Inter-American Development Bank
Banco Interamericano de Desarrollo
Latin American Research Network
Red de Centros de Investigación
Research Network Working paper #R-442

Decentralization and Bailouts in Colombia

by

Juan José Echavarría*
Carolina Rentería**
Roberto Steiner***

*Fedesarrollo
**Ministry of Finance, Colombia
***Universidad de los Andes

July 2002

Cataloging-in-Publication data provided by the
Inter-American Development Bank
Felipe Herrera Library

Echavarría S., Juan José.
Decentralization and bailouts in Colombia / by Juan José Echavarría, Carolina Rentería, Roberto Steiner.

p. cm. (Research Network Working papers ; R-442)
Includes bibliographical references.

1. Intergovernmental fiscal relations--Colombia. 2. Central-local government relations--Colombia. 3. Debt, Public—Colombia. 4. Decentralization in government--Colombia. I. Rentería, Carolina. II. Steiner, Roberto. III. Inter-American Development Bank. Research Dept. IV. Title. V. Series.

336 E336 --dc21

1300 New York Avenue, N.W.
Washington, D.C. 20577

The Research Department (RES) produces the *Latin American Economic Policies Newsletter*, as well as working papers and books, on diverse economic issues. To obtain a complete list of RES publications, and read or download them please visit our web site at:

Abstract*

This paper examines the decentralization process in Colombia, particularly as it relates to reforms embodied in the 1991 Constitution, and the bailouts of territorial entities that have occurred in subsequent years as a result of perverse incentive structures. The paper provides a summary of the basic features of the decentralization process in Colombia, including an analysis of revenue and expenditure assignments, the intergovernmental transfer system and recent developments in terms of territorial indebtedness. Specific case studies involve the determinants of three types of bailouts by the central government to territorial entities: the provision of soft loans to be used by departments to restructure their finances, the bailout of territorial entitities' education expenditures, and the Medellin Metro. The paper concludes with lessons learned and policy recommendations.

* When the project began in 1998, all three authors were affiliated with Fedesarrollo. Currently Rentería is at the Ministry of Finance and Steiner at the University of Los Andes. The authors would like to thank Paulina Lecompte and Juan Pablo Fernández for their research assistance. We have received useful comments from the directors of the Project at the IDB (Ernesto Stein, Eduardo Fernández -Arias, and Jurgen Von Hagen) and from the participants at Fedesarrollo's seminar, especially from Olga Lucía Acosta, Ulpiano Ayala, Alejandro Gaviria, Juan Luis Londoño, Humberto Mora, Henry Rodríguez and Juan Gonzalo Zapata.
This paper would not have been possible without the help and information received from the Ministry of Finance (*División de Apoyo Fiscal*, *División de Crédito Público* and *División de Presupuesto*), DNP (*Unidad Administrativa Especial de Desarrollo Territorial*, *Unidad de Desarrollo Social and Unidad de Análisis Macroeconómico*), and the *Misión Social* at DNP, particularly Alfredo Sarmiento.

TABLE OF CONTENTS

TABLES

FIGURES

1. Introduction

Within the Latin American context Colombia is in a relatively advanced stage in terms of decentralization. According to the IDB (1997), it ranks third in the region after Argentina and Brazil, two countries organized as federal states. While in 1995 average public expenditure allocated by subnational governments amounted to 15 percent of total public expenditure in Latin America and to 35 percent in the OECD countries, it reached 39 percent in the case of Colombia. Economic activity is also very decentralized compared to other Latin American countries.[1]

This advanced stage of decentralization is the result of a process that began at the onset of the 1980s, and has covered aspects of economic, administrative and political nature. This process received a definitive push with the new Constitution of 1991. The development of a decentralized system for over 15 years has revealed its strengths and weaknesses, and has prompted the need to implement changes in order to correct existing problems.

Historically, Colombia has shown a reasonable degree of macroeconomic stability,[2] but macroeconomic management deteriorated abruptly during the 1990s. One of the main causes for the fiscal imbalance has been the increase in the Central Government's (CG) current expenditures, explained mostly by a large increase in transfers to the regions and new interest payments.

Despite the large increase in transfers there have been several situations in which sub-national governments have faced (or are facing) deep financial problems, especially at the departmental level. In recent years departments have been asking for special treatment, both in terms of their debt with the CG and/or in the request of loans to pay wages, pensions, and loans to the commercial banking system. The accumulation of deficits and excessive departmental indebtedness exploded in 1996.

[1] Montenegro (1996) estimates Gini coefficients for the concentration of population in 19 Latin American countries. Colombia comes last in terms of concentration, with a Gini of 0.42, followed by Brazil (0.49), Venezuela (0.54), Bolivia (0.56) and Ecuador (0.57). The more regionally concentrated countries are Chile, Uruguay, Guatemala and Paraguay.

[2] During 1970-92 Colombia was the least volatile economy within the Latin American context (IMF, 1995), and had the most stable economic policy of the countries analyzed. Recently, Jaramillo, Steiner and Salazar (1999) tied the stability of economic policies to the stability of some institutions and to the constitutionalist character of its democracy, one in which the centrifugal tendencies inherent in a pluralistic society are counteracted by the cooperative attitude of the leaders of different segments of the population.

As of February 1999, 15 departments had received loans from the CG for the restructuring of their administrative, financial and fiscal structures, totaling US$107 million, and there are 13 additional petitions on the waiting list. Payments to retirees are not current in 14 departments, affecting around 18,000 persons. According to the Ministry of Finance (MoF), the delays are older than 12 months in four cases (Ministerio de Hacienda, 1999a).

A system of "traffic lights" was designed to control regional indebtedness. A regional entity under green light can contract new credits, but the red light (low liquidity and solvency) forces the region to sign a performance agreement (PA) monitored by the MoF. Currently, of 27 departments for which there are calculations, 17 are in red, 1 in yellow and 9 in green, which means 18 of them are facing liquidity and/or solvency problems.

There are failures in the institutional framework of decentralization that have reduced the fiscal discipline of the sub-national governments, affecting its fiscal balance and increasing the pressure for a bailout from the CG. There is an unavoidable need to modify the fiscal contract among the three levels of government, in order to enhance the principal's (CG) capacity to monitor and control the agent (territorial entities, TEs).

This paper is divided into four sections, including the introduction. The second section provides a summary of the basic features of the decentralization process in Colombia, including an analysis of revenue and expenditure assignments, the intergovernmental transfer system and recent developments in terms of territorial indebtedness.

The third section constitutes the core of the paper. It deals with three types of bailouts by the CG and their determinants: the provision of soft loans to be used by departments to restructure their finances, the bailout of education expenditures of TEs, and, the case of the Metro of Medellin. The last section presents conclusions and some policy recommendations.

1. The Decentralization Process in Colombia[3]

A. Current Political and Administrative Division

Colombia is divided into departments, which in turn are composed of municipalities. There are 32 departments and close to 1,090 municipalities, including four special districts: Bogota, Cartagena, Barranquilla and Santa Marta. Each department constitutes an electoral district for the

[3] This section draws heavily on Correa and Steiner (1999).

election of governors, members of the House of Representatives (Cámara de Representantes) and deputies to the Departmental Assembly. Senators are elected on a national basis.

The 1991 Constitution gave departments autonomy in the administration of sectional matters and in the planning and promotion of economic and social development within their territory. The Departmental Assemblies are administrative corporations, elected by popular vote. Their size varies from 11 and 31 members, who serve three-year terms.

The Governor is the legal representative and the administrative head of the Department, and acts as an agent of the President in relation to the management of public order, the execution of economic policy and as a bridge for agreements between the nation and the department. The governors are elected for three years, without the possibility of reelection, and they can be suspended or dismissed by the President.

Municipalities represent the fundamental entity of the political and administrative division of the State. The Municipal Councils are administrative corporations, elected by popular vote for a period of three years, with its size varying between 7 and 21 members. The mayor, elected for three years, is the head of the local administration and its legal representative. Reelection is not allowed, and the mayors can be suspended or dismissed by the President or the Governor of the department.

B. Stages of Decentralization, 1982-2000

In 1982-1991, during the early stages of the decentralization process, the dominant goal was to achieve fiscal independence among levels of government while protecting the budget balance at the central level (Rojas and Campbell, 1994). The most aggressive efforts in the areas of fiscal and administrative decentralization were concentrated in two laws. Law 14 of 1983 restructured tax structures, allowing lower levels of government to define tariff rates and exemption mechanisms within limits determined by the law. Law 12 of 1986 (and Decree 77 of 1987) redistributed functions among levels of government, strengthened the system of CG transfers and established the co-financing system, a matching grant system that allowed the CG to participate in the funding and implementation of projects assigned to municipalities and departments.

Modifications to the provision of education and health were implemented in 1989 and 1990. Mayors became responsible for the appointment of teachers and for the administration of school payrolls and other expenses. The CG was made responsible for designing health policies, for transferring resources to subnational levels, and for overall coordination and supervision. The nation was given the monopoly over lotteries and gambling activities, the rents from which should be dedicated to finance health programs. Departments and municipalities were made responsible for executing those programs directly or through contracts with the private sector.

The pace of decentralization intensified with the new Constitution of 1991, which reads in its first article: "Colombia is a legally organized social state under the form of a unitary, decentralized Republic with autonomous regional entities." The main reform regarding political decentralization was to establish the popular election of governors. The new Constitution gave greater fiscal autonomy to municipal and departmental authorities, which now have the right to administer and modify taxes so as to comply with their assigned functions. In terms of responsibilities, it dictates that the different territorial levels will be guided by the principles of coordination, concurrence and subsidiarity.

The Constitution additionally modifies the system of transfers, establishing new rules for departments and special districts (*Situado Fiscal*, education and health), for municipalities (participation in the CG's current revenues), and for the distribution of royalties from natural resources. Most importantly, it introduces the principle of balance between functions and resources by stating that no new resources can be given to lower levels of government without the previous assignment of responsibilities. This principle has been systematically violated, as will be seen below.

C. Revenue and Expenditure Assignments, Vertical Imbalances and Transfers

1. Expenditures and Taxes

Figure 1 presents the evolution of expenditures and taxes by the central government and by the departments and municipalities in Colombia between 1990 and 2000. Panel 1a shows total expenditures and taxes, and panels 1b and 1c present the evolution of the different components. Table A.1 provides detailed information on taxes. Colombia was the country where public expenditure grew the most in Latin America during the 1990s (Echavarría, 2000)—from 20.4 percent of GDP in 1990 to 37.7 percent in 2000, while taxes remained relatively constant, at levels close to 14 percent of GDP. The gap has been widening over time, with important and negative consequences for the amount of public debt.

Expenditure by departments and municipalities displayed a similar level to the CG in 1992 but increased faster during the rest of the decade. All expenditures considered in the figure increased during the 1990s, including social security and the decentralized firms.

Panel 1c and Table A.1 show the evolution of revenues at different levels. Taxes from the CG represent 5 times those of the departments and municipalities, and transfers close to 3 times. Transfers (3 points of GDP) and municipal taxes (1 point) increased faster than the other items considered in the panel.

The central government collects income and value-added taxes, as well as taxes on international trade, while the departments collect taxes on liquor and beer, and the Municipalities collect industry, business and property taxes. The property tax is charged on the assessed value, mainly determined by a centralized government agency.[4] Additionally, there has been an optional surcharge on gasoline at the municipal level since 1993 (classified as a non-tax resource), which was made mandatory by the 1998 national tax reform.

A recent report by the Inter-American Development Bank (BID, 1998) highlighted several limitations of the current territorial tax regime. First, an excessive number of taxes generate little revenue and are inefficient. In many instances, departments and municipalities administer taxes of a very similar nature. Second, taxation power remains highly centralized. Third, administration is highly fragmented, organized by taxes rather than functions, and with functions overlapping among the divisions. Moreover, there is almost no systematic program of inspection and collection.

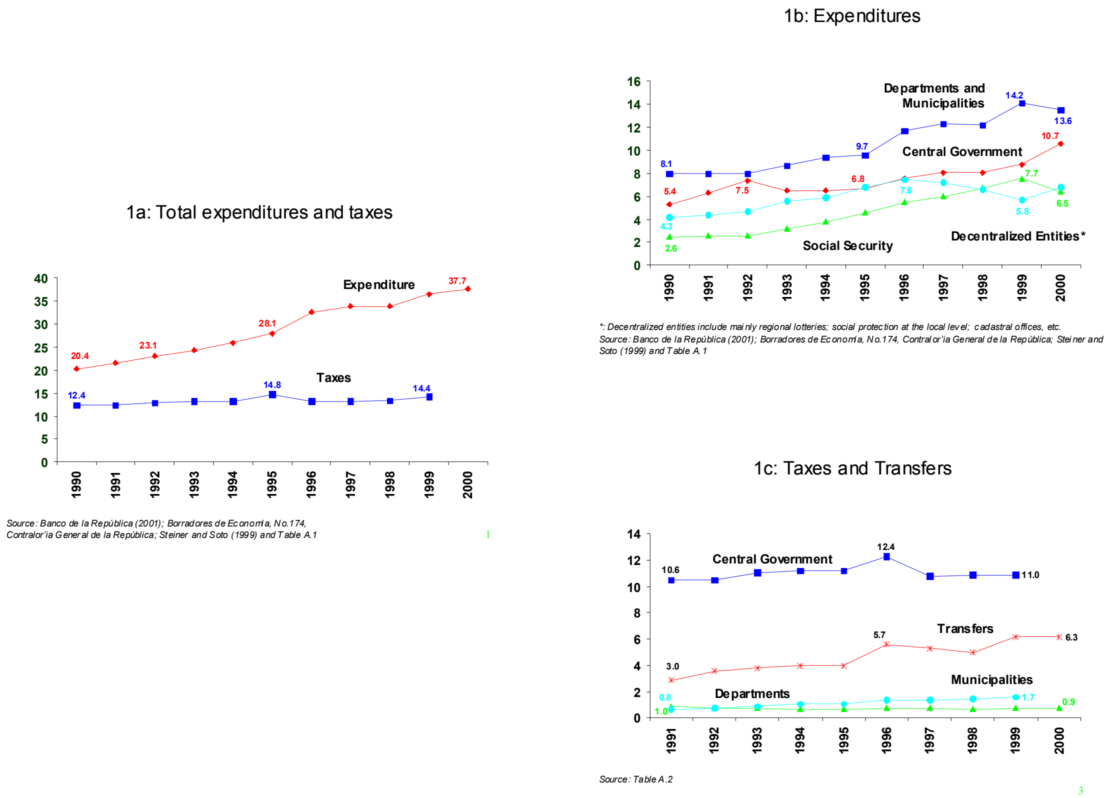
The system of transfers corresponds mainly to a revenue sharing system, and it is expressed in four mechanisms considered in Table A.1: *Situado Fiscal*, a transfer for regional education and health; municipal participations, a transfer to municipalities to finance current expenditure and investment in basic services; royalties, from the exploitation of natural resources; and co-financing, a matching grant system executed by the departments and municipalities. Table A.1 also includes the educational compensation fund (*FEC*), additional money for education, whose characteristics will be considered in Section 1.B.3.

The *Situado Fiscal* and *municipal participations* represent the bulk of the transfer system, growing exponentially between 1991 and 1999 (with a small drop in 2000). *Royalties* and *FEC*

[4] Some major cities have used self-assessment of property values, with positive results in terms of revenue.

became important after 1995. The system of *co-financing* was eliminated after 1998; it reached a peak of 0.9% of GDP in 1996.

Figure 1. Expenditures and Taxes in Colombia, 1991-2000 (% of GDP)



2. Expenditure Assignment

Two patterns of decentralization overlap in Colombia, and the conflict between the two became more evident after 1991. There is the idea, on the one hand, that the central government (the principal) should design all policies, and local governments (the agent) should execute them. But others think that local authorities should define policies at the regional level and obtain their income directly from local potential voters.[5] The hybrid character should imply that the TE is

[5] According to the IMF (1995) "decentralization in Colombia favors a model of functional administration, where the center takes the decisions, and asks local entities to execute them." For the opposite view see Steiner and Soto (1999, p. 126). See also Kure (1995) and Clavijo (1998).

accountable to both the CG and its constituents, but that has not been the case. The confusion that exists has allowed the TE to avoid its responsibilities with both the CG and the citizens.

