policy framework, Colombia is adjusting in an orderly way to changing global conditions.** The decline in world oil prices since mid-2014 has eroded fiscal revenue and oil exports, and the ensuing real effective depreciation of the peso has fueled inflationary pressures. Guided by the deficit targets embedded in the fiscal rule, the government has constrained expenditure, increased tax revenue, while allowing some widening of the headline fiscal deficit. Monetary policy has been aptly tightened to ensure inflation expectations remain anchored and to facilitate the adjustment of domestic demand that is needed to contain the current account deficit. The flexible exchange rate regime has served Colombia well by helping the economy adjust to the change in the terms of trade.

2. **Economic activity will slow down this year and remain below potential in the near-term.** Real GDP growth will moderate from 3.1 percent in 2015 to about 2 percent this year as domestic demand and non-oil exports remain subdued and also constrained by some domestic shocks, including delays in the government's infrastructure agenda and a nationwide truck drivers' strike in June–July. Real GDP growth is projected to strengthen somewhat next year to 2.5 percent in line with a modest recovery in investment. The slowdown in domestic demand, guided by monetary and fiscal tightening, has helped narrow the current account deficit, which remains fully financed by portfolio and FDI inflows. Inflation has started to moderate rapidly in recent months, as food and other temporary factors dissipate and is on track to reach the target level (3 percent) in 2018. As inflation expectations further decline near the target in the following months, there is space to ease the monetary stance, bringing it closer to a neutral level.

3. **The authorities' structural tax reform would help protect key social and infrastructure expending and foster private investment.** Despite the economic deceleration, the headline fiscal deficit target for this year (3.9 percent of GDP) remains on track. The tax reform (currently being discussed in Congress) aims to collect about 3 percent of GDP mostly from an increase in the VAT while reducing the corporate tax burden. The reform, which is broadly aligned with advice from Fund technical assistance, also simplifies the tax system and includes measures to promote formalization. The additional revenue will create space for a higher level of public investment than included in the 2017 budget, while adhering to the fiscal consolidation mandated by the fiscal rule.

4. **The authorities' structural reform agenda rightly targets areas that stand to contribute to a favorable medium-term outlook which, nonetheless is clouded by downside risks.** Growth will gradually increase over the medium-term supported by improved infrastructure and some growth in non-traditional exports. The growth yield of the PPP-based infrastructure agenda will materialize somewhat later than initially expected amid some delays in the first wave of projects. Local and international interest on the agenda remains high. The pipeline of structural reforms—including streamlining regulations,

improved targeting of social expenditure and measures to foster exports and innovation—should also contribute to economic diversification. Pilot projects to identify products with export potential and improve SME’s innovation and managerial skills are showing positive results. Further, the implementation of the recently approved peace agreement would foster regional development and inclusive growth over the medium-term. The financial system remains sound and reforms to bring Colombia’s regulation closer to Basel III standards are advancing. A law that strengthens the regulatory framework for conglomerates, a key pending FSAP recommendation, is being discussed in Congress and prospects for approval are strong. Further, Colombia is close to completing the process to become an OECD member. Downside risks include a hard landing in China, financial volatility and a rise in protectionism in the U.S. (Colombia’s main trading partner), as well as border disruptions and immigrant flows arising from Venezuela’s dire economic situation. Ample international reserves and resources available through the FCL represent key buffers against downside risks.

5. *The latest Executive Board assessment of Colombia is presented in Press Release No. 16/279 for the Approval of the Arrangement under the Flexible Credit Line.* On June 13, 2016, the IMF Executive Board approved a two-year Flexible Credit Line arrangement for SDR 8.18 billion (US\$11.5 billion). The staff report (IMF Country Report No. 16/154) was published.

#### ANNEX 4: ENVIRONMENT AND POVERTY/SOCIAL ANALYSIS TABLE

Prior actions	Significant environmental effects	Significant poverty, social or distributional effects
<b>Prior action #1:</b> The Government adopted measures to reduce its executive branch's recurrent expenditures in the context of the 2016 national budget, including: (i) the implementation of cutbacks in general operating expenses ( <i>gastos generales</i> ) and communication costs; and (ii) the establishment of a set of limitations for hiring new personnel, including a freeze in overall personnel numbers.	No significant environmental effects are likely.	No distributional effects are likely in the short run.
<b>Prior action #2:</b> The Government established a set of rules to improve the funding of public pension liabilities at the subnational level, including: (i) the requirement of registering public pension liabilities in FONPET on a regular basis and by administration sector; (ii) the procedure for transferring funds across said sectors to ensure adequate funding coverage; and (iii) the conditions for using any excess sectoral savings.	No significant environmental effects are likely.	Not likely to have significant effects on poverty and shared prosperity in the short run.
<b>Prior action #3:</b> The Government has adopted a tax reform, which, inter alia, (i) increases the general sales tax (VAT) rate from 16% to 19%; (ii) establishes a single corporate income tax ( <i>Impuesto sobre la Renta de Personas Jurídicas</i> ), and lowers overall corporate tax rates; (iii) applies the Personal Income Tax to dividends; (iv) establishes a single tax (" <i>monotributo</i> ") for small traders; and (v) increases the rates of the tobacco and liquors and wine taxes.	No significant environmental effects are likely.	Even though the reform of indirect taxes is expected to reduce disposable income along the expenditure distribution, it would have progressive absolute and relative incidence effects; while changes to direct taxes are expected to have ambiguous distributional impacts.
<b>Prior action #4:</b> The Government has adopted the following environmental taxes: (i) a carbon tax on fossil fuels proportional to their CO <sub>2</sub> emissions; and (ii) a tax on plastic bags.	Significant positive environmental effects are likely.	The relative incidence of the introduction of a carbon tax on the consumption of transport goods and services is expected to have progressive effects.
<b>Prior action #5:</b> The Government has adopted measures for preventing, controlling and sanctioning contraband, money laundering and tax evasion.	No significant environmental effects are likely.	No significant effects likely.

<b>Prior action #6:</b> The Government has established the regulatory framework which lays the foundations for the subsequent adoption and usage of electronic invoices, including, inter alia: (i) conditions and procedures for issuing, receiving and processing electronic invoices; and (ii) rules for their circulation as legal title.	No significant environmental effects are likely.	Significant direct poverty effects are not likely, but positive distributional effects are possible.
<b>Prior Action #7:</b> The Government adopted: (i) a customs regulatory framework (“regulación aduanera”) to, inter alia, improve risk management practices in connection with custom controls and establish standard procedures for the electronic processing of customs documents; and (ii) procedures for using scanners to inspect goods transiting at the country’s maritime terminals.	No significant environmental effects are likely.	Positive but moderate effects.
<b>Prior action #8:</b> The Government has adopted measures to foster competition including, inter alia: (i) incentives to promote collaboration of cartel members in detecting and investigating anti-competitive agreements; and (ii) a fixed term and objective criteria for the selection and appointment of the director of the Superintendence of Industry and Commerce ( <i>Superintendencia de Industria y Comercio</i> ) whose responsibilities include, inter alia, the carrying out of competition oversight activities.	No significant environmental effects are likely.	Potential positive effects in the medium run.
<b>Prior action #9:</b> The Government has approved a national development policy for productivity development aimed to, inter alia, promote efficient use of public resources by recommending a number of measures, including: (i) a cost-benefit analysis for new projects; and (ii) a periodic review of public expenditures relating to projects in the areas of science, technology and innovation.	No significant environmental effects are likely.	Indirect positive effects in the medium term.
<b>Prior action #10:</b> The Government has established the criteria and procedures for identifying projects entitled to access specific tax incentives under the existing fiscal legislation and within the established fiscal deductions’ cap.	No significant environmental effects are likely.	Moderate positive effects in the medium to long run.



