Country and Sector Background

Despite strong macroeconomic performance, significant reductions in poverty and improvements in social indicators over the past decade, the level of income inequality in Colombia remains high. Between 2002 and 2012, moderate poverty based on monthly income fell from 49.7 to 32.7 percent, while extreme poverty declined from 17.7 to 10.4 percent. While this progress is a positive development, the rate of poverty reduction in Colombia, given its economic performance, falls below that of its regional peers, as it remains constrained by high inequality and relatively unresponsive to growth, compared to Argentina, Brazil and Mexico. Colombia’s unequal distribution of income is reflected by a Gini coefficient that is higher than the Latin America and Caribbean (LAC) regional average and among the 10 highest in the world.

In response, the Government of Colombia (GoC) has made inequality reduction a top priority turning its attention towards understanding how reforms, policies and institutions affect social outcomes, and in particular, equity. This emphasis is reflected in the strategies and goals of the GoC National Development Plan (Plan Nacional de Desarrollo, PND) “Prosperity for All 2010-2014” (Prosperidad para Todos 2010-2014). The three pillar objectives of the Plan are: (i) Sustainable Growth and Competitiveness, (ii) Equality of Opportunities for Social Prosperity, and, (iii) Consolidation of Peace.

Over the last two years, social indicators have improved, including reductions in income inequality, income poverty and the official measure of multidimensional poverty. Between 2010 and 2011, the average income of the bottom 40 percent of the income
distribution grew at a faster rate than the mean growth rate (8.1 versus 3.3 percent). This resulted in a reduction of income poverty but also led to a turning point for income inequality, which started to decrease (from 0.56 to 0.54 between those years). Over the same period of time, 2010 to 2012, the official multidimensional poverty measure (which includes fifteen dimensions related to education, health, employment and assets) dropped by 3.4 points (from 30.4 to 27.0 in 2012).

II. Operation Objectives

The objective is to support the Government of Colombia in improving fiscal, territorial, and gender equity through specific actions in targeted policy areas, while enhancing access to information and accountability in public spending. This is consistent with the three pillars of the GoC’s National Development Plan “Prosperity for All 2010-2014”: (i) Sustainable Growth and Competitiveness, (ii) Equality of Opportunities for Social Prosperity, and (iii) Consolidation of Peace. It is aligned with the World Bank’s Country Partnership Strategy (CPS) FY12-16 strategic theme 3: Inclusive Growth and Enhanced Productivity, by contributing to the long-term outcome of “Improved Public Sector Management and Equity and Efficiency of Economic Policies.”

The proposed operation recognizes and supports reforms that aim to reinforce the recent gains in reducing income inequality and to improve overall equity in several key dimensions. The set of reforms included in this operation will lead to important improvements in equity in the following dimensions: i. Horizontal equity in the tax structure, ii. Regional equity though the reform of the royalties (regalias) system, iii. Equity from a life-cycle perspective by instrumenting policies to reduce poverty among the elderly, iv. Enhanced transparency, quality of information and accountability in the execution of the public budget, v. Enhanced public reporting and transparency of poverty and other social indicators, and vi. Gender equity, by strengthening the framework to protect women against gender-based violence.

The reform program supported by this single-tranche development policy loan (DPL) is built around six policy areas that seek to enhance fiscal capacity towards shared prosperity in Colombia. These are: i. More equitable tax policy and administration; ii. Inter-regional equity and subnational government’s management; iii. Equity in social spending; iv. Equitable access to information and enhanced budgetary and financial management; v. Monitoring of poverty and other social indicators; and vi. Gender equity.

The prior actions supporting Policy Area I: More equitable tax policy and administration include: Prior Action 1: The GoC has improved the progressivity of the tax system by: (i) establishing an alternative income tax (IMAN); (ii) introducing a luxury tax; and (iii) simplifying the value-added tax, as evidenced by the Law No. 1607 of December 26, 2012, duly published in the Borrower’s Official Gazette on December 26, 2012, and; Prior Action 2: The GoC has reduced the cost of formal employment creation by: (i) reducing firms’ payroll contribution for employees with salaries below 10 minimum monthly wages; and, (ii) creating a new tax on corporate profits as evidenced by the Law No. 1607 of December 26, 2012, duly published in the Borrower’s Official Gazette on December 26, 2012.
The prior action supporting Policy Area II: Inter-regional equity and Subnational Government’s (SNG) management is Prior Action 3: The GoC has redesigned the General System of Royalties by mandating that all regional investment projects are approved and supervised by the Órganos Colegiados de Administracion y Decision (OCAD) which are comprised of representatives from the national and sub-national governments, as evidenced by: (i) the issuance of Law No. 1530 of May 17, 2012, duly published in the Borrower’s Official Gazette on May 17, 2012; (ii) the issuance of Decree No. 1075 of May 22, 2012, duly published in the Borrower’s Official Gazette on May 22, 2012; and (iii) the issuance of Decree No. 1949 of September 19, 2012, duly published in the Borrower’s Official Gazette on September 19, 2012.