There is also a remarkable lack of clarity regarding the distribution of responsibilities among the different levels of government in the Constitution of 1991 and in the related legislation that followed it. The result is interference by upper levels of government and special interests, with lower levels demanding support from higher levels, and widespread weak accountability at all levels of government. The CG remains involved even when responsibilities have been transferred to the lower levels.

Table 1 describes the overlapping functions in the provision of different public services in Colombia. According to the Constitution of 1991, a new Organic Law (*Ley de Ordenamiento Territorial*) prevailing over all other related legislation should be drafted to define precisely the functions and responsibilities for each level of government, but has not been presented by the government to Congress. This Organic Law should prevail.

On the other hand, the current law did not require the CG to stop playing a key role in the areas of education and health, or in other areas of decentralization. Central government expenditures on education and health increased from 0.9 percent of GDP in 1991 to 2.7 percent in 1997, while local expenditures increased from 3.3 percent to 5.4 percent in the same period. Expenditure carried out by the National Public Administration still amounted to 25.6 percent of GDP in 1995, while departmental administrations carried out 5.3 percent and the municipalities 5.7 percent. This helps to explain why the CG has been facing continual and increasing fiscal deficits since 1993.

Table 1. Distribution of Functions by Level of Government

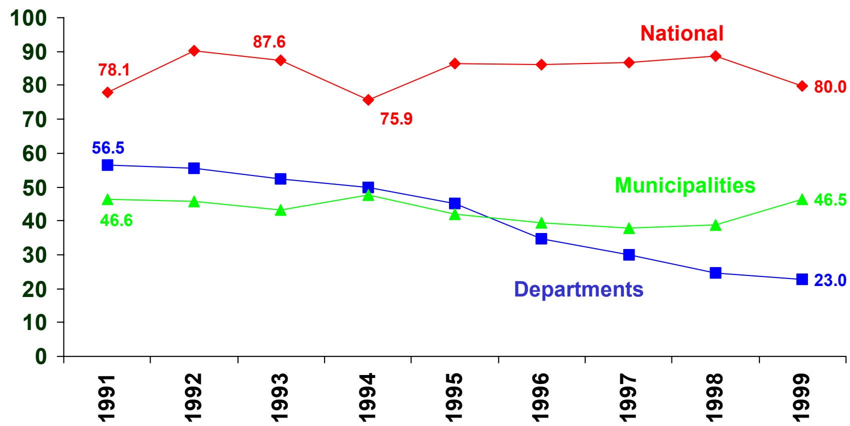
PUBLIC SERVICE	AMOUNT	STRUCTURE	EXECUTION	SUPERVISION
National Defense	N	N	N	N
Natural Resources (Oil)	N	N	N,D,M	N
Education				
Elementary	N,D,M	N,D	N,D,M	N
High School	N,D	N,D	N,D	N
Universities	N	N	N	N
Health	N,D,M	D,M	N,D,M	N
Housing	N,M	N,D,M	M	M
Hospitals	N,D,M	N,D,M	N,D	N
Water Service and Sewerage	M	M	M	N
Public Transportation	M	M	M	M
Streets	M	M	M	M
Waste Disposal and Cleaning	M	M	M	N
Public Lighting	N,M	N	N,M	N
Highways	N,D	N,D	N,D	N,D
Telecomunications	N,M	N,M	N,M	N
Ports	N,M	N,M	N,M	N

Source: IDB, 1997. N: National, D: Departmental, M: Municipal Amount: Who decides the amount to be spent? Structure: Who decides the expenditure structure? Execution: Who executes the expenditure? Supervision: Who supervises the function?

3. *Vertical Imbalances and Intergovernmental Transfers*

Figure 2 shows the evolution of fiscal effort, the relation between taxes and total revenues, for the national government, the departments and the municipalities. It has been relatively stable and high for the national level, and it has decreased markedly and reached low levels for the departments, dropping from 56.5 percent in 1991 to only 23 percent in 1999. Fiscal effort fell markedly for the municipalities between 1991 and 1999, but bounced back to the original levels in 1999 (mainly due to the good behavior of Bogota in the latter year). Similar results are obtained for the departments and municipalities when we calculate the relation between taxes and total revenues less transfers.

Figure 2. Fiscal Effort (taxes/total revenues,%)



Source:Contraloría General de la República and author's calculations

- *Situado Fiscal*

The *Situado Fiscal* was created in 1968 as a transfer to Regional Education and Health Funds, but departments did not receive resources directly since the regional managers were appointed at the central level. The 1991 Constitution called for giving money directly to the regions and stated that the amount transferred to departments and municipalities should be an increasing proportion of current revenue until it reaches 46.5 percent in 2002 (Table 2), a solution not without problems.[6] According to Law 60 of 1993, 15 percent of total revenue of the *Situado* is to be distributed equally among departments and special districts, the remaining 85 percent according to a formula (Table 3).

The 15 percent to be distributed equally favors smaller departments, sparsely populated and with low administrative capacity, mainly those created by the 1991 Constitution.[7] At least 60

[6] The dependence of transfers on current revenue limited discretional behavior but also had negative effects: it institutionalized the lack of correspondence between transfers and costs (the main criteria are geographical, demographical and sectoral), and it introduced a procyclical element into transfers that complicates macroeconomic management (IDB, 1998).
[7] Their expenditure needs should be lower. Obviously, other factors affect needs, including the prices of the inputs used to produce services (Rafuse, 1990).

percent of the *Situado* should go to education and 20 percent to health. The departments can assign the remaining 20 percent to either education or health.[8]

Table 2. Transfers of Central Government Current Revenue in the Constitution of 1991 (% of current revenue)

	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002
Participations (Municipalities)	14.0	15.0	16.0	17.0	18.0	19.0	20.0	21.0	22.0	22.0
Situado Fiscal (Departments)	22.5	23	23.5	24.5	24.5	24.5	24.5	24.5	24.5	24.5
Total	36.5	38	39.5	41.5	42.5	43.5	44.5	45.5	46.5	46.5

Source: Constitution of 1991.

Table 3. Transfers to Departments and Special Districts, *Situado Fiscal* Formulae for Geographical distribution

15%	85%	
To be distributed in equal parts among all the departments and districts	X%	85%-X%
	Variable share which should guarantee enough resources (adding up the 15% of the previous column) to cover the same health and educational services produced in 1992, under conditions of administrative efficiency.	Portion to be distributed according to the following criteria: 1. Potential population of the T.E 2. Fiscal effort (share of all resources in total state income).

Sourec: Law 60 of 1993

- *Municipal Participations*

Municipal participations represent transfers to municipalities, designed to finance current expenditure and investment in basic services (health, education, water provision, sanitation, sports, recreation and culture). The share of current income to be transferred to municipalities represented 14 percent in 1993 and should increase to 22 percent in 2002.

The geographic distribution of the participations follows a complicated formula (Table 4). Like the *Situado*, the participations are for the most part earmarked, and the municipalities can freely allocate only 20 percent of these resources (Table 5).[9]

[8] 75 percent of total expenditures have gone to education, and 25 percent to health.

[9] After a couple of years, some municipalities, especially the smaller ones, were unable to finance their operating and debt service expenditures due to lack of own tax revenue. As a result, legislative Act 01/95 increased the percentage of transfers that can be freely allocated by municipalities with a lower degree of relative development.

Table 4. Geographic Distribution of Participations to Municipalities

x%			Indian Territories (the share is determined by a certain amount of per capita income
5.0%			Municipalities with less than 50.000 inhabitants
1.5%			Municipalities on Magdalena river
0.1%			Federacion Colombiana de Municipios Distribution criteria:
(93.4-x)%	60%	20%	According to population with basic unsatisfied needs (UBN)
		40%	According to relative poverty indexes
	40%	22%	Population / Total national population
		6%	According to fiscal efficiency
		6%	According to administrative efficiency in public services supply
		6%	According to the evolution of an indicator of quality of life

Source: Law 60 of 1993

Table 5. Municipal Participation Formulae for Sectoral Distribution

Education	30%
Health	25%
Water and Sanitation	20%
Culture and Recreation	5%
Discretional	20%

Source: Law 60 of 1993.

- *Co-Financing Funds*

The co-financing funds were established as a matching grant system in 1992, allowing the CG to pursue specific priorities to be executed at the territorial level. The funds' level and composition are defined in the executive's budget and assigned through negotiations at the congressional level. Once defined, the relevant ministries determine the technical, financial and institutional conditions. Municipalities identify, formulate and execute projects, while the departments coordinate, promote, plan and evaluate them.

The allocation of resources to the funds and their geographical distribution are characterized by an arbitrary process, subject to strong political pressure. There are global items in the budget (*partidas globales*) that correspond to allocations managed directly by specific congressmen, representing around 20 percent of total resources allocated through the funds in 1996 (BID, 1998).

The co-financing funds are divided into two kinds: specific destination and free allocation. The former are approved in the budget, and the latter are allocated directly by the funds in order to finance projects presented by the TEs.[10] The criteria for assigning funds to TEs are similar to those used to distribute the *Situado* and participations, so the geographical distribution of grants tends to follow that of transfers, rather than national investment priorities. The programs, on the other hand, are independently formulated by the different agencies involved in the process, with indeterminate criteria for project selection and cost sharing (Fedesarrollo, 1998).

- *Royalties*

The purpose of royalties is to distribute the resources generated from the exploitation of natural resources. Once the amount is determined, royalties are distributed to departments and municipalities involved in production and transportation. A share goes to the National Royalties Fund, to be distributed to the rest of the TEs. Currently, 28 departments and 328 municipalities receive royalties (IDB, 1998).

Departments are required to invest 100 percent of resources from royalties in priority projects included in their development plans, but at least 50 percent of royalties should be directed towards health, education, water and sewerage when there are “deficits” in terms of coverage.

The distribution of royalties is highly skewed, and those departments with small populations have received a large share and misused resources. Departments with large royalties levy relatively few taxes, and a large share of royalties has financed current expenditure rather than investment.

D. Territorial Indebtedness, Performance Agreements and “Traffic Lights”

1. General Considerations

The greater autonomy for contracting credit that the TEs received in the 1991 Constitution, the lack of regulation, more potential leverage given by the new transfers, and the aggressive behavior of banks, produced a rapid increase in TE indebtedness, especially in 1992-94, the term of the first elected governors.

[10] There are four funds: *Fondo de Inversión Social* (FIS), for social investment; *Fondo para la Inversión Rural* (DRI), for infrastructure projects in rural areas; *Fondo de Cofinanciación de Vías* (FCV), for intercity roads; and *Fondo para la Infraestructura Urbana* (FIU), for municipal transport.

With the exception of a registration requirement, domestic credit operations by TEs were free of Ministry of Finance control until 1993, but in that year Law 80 introduced important new restrictions. Financial intermediaries were now required to monitor the destination of loans and the indebtedness capacity of TEs. In addition, banks were made responsible for grading loans, constituting provisions for non-performing assets, and monitoring the nature and quantity of acceptable guarantees. Loans to TEs, moreover, were now calculated in banks' equity to risk-weighted assets ratio.

It is not clear, though, whether the decentralization process has brought important improvements in the areas of education and health. Education coverage did not increase in the large cities, and the quality of secondary public education has deteriorated in relative terms (i.e., compared to private education). Coverage in small municipalities increased, but the main beneficiaries were the teachers, whose wages increased much more than those of others during the 1990s. Improvements in health were notable, but they seem to have responded more to the incentives created by Law 100 than to decentralization.[11]

2. *Performance Agreements and Traffic Lights*

It was not until 1997 that Law 358 introduced the constitutional mandate of limiting debt to payment capacity, establishing a system of "traffic lights" based on indicators of liquidity (interest payment/operational savings) and solvency (debt/current revenue).[12] As described in Table 6, a regional entity with a liquidity indicator lower than 40 percent and a solvency indicator lower than 80 percent has a "green light" and total autonomy to contract new credits. A performance agreement (PA) has to be signed, however, when the region is in the red light range (liquidity indicator between 40 percent and 60 percent and solvency indicator lower than 80 percent) or in some cases in the yellow light zone.[13]

The PA is based on a negotiation between the regional entity and the financial institution, monitored and reviewed by the Division of Fiscal Support (*División de Apoyo Fiscal*, DAF) at the Ministry of Finance. A department can additionally monitor the agreement when one of its

[11] See Alesina, Carrasquilla and Echavarría (2002), Gaviria (2002), and Acosta and Borjas (2002).
[12] A better indicator of solvency would relate liabilities to net worth.
[13] When the new credit increases the real value of the stock of debt. This means that debt can be rolled over automatically in the yellow zone, though not in the red zone.

municipalities new credit is given to one of its municipalities.[14] Access to future credit is limited in case of non-compliance.

Table 6. Indebtedness Alert Signals

Indicator	Autonomous indebtedness Green Light	Intermediate Indebtedness Yellow Light	Critical Indebtedness Red Light
Debt Interests / Operational Savings* (Liquidity indicator)	<40%	40%<60%	>60%
Debt balance / Current revenue (Solvency indicator)	<80%	<80%	>80%
Effect	ET is allowed to contract new credit autonomously	A) ET can contract autonomousl B) Requires indebtedness authorization of the Ministry of Finance or the Department, which will be conditioned to the signing of a Performance Plan with the Financial Institutions	Authorization is required to celebrate credit operations, thus a Performance Agreement with the financial entities should de signed

Source: Ministerio de Hacienda
* operational savings is defined as current revenue – current expenditure (excluding interest payments).

The PA consists of a series of targets and recommendations that the TE must comply with, within a predetermined time frame. These targets include increases in own resources, control of expenditures, generation of current savings and surpluses and an improved debt profile. There are also limits to the evolution of total wages.[15] The agreement specifies that information procedures should be improved in order to guarantee access by the central government and a census of the taxpayers must be available. New programs aiming to avoid tax evasion and smuggling should be designed, and tax receipts should increase by more than 20 percent annually.

Table 7 presents estimates of the legal capacity of indebtedness of departments and capital cities in 1998. Of the 27 departments for which estimates are presented, 17 are in red, 1 in yellow and 9 in green. Most of the liquidity problems can be traced to negative operational savings. The problem seems to be less acute for muncipalities than departments: 13 of 26 cases are in red, 6 in yellow, and 8 in green.

[14] Further regulation developed the risk weighting that financial institutions must apply to TE loans. Operations under green light should be computed for 100 percent of their value, and operations under yellow and red (with authorization) for 130 percent. However, when these operations have the CG's guarantee, they will be computed for 0 percent of their value. This distinction, as will be developed later on, obviously constitutes a perverse incentive.
[15] Total wages cannot increase more than the percentage allowed each year for unit wages of public employees. This is (relatively) similar to keeping constant the number of public employees.