## ANNEX 5: POVERTY AND SOCIAL IMPACT ANALYSIS

1. **This assessment<sup>72</sup> follows the Bank guidelines and is designed to provide an analysis of the potential effects of the measures supported by this operation on poverty, shared prosperity and other welfare outcomes, including household income and expenditures.** The policies supported by this operation such as the measures for fiscal consolidation and reduction of contingent liabilities, are expected to strengthen the fiscal position of the government and positively impact economic growth. In addition, the prior actions aimed at strengthening the trade and competition policy frameworks are expected to facilitate trade and have a positive impact in the competitive conditions of markets in Colombia. As shown over the last decade growth has been the main driver of poverty reduction in the country. Although not all these policies and programs would have direct effects on poverty and inequality, their overall impact on welfare is estimated to be positive. The expected effects are based on quantitative analysis, the review of academic literature and additional information gathered during the preparation of the operation.
2. **The prior actions under Pillar 1 aimed at supporting fiscal consolidation measures and improved contingent liabilities management are not likely to have significant poverty or distributional effects in the short run.** In the medium term, policies design to support fiscal sustainability and reduce contraband are expected to strengthen the fiscal position of the GoC and enhance tax compliance, thus contributing to a balanced fiscal policy and potentially increasing public investment and provision of public goods and services through higher tax revenues.
3. **Even though the reform of indirect taxes is expected to reduce disposable income along the expenditure distribution, it would have progressive absolute and relative incidence effects; while changes to direct taxes are expected to have a net positive distributional impact.** A tax simulation suggests that the fiscal reform of indirect taxes would reduce disposable income across the expenditure distribution, but the absolute and relative incidence effects of the reform would seem to be progressive. Besides, according to the tax reform Law 1819 of 2016, tax revenues from the carbon tax will be used to provide aid in areas affected by the Colombian conflict and could bolster the progressiveness of the impacts of the reform.<sup>73</sup> In addition, the income tax reform places higher tax burdens on the richest households, but taxes on dividends could discourage productive investments from the wealthiest ones. On the other hand, changes to corporate taxes are expected to increase firms' variable cost in the short run, but negative distributional effects would be offset by payroll tax deductions. Furthermore, tax exemptions in areas previously affected by conflict could kick start employment in these regions and become a mechanism to reduce regional inequality; but they may also produce undesired incentives such crowding out and relocation of investments. Finally, the single tax (monotributo), a new tax aimed at small businesses, has the potential of increasing formal employment and enhancing the access to welfare augmenting social services to workers.

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<sup>72</sup> This PSIA was produced by Carlos Rodríguez-Castelán (GPVDR), Sergio Olivieri (GPVDR), Eduardo A. Malásquez (GPVDR) and C. Felipe Balcazar (GPVDR).

<sup>73</sup> Article 223 of Law 1819 of 2016, on the allocation of revenues from carbon taxes indicates that “*El recaudo del impuesto nacional al carbono se destinará al Fondo para la Sostenibilidad Ambiental y Desarrollo Rural Sostenible en Zonas Afectadas por el conflicto ("Fondo para una Colombia Sostenible") de que trata el artículo 116 de la ley 1769 de 2015. Estos recursos se presupuestarán en la sección del Ministerio de Hacienda y Crédito Público.*” The law earmarks these resources to finance the Fund for the Environmental Sustainability and Sustainable Rural Development in the Areas Affected by the Conflict in Colombia.

4. **Similarly, the policies under Pillar 2 are not likely to have significant direct effects on poverty or on the distribution, but may –through indirect mechanisms– contribute positively to welfare.** Policy actions related to trade facilitation would reduce time and costs associated with international commerce and improve livelihoods by reducing consumer prices. Policies to promote attraction and retention of foreign direct investment are also expected to impact positively poverty reduction through expanding demand for labor and potentially increasing wages. Programs that promote firm entry and aim to foster firms’ innovation would potentially increase employment and earnings through higher economic productivity. Finally, policies that would focus on identifying and dismantling collusive behavior, particularly on the retail sector, would enhance household welfare through lower consumer prices.

## **PILLAR 1: Support fiscal consolidation measures and improved contingent liabilities management**

### ***Public expenditure and contingent liabilities***

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***Prior Action 1:*** *The Government has adopted measures to reduce its Executive Branch’s recurrent expenditures in the context of the 2016 national budget, including: (i) the implementation of cutbacks in general operating expenses (gastos generales) and communication costs; and (ii) the establishment of a set of limitations for hiring new personnel, including a freeze in overall personnel numbers.*

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5. **The freeze of the personnel numbers and the cuts on other recurrent expenditures in the 2016 budget are not likely to have a negative impact on welfare.** The policy will not reduce the number of employees in the public sector, nor on the real earnings or the aggregate income distribution. The freeze is only expected to have an effect on the hiring of new or additional public employees.<sup>74</sup> Typically, modeling the poverty and distributional impacts of a policy such as Prior Action 1 would require a clear understanding of the transmission channels such as the fundamental determinants of the distribution of economic welfare in Colombia (Essama-Nssah, 2006).<sup>75</sup> For instance, Bourguignon, Bussolo and Pereira da Silva (2008) discuss several approaches to assess the impact of policies on poverty and income distribution of policies that are expected to have a macro level impact;<sup>76</sup> while Bourguignon, Ferreira, and Lustig (2015) point out that policies affecting growth at the macroeconomic level could have three types of effects on the income distribution: (i) Endowment effects (amounts of resources available to individuals or households); (ii) price effects (changes in relative remuneration of resources); and (iii)

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<sup>74</sup> Since the freeze does not involve direct public employment reduction, the typical framework to analyze the distributional effects of public sector downsizing (see Coudouel and Paternostro, 2006; Rama, 1999; or Haltiwanger and Singh, 1999) in multiple stakeholders such as public workers, one company-towns or communities, providers of services to state firms and taxpayers would not be adequate to analyze the impacts of this prior action.

<sup>75</sup> Essama-Nssah, B. (2006) “Macroeconomic shocks and policies” in *Analyzing the Distributional Impacts of Reforms. A practitioner’s guide to pension, health, labor markets, public sector downsizing, taxation, decentralization, and macroeconomic modelling*. Eds. Aline Coudouel and Stefano Paternostro. Vol. 2. The World Bank, Washington, D.C.

<sup>76</sup> Bourguignon, F., Bussolo, M., and Pereira da Silva, L.A. (2008). “The impact of macroeconomic policies on poverty and income distribution. Macro-micro evaluation techniques and tools” A co-publication of The World Bank and Palgrave Macmillan.

occupational effects (modifications in the allocation of resources).<sup>77</sup> However, from the standpoint of the effect of this prior action on overall economic growth, the freeze and potential cuts on other recurrent spending are not expected to be large enough to have a significant impact on growth and poverty.

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**Prior Action 2:** *The Government has established a set of rules to improve the funding of public pension liabilities at the subnational level, including: (i) the requirement of registering public pension liabilities in FONPET on a regular basis and by administration sector; (ii) the procedure for transferring funds across said sectors to ensure adequate funding coverage; and (iii) the conditions for using any excess sectoral savings.*

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6. **The modification of the regulation associated with FONPET is not likely to have significant direct welfare effects, in particular in the short run.** The Prior Action affects the regulation of the FONPET,<sup>78</sup> a mandatory savings system at the subnational level created by the GoC in 1999. It is expected that the policy supported by this prior action will increase the available resources of territorial entities to attend their financial obligations in the health sector, and potentially lead to an increase in the sectoral coverage of pension liabilities, reducing the uncertainty associated with the expected income stream for future pensioners. An expected side effect is that territorial entities will have more resources to attend their financial obligations in the health sector, contributing to improve the financial sustainability of their health systems (currently the non-payment from territorial entities to hospitals and insurance companies in the subsidized regime is a key issue).

7. **This prior action might help to reduce the uncertainty about future incomes stream for retired employees who receive pensions from subnational governments.** By reducing the probability of default, the expected utility associated with the stream of incomes under the new regulation is such that any risk averse individual would prefer this new scenario. However, retired workers who receive a pension in Colombia are less likely to be in the bottom 40 percent of the income distribution or being in poverty. As a consequence, this prior action is expected only to have a minor direct impact on the welfare of the individuals located at the bottom of the income distribution. According to the Colombian household survey (GEIH) from 2014 (Figure 1), individuals who receive a pension in Colombia tend to be disproportionally located in the highest quintile of the income distribution. While almost 50 percent of the individuals who receive a pension are in the top quintile, less than 1 in 10 retirees who receive a pension belongs to the bottom 40. According to World Bank (2014) nearly half of the 2.4 million people over 60 are poor, but only 30 percent receive pensions, and most of these beneficiaries are not poor. Moreover, the poorest 20 percent of the population receives, on average, no pension's income. Similarly, pensions comprise 0.2 percent of household's income in the poorest households, compared to 10.3 percent in the wealthiest ones.<sup>79</sup>

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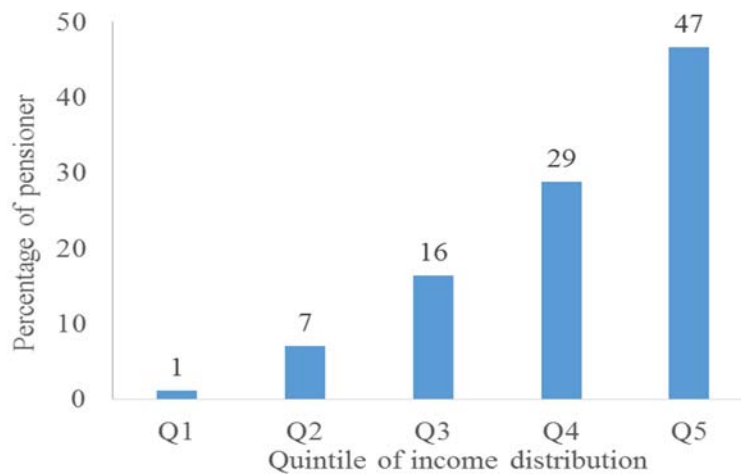
<sup>77</sup> Bourguignon, F., Ferreira, H., and Lustig, N. (2005). "The microeconomics of income distribution dynamics in East Asia and Latin America." New York: Oxford University press.