The prior action supporting Policy Area III: Equity in social spending is Prior Action 4: The Borrower has: (i) issued new rules for the operation of a targeted economic subsidy to senior citizens (Programa de Protección al Adulto Mayor,” renamed “Colombia Mayor”); (ii) increased the budget for expanding the coverage; and (iii) reinforced the targeting of the program towards old-age population under conditions of extreme or moderate poverty, as evidenced by the Ministry of Labor’s Resolutions: (A) No. 1370 of May 2, 2013; and (B) No. 2958 of November 23, 2012.

The prior action supporting Policy Area IV: Equitable access to national financial management information systems is Prior Action 5: The GoC has implemented measures for the operation of the Integrated System of Financial Public Management (SIIF Nacion - Sistema Integrado de Información Financiera) to enhance transparency and accountability in the execution of the public budget, as evidenced by: (i) the Borrower’s Decree No. 2674 of December 21, 2012, duly published in the Borrower’s Official Gazette on December 21, 2012; and (ii) the Ministry of Finance’s Act. No. 16 of February 26, 2013.

The prior action supporting Policy Area V: Monitoring Of Poverty and Other Social Indicators is Prior Action 6: The GoC has issued an updated national official methodology for the measurement of poverty, and has created institutional arrangements for improving the quality, transparency and replicability of poverty and other social indicators, as evidenced by: (i) the publication of Document CONPES Social No. 150 of May 28, 2012; and (ii) the establishment of: (A) the Executive Committee for the Measurement of Monetary Poverty; and (B) the Executive Committee for the Measurement of Multidimensional Poverty, through DANE’s Resolutions No. 871 and 877, respectively, of August 24, 2012.

Finally, the last prior action supporting Policy Area VI: Gender equity is Prior Action 7: The GoC has mandated the provision of specific measures to protect women who are victims of gender violence, and strengthened the implementation of the National Policy to Reduce Gender-Based Violence (GBV), as evidenced by: (i) the Borrower’s Decree No. 2734 of December 27, 2012, duly published in the Borrower’s Official Gazette on December 28, 2012; and (ii) the Ministry of Health’s Resolution No. 459 of March 6, 2012.
III. Rationale for World Bank Involvement

The proposed DPL is aligned with The World Bank’s Colombia Country Partnership Strategy FY-12-16 strategic theme 3: Inclusive Growth and Enhanced Productivity by contributing to the long-term outcome of “Improved Public Sector Management and Equity and Efficiency of Economic Policies.” Furthermore, the proposed DPL complements the World Bank’s commitment to a long-term engagement with the Government of Colombia in the area of fiscal and public sector management and is part of a strategic, programmatic and multi-sectoral engagement which includes lending operations, knowledge products and technical assistance across each policy area of the DPL.

The depth of the World Bank’s partnership with the Government of Colombia on fiscal and public sector management is substantial and has used different World Bank instruments as complementary tools in this endeavor. The tax reform formulation and discussions were support by a series of tax studies carried out under the Fiscal and Growth Programmatic Knowledge Services (P124256). The Colombia Subnational Institutional Strengthening investment loan (P123879), currently under preparation for $70 million, supports increased public service delivery at the subnational level in the areas of: (a) tax administration, (b) public expenditure (budget planning and execution, accounting, payments), (c) procurement, (d) human resources, (e) monitoring and evaluation, and (f) transparency and social participation. The proposed DPL complements this investment loan by supporting complementary policy reforms in policy areas II and IV of the DPL, with regard to strengthening subnational performance in core public management areas and utilization of the national financial management system, Sistema Integrado de Información Financiera, or SIIF (Consolidation of Public Management Information Systems, P106628). Furthermore, since July 2011 a programmatic series of DPLs supporting Colombia fiscal reforms totaling $500 million has been approved. The proposed DPL builds off of the aforementioned programmatic series in the tax reforms supported in policy area I.

IV. Tentative financing

<table>
<thead>
<tr>
<th>Source: International Bank for Reconstruction and Development</th>
<th>($m.)</th>
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<tbody>
<tr>
<td>Borrower</td>
<td>0</td>
</tr>
<tr>
<td>Borrower/Recipient IBRD</td>
<td>600</td>
</tr>
<tr>
<td>Others (specify)</td>
<td></td>
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<tr>
<td><strong>Total</strong></td>
<td><strong>600</strong></td>
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V. Institutional and Implementation Arrangements

The Ministry of Finance and Public Credit (MHCP) is the responsible implementing agency and will coordinate with the National Planning Department (DNP) in the area of monitoring and evaluation. The Department for Public Credit within the MHCP will collect the necessary data to assess the implementation progress for which the MHCP is
responsible and report it to the World Bank. Similarly, the Directorate of Evaluation of Public Policies within the DNP, responsible of the National Evaluation System of Management and Results (SINERGIA) will collect and report to the World Bank the information related to the implementation progress of royalties, Colombia Mayor, SIIF and gender indicators. Finally, the National Bureau of Statistics (DANE) will be responsible of the annual online release of household survey micro-data for replicating poverty and other social indicators. The World Bank will monitor the selected actions and review progress of the proposed operation as well as subsequent actions of the Government’s program through semiannual implementation status and results reports.