Table 7. Legal Capacity of Indebtedness in 1998

	RATIOS		TRAFFIC LIGHTS		
DEPARTMENT	LIQUIDITY*	SOLVENCY*	LIQUIDITY	SOLVENCY	SITUATION
VALLE	(23.7)	222.3	RED	RED	RED
ANTIOQUIA	(163.4)	46.9	RED	GREEN	RED
ATLANTICO	339.0	65.2	RED	GREEN	RED
TOLIMA	(13.1)	86.6	RED	RED	RED
NARIÑO	(64.7)	186.5	RED	RED	RED
MAGDALENA	(18.2)	57.0	RED	GREEN	RED
HUILA	(30.5)	11.5	RED	GREEN	RED
CESAR	70.6	38.0	RED	GREEN	RED
SANTANDER	106.9	11.1	RED	GREEN	RED
CALDAS	(7.6)	16.0	RED	GREEN	RED
BOLIVAR	273.5	5.2	RED	GREEN	RED
SUCRE	233.8	22.7	RED	GREEN	RED
QUINDIO	(4.8)	12.2	RED	GREEN	RED
AMAZONAS	(1.2)	101.3	RED	RED	RED
VAUPES	(0.5)	81.2	RED	RED	RED
VICHADA	(4.2)	28.0	RED	GREEN	RED
CORDOBA	(326.3)	-	RED	GREEN	RED
N. DE SANTANDER	47.4	10.9	YELLOW	GREEN	YELLOW
CUNDINAMARCA	9.6	30.8	GREEN	GREEN	GREEN
RISARALDA	19.8	39.6	GREEN	GREEN	GREEN
GUAJIRA	12.7	76.9	GREEN	GREEN	GREEN
ARAUCA	16.8	14.8	GREEN	GREEN	GREEN
CAUCA	30.1	18.3	GREEN	GREEN	GREEN
BOYACA	17.4	11.6	GREEN	GREEN	GREEN
CAQUETA	7.2	9.2	GREEN	GREEN	GREEN
PUTUMAYO	27.5	13.6	GREEN	GREEN	GREEN
META	30.7	-	GREEN	GREEN	GREEN
MUNICIPALITY					
MEDELLIN	(87.5)	26.4	RED	GREEN	RED
BARRANQUILLA	94.2	29.2	RED	GREEN	RED
SANTAFE DE BOGOTA D.C.	105.9	7.0	RED	GREEN	RED
CARTAGENA	(72.6)	44.7	RED	GREEN	RED
TUNJA	78.3	27.5	RED	GREEN	RED
FLORENCIA	209.5	36.5	RED	GREEN	RED
POPAYAN	67.4	42.7	RED	GREEN	RED
MONTERIA	103.9	333.9	RED	RED	RED
NEIVA	(12.3)	32.6	RED	GREEN	RED
SANTA MARTA	102.5	44.6	RED	GREEN	RED
BUCARAMANGA	128.7	94.3	RED	RED	RED
PASTO	(18.5)	48.6	RED	GREEN	RED
INIRIDA	(7.3)	99.5	RED	RED	RED
PEREIRA	52.9	26.1	YELLOW	GREEN	YELLOW
MANIZALES	45.9	74.0	YELLOW	GREEN	YELLOW
SINCELEJO	44.0	35.6	YELLOW	GREEN	YELLOW
IBAGUE	43.1	5.1	YELLOW	GREEN	YELLOW
CALI	49.7	-	YELLOW	GREEN	YELLOW
CALI	49.7	53.6	YELLOW	GREEN	YELLOW
VILLAVICENCIO	22.7	19.5	GREEN	GREEN	GREEN
ARMENIA	16.8	19.2	GREEN	GREEN	GREEN
ARAUCA	27.1	63.7	GREEN	GREEN	GREEN
YOPAL	30.0	67.2	GREEN	GREEN	GREEN
MOCOA	16.4	31.6	GREEN	GREEN	GREEN
LETICIA	21.4	15.6	GREEN	GREEN	GREEN
MITU	-	26.8	GREEN	GREEN	GREEN
PUERTO CARRENO	5.2	6.4	GREEN	GREEN	GREEN

Source: DNP

Liquidity: interest payment/operational savingsl; solvency: debt/current revenue. Operational savings is defined as current

According to the *National Federation of Departments* (1999), the use of transfers as leverage for indebtedness (Law 85 of 1995) resulted in TE financing current expenditures with loans, and, in many cases, paying debt service with new credits. Debt service increasingly compromised all sources of revenue, since they had been used as collateral. Resources were turned over directly to financial institutions without even going through the government's "cashier."

As a result, regional governments postponed payments to contractors, employees and retirees, or relied on liquidity loans and overdrafts. These short run loans became recurrent and were not repaid during the year, as mandated. It is important to stress that these practices cannot get done without the connivance of the financial institutions.

In order to address the critical situation faced by the departments of Chocó, Nariño and Putumayo in 1995 the CG loaned them resources and, as a condition, each department had to sign performance agreements (PAs) with the Ministry of Finance. Since 1996 the Ministry has received an increasing flow of petitions of support and created the PASFFIET (Program of Support for Fiscal Reorganization and Institutional Development of TEs) to address them in a systematic way.

Decree 488 of 1999 relaxed some of the restrictions on extending credit due to difficulties faced in the signing of agreements under the PASFFIET, especially because of lack of interest on the part of financial intermediaries.[16] In particular, the weighting for entities with red light status decreased to 100 percent if an agreement with the Ministry of Finance, within the PASFFIET, was signed. If there is national guarantee, financial intermediaries are allowed to reduce the weighting by the percentage guaranteed by the Nation. This means that the central government assumes the new obligations; the legislation goes in the wrong direction and a moral hazard problem clearly emerges.

The indebtedness law has not been effective. Some entities with red light status have contracted new credits without permission of the MoF. Of the 21 departments that required permission for new loans in 1997, 10 apparently obtained new credit without permission from the Ministry and five other departments that were authorized entered into performance agreements that were impossible to comply with (Ministerio de Hacienda, 1999a). Departments presented defective financial information in order to circumvent the law, and the financial institutions engaged in only superficial analysis of the data. In addition, in some instances the Ministry of Finance gave authorization in cases when it should have been denied. "Drunk" regions, like drunk people, do not respect traffic lights.

[16] It has been argued that financial intermediaries did not believe in the diagnosis or the proposed solutions contained in the agreements.

PAs have also being signed with the Ministry of Finance, outside the PASSFIET. One agreement was signed between the department of Valle (which had the largest debt in 1997, 23 percent of the total debt of departments) and its creditors, with little CG involvement.

3. Regional Debt and the Financial System[17]

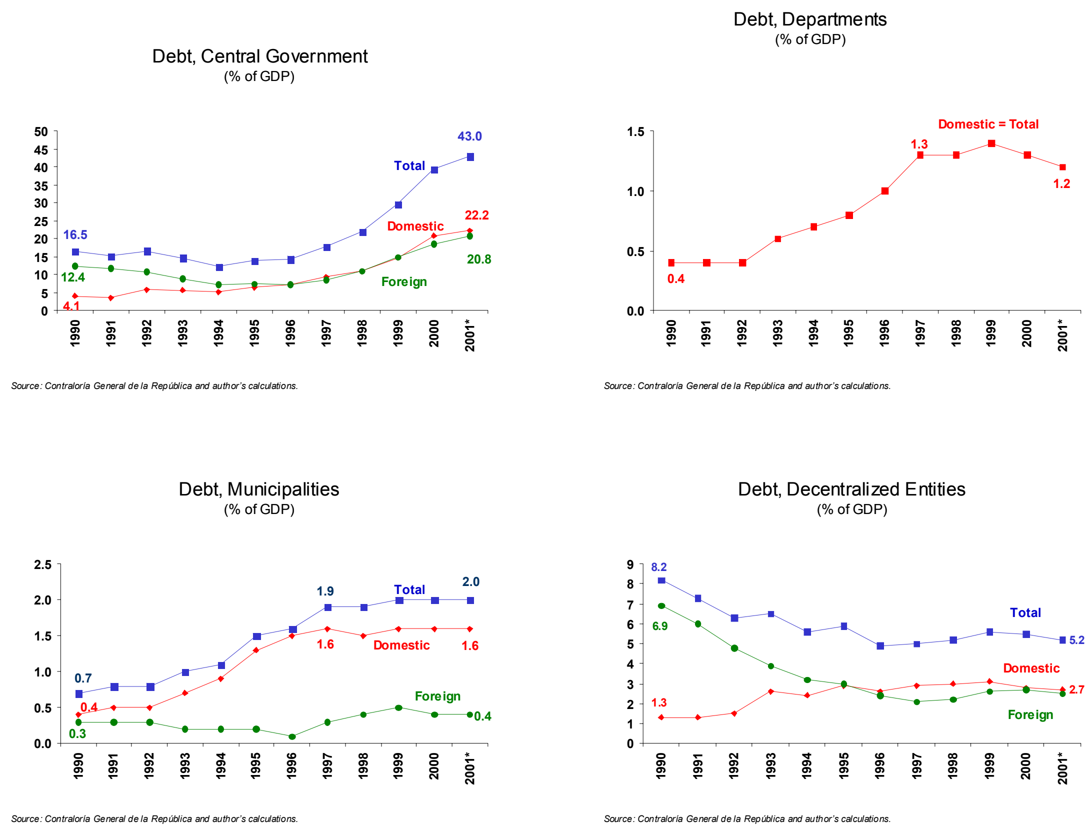
Figure 3 shows the evolution of domestic and foreign debt between 1990 and 2001 for the central government, the departments and municipalities, and for the other decentralized entities. CG's total debt exploded during the 1990s, from 16.5 percent of GDP in 1990 to 43 percent in 2001, to finance the huge gap described in Figure 1. Total debt for other decentralized entities[18] represented 5.2 percent of GDP in 2001, much more than for municipalities (2.0 percent of GDP) and departments (1.2 percent). It increased very fast for departments and municipalities between 1990 and 1997 but remained relatively stable after 1997. Debt fell smoothly during the 1990s for the decentralized entities, mainly due to the relative contraction of foreign debt.

Debt in constant col $ increased, between 1990 and 1997 at huge annual rates of 25 percent, 22 percent, 15 percent and 14 percent for municipalities, departments, the CG and other regional entities, respectively; the corresponding figures for 1990-2001 were 14 percent, 12 percent, 18 percent and 7 percent. The comparison shows the very large expansion of CG's debt after 1997 and the relative improvement for other regional entities.

The amount of foreign debt in 2001 was similar to domestic debt for the decentralized entities, while it has been nil for the departments and relatively small for the municipalities. More research is needed in the area, however, since the large amounts of debt originating in the regional pension system are not included.[19]

[17] This section is based on Asociación Bancaria (2000).
[18] Include mainly regional lotteries and social protection at the local level such as supervisory boards, assessors' offices, etc. See Figure 1b.
[19] Debt with "contratistas" is not included, either, but it seems to be relatively unimportant, representing close to 12 percent of total regional debt.

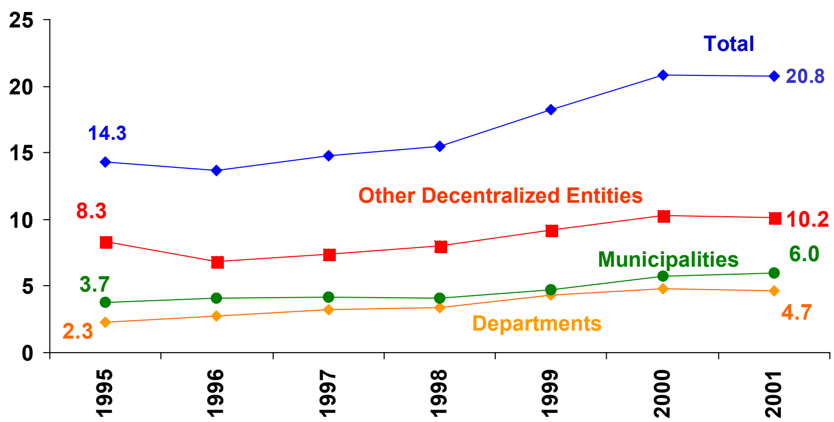
Figure 3. Domestic and Foreign Debt (% of GDP)



The financial system is still in a precarious situation (Arbeláez, Echavarría and Gaviria, 2002) and its exposure to TEs is one important factor. Figure 4 shows that the participation of regional loans (in the total loans of the Colombian financial system) increased from 14.3 percent in 1995 to 20.8 percent in 2001; the increase was equally shared by other regional entities (1.8 additional points), the departments (2.4 points) and the municipalities (2.2 points).

Finally, the quality of regional loans has been deteriorating fast—a cause of great concern. Thus, the relation between nonperforming loans and total loans jumped from 11.2 percent in 1998 to 60.6 percent in 2000 for the departments, and from 11 percent to 50 percent for the municipalities. A regional default could certainly hit the Colombian financial system. Nonperforming loans for the whole country moved from 13.1 percent in 1998 to 16.8 percent in 2000.

Figure 4. Banking Sector Loans to the TEs (regional loans/total loans, %)



Source: Contraloría General de la República and author's calculations.

4. Recent Developments: Some Relatively Good News

As noted in the previous section, the debt situation of the Tes has improved recently. Market discipline operated and banks simply stopped lending during the crisis of 1998-2000 (Arbeláez Echavarría and Gaviria, 2002), but recent measures also had a favorable impact. Some of them were motivated by the knowledge that a TE default with a private bank would end up being paid by the CG.

There have been important cuts in regional expenditures, increases in taxes, debt control measures and more fiscal responsibility in some of the reforms adopted in 2000-2002. In fact, oil and the fiscal adjustment of the TEs has allowed Colombia to reach the fiscal goals agreed upon with the IMF. Just as importantly, Colombia accepted the idea that regions are different, and they should have different relations with the CG during a "transition period."

Zapata, Acosta and Gonzáles (2001) present a detailed review of some of the most important recent legislation in the area, and we will only introduce here a brief summary of them:

Law 549 of 1999, which created FONPET (the national fund to cover the liabilities of the TEs), provides additional money from the CG and from the TEs to cover the pension system liabilities at the regional level. Most of the increase in transfers to the regions between 2000 and 2002 (Table 2), 20 percent of national royalties, and the resources from potential future privatizations will go to this fund.

Law 617 of 2000 creates limits to the current expenditures of the TEs and creates seven different categories of departments and municipalities. The small-poor municipalities and departments can spend 80 percent of their current income on operational expenditures (wages, interests and general expenditures), while the limit for large-rich TEs is 50 percent. Some public wages (mayor, Assembly member, etc.) vary among the seven categories, and there are limits to the size and growth of public wages in the TE.

The Legislative Act 012 of 2001 modified Articles 356 and 357 of the Constitution of 1991 and created the General System of Participations (*Sistema General de Participaciones*), which subsumes the old *Situado Fiscal,* the *FEC* and the municipal participations. It also delinks regional transfers from the CG's current income until 2008.[20]

Law 715 of 2001 improves the criteria used in Law 60 for regional expenditures in education and health. Thus, for example, transfers are now assigned according to the number of children enrolled at the schools for each TE, instead of the complicated previous rules for *Situado Fiscal* (Table 3) or the obscure or non-existent rules of FEC (Section 1.B.1). It was a politically sensitive issue opposed by FECODE, the powerful teacher's union. Nonetheless, it is clearly better to assign money for education based on the number of children covered than by the value of total wages for education in each TE.

The recent measures imply a return to the old principal-agent model, however, where the central government (the principal) designs policies, and local governments (the agent) execute them. Greater fiscal discipline is assured, but efficiency would suffer without accountability and autonomy at the local level. The debate will continue, of course, and some authors have proposed a radical change in the decentralization model in the opposite direction: regions should be totally free to choose the type of expenditures required, and regional debt should be prohibited (Alesina, Carrasquilla and Echavarría, 2000).[21]

---

[20] But real transfers should grow 2.5 percent per year between 2002 and 2004, and 2.0 percent between 2004 and 2008.

[21] Regions can only obtain some lending from the CG against next year transfers. Alesina's proposals also consider that taxes should be collected at the central level and returned to the regions according to GDP. Redistribution should be implemented via the creation of a special fund where the rich regions give money to poor regions.

3. Different Types of Bailouts

The previous section described the main elements of inter-governmental relations in Colombia and the main obstacles to imposing fiscal discipline on the TEs. At various times and through different mechanisms the territorial entities were bailed out, paying debt with new loans from the central government. This section will describe the circumstances under which the CG has extended bailouts, with the final objective of identifying the institutional framework that promoted them.

Three types of bailouts will be analyzed. Section 1.A will analyze the provision of loans by the CG to be used by the departments in their financial restructuring and the characteristics of the PA agreements (Type 1). Section 1.B[22] will consider the violation of the contract that settled the criteria for assigning transfers for financing school education (*Situado Fiscal*), and the expansion of the *Situado* by means of the Educational Compensation Fund (FEC); this is Type 2. Finally, the specific case of the Medellin Metro will be considered in Section 1.C.