<sup>78</sup> The National Pensions Fund for Territorial Entities or Fondo Nacional de Pensiones de las Entidades Territoriales-FONPET, in Spanish, created by Law 549 of 1999.

<sup>79</sup> World Bank (2014:200-201,210). "Towards Sustainable Peace, Poverty Eradication, and Shared Prosperity: Colombia Policy Notes." The World Bank Group. September 2014. Available at:



**Figure 1. Distribution of pensioners by income quintile (2014)**



Source: LAC Equity Lab tabulations of SEDLAC (CEDLAS and the World Bank). Information for Colombia based on GEIH 2014.

Note: Standard errors in parentheses.

### ***Tax administration and tax policy***

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***Prior Action 3:*** *The Government has adopted a tax reform, which, inter alia, (i) increases the general sales tax (VAT) rate from 16% to 19%; (ii) establishes a single corporate income tax (Impuesto sobre la Renta de Personas Jurídicas), and lowers overall corporate tax rates; (iii) applies the Personal Income Tax to dividends; (iv) establishes a single tax (“monotributo”) for small traders; and (v) increases the rates of the tobacco and liquors and wine taxes.*

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8. **The distributional analysis**<sup>80</sup> suggests that, even though the reform of indirect taxes (VAT and national consumption tax) would reduce incomes across categories in the short run, it would also have progressive absolute and relative incidence effects (partly due to the exclusion of essential items that account for a larger share of poor households’ expenditure).<sup>81</sup> The baseline scenario of the analysis does not account for changes in behavioral impacts, and assumes (i) that the increases in indirect taxes are fully transferred to the final price of the goods and services; and (ii) that there is no tax evasion, among others. This section of the analysis focuses in the modifications of indirect taxes such as the Value Added Tax (VAT) from 16 to 19 percent, the increase in excise taxes to alcohol and tobacco and the widening of the tax base of the National Consumption Tax (to internet traffic on tablets and smartphones and to consumption in franchise restaurants), as well as the adoption of carbon taxes. This analysis relies on consumption data from the *Encuesta de Calidad de Vida* (ECV) of 2014 conducted by the

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<http://www.worldbank.org/content/dam/Worldbank/Feature%20Story/lac/Colombia%20Policy%20Notes%20Final%20web%20%20Sept%2024-2014.pdf>

<sup>80</sup> This analysis of Colombia’s tax reform of December 2016 focuses on assessing the distributional impact of changes in indirect taxes such as the Value Added Tax (VAT) and consumption taxes (i.e. introduction of taxes to internet traffic on mobile equipment, and restaurants), modifications in direct taxes such as personal and corporate income taxes and the single-tax, as well as changes in taxes aimed at reducing externalities like taxes on tobacco, liquors and carbon taxes. See Olivieri, et al (2017).

<sup>81</sup> For details on the sensitivity analysis performed, please refer to Olivieri et al. (2017). “Colombia’s Tax Reform of 2016. Distributional analysis.”

*Departamento Administrativo Nacional de Estadística (DANE).* This analysis focuses on the effects of taxes across the consumption distribution (or income, in an alternative scenario), under the assumption that individual's purchasing habits remain the same.

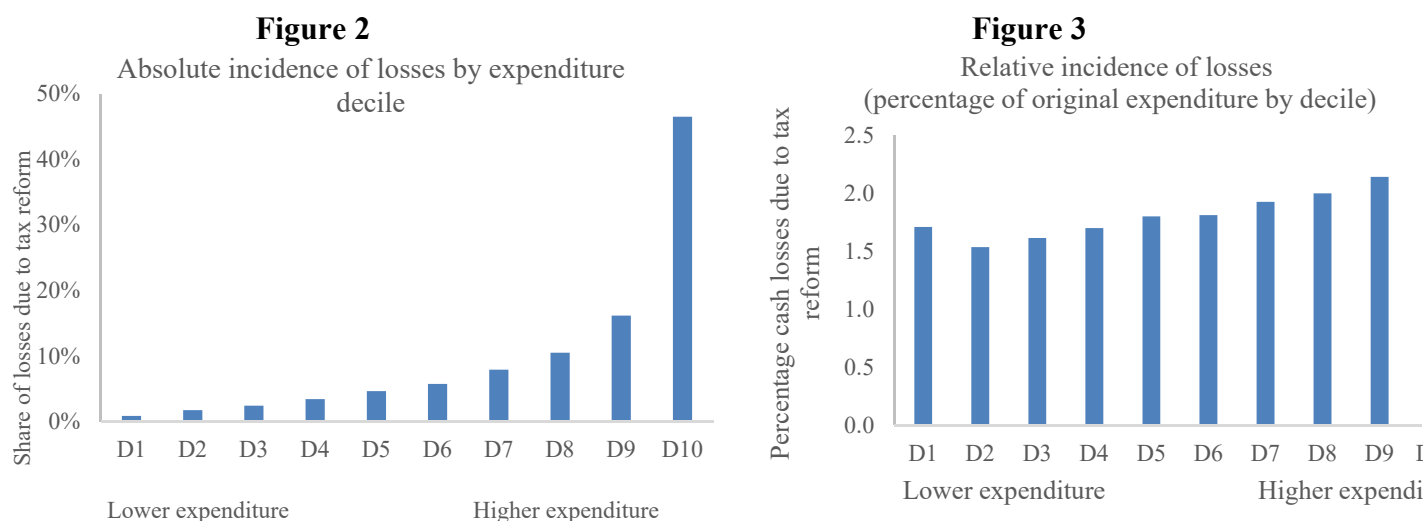
9. **Table 1 shows the structure of the consumption by expenditure decile, classified in 12 categories of good and services.** According to Table 1, in the first decile of the expenditure distribution the share of food and non-alcoholic beverages, diverse goods and services, and rent, water, electricity, gas and other services represent more than 80 percent of the average household budget. Moreover, despite the fact that the share of food and non-alcoholic beverages seems to decrease as expenditure increases (and we move to the right towards higher expenditure deciles), food, diverse goods and rent represent more than 65 percent of the average basket even in the highest decile. Note, however, that due to limitations in the information available in the ECV, it is not possible to analyze important dimensions such as the quality of food or services purchased, which could also play an important role explaining the differences in the composition of the consumption basket and the utility that household derive from consumption.

Table 1. Category of consumption by expenditure decile  
(Percentage)

