

**PROGRAM INFORMATION DOCUMENT (PID)
APPRAISAL STAGE**

November 3, 2016
Report No.: 110651

Operation Name	Colombia First Fiscal Sustainability and Competitiveness Development Policy Financing
Region	LATIN AMERICA AND CARIBBEAN
Country	Colombia
Sector	General public administration sector (50%); Public administration- industry and trade (50%)
Operation ID	P158739
Lending Instrument	Development Policy Financing
Borrower(s)	Republic of Colombia
Implementing Agency	Ministry of Finance and Public Credit, National Department of Planning
Date PID Prepared	November 3, 2016
Estimated Date of Appraisal	December 5, 2016
Estimated Date of Board Approval	January 24, 2017
Corporate Review Decision	Following the corporate review, the decision was taken to proceed with the appraisal of the operation.

I. Country and sector background

Sound macroeconomic and structural policies, coupled with favorable external conditions, 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 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 its regulatory system and reduce factor and product market rigidities. Extreme poverty fell from 17.7 percent in 2002 to 8.1 percent in 2014, while total poverty fell from 49.7 percent in 2002 to 29.5 percent in 2014. 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).

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 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)¹. 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.

II. Operation Objectives

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 a less favorable external environment. The proposed DPF series recognizes and supports the Colombian authorities' reform efforts in the adjustment to this new 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 stability and growth over the medium term.

Fiscal reforms are a central priority to maintain sustainability. Oil-related fiscal revenues for the Central Government fell by 2.1 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 an expected 3.2 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 2.9 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.

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 decades was driven heavily by factor accumulation.² Moreover, FDI over the last decade was heavily concentrated in the extractive sectors. In the current

¹ The Fiscal Rule, effective since 2012, targets the reduction in the structural fiscal deficit of the Central Government to 1 percent of GDP by 2022, with intermediate targets of 2.3 percent (2014) and 1.9 percent of GDP (2018).

² World Bank (2014a).

external environment, these drivers of growth are facing constraints. In turn, faster productivity growth becomes an urgent priority. Over the last 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 other. But further progress is needed in these areas and others, including to facilitate trade and FDI, and improve competition.³ 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.

III. Rationale for Bank Involvement

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. Despite recent setbacks in the process, the national government remains committed to building peace in Colombia.⁴ While there are no official estimates of the costs of the agenda for peace building, fiscal space is required to accommodate the costs associated with the peace process. Finally, this operation supports Pillar 3 of the CPF, which aims at supporting fiscal sustainability and productivity. By contributing to this objective, the operation further supports the CPF’s cross-cutting area of constructing peace.

IV. Tentative financing

Source:	(\$m.)
Borrower	0.00
International Bank for Reconstruction and Development	600.00
Total	600.00

V. Institutional and Implementation Arrangements

The Ministry of Finance and Public Credit (MHCP) and the National Planning Department (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 reform program supported by this DPF series. The World Bank team has worked closely with the two agencies in order to define results indicators that are clearly spelled out and measurable, giving

³ World Bank (2014a).

⁴ 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. The government has initiated discussions with the political forces that campaigned for the “NO” and has expressed its commitment to work with the different parties to bring to the table some modifications to the agreement that could help build consensus. The FARC has reiterated its commitment to continuing the dialogue and conversations have resumed in La Habana.

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.

VI. Risks and Risk Mitigation

The overall risk associated with the proposed DPF is assessed as moderate. Most of the reforms supported by the operation form part of the National Development Plan and benefit from strong ownership of the respective Government institutions. The most relevant risks are related to the political and governance, macroeconomic and institutional capacity categories affecting the reforms. Political and governance risks are related to the uncertainty associated with the ongoing peace negotiations and its repercussions in other areas. Macroeconomic risks also arise from the uncertainty in the external outlook. Mitigating factors include the Government's acknowledgment that fiscal and structural reforms are necessary to safeguard Colombia's credibility with international investors and advance with its objective of OECD accession.

VII. Poverty and Social Impacts and Environment Aspects

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 the medium to long term. 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. 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. The only prior action that has immediate poverty and distributional effects is the enactment of the Liquor Law. The PSIA shows that the increase in the tax on liquors and wine is regressive, but given that consumption of these alcoholic beverages represents a very small share of total household consumption, the impact would be negligible. On the other hand, increased public expenditure (especially on health) resulting from higher tax collections could result in positive medium- to long-term effects on welfare.

The prior actions supported by this operation are not likely to have significant negative effects on the environment, forests and other natural resources. 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 and other related agencies. It is, however, 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. 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.

VIII. Contact point

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