In the first case (PAs), the CG implemented a restructuring program by conditioning the TE's access to new loans to the signing of performance agreements (PAs). As explained in Section I.D, the credit contracts have not been enforced, and some departments have signed more than one agreement when the first was violated and financial conditions have worsened.

The second case involves the expansion of the *Situado Fiscal* by means of the *Educational Compensation Fund* (FEC). Since the Constitution of 1991, the *Situado Fiscal* has financed access to preschool and basic education (primary and secondary up to ninth grade), and it has been shown that it should be possible to finance almost all the educational needs with the money from the *Situado* (Vargas and Sarmiento, 1997).

However, an agreement signed between the CG and the teacher's union in 1995 created another fund (the Educational Compensation Fund, or FEC) to finance a "deficit of *Situado*" and some additional education expenditures by departments and municipalities. In its first year, 1996, the FEC represented 7.5 percent of the *Situado*, and 31.7 percent in 1998. The CG recently announced the elimination of the FEC, but this idea lasted only weeks, and the Nation is currently trying to negotiate with the departments the allocation of FEC resources subject to the

[22] Limitations of information prevented the analysis of another bailout experience: CG's involvement in secondary and tertiary road systems. The Law states that these items should strictly be a TE responsibility

signing of new PAs. Neither the CG nor the departments, have the backing of the main force, the national teacher's union (FECODE).

The final case involves the rail system built in Medellin. The project could not be defended on technical grounds, but the government justified its undertaking on the basis of highly doubtful externalities and as the instrument for the economic recovery of Antioquia. President Betancur, born in the region, was the project's main supporter. The project was virtually bankrupt at the end of the 1980s, when the Nation started servicing the train's foreign debt, and the region has recurrently defaulted on payments.

All three cases of bailouts started as ad hoc interventions by the CG to support a TE in crisis. They became common practice in a very short time, increasing in size, and the CG was unable to enforce a commitment to its announced policies. A trade-off took place between beneficial short-run interventions and long-run reputation and incentives (Wildasin, 1997).

The paper also discusses a number of determinants of Bailout Types 1 and 2 in Colombia. Possibilities include the characteristics of the tax base, political considerations and institutional arrangements.

A. Bailout Type 1: Restructuring Central Government Loans To Departments

1. Early Experiences and PAs[23]

In 1995 the CG launched a program to assist Chocó, Putumayo and Nariño, three departments with structural fiscal deficits and negative current savings. The idea was to give them soft credits and technical assistance to achieve a healthy financial situation. The recovery was to be attained by following the conditions agreed upon on in the Performance Agreements (PA) that each of them should sign.

Table 8. Indicators for Chocó, Nariño and Putumayo

	CHOCO	NARIÑO	PUTUMAYO
Loan in millions of pesos	3,000	2,860	3,200
Loan in millions of dollars	3.3	3.1	3.5
Date of PA	Jul-95	Sep-95	Jul-95
Loan / Department's Current Revenue	77%	24%	74%
Population	363,438	1,192,515	237,166
Per capita GDP (% of National per capita)	28.33%	43.76%	16.98%
Per capita current revenue (% of National per capita)	34.33%	32.63%	58.82%
Per capita general expenditure (% of National per capita)	82.10%	73.90%	163.40%
Current Savings / Current Revenues %	5.5	-14.4	-16.5

Source: Gutiérrez, 1996.

[23] This section includes information from Gutiérrez (1996) and from PAs signed by the TEs.

The loans were large, especially in the case of Chocó and Putumayo, representing 77 percent and 74 percent, respectively of their 1994 current revenue (Table 8). The three departments were small, meagerly populated, and with per capita GDP and revenue collection well below the national average; the per capita GDP of Chocó and Nariño amounted to a third of the national average. In the case of Putumayo, a department highly dependent on oil royalties, the share of income from taxes was only a quarter of the national average. These limitations in terms of income were not mirrored by their expenditures: per capita general expenditures were close to the average in Chocó and Nariño, and 60 percent higher in the case of Putumayo. All three had negative current savings. Table 9 shows the main loans made to each of the three departments in 1995-1998.

Table 9. Indicators for Chocó, Nariño and Putumayo

DEPARTMENT	DATE	U$ MILLIONS
CHOCO	Jul-95	3.3
CHOCO Amendment No.1	Dec-95	0.0
CHOCO Amendment No.2	Dec-96	1.1
CHOCO Amendment No.3	Nov-98	3.5
CHOCO TOTAL		**7.9**
NARIÑO	Sep-95	3.1
NARIÑO	Oct-98	2.4
NARIÑO TOTAL		**5.5**
PUTUMAYO	Jul-95	3.5
PUTUMAYO Amendment No.1	Dec-96	1.0
PUTUMAYO Amendment No.2	Dec-97	1.1
PUTUMAYO Amendment No.3	Jul-98	2.3
PUTUMAYO TOTAL		**7.8**
TOTAL 3 CASES		**21.2**

Source: PA and authors calculations.

Chocó. The department complied with most of the conditions imposed in the first PA[24] on the revenue side but not on expenditure reduction. The removal of personnel was timid, the salaries of the departmental assembly members kept rising and the budget that was approved implied only a 30 percent reduction in expenditures, despite the fact that the PA asked for a reduction of 60 percent. The figure is high, but not excessive, given the very irresponsible behavior of the department at the time. Wages paid to deputies were larger than in most other regions in the country, and the number of pensioners kept rising through time. The magnitude of the adjustment required today in other departments (e.g., Valle Department, in Section 1.A.4) is relatively similar.

The second PA was designed to finance personnel reduction but the accumulation of obligations with employees and retired personnel, the weakening (once again) of the tax base and legal problems, caused a critical situation. Again, the third loan mentioned the reduction of personnel and the rationalization of expenditures.

Nariño. The reduction of personnel attained after signing the first PA was aggressive, very expensive (due to the existence of an onerous labor contract) and insufficient for the financial constraints involved. Tax revenue declined in real terms, the burden of retirees and teachers kept draining limited resources, and the level of indebtedness almost doubled between 1996 and 1997.

Putumayo. Although important reductions in personnel took place and there was compliance with the tax goals set in the PA, the obligations with retirees, wage increases, and higher costs at the Departmental Assembly and the Department's fiscal control office (*Contraloría*), new legal demands and a reduction in royalties, did not permit a healthy financial situation. The second and third loans were directed at further reducing personnel, at limiting wage increases and special privileges for assembly members, the Governor and upper level managers.

The PAs signed with Chocó, Nariño and Putumayo have not worked as expected. Debt has increased and the financial situation has worsened, despite some personnel reductions personnel and tax increases. In fact, the CG has often been forced to commit additional resources to these TEs after the PAs have been signed. Table 9 shows that the CG signed two additional PAs with Chocó (for a total of US$ 7.9 million), one with Nariño (for US$ 5.5 million) and three with Putumayo (for a total of US$ 7.8 million). All told, the CG provided $21.2 million in 1995-98 to three departments that are currently continuing to face an extremely difficult financial situation.

---

[24] Revision and verification of the payable accounts and legal procedures against the Department, refinancing of debt, compliance with measures designed to increase own revenues, and administrative restructuring.

The critical situation in Chocó resulted from a combination of weak growth in current revenue—as a result of a sharp decrease in tax income, not compensated by increases in transfers from the CG—and a rapid increase in debt service and operating expenditures. Between 1992 and 1994 Nariño's current expenditures were greater than its revenues (i.e., negative current savings). Fiscal deficits and debt rollover became the norm, and the department was forced to obtain new loans in order to pay its employees. In 1995 Putumayo had a very large fiscal deficit (the current deficit represented almost 40 percent of current income, and the total deficit 23 percent of total income), mainly as a result of a sharp reduction in royalties. By contrast, there was a significant increase in operating expenditure (due to a large number of new employees) and in interest payments.

There is a special division in the Ministry of Finance (DAF, for División de Apoyo Fiscal or Fiscal Support Division)[25] to deal with TEs and with the signing of PAs but the control and evaluation of PAs has been extremely complicated, disorganized and inefficient. There has been widespread fiscal indiscipline at the regional level and the TE may even be providing untimely and unreliable information as a strategic behavior to drive a bailout.[26] The DAF was supposed to follow and execute loans, but it was never given wide supervision and control powers. It could also be a bad idea to have the DAF inside the Ministry of Finances, both "controlling" and giving the money to the TEs.

The conditions imposed by the PA's were weak, implied no real penalty in case of lack of compliance, and the financial situation of the three departments continues to be critical. PAs were used to circumvent short run liquidity problems without solving structural imbalances. It is politically difficult and costly to lay off a large number of employees, particularly when the regional Assemblies are weak, when compensation costs and the probability of future legal demands are high. Restructuring loans has become pervasive, perverse incentives are being created, and a "bailout" situation has emerged. A moral hazard situation has clearly developed and the CG is always expected to grant further bailouts.

[25] Another division at the MoF (Public Credit, *División de Crédito Público*) also deals with TEs and PAs.

[26] We could not easily collect the information needed and total reliability is not always guaranteed. The information is not totally reliable since there is almost no systematic program of inspection and collection (BID, 1998; see also Section 1.D. above). Some regions can partially manipulate information for their own benefit and remain in the yellow light (see Section I.D.2). The information on flows is much more reliable than the information on stocks, and few regions include pension liabilities in their calculations of debt. It is easy to get information on an individual PA

2. The PASFFIET and other PAs

The financial situation of territorial entities was in deficit but seemed sustainable until 1995, with TEs being able to cover their operational expenditures and generate some savings and investment. Things began to deteriorate at a rapid pace after 1996, however, especially for the departments, with lower savings and increasing debt financing larger investments. The situation became critical in 1997, as most departments started to show negative current savings to rely on loans to pay wages, other general expenditure and interests, and to delay payments to employees, contractors and retirees.

The causes of the recent crisis are both exogenous and endogenous (Ministerio de Hacienda, 1999a). The exogenous factors are lower aggregate growth (and consequently lower current revenue for the CG and lower transfers to the TEs), extremely high interest rates,[27] and the inelastic nature of tax revenue at the departmental level. The endogenous factors include inefficient and inadequate tax administration (no classification of taxpayers, no follow-up of their accounts and lack of systematization); large increases in operating expenditures; a mismatch between employees' skills and their functions; lack of discipline in bureaucratic assemblies and control offices; a very complex problem with retirees; and unsustainable levels of debt.

The PAs were originally designed to control TE's debt, without too much involvement by the CG, but this only happened in the case of the Valle's agreement (Section 1.A.4). The CG has become the main sponsor of the program in the other cases, helping in the design of the PA and its conditions, weakening the restrictions imposed by the PASFFIET on the financial institutions, and serving as guarantor to PASFFIET's credits. The scope of the CG became larger once new fiscal and administrative conditions were established to regain access to credit. Some new loans have been directed to finance personnel laid-offs, administration and financial restructuring.[28]

There are two clearly defined sources for funding the performance agreements: those coming from the PASFFIET, and those coming directly from the national budget. However, there is a third, very irregular source, the short-term *créditos de tesorería:* supposedly they

---

but it is difficult to obtain the consolidated information for Colombia, and not much information is available in magnetic files.

[27] Real interest rates jumped from 3 percent to 19 percent between January and December, 1998, the largest in Latin America after Brazil.

should be repaid during the fiscal period, but they soon became long-term debt.[29] Table A.2 shows the composition of the credits approved in the period 1997-1999 and the corresponding type of financing.

Regions in financial trouble preferred new money through a PA or from *Dirección de Crédito Público* because PASFFIET's loans came under stricter conditions from the international agencies supporting the program, and the devaluation risk had to be assumed by the TEs. They also knew that a bailout was a real possibility under a PA but not under the PASSFIET. Some regions used the PASSFIET at the beginning but ended up signing a PA when they could not fulfill their obligations, and some small regions like Chocó simply did not have the administrative capacity to use the PASSFIET.

As of February 1999, 15 out of 32 departments have received loans from the CG (US$ 115.7 million) under the PASFFIET or under other mechanisms, directed towards the restructuring of their administrative, financial and fiscal structure. Under the PASFFIET umbrella, eight departments have signed PAs, while the other seven have signed them with the *Dirección de Crédito Público* of the MoF.[30] There were 13 additional requests in the CG's waiting list.

Table 10 provides information on the departments that have signed PAs. The "need" for additional financial resources increased dramatically in 1997 and 1998, and the CG provided almost US$100 million to 12 departments. The relative size of the loans varied significantly, from a minimum of 2.7 percent of current income in the case of Meta to 70.7 percent in Guajira. Out of the 15 departments that have received a "bailout" from the CG, five—Chocó, Cauca, Guajira, Nariño and Putumayo—have signed more than one PA, basically because the initial loans did not improve the financial situation.

[28] It is important to stress that the vast majority of resources are directed towards the financing of the retirement of personnel. The technical assistance component is very small.
[29] Short-term credits can be converted into long term in Law 488 of 1998.
[30] Caquetá, Bolívar, Huila, Cauca, Cesar, Magdalena, Meta and Norte de Santander.

Table 10. Indicators for Chocó, Nariño and Putumayo

DEPARTMENT	1995	1996	1997	1998	TOTAL U$	PA/CURRENT REV
ATLÁNTICO			5,565		5,565	5.70%
BOLÍVAR				6,193	6,193	19.80%
CAQUETÁ			4,638		4,638	58.20%
CAUCA				12,310	12,310	27.00%
CESAR			3,782		3,782	25.20%
CHOCÓ	3,288	1,061		3,505	7,854	57.70%
GUAJIRA		5,875			5,875	70.70%
HUILA				12,741	12,741	46.10%
MAGDALENA				6,846	6,846	43.40%
META			1,314		1,314	2.70%
NARIÑO	3,134			2,384	5,518	11.80%
NORTE DE SANTANDER		1,929			1,929	8.10%
PUTUMAYO	3,507	965	1,052	2,314	7,838	31.50%
TOLIMA			8,796		8,796	10.20%
VALLE DEL CAUCA			24,537		24,537	7.50%
TOTAL					115,736	14.15%

Source: Own calculations based on PA from DAF and Crédito Público, MoF.

Conditions have not changed much in 1995-98: 13 out of 15 cases considered in Table A. **3** presented deficits when the agreements were signed; 14 reported accelerating expenditures (11 with large increases in personnel costs); and 11 mentioned insufficient revenues. Twelve departments reported large debts and debt service. Reduction of CG transfers and royalties were mentioned as causes of the crises.

In addition, the treasury "lent" short-term money to the Departments (and to some municipalities) to be repaid during the same fiscal year, but it was not, and the amount of money involved increased. The very "unorthodox" Law 488 of 1999 allowed short-term loans to be converted into long-term loans guaranteed by the central government and bailouts surged. The only requirement was to sign a PA, but the next section will show that PAs did not discipline the TEs.

3. Did PAs Work?

Was the CG able to discipline the regions with the conditions imposed in the PAs? The preliminary information suggests otherwise (as noted above and in Table A. **3**) but this central issue clearly merits further exploration. Table 11 shows the evolution of three proxies of fiscal discipline for the group of departments that signed PAs in 1995, 1996 or 1997 (with information considered for 1993-98).

The median value of taxes/(taxes+transfers) in column (1) was 0.71 before 1995 (1994 and 1995), and 0.33 after 1995 (1996-1998). Fiscal effort decreased since the relation between those two numbers is 0.46 in column (3). The table also indicates that the two medians are statistically different at the 1 percent level of significance.[31] Similar reductions are shown for those PAs signed up to 1996 and up to 1997. The results for the other two variables show that expenditures did not decrease after the signing of the PA since the differences are not statistically significant.[32]

Table 11. Impact of PAs on Fiscal Discipline, 1993-1998
(median after the PA/median before the PA)

PAs signed on:	1995			1996			1997		
	Before (1)	After (2)	Relation (3) (2)/(1)	Before (4)	After (5)	Relation (6) (4)/(3)	Before (7)	After (8)	Relation (9) (5)/(6)
# of Pas signed		3			5			11	
Taxes/(Taxes+Transfers)	0.71	0.33	**0.46** (19.06)***	0.63	0.31	**0.49** (3.30)**	0.64	0.10	**0.15** (9.96)***
Expenditure/(Taxes+Transfers)	1.39	1.50	**1.08** (1.54)	2.27	3.00	**1.32** (-0.21)	1.98	2.00	**1.01** (-0.38)
Expenditure/(Taxes+Transfers+Royalties)	1.39	1.00	**0.72** (4.07*)	1.41	1.00	**0.71** (-0.48)	1.34	1.00	**0.75** (-0.50)

Statistics in parenthesis correspond to t values for the difference of means; ***: significant at 1% level; **:5%; *: 10% level
1995 (3): Chocó, Nariño and Putumayo; 1996 (4): Choco, La Guajira, Norte de Santander, Putumayo; 1997 (7): Atlántico, Caqueta, Cesar, Meta, Putumayo, Tolima, Valle; 1998 (8): Atlántico, Cauca, Choco, Huila, Magdalena, Nariño, Putumayo, Valle.