	D1	D2	D3	D4	D5	D6	D7	D8	D9	D10
<b>Food and beverages (non-alcoholic)</b>	<b>58.8%</b>	<b>64.9%</b>	<b>61.8%</b>	<b>56.3%</b>	<b>53.5%</b>	<b>51.1%</b>	<b>47.7%</b>	<b>43.6%</b>	<b>39.4%</b>	<b>28.1%</b>
Food and water	58.4%	64.0%	60.9%	55.5%	52.6%	50.0%	46.7%	42.7%	38.5%	27.4%
Food not affected by VAT	39.3%	41.9%	40.1%	35.9%	34.6%	32.5%	30.1%	27.1%	23.8%	15.4%
Food taxed with partial VAT	10.8%	10.7%	10.0%	8.9%	7.5%	7.2%	6.6%	5.8%	4.8%	3.2%
Food affected by VAT	8.3%	11.3%	10.9%	10.7%	10.5%	10.3%	10.0%	9.7%	10.0%	8.8%
Sugary beverages	0.4%	0.9%	0.8%	0.8%	1.0%	1.0%	1.0%	0.9%	0.9%	0.7%
<b>Alcoholic beverages, tobacco and drugs</b>	<b>0.7%</b>	<b>0.6%</b>	<b>0.7%</b>	<b>0.6%</b>	<b>0.7%</b>	<b>0.6%</b>	<b>1.1%</b>	<b>0.8%</b>	<b>1.1%</b>	<b>1.5%</b>
Alcoholic beverages	0.0%	0.2%	0.2%	0.3%	0.3%	0.4%	0.8%	0.6%	0.9%	1.3%
Tobacco	0.7%	0.4%	0.4%	0.3%	0.4%	0.2%	0.3%	0.2%	0.2%	0.2%
<b>Clothes and shoes</b>	<b>2.1%</b>	<b>2.0%</b>	<b>2.4%</b>	<b>2.2%</b>	<b>2.2%</b>	<b>2.4%</b>	<b>2.6%</b>	<b>2.8%</b>	<b>3.0%</b>	<b>3.0%</b>
<b>Rent, water, electricity, gas and other services</b>	<b>7.1%</b>	<b>8.0%</b>	<b>9.7%</b>	<b>13.3%</b>	<b>15.6%</b>	<b>16.6%</b>	<b>18.0%</b>	<b>19.5%</b>	<b>19.2%</b>	<b>17.9%</b>
<b>Furniture and decorations, gardens, others</b>	<b>0.5%</b>	<b>0.5%</b>	<b>0.5%</b>	<b>0.7%</b>	<b>0.7%</b>	<b>1.0%</b>	<b>0.8%</b>	<b>1.0%</b>	<b>1.1%</b>	<b>1.2%</b>
<b>Health</b>	<b>1.3%</b>	<b>1.2%</b>	<b>1.4%</b>	<b>1.3%</b>	<b>1.7%</b>	<b>1.6%</b>	<b>1.8%</b>	<b>1.8%</b>	<b>2.2%</b>	<b>3.4%</b>
<b>Transport</b>	<b>7.5%</b>	<b>7.1%</b>	<b>8.6%</b>	<b>9.7%</b>	<b>10.8%</b>	<b>11.2%</b>	<b>12.3%</b>	<b>13.0%</b>	<b>13.1%</b>	<b>13.6%</b>
Fossil fuels	1.6%	1.5%	1.9%	2.2%	2.4%	2.7%	2.8%	3.3%	3.4%	4.6%
Other transport costs	5.9%	5.6%	6.7%	7.5%	8.5%	8.5%	9.5%	9.7%	9.7%	9.0%
<b>Communications</b>	<b>0.7%</b>	<b>0.6%</b>	<b>0.6%</b>	<b>0.6%</b>	<b>0.6%</b>	<b>0.7%</b>	<b>0.5%</b>	<b>0.4%</b>	<b>0.5%</b>	<b>0.4%</b>
<b>Recreation and culture</b>	<b>0.2%</b>	<b>0.2%</b>	<b>0.4%</b>	<b>0.3%</b>	<b>0.4%</b>	<b>0.5%</b>	<b>0.6%</b>	<b>0.7%</b>	<b>1.0%</b>	<b>1.2%</b>
<b>Education</b>	<b>1.0%</b>	<b>0.9%</b>	<b>1.1%</b>	<b>0.9%</b>	<b>1.1%</b>	<b>1.2%</b>	<b>1.4%</b>	<b>1.7%</b>	<b>2.2%</b>	<b>2.3%</b>
<b>Restaurants and hotels</b>	<b>0.3%</b>	<b>0.4%</b>	<b>0.4%</b>	<b>0.9%</b>	<b>0.8%</b>	<b>1.2%</b>	<b>1.7%</b>	<b>3.0%</b>	<b>4.2%</b>	<b>7.7%</b>
Restaurants (franchise and others)	0.2%	0.4%	0.4%	0.9%	0.8%	1.2%	1.6%	2.9%	4.0%	6.7%
Hotels and others	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.1%	0.1%	0.3%	0.9%
<b>Diverse goods and services</b>	<b>18.6%</b>	<b>13.2%</b>	<b>12.2%</b>	<b>12.3%</b>	<b>11.5%</b>	<b>11.8%</b>	<b>11.5%</b>	<b>11.7%</b>	<b>13.4%</b>	<b>19.6%</b>
PCs, laptops, mobile/smart phones	0.1%	0.1%	0.2%	0.2%	0.3%	0.3%	0.3%	0.3%	0.4%	0.5%
Other goods and services	18.6%	13.0%	12.0%	12.1%	11.2%	11.5%	11.2%	11.4%	13.0%	19.0%

10. **A tax simulation analysis suggests that, at the national level, the absolute and relative incidence of the reform is expected to be progressive; although disposable income would be**

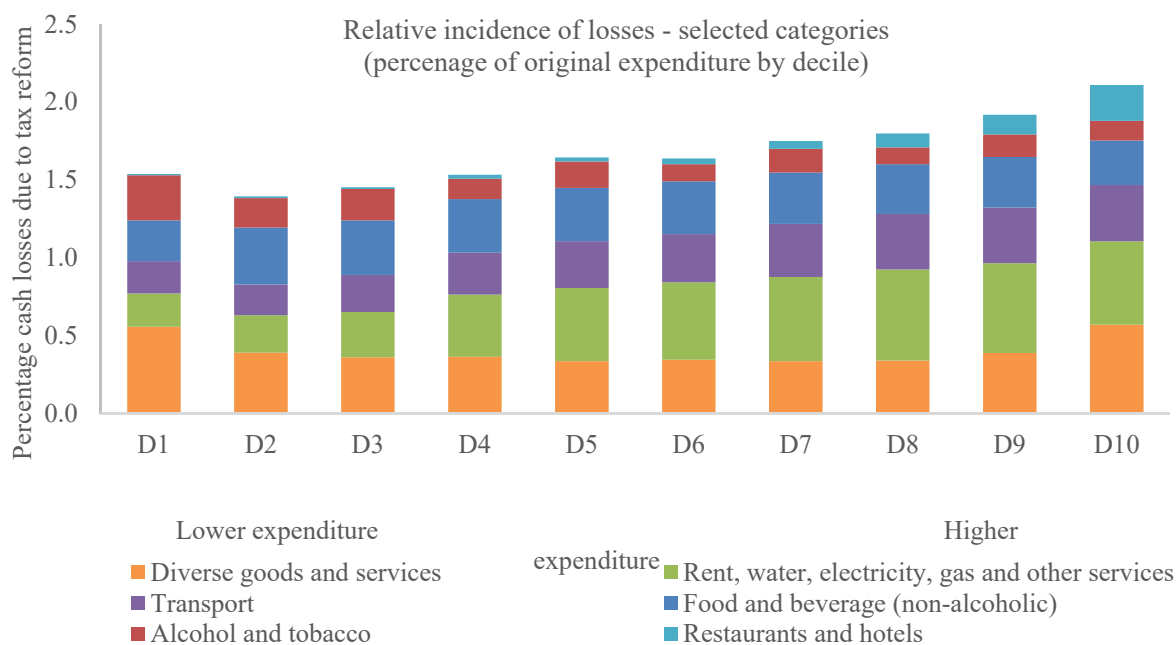
**negatively affected along the expenditure distribution in the short run.** Figure 2 shows the absolute incidence of the tax reform suggesting that the reform is progressive in absolute terms since higher expenditure deciles carry a larger share of the tax burden (in particular, the height of each bar corresponds to the share of the additional taxes generated by the reform paid by each decile). Note, however, that the reform of indirect taxes is expected to have negative impacts on disposable income across whole expenditure distribution and thus represents a decrease in wellbeing with respect to the current situation. Under the assumption of no tax evasion, the top 10 percent of the expenditure distribution pays about 45 percent of the additional taxes generated by the reform in indirect taxes. Partially, this larger tax burden might be explained by the larger consumption levels in higher expenditure deciles, but also due to higher taxation of goods that are consumed more intensively by the individuals in these deciles (such as fossil fuels and restaurants). In contrast, Figure 2 also shows that the households in the lowest decile of the expenditure distribution pay just about 1 percent of the additional taxes generated by the reform.



11. **The relative incidence of the reform is also progressive, and the relative incidence seems relatively constant across the expenditure deciles.** It must be noted that even though the absolute incidence seems to be very progressive (Figure 2), the relative incidence (Figure 3) shows more stable incidence across the expenditure distribution. The bars in Figure 3 represent the expected relative change in expenditure for each consumption decile with respect to the original budget due to the tax reform (again, assuming no behavioral impacts from consumers). The relative losses for the households across the distribution are fairly similar, starting from losses ranging from 1.54 to 2.36 percent of the original decile expenditure level. Figure 3 suggests that in the first four deciles of the expenditure distribution the relative incidence due to the reform is expected to be relatively uniform (moving between 1.5 and 1.7 percent); while these losses increase in the 4 higher expenditure deciles. In addition, it must be noted that the general conclusions of the analysis are consistent to the use of alternative values of elasticities of demand, as well as sorting the individuals based on their income levels, instead of their expenditure.<sup>82</sup>

<sup>82</sup> *Idem.*

of losses -



<sup>83</sup> According to Zapata and Sabogal (2012), the share of beer in the market of alcoholic beverages in Colombia was

<sup>84</sup> Article 16. “Tax revenues allocation”. Law 1816 of 2016.

health system).<sup>85</sup> Moreover, the future benefits of nonsmoking outweigh the losses attributed to tobacco taxes among the population in general and, specifically, low-income groups (Denisova and Kuznetsova 2014; Verguet et al. 2015; Fuchs and Meneses, 2016). The latter is true as long as low-income groups reduce their consumption of tobacco (Verguet et al. 2015).

14. **Changes to direct taxes are expected to have ambiguous distributional effects.** The income tax places higher tax burdens on the richest households, but taxes on dividends could discourage productive investments from the wealthiest ones. On the other hand, changes to corporate taxes are expected to increase firms' variable cost in the short run, but negative distributional effects will be offset by payroll tax deductions. Furthermore, tax exemptions in areas previously affected by conflict could kick start employment in these areas and become a mechanism to reduce regional inequality; but they may also produce undesired incentives such as crowding out and relocation of productive investments. Finally, the single tax, a new tax aimed at small businesses, has the potential of increasing formal employment and enhancing the access to welfare augmenting social services to workers.

15. **Tax incentives in areas previously affected by conflict have the potential to boost employment and reduce poverty in these regions, as well as reduce regional inequality.** The reform includes strong tax incentives for firms created from 2017 onwards and based in zones heavily affected by armed conflict. These incentives have the potential of attracting productive investment, as firms have previously declared their willingness to invest more in the absence of conflict (Rettberg, 2008). Moreover, they have the potential of boosting growth, improving labor markets and the living conditions of populations affected by violence (see Calderón and Ibáñez, 2009; Ibáñez, 2008; Bozzoli et al., 2011; Arias et al., 2014; Morales, 2016, for a related discussion). Given that regions in conflict tend to lag behind in comparison to others (Arias et al., 2014), we could expect a reduction in regional inequality. Even though tax exemptions in areas previously affected by conflict could kick start employment in these areas and become a mechanism to reduce regional inequality; they also may provide undesired incentives for crowding out and relocation of productive investments from other parts of the country.

16. **Finally, the single tax (monotributo), a new tax aimed at small traders, has the potential of having positive impacts in welfare, by increasing formal employment and enhancing the access to welfare-augmenting social services to workers.** The monotributo is a new (optional) tax rate for individuals working in small trading businesses<sup>86</sup> that has the potential of increasing the number of formal workers and have positive effects in a number of social indicators. Over the last decades, similar schemes have been implemented in several countries in Latin America (see Perry et al., 2007; Farazi, 2013; ILO et al., 2014; Sabani, 2015; for discussions

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<sup>85</sup> According to the Article 221 of Law 1819 of 2016 “*Los ingresos adicionales recaudados por efecto del aumento de la tarifa del impuesto al consumo de cigarrillos serán destinados a financiar el aseguramiento en salud.*”

<sup>86</sup> The single tax is an optional tax scheme accessible to working in small establishments, hair salons and similar businesses, belonging to the simplified rent scheme, with gross annual income between 1400 (1000 by 2018) and 3500 UVT, working in a space less than 50m<sup>2</sup>. The tax will be progressive, in three brackets, with a minimum value of 16 UVT and a maximum of 32 UVT; associated rents will not be deducted of withholding tax at the source. Several incentives have been introduced in order to encourage potential tax payers to enroll: The single tax dispositions provide access to death and disablement insurance, to occupational hazards insurance, health insurance and family welfare funds, for those under the scheme.

in Argentina, Bolivia, Brazil, Paraguay and Uruguay) with very significant impacts on facilitating the transition of taxpayers to the formal labor market.<sup>87</sup>

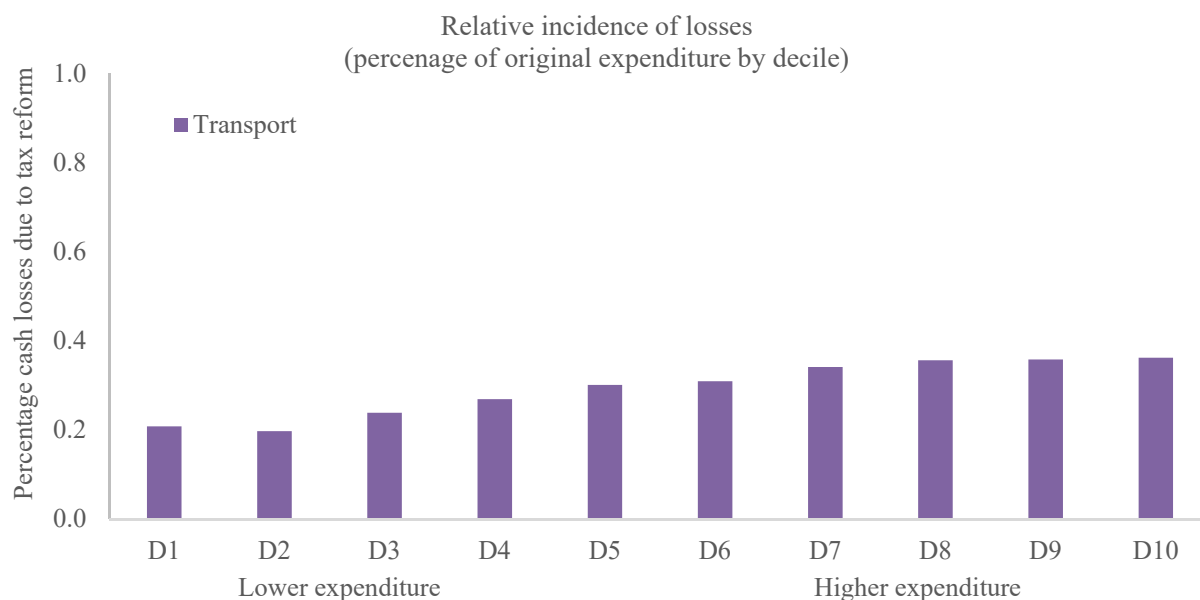
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**Prior Action 4:** *The Government has adopted the following environmental taxes: (i) a carbon tax on fossil fuels proportional to their CO2 emissions, and (ii) a tax on plastic bags.*

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17. **The relative incidence of the introduction of a carbon tax on the consumption of transport goods and services is expected to have progressive effects, as shown in Figure 5.** This result is probably driven by the higher participation of consumption of fuel for personal vehicles in higher expenditure deciles.<sup>88</sup> For instance, the individuals in the top deciles of the expenditure distribution are more likely to own a car and therefore are more exposed to the increases in taxes due to the introduction of the carbon tax. It should be noted that the carbon tax applies to all fossil fuels, not only those used for transport, so there may be additional effects on households stemming from higher prices of energy more broadly.<sup>89</sup>

Figure 5. Categories affected by introduction of carbon taxes



18. **Moreover, according to the reform, the tax revenues from the carbon tax will be used to finance the Fund for the Environmental Sustainability and Sustainable Rural Development in the Areas Affected by the Conflict in Colombia.** Earmarking these resources to provide aid in areas affected by the Colombian conflict could bolster the progressiveness of the

<sup>87</sup> Perry et al., 2007; Farazi, 2013; ILO et al., 2014; Sabani, 2015; Dominguez, 2011, Gomez, 2015

<sup>88</sup> For this segment of the analysis, we assume that the only relevant change on fossil fuel taxes was the adoption of the carbon tax.

<sup>89</sup> However, close to 70 percent of Colombia's electricity is produced by renewable energy sources (primarily hydropower). As a result, electricity prices are not likely to be affected by the carbon tax.

impacts of this tax.<sup>90</sup> While there is no available information on the level of household expenditure on plastic bags, it is not likely that the implementation of this type of environmental taxes would have significant effects on household welfare.