The results of the previous section only considered those departments that signed PAs, but the trends observed could have been common to all departments (with and without PAs). Table 12 compares the behavior of departments signing PAs with "non-Pas."[33] The results confirm our previous conclusions, since departments with PAs behaved worse than those without PAs: taxes decreased more in the three years considered, and expenditures increased more in 1996 and 1997.[34]

On the whole, a perverse story seems to emerge. Transfers from the central government created structural expenditure pressures, and irresponsible behavior in terms of debt (mainly loans from the banks) brought the departments into default and forced the central government to bail them out. Not only that, but, more importantly, the PAs did not work. On the contrary, taxes decreased and expenditures did not fall in relative terms. The empirical results of this section confirm our previous intuition of important deficiencies in the PA's program: they were

[31] Formally, the test is for the difference between the two means.
[32] We obtained similar results when comparing those departments signing the PA in that year (instead of up to that year) with those not signing it.
[33] Numbers for PAs are close (relations between averages instead of medians) to those of columns (3), (6) and (9) of the previous Table.

implemented ad-hoc, and the rules of the game were not changed for the newcomers. The program increased its size and scope without the required modifications.

Table 12. Impact of Performance Agreements, PAs vs. No PAs (average after/average before)

	1995		1996		1997	
	Pas	No Pas	Pas	No Pas	Pas	No Pas
Taxes/(Taxes+Transfers)	0.48	0.71	0.56	0.60	0.23	0.49
Expenditure/(Taxes+Transfers)	0.71	1.00	1.22	0.98	1.13	0.94
Expenditure/(Taxes+Transfers+Royalties)	0.72	1.05	1.24	1.04	1.15	0.92

Figures for Pas are close (relation between averages instead of medians) to those of columns (3), (6) and (9) in the previous Table

4. *The Case of the Department of Valle*

Valle, the most indebted department, signed a PA with the Nation in December 1997 as a previous step before getting new loans. The new obligations were not fulfilled, however, and a new PA was signed with the banks in September 1998, without too much government involvement. This makes it a special case because the 23 financial institutions involved (eight of them accounting for 70 percent of total debt), and not the CG, imposed the obligations. The agreement's aim was to refinance debt with the financial system, reduce the level of indebtedness to sustainable levels, and recover the financial viability of the Department.

It is important to describe the conditions imposed by the financial institutions to Valle, and compare them with the other agreements involving the Nation:

- Valle was forced to contract an irrevocable trust deposit with a fiduciary society that will administer the resources involved. The society will transfer to the Department resources to pay personnel and other general expenditures, and the other responsibilities in force by the date of the agreement. The fiduciary will expeditiously cancel the debt service.
- The Department was forced to contract an irrevocable trust deposit with a fiduciary society, which will value, administer and sell shares owned by the Department in the areas of energy and ports.[35]

---

[34] More research is needed in this area, however, since the poor record of the regions signing PAs could be associated with poor growth in the following years, or with other exogenous variables that hit taxes.

[35] The *Empresa de Energía del Pacífico S.A.* (EPSA) and in the *Sociedad Portuaria Regional de* Buenaventura*, S.A.* If the product of the sale of the shares to be given to the financial institutions is lower than col $120 billion, the Department is forced to provide alternatives to complete this amount and be able to credit it to the debt balance.

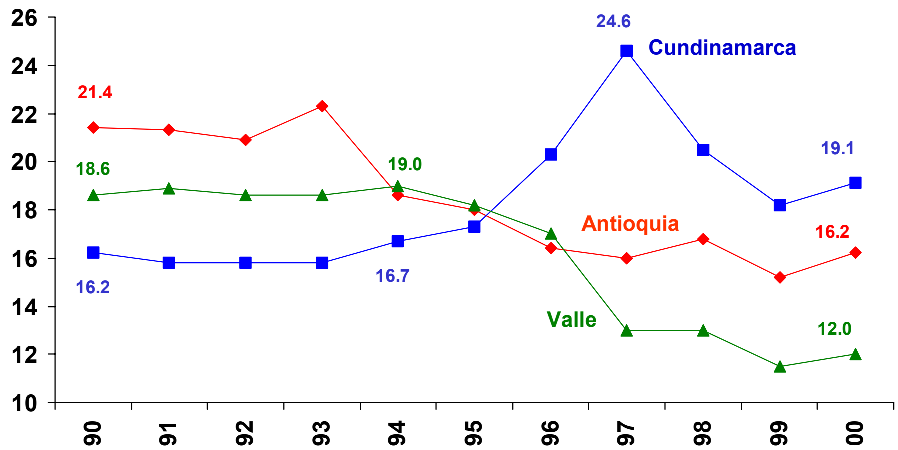
- Before signing the PA the Department needed an authorization to reprogram and refinance short-term loans, and to increase its level of debt, to pay interests overdue, short-term credits, and the interests generated in the period.
- Personnel and other current expenditures not covered by the *Situado Fiscal*[36] should be cut by at least 5 percent in real terms during 1999 and 2000. The (mandatory) increments in current revenue should be firstly directed to honor the debt service. The department can freely allocate 50 percent of the additional revenue only when the annual real increments are larger than 2.5 percent.

In general terms, this PA improves the debt profile: the amortization period increases and the interest rates decrease. Should one of the non-fulfillment clauses occur, the financial institutions can declare the total amount of the debt, the restructured debt, the interests and other obligations as under non-fulfillment and therefore as immediately due.

It is still difficult to predict the final outcome of the agreement, but the preliminary evidence is not very encouraging. The department has barely fulfilled its obligations, and has not been able to show a good record in terms of taxes. Thus, as shown in Figure 5, the participation of Valle in total departmental taxes remained relatively constant in 1990-94 but has been falling since that year. The pattern observed for Valle is much worse than for Antioquia or Cundinamarca, the other two large departments in Colombia. The preliminary evidence on current expenditures is not encouraging, either.

[36] Expenditures cannot grow in real terms after year 2001.

Figure 5. Valle, Cundinamarca and Antioquia
(taxes in each department/total departmental taxes, %)



Source: Contraloría General de la República, DAF and author's calculations

5. Conclusions on the Disciplining Effects of PAs

Despite the fact that the indebtedness law specifies that the agreements should be signed with financial institutions, the Ministry of Finance has actively pursued the signing of agreements with the nation. Under this scheme, the nation diminishes the responsibilities of the financial sector. In the words of the Contraloría General de la República (1997, p. 112) "Law *358* and the performance agreements are instruments that continue with the paternalistic tradition of helping bad administrators of local finances."

Only the Department of Valle has signed an agreement directly with its debtors, which differs radically from those signed with the Nation, the basic criteria behind it being the recuperation of loans by the financial institutions. Issues such as modifying the organizational structure of the department, diminishing its personnel plant and other adjustments are implicit in the agreement.

The two main actors—the CG via the Ministry of Finance, and the Departments through their National Federation—agree that the indebtedness law has been violated and, therefore, does not really act as a restriction. Also, they note that the ratio assessing the liquidity of the TE only includes payment of interest, excluding amortization, thereby undervaluing the debt service that for which the TE is responsible.

As shown in the last section, PAs did not produce the expected disciplining results and the intervention of the CG instead tended to promote misbehavior by the departments. The CG was considered a potential source of finance and a good partner in the negotiations with the financial sector. In short, the central government clearly bailed out the Colombian regions. The mechanism has become perverse: wrong incentives are being created, a moral hazard situation is clearly emerging, and a further softening of the TE budget constraint has developed. The PA signed with the department of Valle has not shown the expected results either.

A very perverse history in the area of PAs emerges. The new resources offered by the central government (transfers and co-financing) and the banks (debt) allowed the (mainly poor) departments to reduce fiscal effort with predictable consequences. The system was originally designed in an ad-hoc manner, to solve the problems of 3 or 4 small departments, but no important modifications on the rules of the game were introduced when latecomers joined the club.

6. Quantitative Analysis of the Determinants of Type 1 "Bailouts" (Performance Agreements)

The characteristics of the tax base, political considerations and institutional arrangements should matter when looking at the determinants of bailouts. To start with, bailouts may be less likely when local governments have a robust tax base, generate a large part of their revenue (vertical balance), have autonomy for modifying the tax base (more flexibility on the tax bases and on rates) or when expenditure responsibilities are less widespread.

The causality is less clear when political considerations are taken into account. Thus, bailouts may be larger or more likely when the lower level government belongs to the same political party as the higher level government, but it must also be recognized that bailouts could be extended in exchange for a favorable vote in Congress from the opposition, and mainly when party discipline is weak, when the political system is unstable, when reelection is not allowed, and when elections are close. Obviously, bailouts should be more likely when the local crisis can be partly traced to actions undertaken by the central government (e.g., education in Colombia, as will be discussed below).

Finally, institutional arrangements matter and bailouts could be more likely when the Constitution stipulates a mandatory rescue, when there are no debt limits for local entities (as is the case in the United States), when there are local banks owned by the states (as in Brazil) and when transfers can be used as guarantees.[37]

This section attempts to include some of these variables in our empirical analysis of the determinants of PAs in Colombia. A probit regression analysis is used to predict the probability of a department's signing a PA in 1995-1998. Table 13 considers some of the variables potentially relevant in the explanation of the bailouts, classified under 6 categories: vertical imbalance and dependence, debt, poverty, political, violence and size.

Five proxies were used for vertical unbalance and dependence: the three variables considered in Table 11, per capita transfers and cofinancing; two proxies for poverty, GDP per capita and unsatisfied basic needs; and two proxies for size, GDP and population. For the political category a dummy variable was used with a value of 1 when there was a Liberal governor in that department in any of the years of the period 1994-1998; and for violence used the rate of criminal activities was used. The average of each variable in 1994-98 was used when the variables were not dummy variables.

[37] See IDB (1998).

Table 13. Variables Potentially Relevant in the Determination of a PA

Type or Variable	Variable
Vertical unbalance and dependence	
	Taxes/(Taxes+Transfers) Expenditures/(Taxes+Transfers) Expenditures/(Taxes+Transfers+Royalties) Per capita transfers Co-financing Funds per capita
Debt	Debt per capita
Poverty	Per capita GDP % of population with unsatisfied basic needs
Political	Political Party of Governor
Violence	Rate of criminal activities per 10000 people
Size	GDP Population

Table 14 shows the results of the probit regressions. The coefficients in parentheses correspond to the t statistic (white) adjusted for heteroskedasticity. The number of observations is 23, since there is no information on some key variables (i.e., GDP per capita) for 9 of them. The dependent variable takes a value of 1 when a PA was signed by that department during the period 1994-97 and 0 otherwise.

Column (1) presents the "basic" model and shows that the likelihood of signing a PA increases with debt and poverty (GDP per capita), and decreases with fiscal effort (taxes/taxes+transfers). A PA is also less likely when the governor of the department belongs to the political party of the President (liberal in those years). All the coefficients are significant at the 1 percent level, and the R^2 of 0.66 is acceptable for a cross section exercise. The analysis of possible outliers (not shown) suggests that the results are relatively consistent for all the departments except Chocó, but results are robust to the exclusion of Chocó.

Columns (2) –(4) consider different indicators of vertical unbalance and dependence. Comparison with the *basic model* suggests that taxes are a better measure of fiscal effort than expenditures.[38] Transfers per capita are significant at the 5 percent level and have the correct sign, but only when we exclude our "best" index of fiscal effort in the basic model. The inclusion

[38] We considered Expenditures/(Taxes+Transfers+Royalties), but the results do not change for Expenditures/(Taxes+Transfers).

of cofinancing per capita (not shown), unsatisfied basic needs (the second proxy for poverty), and the two proxies for size (GDP and population) do not add to the explanatory power of the independent variables.

The results of column (6) suggest that those departments suffering more violence are likely to get involved into PAs, though the significance of debt disappears. The R^2 increases to 0.78 and "violence" could also have been included in the *basic model* of column (1).[39]

Table 14. Determinants of PAs, PROBIT Regressions

Dependent Variable: PA (1 or 0)	Basic	Fiscal Effort and dependence			Poverty	Violence	Size	
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
FISCAL EFFORT AND DEPENDENCE								
Taxes/(Taxes+Transfers)	-15.75			-16.94	-15.42	-22.73	-14.56	-15.65
	-(2.68)***			-(3.00)***	-(2.41)***	-(5.06)***	-(2.38)***	-(2.48)***
Expenditures/(Taxes+Transfers+Royalties)		-0.89						
		-(0.99)						
Per-Capita Transfers			82.01	-35.82				
			(1.95)**	-(0.74)				
DEBT (stock)								
Debt per capita	249.95	112.35	219.04	200.51	247.27	79.32	237.02	248.84
	(2.19)**	(2.42)***	(2.41)***	(1.80)*	(2.15)**	(1.28)	(2.36)***	(2.21)**
WEALTH OR POVERTY								
GDP per capita	-7.47	-3.75	-7.42	-5.64	-7.41	-5.53	-6.74	-7.43
	-(2.42)***	-(3.22)***	-(2.74)***	-(1.56)	-(2.42)***	-(3.53)***	-(2.27)***	-(2.46)***
% of Population with Unsatisfied basic needs					-1.67E-07			
					-(0.14)			
POLITICAL								
Liberal Governor between 1994 and 1998	-4.13	-1.24	-2.21	-3.56	-4.07	-8.99	-4.08	-4.12
	-(2.43)***	-(1.80)*	-(2.08)**	-(2.30)***	-(2.25)***	-(4.42)***	-(2.54)***	-(2.40)***
VIOLENCE								
Rate of Criminal activities per 10000 people						12.96		
SIZE						(2.76)***		
GDP							-3.40E-07	
							-(0.51)	
Population								-2.73E-08
								-(0.03)
Observations	23	23	23	23	23	23	23	23
(Pseudo) R2	0.66	0.37	0.50	0.66	0.66	0.78	0.61	0.66

Probit regressions in all cases for 32 departments; averages for 1994-98; White correction for heteroscedasticity in all cases. Numbers in parenthesis correspond to the (asymptotic) t t ***: 1% level of significance, **: 5%; *: 10%; results for the constant not reported

Fortunately, some of the three significant variables can be targeted as policy instruments, and can be modified in order to improve the institutional arrangement of decentralization in Colombia. Fiscal effort should be promoted and special incentives could be designed to increase the collection of higher taxes in the regions. Transfers have increased drastically during the 1990s, as ordered by the Constitution of 1991, but they are under heavy discussion. Our empirical exercise suggests that large transfers distort local finances and increases the probability of PAs and trouble, and there are some suggestions on how to rationalize them (Alesina, Carrasquilla and Echavarría, 2000).

[39] Most of our previous results remain when *violence* is included in the other regressions of the table, with both violence and debt remaining significant in some of them.

Cofinancing funds have not worked properly (*Coyuntura Económica*, 1998) and they could represent an alternative form of bailout, a way to provide additional funds to certain jurisdictions, which then have less need for PAs. But that variable did not result significant in our previous analysis, and the amounts involved are small when compared with other types of transfers.