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**Prior Action 5:** *The Government has adopted measures for preventing, controlling and sanctioning contraband, money laundering and tax evasion.*

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19. **The reduction in tax evasion associated with the new anti-smuggling law is not likely to have negative direct effects on welfare.** While it is difficult to quantify the impact of smuggled goods on tax collection, the GoC's estimates suggest that contraband or illegal smuggling in Colombia resulted in a yearly potential loss of revenues up to COP3.3 trillion (0.5 percent of GDP) at the central level, due to import tariffs, as well as VAT losses and income taxes.<sup>91</sup> Tax evasion undermines state legitimacy, limiting GoC's ability to deliver public services and constituting an unfair competition to the firms that comply with the tax system, thus imposing obstacles for private investment and economic development. Moreover, according to the MVCP, smuggling activities may also foster and finance criminal organizations, which also have a negative on productive activities and the general wellbeing of the citizens.<sup>92</sup>

20. **Although a decline in tax evasion is not expected to have a significant direct impact on poverty or shared prosperity, the potential additional tax revenues associated with the reduction in contraband could be used to improve the provision of public services.** Due to the contraband or illegal smuggling of goods, the GoC stops receiving resources from the collection of import duties, value added tax (VAT) and income tax. At the same time, the subnational governments stop receiving funds from the excise tax on products like cigarettes and liquor. According to the DIAN, even though the rate of tax evasion (the estimated ratio between tax evasion and potential tax revenues) of the VAT has been decreasing in Colombia since 2005, is still above 20 percent, suggesting that there is still space to enhance tax enforcement. Higher government revenues could be used to finance an expansion in provision or improvement of public good and services, with potential positive effects in the wellbeing of all the Colombians. In Colombia contraband has been linked to reduced sustainability and competitiveness of important sectors of the economy, such as clothing, textiles, oil, food, medicine, liquor, footwear, cigarettes, livestock, auto parts and metals.<sup>93</sup> According to DIAN (2014), the industrial and commercial sectors in Colombia suffer serious limitations to compete with importers and traders who evade paying taxes or under-report commercial value of imports. This situation leaves the members of the industrial and commercial sectors competing under the framework of legality in

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<sup>90</sup> Article 223 on the allocation of revenues from carbon taxes indicates that “*El recaudo del impuesto nacional al carbono se destinará al Fondo para la Sostenibilidad Ambiental y Desarrollo Rural Sostenible en Zonas Afectadas por el conflicto ("Fondo para una Colombia Sostenible") de que trata el artículo 116 de la ley 1769 de 2015. Estos recursos se presupuestarán en la sección del Ministerio de Hacienda y Crédito Público.*”

<sup>91</sup> Estimate is for the year 2011 in DIAN (2014) “Plan Anticontrabando 2015-2018. El contrabando: Una visión integral, sus tipologías y las estrategias de la Entidad.” Dirección de Impuestos y Aduanas Nacionales (DIAN). Bogotá, DC. May 2015.

<sup>92</sup> MHCP (2015). “ABC del proyecto anticontrabando.” Oficina de Comunicaciones. Ministerio de Hacienda y Crédito Público (MVCP). 2015. [www.minhacienda.gov.co](http://www.minhacienda.gov.co)

<sup>93</sup> Estimate is for the year 2011 in DIAN (2014) “Plan Anticontrabando 2015-2018. El contrabando: Una visión integral, sus tipologías y las estrategias de la Entidad.” Dirección de Impuestos y Aduanas Nacionales (DIAN). Bogotá DC. May 2015.



unfavorable situation, discouraging local and foreign investment and affecting labor markets negatively.

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**Prior Action 6:** *The Government has established the regulatory framework which lays the foundations for the subsequent adoption and usage of electronic invoices, including, inter alia: (i) conditions and procedures for issuing, receiving and processing electronic invoices; and (ii) rules for their circulation as legal title.*

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21. **Policies promoted by Prior Action 6 are expected to relax credit constraints, especially for smaller firms, potentially having positive welfare effects operating through the labor market.** These policies are expected to have two main effects. On the one hand, the regulation of the requirements for the issuance of electronic invoices is expected to contribute to tax compliance by reducing the costs that firms face for paying taxes. Typically the owners of micro and small businesses consider tax registration and administration complex and costly, and do not see any clear benefits apart from the need to avoid fines.<sup>94</sup> On the other hand, the use of electronic invoices as underlying securities fostering the access of firms to financing<sup>95</sup> is especially important for smaller firms, which are more likely to face binding credit constraints. The impact on poverty and inequality of additional government revenues due to higher tax compliance will depend on the government use of the additional resources; while the effects of reduced credit constraints due to electronic invoices for factoring depend on its impact on firms' investment and thus on labor demand, especially for smaller firms which are more likely to hire less-skilled workers.

22. **Promoting the use of electronic invoice as titles, facilitating the access to factoring and thus to credit for small firms, is expected to improve access to financing and increase the engagement in entrepreneurial activities of the poor.** Prior action 4 is expected to facilitate the access for small firms to alternative sources of financing through factoring, potentially increasing investment, generating more jobs, becoming more competitive and having positive impacts in productivity. Empirical evidence suggests that small firms face larger growth constraints and have less access to formal sources of external finance (Beck and Demirguc-Kunt, 2006;<sup>96</sup> Duda, 2013;<sup>97</sup> Gindling and Newhouse, 2014;<sup>98</sup> and Covarrubias et al. 2012<sup>99</sup>).

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<sup>94</sup> ILO (2014). "Policies for the formalization of micro and small enterprises in Chile." Notes on Policies for the Formalization of Micro and Small Enterprises. Program for the promotion of Formalization in Latin America and the Caribbean – FORLAC. Available at: [https://ecampus.itcilo.org/pluginfile.php/14063/mod\\_page/content/13/small.pdf](https://ecampus.itcilo.org/pluginfile.php/14063/mod_page/content/13/small.pdf)

<sup>95</sup> On top of the regulation for the issuance of electronic invoices and the interoperability of systems.

<sup>96</sup> Beck, T., and Demirguc-Kunt, A. (2006: 2931). "Small and medium-size enterprises: Access to finance as a growth constraint". Journal of Banking and Finance. 30 (2006). pp. 2931-2943.

<sup>97</sup> Duda, J. (2013:7). "The Role of Bank Credits in Investment Financing of the Small and Medium-Sized Enterprise Sector in Poland". Managerial Economics, [S.l.], v. 13, pp. 7, Aug. 2013. ISSN 1898-1143. Available at: <http://journals.agh.edu.pl/manage/article/view/591/448>. Doi: <http://dx.doi.org/10.7494/manage.2013.13.7>

<sup>98</sup> Gindling, T. H., and David Newhouse (2014). "Self-Employment in the Developing World." World Development 56: 313–331. doi:10.1016/j.worlddev.2013.03.003

<sup>99</sup> Covarrubias, K., Benjamin, D., and Winters, P. (2012). "From Protection to Production: Productive Impacts of the Malawi Social Cash Transfer Scheme." Journal of Development Effectiveness 4 (1): 50–77. doi:10.1080/19439342.2011.641995



## PILLAR 2: FOSTER PRODUCTIVITY IN NON-EXTRACTIVES SECTORS BY STRENGTHENING THE POLICY FRAMEWORK FOR TRADE FACILITATION, INVESTMENT, COMPETITION, BUSINESS REGULATION AND INNOVATION

### Promoting trade and investment attraction

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**Prior Action 7:** *The Government has adopted: (i) a customs regulatory framework (“regulación aduanera”) to, inter alia, improve risk management practices in connection with custom controls and establish standard procedures for the electronic processing of customs documents; and (ii) procedures for using scanners to inspect goods transiting at the country’s maritime terminals.*

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23. **The reforms implemented by the GoC are expected to facilitate trade by reducing the time and costs associated with trade activities, which in turn may have positive indirect effects on welfare.** The effects on welfare of the international trade facilitation policies are expected to be mostly indirect, operating through channels such as general economic growth, higher labor incomes and lower consumer prices. However, the specific implementation of a more efficient inspection system (customs scanners) supported by Prior Action 7 is only expected to have a modest impact on income distribution. Policies promoted by Prior Action 6 could have a marginal but positive effect reducing consumer prices, and positive second order effects on poverty reduction.