Debt limits should be implemented. They restrict the amount of (future) resources transferred by the CG, promote fiscal discipline, and reduce the probability of bailouts. GDP per capita-poverty comes out as a significant variable in our results, and this suggests that special policies should be designed for the group of poor departments. They simply do not have the infrastructure needed to run a modern and efficient public administration.

Violence does not only affect growth directly through its impact on investment and productivity, but also indirectly through its effect on public policy and administration (Arbeláez, Echavarría and Gaviria, 2001). Investing in the reduction of violence is the most important economic "project" the country can undertake. No wonder that departments with high indexes of violence are also more likely to behave badly and end up signing PAs.

B. Bailout Type 2: The Educational Compensation Fund (FEC)

The second type of bailout considered in the paper is related to the provision and financing of pre-school, elementary and secondary education in Colombia. The Constitution of 1991 and *Law 60* of 1993 partially regulated the assignment of resources and responsibilities among levels of government, and provided the legal framework for education financing.

1. The Situado Fiscal and the FEC

The Constitution (Article 67) defines education as mandatory for children between 5 and 15 years of age, covering at least one year of pre-school and nine of basic education (five of elementary and four of secondary). The constitutional responsibility of the CG and the TE remains vague, however, claiming that education should be free in state institutions, but also that those who can pay should do so.

Article 356 states that the *Situado Fiscal* should be directed towards financing pre-school, primary and secondary education, and health services. Law 60 regulated this article, defined the *Situado* as the main instrument for financing education, and established the percentage of CG's current income that would be transferred to the departments, the Capital District (Bogotá) and four special districts, and the sectoral and regional distribution of the resources.

Out of 290,000 public sector teachers, 220,000 are paid through the *Situado*. The rest are financed through the *co-financing* system (around 15,000 teachers), municipal participations (that were intended to finance infrastructure investment and better quality), own resources, and (recently) the *Education Compensation Fund* (FEC; see Section I.C.3)

There are several deficiencies in the Assignment of the Educational Resources through the *Situado:*

- Confusion. There is no clear definition of responsibilities among levels of government, and fragmented functions generate confusion and disorganization.
- Inefficiency. There are no incentives for the organizations to operate efficiently (Duarte, 1997): the departments do not have incentives to rationalize or reduce the number of teachers on the payroll, since they perceive that the CG pays for these inefficiencies, and they hire teachers under the (correct) assumption that the CG will end up paying their salaries if they run out of resources.[40] Soft budget constraints are the best environment for FECODE, the national teacher's union, to operate (see below).
- Managerial and administrative problems. Lack of confident and timely information, and the politicization of the sector have resulted in continuous and growing demands for resources. There is no information on key variables such as the number and type of teachers at the national, departmental or municipal level, on the number of students or potential children to be covered.
- Inequity. The formulae for resource allocation in terms of sectoral distribution (education, health and other services) does not take into account the particular needs of different regions, generating local excesses or lack of resources in health and/or education.

[40] There is an additional ingredient that increases the pressure faced by the CG. The largest union is the teachers union, FECODE. It includes all national teachers and around 220,000 and 70,000 departmental and municipal teachers, respectively. When one TE stops payment of wages to the teachers under its responsibility, the union announces that the "Government" is not fulfilling its responsibilities. It calls for a strike, and all public school teachers comply.

The formula for the distribution of the *Situado* for public education is based primarily on the number of teachers assigned to each region in 1993. This arrangement, which originally motivated regions to accept the new decentralization scheme, helped to perpetuate the distortions, inefficiencies and inequities existent in relation to the regional distribution of teachers and thus, of education resources (Duarte, 1997). The present model is based on the costs of the system, not on results, as there is no assignment on a per capita or per alumni basis.

2. Some Background on FECODE

Some background on FECODE could be useful. The Colombian Federation of Teachers (FECODE) assembles all employees working in public education, at most levels of schooling, and has become one of the few labor organizations in Colombia able to exert real pressure on the central government. The average period in power of the Minister of Education in Colombia during the last decade has been less than one year, and that defines very well who gains in a negotiation generally marked by strong confrontation. FECODE's demands are most of the time related to wage increases (the quality of education or related issues generally being absent from the negotiations) and results have been impressive.

In 1995 the government offered col \$ 300 billion for the educational sector, 30 percent of them related to "incentives," but after the strike of that year FECODE got col \$ 800 billion and only 18 percent for "incentives"; most of it went to wage increases. Nominal wages for teachers in the public sector have increased 8 percent faster than for the rest of the public sector year after year in 1996-98. In 1996 teacher's wages increased 25 percent, compared to 15.5-19.5 percent for public employees; figures for 1997 and 1998 are 21.5 percent vs. 13.5 percent and 24 percent vs. 16 percent, respectively.

In 1997 FECODE and the CG negotiated the construction of five new recreational centers in five departments, for the use of educators and their families. These recreational centers, together with the real increase of 26 percent in wages, correspond to a program of "incentives to educators designed to improve the quality of education." FECODE still argues that average wages for teachers are lower than for other public employees, but that seems to be dubious once you adjust for the number of hours worked (Ayala and Hernández, 1998).

The Constitution of 1991 and Law 60/93 aim towards the decentralization of education, but FECODE opposes it. It has systematically opposed wage negotiations at the local level since that "promotes politicization." FECODE has also forced the CG to intervene and pay salaries and pensions when local authorities do not have the money or the will to do it.

3. Is the Educational Compensation Fund - FEC a Bailout?

The amount of money going to *Situado* should be enough to cover all the educational needs (Vargas and Sarmiento, 1997) but, for reasons explained below, the CG created the Educational Compensation Fund (FEC), designed to compensate for the "deficits in the *Situado*."

The FEC was created to finance additional wages[41] negotiated in 1995 between the CG and the national teacher's union (FECODE) for all teachers in the country, but new goals have been added later on, such as the financial backing for teachers paid by departments and municipalities,[42] and the attention to families and teachers displaced by poverty and violence in rural areas. The FEC also incorporated some of the additional money needed to finance those expenditures described in the previous section.

FECODE is a powerful union in the country, and the size and importance of FEC has increased dramatically, from 7.5 percent of *Situado* in 1996 to 32 percent in 1998. The *Situado* and FEC amounted to 30 percent of CG's current income in 1998, and to 0.7 percent of GDP in 1999 (Table A.1). The amount involved in the FEC represented close to 30 percent of the *Situado Fiscal*.

The Planning Office (*Planeación Nacional*) determines the global amount of the FEC, and the Ministry of Education produces the detailed figures for the different regions after intense negotiations. The Ministry of Finance can always modify the "final" numbers. Those regions that "modernized" their administration of the educational system did not have to pay this credit back.

---

[41] Due to wage increases, the promotion of teachers in the salary scale, and the incorporation to the National payroll of co-financed teachers (MoF, 1998). In 1995 the National Government and FECODE agreed to an additional increase in salaries for teachers and managers in the public education system, with respect to the raise given to the rest of the public officials.

[42] A share of it correspond to the agreements reached at the negotiation table in 1996 when organized peasants marched in the Departments of Putumayo, Caquetá, Cauca, Guaviare, Bolivar, Santander, Meta and Nariño.

Table 15. *Situado Fiscal* and Educational Compensation Fund
(Millions of dollars unless otherwise stated)

	1995	1996	1997	1998
Situado Fiscal	2,004	2,348	2,459	2,248
Situado Fiscal for Education		1,706	1,751	1,597
Educational Compensation Fund (ECF)		128	317	507
Situado Fiscal for Education + ECF		1,834	2,067	2,104
Current Revenues *	8,526	9,583	10,036	9,176
Situado Fiscal / Current Revenues	23.5%	24.5%	24.5%	24.5%
Situado Fiscal + ECF / Current Revenues		25.8%	27.7%	30.0%
ECF as a percentage of Situado Fiscal		5.5%	12.9%	22.5%
ECF as a percentage of Situado Fiscal for Education		7.5%	18.1%	31.7%

* Calculated by applying the participation (by law) of the Situado in the current revenue

Source: NPD and M o F, Author's calculation

The definition of the portion of FEC that constitutes a bailout is a tricky question, one that clearly reveals the problems of lack of accountability, confusion of responsibilities, existence of unreliable information and of perverse incentives. Basically, even if the CG knows that the contract for the provision and financing of education services that was established with the TE has been breached, it could be unable to monitor and evaluate the TE behavior because the contract is incomplete.

It is not a bailout to give additional money to the regions in order to compensate for wage increases agreed upon at the national level between the CG and FECODE (part of the true story), but a clear bailout arises when the regions appoint new teachers (not having the resources needed) trusting that the CG will provide the additional money in the future, once the political situation is out of control. The analogy to the issues posed by Wildasin (1997) is clear:

- There is a contract that has been established between the Principal (CG) and the agent (department) for the provision and financing of education services at the school level. The *Situado* has been defined as the mechanism through which the CG guarantees a level of education that it considers to be correct, and Law 60 provides the legal mechanisms though which the *Situado* should be assigned.
- In a second step, the TE makes decisions in terms of resource generation and expenditure (patterns and levels). Despite the existence of a contract with the CG, the department decides

a level of education expenditure larger than the resources available, and a violation of the contract occurs.

- In the third step the CG steps in, and validates through FEC the local decisions. The budget constraint is no longer binding and a "bailout" has occurred.

4. *Econometric Determinants of Type 2 "Bailouts" (Educational Compensation Fund, FEC)*

The regressions in Table 16 considered the amount of FEC transferred to each department as the dependent variable. The independent variables are the growth rate in 1996-98 for the number of teachers appointed at the local level (i.e., paid by the departments and municipalities) and teachers appointed (and paid) at the national level.[43] Also included are the S*ituado Fiscal* for education, the student/teacher ratio, the existence or absence of PAs in that department (1 or 0), a dummy for Liberal governor in that department and period, and the number of senators.

To include the expansion of teachers appointed at each level seems appropriate for the analysis since the goal is to detect signs of "misbehavior" at the local level: did the FEC increase because the regional authorities were appointing teachers, and the central government just validated such behavior ex-post? This could be a clear sign of bailout. To compare trends, those teachers appointed at the central level are also included.

It also seems appropriate to include the *Situado* for education in the regressions since FEC could just be an extension, a result of bad planning when the education program started (i.e., *Situado* funds were not enough). That could hardly be called a bailout from the CG. But no other variable should prove significant if this is the case, an empirical issue considered below.[44] The inclusion of PAs is obvious, with those departments that misbehaved at a general level (Bailout Type 1) being good candidates for misbehavior in the area of education expenditures. The student/teacher ratio is also included as a good proxy for effort, efficiency and discipline in this area.

The first column shows a significant and positive relation between FEC in education and *Situado Fiscal,* a relation that remains in the other regressions of the table. This means that

[43] Thanks are due to Fabio Sánchez for providing this valuable (but not official) information.
[44] In any event, what is the logic of giving money to the regions for education, under different criteria? Are the allocation parameters of *Situado* wrong?

regions with large *Situado Fiscal* disbursements also received large amounts of money from FEC, which in turn suggests that there was indeed an element of initial bad planning.

But this is not the end of the story, since other variables turn out to be significant. Thus, there is a positive and highly significant relation between FEC and (the growth rate of) teachers appointed by departments and municipalities, and a negative and significant relation with the number of teachers appointed at the central level. This suggests that local authorities appointed teachers with their resources and got additional funds from FEC later on.[45] Finally, the results show that Liberal governors got more money from FEC than their Conservative friends in other departments. The student/teacher ratio does not have a large explanatory power (it is significant in half of the regressions, and only at the 10 percent level). PAs and the number of senators per department prove even less important.

[45] It is known that regions that quickly increased the number of teachers appointed with their own resources also received large amounts of FEC later on, and this suggests the kind of story that this section attempts to document. Unfortunately, information is available only on the number of teachers for 1996 and 1998, which is insufficient for a detailed analysis of lags.

Table 16. Determinants of FEC (Bailout Type 2)

Dependent Variable: FEC							
Independent Variables							
Growth rate of the number of teachers appointed (and paid) by departments and municipalities		102.18	78.32	78.50	102.57	78.72	79.45
		(2.41***)	(1.96**)	(1.93**)	(2.44***)	(1.88**)	(1.90**)
Growth rate of the number of teachers appointed (and paid) by the central government		-322.79	-196.16	-195.46	-321.33	-264.02	-265.67
		(-2.44***)	(-1.28)	(-1.29)	(-2.41***)	(-1.76**)	(-1.93**)
Situado Fiscal for Education	0.16	0.13	0.13	0.13	0.13	0.13	0.13
	(4.60***)	(4.31***)	(4.97***)	(5.17***)	(4.47***)	(5.91***)	(3.40***)
Student/Teachers			-308.76	-308.82		-221.38	-222.20
			(-1.71*)	(-1.72*)		(-1.20)	(-1.19)
PAs (0, 1)				112.33	241.10	1035.53	1062.95
				(0.05)	(0.11)	(0.54)	(0.51
Liberal Governor (0, 1)						11531.66	11534.92
						(3.27***)	(3.19***)
Senators per Deparment							41.92
							(0.05
Observations	81	69	69	69	69	69	69
R^2	0.61	0.72	0.75	0.74	0.72	0.77	0.77

Regression for a panel data with i: 32 departments; t: 1994-98; White correction for heteroscedasticity.
Numbers inparenthesis correspond to the (asymptotic) t statistic: *: 1% level of significance, **: 5%; ***: 10%; results for the constant not reported

C. *Bailout Type 3: Medellin's Metro Rail System*

The third type of bailout examined is the construction of the Metro of Medellin. When the decision was made to build Medellin's Metro system, there existed numerous institutional mechanisms at the regional and national level to ensure that only profitable projects were implemented. These mechanisms notwithstanding unfavorable feasibility studies were disregarded, Ministers of Finance were pressured, a deceptive media campaign was carried out and laws were amended whenever needed. Medellin's Metro Rail system has produced a highly negative internal rate of return. Demand has been three times lower than originally estimated, total cost three times higher,[46] and the benefits in terms of traffic reduction questionable.[47] Ultimately, the CG had to assume a considerable portion of the cost of the Metro.

It was agreed from the beginning that the project should be financed with foreign resources, and the international private banks always conditioned their involvement on the procurement of a guarantee from the CG. This guarantee in turn depended on a favorable concept from the planning office (DNP) and approval by the National Council on Economic and Social Policy (CONPES).

The first enterprise created by the municipal government of Medellin to review the train issue—Metropolitana del Aburrá—concluded in 1968 that the project was not feasible. Its manager submitted a report that expressed several major reservations. First, Medellin does not and will not have sufficient population to make a train system feasible. Second, most of the city's inhabitants live on the mountainside, which is inaccessible by train. Third, more suitable alternatives for mass transportation existed.

After creating a new enterprise—the Empresa de Transporte Masivo del Valle de Aburrá, ETMVA[48]—commissioning several deficient studies,[49] and overcoming multiple obstacles at the municipal level, a foreign indebtedness application for $263 million was submitted to DNP and to the Ministry of Finance in 1979. It was not approved.

In September 1981, ETMVA submitted a new study to the DNP, with an Internal Rate of Return (IRR) of 22 percent. Following several corrections, DNP obtained an IRR of 8.4 percent (DNP, 1982a). A year later, EMTVA submitted a new indebtedness application, this time for $656 million. DNP proposed two alternatives: a) the project design should be concluded before being submitted again; or b) the contract should be started without final designs, with CONPES giving its opinion when the designs were completed.

[46] Pachón (1991, pp. 53-54) finds an internal rate of return of -1.7 percent, assuming a demand of 900,000 passengers per day (ppd). In 1981 the DNP had put demand at 300,000 ppd. The actual figure for 1998 was 281,000 ppd.
[47] It is worth noting that the Avenida Caracas Trunk Road Project, in Bogota, a transportation system with buses, mobilizes twice the amount of passengers, at a cost one hundred times less than the Medellin train.
[48] Incorporated as a partnership between the Municipality of Medellin and the Department of Antioquia. In those years the President of the Republic appointed the highest local authorities (Mayor and Governor). From 1986, the mayors are elected by popular vote. The same would apply to Governors from 1991.
[49] The main criticisms formulated by the DNP had to do with cost underestimation and demand overestimation, by a ratio of 20 to 1.

The technical team of DNP proposed "indebtedness procedures authorized on the assumption that the bidding forms will allow for competition of the bidders without a guarantee from the Nation" (DNP, 1982b, p. 39), and the Director of DNP considered that "all the studies carried out led to believe that, even under the most negative assumptions, the investment is profitable" (CONPES, 1982).[50] The President congratulated DNP for the study and emphasized that "the project was essential to restore Medellin's lost dynamism and to open new horizons, to regain the leadership of Antioquia it had traditionally exercised" (CONPES, 1982).

CONPES granted the Nation's guarantee, although the DNP study explicitly denied its feasibility. This guarantee implied that the Nation would be liable for the project in the event that ETMVA was unable to meet its obligations. In case the guarantee was made effective, the Nation should eventually recover the funds by making effective counter-guarantees with the Municipality of Medellin and the Department of Antioquia.

On January 14, 1982 the Minister of Finance received the indebtedness application and a few days later granted the guarantee, without requiring the corresponding counter-guarantees from Medellin and Antioquia, that is, without committing the region to pledge any funds. The CGR believed that there was lack of diligence on the part of the Ministry of Finance, since it was aware of the fragility of the project (CGR, 1994, Introduction).

Conservative President Betancur was originally from Antioquia, a traditionally Conservative region that played a crucial role in his election. The Conservative party had been a minority for years, but the Liberal party was divided and this helped him to finally win his fourth presidential campaign. Contrary to the moderate distance he kept in the previous campaign on this issue, Betancur now fully endorsed Medellin's metro. The arguments were based more on the (very doubtful) positive externalities than on transportation benefits for citizens. Instead of considering technical arguments, Betancur viewed the Metro as an instrument for the city's recovery and return to its role as the leading city of Antioquia.

Antioquia has always been an important region, economically and politically. It accounts for about 15 percent of the national GDP, produces a significant portion of the coffee harvest, and has the second largest manufacturing sector in the country. Like the country as a whole,

[50] Officials attending the meeting included, among others: the President of the Republic; the Ministers of Finance (who abandoned the room as soon as the discussion on the Train began), Foreign Relations, Development,

Antioquia was suffering a large economic crisis in 1982, with GDP and industry falling 1.3 percent and 6 percent, respectively. Unemployment jumped to 14 percent in Medellin in 1982, and to 17 percent in 1983. Ex post, it is evident that building the Metropolitan Train was not a solution to the region's serious problems, and the construction of the train only generated 2,500 direct jobs and approximately 7,500 indirect ones—between 1 and 1.5 percent of Medellins total employment.[51]

Once CONPES approved the project, Spanish entrepreneurs pressured their government to obtain the contract,[52] and the construction contract was awarded to the Spanish-German consortium METROMED in October of 1983, with financing by a syndicate of Spanish and German banks. The cost of the project on the part of the ETMVA and METROMED was not established in the contract, which in practical terms meant the signing of a "blank check."

The Minister of Finance demanded regional counter-guarantees in August of 1984 since the project had a regional scope. But Jorge Valencia (then Senator for Antioquia) defined the line that would become the strategic behavior of the region, anticipating the conception of Law 310 of 1996 (see below). According to Valencia, the counter-guarantee should simply be considered "a declaration of good intentions" that must not be executed for the full amount of the project. Additionally, the pledge of departmental and/or municipal income will not be effected because sooner or later "the Nation [will support] cities in projects such as this one" (*El Colombiano*, October 11, 1984).

In November 1984, the Departmental Assembly and the Municipal Council extended the counter-guarantees, but the Minister of Finance took some time to approve them. For the local press "the people anxiously await the works and international institutions are running out of patience... If the President has committed himself with such an important project, his Minister

---

Agriculture and Public Works and Transportation; the Governor of the Central Bank; the Manager of the National Coffee Growers Federation; the Head of the DNP; the President of ECOPETROL and the Mayor of Medellin.

[51] This amount of jobs is 20 times smaller than the variance of the quarterly employment series. In a regression to explain employment, a dummy for the metro rail system was not significant. Estimates are available from the authors.

[52] According to Madrid's newspaper *El País* (October 10, 1983) "the visit that the President of Colombia (and former ambassador to Spain), began on Friday the 7th, will be used by the Spanish administration to try to have construction of the Medellin Metro Rail system awarded to one of the Spanish consortiums that are competing for it [...] The Colombian Minister of Economic Development stated that Spain is very likely to be awarded the project [...] since not only will financing conditions be considered, but also the circumstances in which bilateral relations are being conducted" (Alvear, 1990, pp. 30-31).

must act in accordance" (*El Colombiano*, cited by Acevedo, Salazar and Castañeda, 1993, pp. 76-77).

The construction of the train started to fall behind schedule and costs increased, but the consortium cited the devaluation of the peso and problems with import licenses that had to be granted by Incomex (the CG agency in charge of regulating foreign trade). Those justifications did not seem entirely reasonable. The exchange rate adjustment was foreseeable given the balance of payments situation of the country, and devaluation had been mentioned by the Ministry of Finance as an argument against the project's feasibility. In fact, ten years later the CG transferred resources to the project to assume the financial burden generated by devaluation. The consortium's reference to import licenses also seemed unfounded. In the contract it had been specified that import costs would be borne by METROMED, which had stated that it was familiar with legal regulations on the matter.

The project was virtually bankrupt at the end of the 1980s, and ETMVA was using working capital to pay interest. The Nation, at that time involved in improving the profile of its foreign debt, began facing major problems abroad. Following the depletion of foreign credit, the CG was forced to assume the obligations of the project, as ETMVA had barely received previously agreed contributions from the municipality and the department.

On July 1989 the Spanish Prime Minister requested President Barco (1986-1990) "to ensure the continuity and final completion of the project" (CGR, 1994, p. 308), and in March 1989, the Colombian government and the banks held a meeting and entered into the Madrid Protocol, aimed at refinancing the project. The banks conditioned their approval on new guarantees by Colombia. In December 1989, the national government enacted the "Metropolitan Train Law" (Law 86) aimed at creating a national and municipal tax infrastructure to allow for the financing of mass transportation projects, particularly Medellin's Metro Rail system.

Additionally, the Nation's commitment to restructuring the debt of the Medellin Metro (the $656 million of 1984) was conditioned on a counter-guarantee, backed by a pledge of local income from a 10 percent surcharge on gasoline and a property appreciation tax that the region committed itself to collect. The law authorized the Nation to contract or guarantee foreign credits for an additional $500 million, destined for public transportation systems. To grant the guarantee it was established (Art. 4) that at least 80 percent of the debt service had to be pledged, but this requirement was never met.

The position of the Gaviria administration (1990-1994) was apparently more responsible. His Minister of Finance stated, "we are willing to help Antioquia, but this is a regional problem and no Minister of Finance can extend a $2 billion guarantee without the certainty that the money can be recovered." In what later became known as the Medellin Protocol, the Government agreed with the regional authorities[53] that if works were completed by September, 1994, the total cost of the project would amount to $1.9 billion, of which $1.2 billion was financed.

The remaining $726 million would be covered by $500 million with a new foreign credit guaranteed by the Nation and $226 million with domestic resources. The Nation committed itself to procure the new guarantees before the CONPES and to obtain the credits. The ETMVA promised to settle the situation with METROMED and, jointly with the Mayor's Office and the Department, to pledge resources and deliver assets, whenever necessary.

The Nation has continued to service the train's foreign debt. The region has once again defaulted on payments—except for the pledge of income on which a contractual commitment was required in order to meet the first tranche of $650 million. The collection of the property appreciation tax was suspended and the Department ceased delivering the taxes on tobacco. Currently, only the gasoline surcharge—collected directly by the CG—is being pledged.[54]

The largest transfer from the CG to the Medellin Train (and probably the most significant strategic mistake) took place with the enactment of Law 310 of 1996, which set forth that the Nation would pay 40 percent of the net present value of the debt of the Medellin Train and up to 70 percent of that for other trains to be built.

D. What Did We Learn? Some Recommendations for the Future

Before finishing, it could be useful to speculate on some potential improvements designed to avoid the huge regional misbehavior of the 1990s, additional to those measures already mentioned in Section I.D.4. What can we learn from a decade of "decentralization"? Can we make some recommendations for future improvements?

---

[53] The meeting was held in December 4 of 1990, with the presence of President Gaviria, his Ministers of Finance and Public Works, the Head of DNP, the Governor of Antioquia, the Mayor of Medellin and the manager of ETMVA.

[54] According to our estimations, the Nation has received approximately $150 million from the execution of guarantees.

To start with, no reasonable policy can be adopted when information is lacking. We had huge problems collecting and organizing the information required for this document, and the situation had to be much worse during the first part of the 1990s when the system was in its initial stages (and already exploding). Not even the banks collected information, always assuming that the central government would respond. A system is necessary in which some CG agency unifies and certifies figures reported by the TEs, with clear common accounting procedures for all TEs.

Much responsibility was given to DAF, but DAF was never supposed to be a supervisory agency. It operated inside the Ministry of Finances, and it is not a good idea to have the "control" entity operating in the same place of the agency providing the money to the regions. Under those circumstances, the political pressure on DAF was huge.

Colombia lacks a set of clear fiscal rules that be followed by the different governments. Regional finances should be an important part of these rules, which should also apply to regional firms and entities. In addition, there should be a special supervisory agency in charge of regional finances and their relations with banks, with clear rules defined in advance of any potential crisis. Why did the *Superintendencia Bancaria* allow banks to provide new credits to TEs in a bad situation? Likewise, it is not even clear that those risk-prone banks lost money and, if so, how much. Transfers to the regions should not be used as guarantees with the banking system.

Market supervision must be brought into the picture, and international agencies such as Moodys could provide grades for the regions, considered by banks when designing their lending policies. There could be a combination of the present system of traffic lights (red lights, no new lending) and those grades. The yellow light should have never existed, since it created too much room for arbitrary behavior.

Regional taxes are an important part of total taxes in most developed countries, but Colombia's present tributary structure have created a system of incentives that discourages fiscal effort. The result has been low and decreasing fiscal effort by the departments, and also by municipalities other than Bogota.

At the same time, no system of rules will produce the desired impact unless citizens can control and influence the expenditure of transfers and regional taxes. At the moment, Colombian citizens still think that education and health are the responsibility of the CG. The reelection of mayors could contribute to a change in this area, but much more is needed.

New large bailouts are in the making, and it will be important to learn lessons fast. The social security system is broken, the electrical system is under stress, and Telecom (the public telecommunication company) could become a large black hole in the future; some road concessions to the private sector are likely to revert to the state. A new "Metro Law" has been approved, and could be instrumental in avoiding a repeat of the Medellin Metro experience, but it could still be declared unconstitutional.

4. Conclusions

Within the Latin American context Colombia ranks high in terms of decentralization. The process started at the beginning of the 1980s and received a big push with the new Constitution of 1991. The level of expenditure allocated by sub-national governments is much larger than in the rest of Latin America, except Brazil and Argentina, and even higher than in the average OECD country. Decentralization allows a better match between local preferences and the basket of goods (and taxes) available, but it can also weaken the fiscal discipline of sub-national governments.

One key factor undermining fiscal discipline in Colombia is the model of decentralization implemented by the Constitution of 1991, a hybrid between the model of principal-agent and that of fiscal choice. The hybrid character should imply that the TE is accountable to both the CG and its constituents, but that has not been the case. The confusion that exists has allowed the TEs to avoid their responsibilities to both the CG and the citizens, and it partially explains the large overlaps in expenditures (at the different levels of government) that still remain.

Substantial transfers from the central government to the sub-regions created structural expenditure pressures and irresponsible behavior in terms of debt (mainly loans from the banks), brought the departments into default and forced the central government to bail them out. The departments that negotiated performance agreements (PAs) with the CG, far from being disciplined, behaved worse than the others. The probability of this outcome, "Bailout Type 1," was higher in poor, highly indebted and violent regions, where fiscal effort was low and where the governor belonged to the same (Liberal) party of the President.

We considered a "Bailout Type 2" in the paper, consisting of the additional money given for regional education, beyond the initial budget contemplated for that purpose in the *Situado Fiscal*. The issues involved in this case are complex, however, and the amount of the bailout cannot be defined as neatly. Part of FEC was indeed caused by a low initial budget, and part by the negotiations between the CG and the teacher's union (FECODE), two stories that do not fit well into the classic definition of bailouts. But these two factors do not account for the whole story behind FEC. There is evidence in the press and evidence derived from the empirical analysis presented here showing that the regions massively appointed new teachers and forced the CG to bail them out later on with the additional funds required.

Finally considered was the case of the Medellin rail system. Since the project could not be defended on technical grounds, the President (who was born in that department) and the government justified its undertaking on the basis of very doubtful externalities and as the instrument for the economic recovery of Antioquia.

The results have dashed these expectations. The project was virtually bankrupt at the end of the 1980s, the Nation started servicing the train's foreign debt, and Antioquia has recurrently defaulted on payments. A new Law approved in 1996 stated that the Nation would pay 40 percent of the net present value of the debt of the Medellin Train, and a bill currently under consideration would increase transfers to the Medellin project from 40 to 70 percent of the total cost.

The Constitution of 1991 introduced very drastic modifications in the scope and characteristics of decentralization in Colombia, and it would not be surprising to observe some costs involved in the process of "learning by doing." The analysis of bailouts forced us to focus on the most problematic side of the decentralization process in Colombia, but not all the news is bad.

In fact, the recent evidence and the new laws passed by Congress allow for some optimism. The reforms adopted in 2000-2002 introduced some important cuts in regional expenditures, increased taxes and brought more fiscal responsibility. Regional debt is under relative control (unlike the experiences of Argentina or Brazil), and Colombia accepted the idea that rich and large TEs could decentralize faster and more productively than other small and poor regions, at least during a "transition period."

Finally, there were many examples of productive decentralization (even) during the chaotic years of the 1990s (Zapata and Acosta, 2001). The huge improvement in the administration and fiscal management of Bogota would have been inconceivable without the reforms introduced in the Constitution of 1991. Finally, Law 310 of 1996 introduced very stringent conditions for the construction of another Metro in Colombia (though it could still be declared unconstitutional).

While this paper provides recommendations on improving the system to avoid some of the huge mistakes of the decentralization process in Colombia during the 1990s, these policy prescriptions they will not help much unless citizens start controlling and improving the efficiency of expenditures on education and health. Reelection of mayors could be a step in that direction but much more is clearly needed. Recent measures to improve regional finances, though, imply a return to the old principal-agent model, a step in the opposite direction.

5. References

Acevedo, J., J.C. Salazar and W. Castañeda. 1993. "El Metro de Medellín: Una ilusión costeada por todos los colombianos." Bogota, Colombia: FONADE, Instituto SER de Investigación. Mimeographed document.

Acosta, O.L., and G. Borjas. 2002. "Reformas Institucionales en Colombia: La Reforma a la Educación." Bogota, Colombia: Fedesarrollo. Mimeographed document.

Ahmad, E., and K. Baer. 1997. "Colombia." In: T. Ter-Minassian, editor. *Fiscal and Federalism in Theory and Practice*. Washington, DC, United States: IMF.

Alesina, A., G. Cohen and N. Roubini. 1991. "Macroeconomic Policy and Elections in OECD Democracies." NBER Working Paper 3830. Cambridge, United States: National Bureau of Economic Research.

Alesina, A., and N. Roubini. 1992. "Political Cycles in OECD Economies." *Review of Economic Studies* 59: 663-688.

Alesina, A., R. Hommes, R. Hausmann and E. Stein. 1998 "Budget Institutions and Fiscal Performance in Latin America." *Journal of Development Economics* 59: 253-273.

Alesina, A., A. Carrasquilla and J.J Echavarría. 2000. "Fiscal Federalism in Colombia." Bogota, Colombia: Fedesarrollo. Mimeographed document.

Alvear, J. 1990. *El Negocio del Metro: Experiencias para Bogotá*. Medellín, Colombia: Señal Editora.