24. **The net welfare effect of trade would depend on which groups are the main beneficiaries of the additional economic growth and how trade affects these heterogeneous groups of the population.** The links between trade actions and poverty are usually complex and case specific, with similar trade policies having widely varying impacts on poverty in different countries.<sup>100</sup> Coudouel and Paternostro (2006) discuss three main pathways how trade policies can affect income distribution and poverty: (i) the prices of goods; (ii) returns to factors of production; and, (iii) the government revenues and expenditures. Even though most of the literature discusses the role of tariff rates as barriers for trade, recently there is a recognition that non-tariff regulations are an important obstacle for international trade (Márquez-Ramos et al., 2012;<sup>101</sup> Cali et al. 2015;<sup>102</sup> and Nguyen-Viet, 2013<sup>103</sup> and 2015<sup>104</sup>). Trade and trade facilitation can drive poverty reduction by boosting growth, since it allows each country to use its resources more efficiently by specializing in the production of the goods and services that it can produce more cheaply, it gives access to more advanced technological inputs and it enhances the incentives

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<sup>100</sup> Coudouel, A., and Paternostro, S. (2006:xii-xiv). “Introduction” in Analyzing the Distributional Impacts of Reforms. A practitioner’s guide to pension, health, labor markets, public sector downsizing, taxation, decentralization, and macroeconomic modelling. Eds. Aline Coudouel and Stefano Paternostro. Vol. 2. The World Bank, Washington, D.C.

<sup>101</sup> Márquez-Ramos, L., I. Martínez-Zarzoso, and C. Suárez-Burguet. 2012. “Trade Policy Versus Trade Facilitation: An Application Using ‘Good Old’ OLS.” Economics: The Open-Access, Open-Assessment E-Journal 6: 2012–2011.

<sup>102</sup> Cali, M. Hollweg, C.H., and Ruppert-Bullmer, E. (2015). “Seeking shared prosperity through trade.” Policy Research Working Paper, No. WPS 7314. Washington, D.C.: World Bank Group. Available at: <http://documents.worldbank.org/curated/en/2015/06/24649967/seeking-shared-prosperity-through-trade>

<sup>103</sup> Nguyen-Viet, C. (2013:3). “Poverty, inequality and trade reduction: Literature review and framework”, Chapter 3 in “Impacts of trade facilitation measures on poverty and inclusive growth: Case studies from Asia”. A Study by the Asia-Pacific Research and Training Network (ARTNet). Edited by Ravi Tarnayake, Rajan Sudesh Tarna, Martina Francesca Ferracane and Yann Duval. United Nations Publications. 2013.

<sup>104</sup> Nguyen-Viet, C. (2015:331). “The impact of trade facilitation on poverty and inequality: Evidence from low- and middle-income countries.” The Journal of International Trade & Economic Development. Vol. 24, Iss. 3, 2015.

to innovate, through the labor market (McCulloch et al., 2001)<sup>105</sup> or expansion of export sectors (World Bank and WTO, 2015).

## Regulatory improvement and fostering competition

**Prior Action 8:** *The Government has adopted measures to foster competition including, inter alia: (i) incentives to promote collaboration of cartel members in detecting and investigating anti-competitive agreements; and (ii) a fixed term and objective criteria for the selection and appointment of the director of the Superintendence of Industry and Commerce (Superintendencia de Industria y Comercio) whose responsibilities include, inter alia, the carrying out of competition oversight activities.*

25. The reforms supported by prior action 8 are expected to strengthen the Competition authority and foster a more robust product competition in Colombian markets, which is expected to deliver benefits especially for low income households. The relationship between the level of competition and the welfare of those household at the lower end of the income distribution can be examined in terms of the roles as consumer, producers and employers that the individuals perform in the markets;<sup>106</sup> however the analysis of the prior action will emphasize the role of households as consumers, affecting relative prices faced by all households, which potential benefits for consumers in the bottom 40 of the income distribution.

Table 2. Cartel and Anticompetitive Behavior in Final Goods in Colombia

Date	Sanctioned firms	Sector / Product	Practice	Penalty Fee (US\$)
Oct-15	ASOCAÑA, CIAMSA, DICSA, 12 INGENIOS + 13 PN	Sugar	Imports obstruction agreement	\$108,147,000
May-16	KIMBERLY COLPAPELES S.A., PROD. FAMILIA S.A., PAPELES NACIONALES S.A., C. Y P. DEL R. S.A. + 21 PN	Soft-papers	Price cartel	\$ 61,805,734
Jun-16	TECNOQUIMICAS S.A., PRODUCTOS FAMILIA S.A. Y COLOMBIANA KIMBERLY COLPAPEL S.A. + 16 PN	Diapers	Price cartel	\$ 69,635,874

26. The economic literature and empirical evidence suggests that policies aimed at reducing monopoly power could have positive effects on economic growth and the

<sup>105</sup> McCulloch, N., A. Winters, and X. Cirera. (2001). "Trade Liberalization and Poverty: A Handbook." London: Centre for Economic Policy Research.

<sup>106</sup> Begazo, T. and Nyman, S. (2016). "Competition and Poverty". View Point. Note No. 350. Trade and Competitiveness Global Practice. The World Bank Group. Available at: [http://www-wds.worldbank.org/external/default/WDSPContentServer/WDSP/IB/2016/05/09/090224b0843104f4/2\\_0/Rendered/PDF/Competition0and0poverty.pdf](http://www-wds.worldbank.org/external/default/WDSPContentServer/WDSP/IB/2016/05/09/090224b0843104f4/2_0/Rendered/PDF/Competition0and0poverty.pdf)

**distribution of incomes.** Low income households tend to be more than proportionally affected by market outcomes in sectors that are more prone to anticompetitive behavior and more subject to restrictive regulations imposed by governments (World Bank, 2016;<sup>107</sup> Dutt, 1984;<sup>108</sup> and Ahn, 2002<sup>109</sup>). The empirical evidence suggests that poor households suffer larger welfare losses in relative terms from monopoly and imperfect competition (Begazo, 2015; Urzua, 2013; and Creedy and Dixon, 1998). The low elasticity of demand associated with food staples and high relative spending on food, particularly for those households in the lowest deciles, implies important welfare costs and distributional effects as a result of market power.<sup>110</sup> Just in the last 12 months (since October 2015), the Colombian competition authority sanctioned anti-competitive behaviors (see Table 2) in three markets of goods of general consumption, such as sugar, toilet paper and diapers. The empirical evidence is consistent with the fact that consumption of food staples, such as sugar, has a larger share of the household budget in low income households, than for the household at the highest deciles (given limitations of the data it is not possible to simulate in detail the effects on changes in sugar prices<sup>111</sup> and toiletries<sup>112</sup> on individual consumption).

27. **Figure 6 shows the average expected gain from the elimination of cartels in the sugar and the toiletries industry. This analysis follows the criteria of the European commission to estimate the effects of the cartel dissolution on prices.** The European Commission assumes avoided price increases between 10 and 15 percent for cartel prohibitions, for a duration of 1, 3 or 6 years depending on the stability of the cartel.<sup>113</sup> For this estimation we are assuming that 33 percent of the spending in “Sugar, salt, condiments and sauces” was allocated exclusively in sugar; and similarly that 33 percent of the spending in “Toiletries” corresponds to toilet paper and diapers. In the case of sugar, the gains of the cartel dissolution reach 0.9 percent for the households in the lowest income decile who reported a positive consumption. Similarly, the gains for the households in the lowest deciles for the elimination of the cartel in paper and diapers is almost 0.5 percentage.

<sup>107</sup> World Bank (2016b:4). “A Step Ahead: Competition Policy for Shared Prosperity and Inclusive Growth”. Conference Edition. The World Bank Group.

<sup>108</sup> Dutt, A. K. (1984). “Stagnation, Income Distribution and Monopoly Power,” Cambridge Journal of Economics, Oxford University Press, vol. 8(1), pages 25-40, March.