Arbeláez, M.A., J.J. Echavarría and A. Gaviria. 2002. "Crédito, Liberalización Financiera e Inversión en Colombia." *Coyuntura Económica*. Forthcoming.

Asociación Bancaria y de Entidades Financieras de Colombia. 2000. "Endeudamiento de los Entes Territoriales con el Sistema Financiero Colombiano." Bogota, Colombia: Asociación Bancaria y de Entidades Financieras de Colombia.

Ayala, U., and L. Hernández. 1998. "La remuneración y el mercado de trabajo de los maestros públicos en Bogotá." Bogota, Colombia: Fedesarrollo. Mimeographed document.

Banco de la República (1996). Indicadores del Sector Público no Financiero 1987-1995, Subgerencia de Estudios Económicos.

----. Revista del Banco de la República. Bogota. Several Issues.

Banco Interamericano de Desarrollo. 1996. "Fortalecimiento de las Entidades Territoriales." Programa 977 OC-CO. Washington, DC, United States: Banco Interamericano de Desarrollo.

----. 1997. *América Latina tras una década de reformas*. Progreso económico y social de América Latina. Washington, DC, United States: Banco Interamericano de Desarrollo.

----. 1998. "Descentralización en Colombia: Nuevos desafios." Serie de Estudios Económicos y Sectoriales, Región 3, January.

Clavijo, S. 1998. "Impuestos, gasto público y 'fiscalizadores creibles': Breve historia de las Comisiones de Finanzas Públicas en Colombia." Documento CEDE 98-02. Bogota, Colombia: Centro de Estudios sobre Desarrollo Económico.

Comisión de Racionalización del Gasto y de las Finanzas Públicas. 1997. *Tema III*: *Descentralización, Informe Final*. Bogota, Colombia: Comisión de Racionalización del Gasto y de las Finanzas Públicas

Consejo Nacional de Política Económica y Social (CONPES). 1982. *Acta de la sesión No. 484 efectuada el 14 de diciembre de 1982*. Bogota, Colombia: Consejo Nacional de Política Económica y Social.

Contraloría General de la República. 1997. *La Situación de las Finanzas del Estado*. Bogota, Colombia: Contraloría General de la República.

----. 1994. *Evaluación de la Gestión Financiera y Legal del Metro de Medellín*. Bogota, Colombia: Contraloría General de la República.

Correa, P., and R. Steiner. 1999. "Decentralization in Colombia: Recent Changes and Main Challenges." In: C.C. Callahan and F. Gunter, editors. *Colombia: An Opening Economy?* Greenwich, United States: Jai Press, Inc.

Departamento Nacional de Planeación (DNP). 1982a. "Proyecto tren metropolitano de Medellín." Documento DNP-1986-UINF. Bogota, Colombia: DNP.

----.1982b. "Proyecto tren metropolitano de Medellín." Documento DNP-1957-UINF. Bogota, Colombia: DNP.

----. 1997. "Política de consolidación de la descentralización." Documento CONPES 2788. Bogota, Colombia: DNP.

----. 1998. "La situación financiera departamental, 1993-1997." Documentos para el Desarrollo Territorial No.10.UAEDT. Bogota, Colombia: DNP.

----.1998. "Agenda de ajuste de la política de descentralización." Documentos para el Desarrollo Territorial No.7. UAEDT. Bogota, Colombia: DNP.

Duarte, J. 1997. "Problemas del esquema actual de asignación de recursos en educación y salud." *Coyuntura Social* 16.

Echavarría, J.J. 2000. "Colombia en la década de los 90s: Neoliberalismo y reformas estructurales en el trópico." *Coyuntura Económica* 30(3): 121-148.

Escobar, A. 1996. "Ciclos políticos y ciclos económicos en Colombia: 1950-1994." *Coyuntura Económica* 26(1): 115-141.

Federación Nacional de Departamentos. 1999. "La crisis fiscal de los departamentos." Bogota, Colombia: Federación Nacional de Departamentos.

Fedesarrollo. 1998. "Análisis Coyuntural." *Coyuntura Económica* 28(2).

Gaviria, A. 2002. "Calidad de la Educación en Colombia." Bogota, Colombia: Fedesarrollo. Mimeographed document.

Gutierrez, C. 1996. "Análisis de los convenios de desempeño suscritos entre la Nación y los Departamentos: Los casos de Chocó, Nariño y Putumayo." Bogota, Colombia: Fedesarrollo. Mimeographed document.

Inter-American Development Bank. 1998. "Decentralization and Fiscal Discipline in Sub-National Governments: The Bailout Problem." Research Network Project, Terms of Reference. Washington, DC, United States: Inter-American Development Bank, Research Department. http://www.iadb.org/res/laresnetwork/studies/st64tor.pdf

----. 1997. *Latin America after a Decade of Reforms*. Economic and Social Progress in Latin America. Washington, DC, United States: Inter-American Development Bank.

----. International Monetary Fund. 1995 "Colombia: Reforming Territorial Taxation and Transfers. Fiscal Affairs Department Aide-Memoire, January 30. Washington, DC, United States: IMF.

Jaramillo, J.C., R. Steiner and N. Salazar. 1999. "The Political Economy of Exchange Rate Policy in Colombia." Fedesarrollo Working Paper Series 11. Bogota, Colombia, Fedesarrollo.

Kornai, J. 1986. "The Soft Budget Constraint." *Kyklos* 39(1): 3-30.

Kure, I. 1995. "La descentralización: Retos para su consolidación." Revista de Planeación y Desarrollo 36(2): 89-130.

Ministerio de Hacienda y Crédito Público. 1999a. "La problemática fiscal de los departamentos y la posición del Gobierno Nacional en la búsqueda de soluciones". Ibagué, Colombia: Ministerio de Hacienda y Crédito Público.

----. 1999b. "Crisis fiscal y financiera de los departamentos." Análisis y Propuesta del Gobierno. Asamblea General de Gobernadores. Bogota, Colombia: Ministerio de Hacienda y Crédito Público.

----. 1999c. "Programa de Apoyo al Saneamiento Fiscal y Fortalecimiento Institucional." Bogota, Colombia: Ministerio de Hacienda y Crédito Público.

----. 1999d. "Dirección de Apoyo Fiscal: Convenios de Desempeño suscritos entre la Nación y los Departamentos." Bogota, Colombia: Ministerio de Hacienda y Crédito Público.

Mora, H. 1999. "Financiamiento del Régimen Subsidiado en Salud." Paper presented at the Inter-Union Committee on Social Security in Health, Fedesarrollo, Bogota, Colombia.

Moreno, A. 1998. "Ciclo político y política económica: Un análisis del caso colombiano 1930-1995." Informe Financiero, Contraloría General de la República (Febrero): 13-73.

Pachón, A. 1991. "Evaluación expost del Metro de Medellín." Bogota, Colombia: Alvaro Pachón y Asociados.

Rafuse, Robert. 1990. "Representative Expenditures: Addressing the Neglected Dimension of Fiscal Capacity." Document M-174. Washington, DC, United States: U.S. Advisory Commission on Intergovernmental Relations.

República de Colombia. 1991. Constitución Política de la República de Colombia.

----. 1996. Proyecto de Ley No.68 por la cual se reglamenta el artículo 364 de la Constitución y se dictan disposiciones en materia de endeudamiento.

Rojas, F., and T. Campbell. 1994. "Poverty Reduction in a Decentralized Setting: Equity, Efficiency and Accountability." Washington, DC, United States: World Bank. Mimeographed document.

Rosas, G. 1998. "Papel de los Departamentos en la Descentralización." Bogota, Colombia: Federación Nacional de Departamentos.

Steiner, R., and C. Soto. 1999. *Cinco Ensayos sobre Tributación en Colombia*. Cuadernos de Fedesarrollo 6. Bogota, Colombia: Fedesarrollo.

Ter-Minassian, T., editor. 1997. *Fiscal Federalism in Theory and Practice*. Washington, DC, United States: IMF.

Vargas, J., and A. Sarmiento. 1997. "Descentralización de los servicios de educación y salud en Colombia." *Coyuntura Social* 16.

Wildasin, D. 1997. "Externalities and Bailouts: Hard and Soft Budget Constraints in Intergovernmental Fiscal Relations." Policy Research Working Paper 1843. Washington, DC, United States: World Bank.

Zapata, J.G., O.L. Acosta and A. Gonzáles. 2001. "Evaluación de la Descentralización Municipal en Colombia: ¿Se consolidó la sostenibilidad fiscal de los municipios colombianos durante los años noventa?" Bogota, Colombia: Departamento Nacional de Planeación, Archivos de Economía.

6. ANNEX TABLES

Table A.1. Taxes and Transfers (% of GDP)

Taxes and Transfers (% of GDP)

	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	Average 1991-1999
TAXES	**12.4**	**12.4**	**13.0**	**13.4**	**13.3**	**14.8**	**13.4**	**13.4**	**13.5**	**14.4**	**13.3**
NATIONAL LEVEL	10.6	10.6	11.2	11.3	11.3	12.4	10.9	11.0	11.0	.na	11.1
Rent	4.6	4.7	4.4	4.1	4.0	3.8	4.3	4.1	4.1	12.4	4.2
Value Added Tax	2.8	3.4	4.4	4.3	4.2	4.8	4.9	4.8	4.2	12.4	4.2
Foreign Commerce	1.4	0.9	1.1	1.1	1.0	0.9	1.1	1.0	0.9	13.0	1.0
Others	1.8	1.7	1.4	1.9	2.0	2.9	0.6	1.1	1.7	13.4	1.7
DEPARTMENTAL LEVEL	**1.0**	**0.9**	**0.9**	**0.8**	**0.8**	**0.9**	**0.9**	**0.8**	**0.9**	13.3	**0.9**
Liquor	0.4	0.4	0.4	0.3	0.3	0.3	0.3	0.3	0.3	14.8	0.3
Beer	0.3	0.3	0.2	0.3	0.3	0.3	0.3	0.3	0.3	13.4	0.3
Cigarette	0.2	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	13.4	0.1
Vehicles	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	13.5	0.1
Others	0.1	0.1	0.1	0.1	0.1	0.1	0.2	0.1	0.2	14.4	0.1
MUNICIPAL LEVEL	**0.8**	**0.9**	**1.0**	**1.2**	**1.2**	**1.5**	**1.5**	**1.6**	**1.7**	#N/A	**1.3**
Industry and Commerce	0.4	0.4	0.4	0.5	0.5	0.6	0.6	0.7	0.7	.na	0.5
Property tax	0.3	0.3	0.3	0.4	0.4	0.5	0.5	0.6	0.6	.na	0.4
Vehicles	0.0	0.0	0.0	0.1	0.0	0.1	-	-	-	.na	0.0
Others	0.2	0.2	0.2	0.2	0.2	0.3	0.4	0.4	0.4	.na	0.3
TRANSFERS	**3.0**	**3.7**	**3.9**	**4.1**	**4.1**	**5.7**	**5.4**	**5.1**	**6.3**	**6.3**	**4.6**
Situado Fiscal	1.7	2.0	2.1	2.2	2.2	2.6	2.4	2.3	3.1	2.6	2.3
Participation	0.9	1.1	1.3	1.2	1.3	1.5	1.6	1.8	2.1	1.9	1.4
FEC (Educational Compensation Fund)	-	-	-	-	-	0.1	0.3	0.5	0.3	0.7	0.1
Cofinancing	0.4	0.5	0.5	0.6	0.7	0.9	0.6	-	-	-	0.5
Royalties	-	-	-	-	-	0.5	0.5	0.5	0.8	1.1	0.3

Source: Contraloría General de la República, Banco de la República, Steiner and Soto (1999), author's Calculations.

Table A.2.
Credits Approved: Short-Term “Créditos de Tesorería,” Performance Agreements and Pasffiet Millions of Col $

	PASFFIET *				Performance Agreements						TESORERIA ***			TOTAL
	1997	1998	1999	TOTAL	1995	1996	1997	1998	1999	TOTAL	1997	1998	TOTAL	
Amazonas														
Antioquia														
Arauca														
Atlantico														
Bolivar			5,015	**5,015**							9,913	12,000	**21,913**	**26,928**
Boyaca												4,000	**4,000**	**4,000**
Caldas														
Caqueta	5,494			**5,494**										**5,494**
Casanare														
Cauca			6,803	**6,803**										**6,803**
Cesar	652			**652**										**652**
Choco					3,000	1,100			3,000	**7,100**				**7,100**
Cordoba												11,885	**11,885**	**11,885**
Cundinamarca														
Guainia														
Guajira						3,700				**3,700**				**3,700**
Guaviare														
Huila		10,742		**10,742**								4,920	**4,920**	**15,662**
Magdalena			10,070	**10,070**							4,220	5,620	**9,840**	**19,910**
Meta														
Narino					2,860					**2,860**				**2,860**
Norte de Santander						1,500				**1,500**	590		**590**	**2,090**
Putumayo					3,200	1,000	1,200	4,500		**9,900**				**9,900**
Quindio														
Risaralda												4,000	**4,000**	**4,000**
San Andres y Providencia												5,000	**5,000**	**5,000**
Santander												26,462	**26,462**	**26,462**
Sucre														
Tolima											14,220	25,651	**39,871**	**39,871**
Valle del Cauca											24,828	17,460	**42,288**	**42,288**
Vaupes														
Vichada														
TOTAL DEPARTAMENTOS	**6,146**	**10,742**	**21,888**	**38,776**	**9,060**	**7,300**	**1,200**	**4,500**	**3,000**	**25,060**	**53,771**	**116,998**	**170,769**	**234,605**
Barranquilla											2,101	2,000	**4,101**	**4,101**
Cali												21,000	**21,000**	**21,000**
Candelaria (Valle)														
Cartagena											4,700		**4,700**	**4,700**
Copacabana (Antioquia)														
Ibague		3,590		**3,590**							9,967	12,632	**22,599**	**26,189**
Itsmina														
Lebrija (Santander)														
Monteria			3,629	**3,629**										**3,629**
Palmira												5,000	**5,000**	**5,000**
Plato (Magdalena)														
Quibdo														
Santafe de Bogota D.C.														
Santa Marta												4,100	**4,100**	**4,100**
Sincelejo														
Sogamoso		898		**898**										**898**
Tibu														
Tulua												2,100	**2,100**	**2,100**
Tunja														
TOTAL MUNICIPIOS	**0**	**4,488**	**3,629**	**8,117**	**0**	**0**	**0**	**0**	**0**	**0**	**16,768**	**46,832**	**63,600**	**71,717**
TOTAL DEPTOS Y MUN	**6,146**	**15,230**	**25,517**	**46,893**	**9,060**	**7,300**	**1,200**	**4,500**	**3,000**	**25,060**	**70,539**	**163,830**	**234,369**	**306,322**

* At sept 30, 1999

Source: Dirección General de Apoyo Fiscal, Ministerio de Hacienda y Crédito Público

Table A. 3.
Diagnostic of the Situation of Departments in the Performance Agreements

DIAGNOSTIC	Atl	Bol	Cau	Caq	Ces	Cho	Gua	Hui	Mag	Met	Nar	Nor	Put	Tol	Vall	CASES
Current Deficit	X	X	X	X	X	X		X	X	X	X	X	X		X	13
Accelerated increment in expenditure		X	X	X	X	X	X	X	X	X	X	X	X	X	X	14
High dependence on transfers, cofinancing and royalties in some cases								X	X				X			3
Existence of non-authorixed remuneration								X	X							2
Increase in personnel expenditure that has increased long term liabilities		X	X	X		X	X	X	X	X	X	X	X			11
High indebtedness	X	X	X	X	X		X	X	X	X	X	X			X	12
Inefficient organizational structure		X			X		X			X		X		X		6
High levels of liquidity				X	X		X									3
Deficient behavior of revenues		X		X	X	X	X	X		X	X	X	X		X	11
Loss in dynamism of revenue collection		X			X	X	X	X			X	X			X	8
Defficiencies in budget management						X							X			2
Judiciary processes						X							X			2