<sup>109</sup> Ahn, S. (2002). “Competition, Innovation and Productivity Growth: A Review of Theory and Evidence”. OECD Economics Department Working Papers. No. 317. January, 17 of 2002. OECD Publishing. Available at: <http://www.oecd-ilibrary.org/docserver/download/5lgsjlvj7xq5.pdf?expires=1465444278&id=id&accname=guest&checksum=7E9F17292AB151C0644254E56C79C8FE>

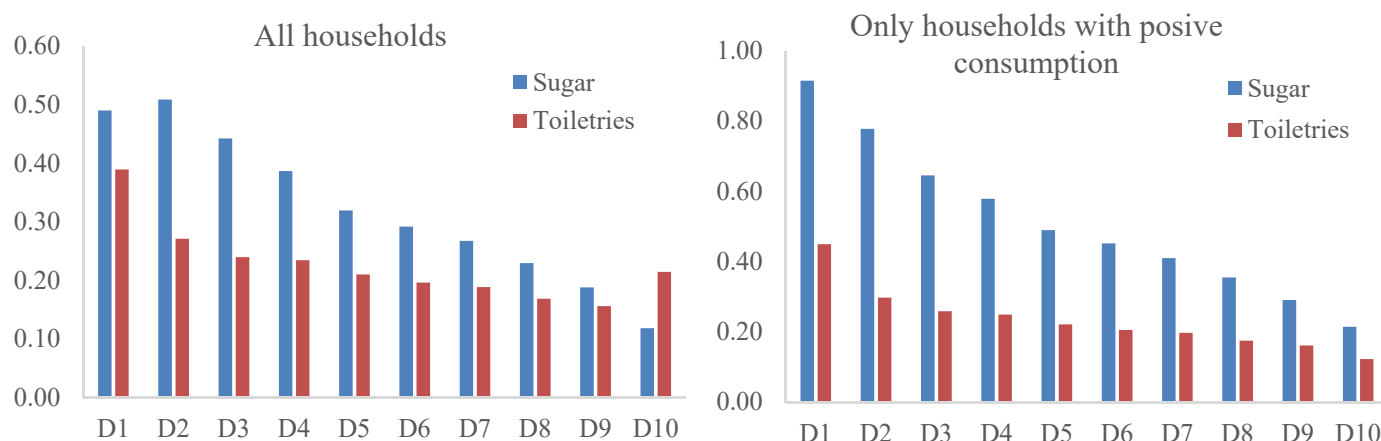
<sup>110</sup> World Bank (2016a). “Competition and Poverty. How Competition Affects the Distribution of Welfare.” Viewpoint, Trade and Competitiveness Global Practice, April 2016. The World Bank Group.

<sup>111</sup> In the ECV 2014 the expenditure in sugar is included in the category “Sugar, salt, spices and sauces”. Since it is not possible to observe directly what is the actual spending in sugar at the household level, an assumption was made regarding the participation of sugar within the total category.

<sup>112</sup> Given limitations of the data it is not possible to simulate in detail the effects on changes in the prices of toilet paper and diapers on individual consumption. In the ECV 2014 the expenditure in both of this good is included in the category “personal cleaning goods”. The category of “personal care” includes, in addition to the personal cleaning goods, the expenditure in services such as hair cuts or manicure.

<sup>113</sup> Ilzkovitz, F. and Dierx, A. (2016). “Competition policy and inclusive growth”. VOX CEPR’s Policy Portal. Available at: <http://voxeu.org/article/competition-policy-and-inclusive-growth>

**Figure 6. Relative gain in welfare by decile**  
**(Average increase of 15 percent in sugar and toiletries and unitary elasticity)**



Source: Own calculations based on ECV 2014.

## Fostering productivity and innovation

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**Prior Action 9:** *The Government has approved a national development policy for productivity development aimed to, inter alia, promote an efficient use of public resources by recommending a number of measures, including: (i) a cost-benefit analysis for new public projects; and (ii) a periodic review of public expenditures relating to projects in the areas of science, technology and innovation.*

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28. **A better alignment of efforts to promote technological development and competitiveness can increase earnings by improving firms' productivity and fostering economic growth, leading to potential positive effects in poverty.** Prior Action 9 aims to promote productivity and innovation, which constitute key elements for Colombia to sustain inclusive growth in an environment of low commodity prices and the general economic slowdown of the region. Policies able to effectively promote innovation across different sectors may have a positive impact on economic growth and firms' productivity in the medium to long-run, which could lead to positive impacts on incomes and to the reduction of poverty.

29. **Economic theory has largely acknowledged the importance for economic growth of investment in human capital, innovation and knowledge, since these elements help to develop new technologies and promote that production becomes more efficient.** Innovation is an important engine for development of modern economies, and is a distinguishing feature of emerging countries that exceed poverty traps and pass the threshold to progress. In particular, the endogenous growth theory (Romer, 1990) argues that technological change is a response to economic incentives that can be influenced by the government or the private sector,<sup>114</sup> and investment in research and development (R&D), leading to innovation, is a key driver for

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<sup>114</sup> Romer, P.M. (1990). "Endogenous Technological Change." *Journal of Political Economy* 98, S71-102.

technological change and economic growth. The GoC is promoting systemic reforms to improve the effectiveness of its productive development policies and to limit the risks of distortions, by setting specific criteria for interventions of the Government. In particular, productive development programs would be primarily justified only to address specific market failures and distortions that hinder increases in productivity. The rationalization of the intervention of the Government through productivity policies and programs could foster a simpler and more transparent framework, which promotes economic growth.

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**Prior Action 10:** *The Government has established the criteria and procedures for identifying projects entitled to access specific tax incentives under the existing fiscal legislation and within the established fiscal deductions' cap.*

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**30. Policies promoted by Prior Action 10 are expected to support growth and competitiveness in the medium and long-run, therefore indirectly collaborating with poverty reduction.** Innovation applies to multiple economic activities, extends to different linkages, and translates into growth, quality jobs and greater prosperity.<sup>115</sup> In recent years, empirical evidence finds that investing in scientific, technological and innovation projects, including assessments for the Latin American region (Crespi and Zuniga, 2012; Crespi et al., 2014) and Colombia (Arbeláez and Parra, 2011). For Colombia, Arbeláez and Parra (2011) find strong evidence that innovation increases firm sales and efficiency, which in turn leads to potential job creation and the enhancement of economic activity.<sup>116</sup> At a regional level, several authors find a strong association between innovation and productivity (Crespi and Zuniga, 2012),<sup>117</sup> as well as improvements in production processes and labor productivity (Crespi et al., 2014).<sup>118</sup> Moreover, recently Dechezlepretre et al. (2016)<sup>119</sup> show the positive impacts of a tax relief program in investment in research and development for small and medium firms.

**31. Despite the importance of innovation for productivity and growth, fiscal resources are limited and have competing uses.** Recent evidence (Becker, 2015)<sup>120</sup> suggest that there are positive effects of tax credits in investment in research and innovation, shifting away from earlier findings suggesting that public subsidies often crowd-out private investment (see Bloom et al.,

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<sup>115</sup> Gomez, H.J., Mitchel, D. (2014:7). “Innovación y emprendimiento en Colombia - Balance, perspectivas y recomendaciones de política: 2014-2018”. *Cuadernos de FEDESARROLLO*. March, 2014. Available at: <http://hdl.handle.net/11445/149>

<sup>116</sup> Arbeláez, M. and Parra, M. (2011). “Innovation, R&D Investment and Productivity in Colombian Firms”. Inter-American Development Bank.

<sup>117</sup> Crespi, G. and Zuniga, P. (2012:273-274,283). “Innovation and Productivity: Evidence from Six Latin American Countries.” *World Development*. Vol. 40, No. 2, pp. 273-290, 2012.

<sup>118</sup> Crespi, G., Tacsir, E. and Vargas, F. (2014:4-6). “Innovation and Productivity in Services: Empirical Evidence from Latin America.” Technical Note No. IDB-TN-690. Competitiveness and Innovation Division. Institutions for Development Sector. Inter-American Development Bank. Available at: <http://publications.iadb.org/handle/11319/6592>

<sup>119</sup> Dechezleprêtre, A., Einiö, E., Martin, R., Nguyen, K. T., and Van Reenen, J. (2016). “Do Tax Incentives for Research Increase Firm Innovation?” NBER Working Paper No. 22405. Available at: <http://www.nber.org/papers/w22405.pdf>

<sup>120</sup> Becker, B. (2015). “Public R&D Policies and Private R&D Investment: A Survey of the Empirical Evidence.” *Journal of Economic Surveys* (2015), Vol. 29, No. 5, pp. 917-942.

2002;<sup>121</sup> and, Cappelen et al. 2011<sup>122</sup>), towards results that indicate that subsidies typically stimulate private R&D. This positive effect seems to be particularly prevalent in small firms, more likely to experience financial constraints, and important creators of jobs in developing countries. However, a comprehensive impact analysis of these policies would require to evaluate the opportunity cost for the resources allocated for the specific tax incentives.

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<sup>121</sup> Bloom, N., Griffith, R., and Van Reenen, J. (2002:1). “Do R&D tax credits work? Evidence from a panel of countries 1979-1997”. *Journal of Public Economics*. Volume 85, Issue 1, July 2002, pp.1-31.

<sup>122</sup> Cappelen, A., Raknerud, A., and Rybalka, M. (2012:334). “The effects of R&D tax credits on patenting and innovations”. *Research Policy*, Vol. 41, Issue 2, March 2012, pp. 334-345.

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