VI. Risks and Risk Mitigation

This DPL is subject to economic risks, political and social risks and implementation risks. The economic risks are related to a deteriorating external economic environment. Despite solid fundamentals, Colombia’s near-term macroeconomic outlook could be adversely affected in the event of external shocks. This risk is mitigated by a high policy response capacity. The political and social risks are related to recent labor unrest in several sectors and increasing political opposition from groups associated to the previous administration. These have had negative impacts on the approval ratings of the president. However, overall political risk in the country remains low, partially helped by the Government’s stout Congressional majority. This strong presence is expected to ensure policy continuity, and contribute towards the approval of the upcoming healthcare and pension reforms. Implementation risks due to delays in policy reforms are mitigated by the choice of a single tranche DPL operation, which recognizes and supports the ongoing reforms, while mitigating the risk of a programmatic approach under the current political calendar in the country, where the upcoming electoral cycle will make immediate further reforms unlikely. Furthermore, the operation was designed to exclusively support administrative measures which do not depend on legislative processes.

Taking into account the risk presented and discussed above, along with the associated mitigation measures, the overall risk of this operation is low. On balance, the potential risks of the operation are offset by the expected benefits.

VII. Poverty and Social Impacts and Environment Aspects

The Government policies supported in this DPL are expected to have a positive poverty and social impact. The present Poverty and Social Impact Assessment is being carried out, documenting these expected positive impacts from a gender-sensitive, social and distributional perspective. The assessment is meant to provide a robust analysis of the positive outcomes on equity of these policy actions. The PSIA thus is structured to follow the policy areas outlined under the Proposed Operation. There are reasons to expect a positive impact from each supported reform, as summarized below.

Within Policy Area I, the implementation of IMAN and the reforms to the VAT structure which reduce administrative and compliance costs and introduce a new luxury tax are expected to contribute to greater equity. A specific study is being conducted as part of this PSIA, using data from the 2011 tax records and the 2011 GEIH household survey to
assess the distributional impact of the IMAN; and the 2010 EVC survey on living conditions, to assess the joint impact of the IMAN and VAT reforms. Preliminary results show that with the changes regarding IMAN, the Gini coefficient of market income of a distribution that include top earners will decline in almost one percentage point (from 0.586 to 0.579), while fiscal collection will stay the same. This reduction of the Gini is not trivial, considering, for example, the average yearly reduction of the Gini in Latin American countries (1.2 percent annually) over the last 10 years (Lustig et al. 2012). Following a different methodology, which does not include incomes of top-earners—the Commitment to Equity Assessment (CEQ)—the results also indicate that the tax reforms will have a positive impact on decreasing income inequality, as well as on poverty reduction. The Gini coefficient would decrease from 0.535 to 0.534, while moderate poverty is estimated to drop from 33.4 to 33 percent, and extreme poverty from 18.2 to 17.7 percent. This methodology—given that it does not contemplate top earners, is likely to underestimate the effect of the reforms, which is why the change found in the Gini is lower.

In terms of Policy Area II, the policy actions regarding Subnational Governments Management are expected to have a positive impact on regional equity. While the previous royalties system has been found to be a factor of divergence among Departamentos in Colombia from 2000 to 2011, the new royalties system is expected to become a factor of regional convergence in the 2012-2016 period, by accelerating the catch-up effect between poor and rich Departamentos. A study, conducted as part of this PSIA, estimates the potential regional development patterns given the recent changes in the formula of distribution of the royalties system. Preliminary results from the assessment suggest that, in the post-reform scenario, regional inequality would indeed decline; while the speed of convergence (in terms of economic growth) from the poorer regions with respect to the national average, would increase.

The actions of Policy Area III, towards enhancing equity in social spending with a focus on the elderly, are found to have a positive impact on poverty reduction and inequality. The analysis performed uses a micro-simulation exercise to study the potential impacts on poverty and inequality of the expansion in coverage of Colombia Mayor for the years 2013 and 2014. Based on the ECV 2011, the study creates estimations for employment, earnings, and the income distribution for the years of interest, and uses these as a benchmark to estimate the changes in poverty and inequality that result from simulated expansions to the program. Preliminary results show a reduction in poverty incidence for the population group of 65 years of age and older, which could be attributed to the adequate targeting of the subsidy using proxy-mean tests. The results also suggest a small decline of the Gini Coefficient at the national, rural and cabeceras levels, under all simulated expansions.

Regarding Policy Area VI, the legislative measures aimed at increasing gender equality are expected to contribute to reduce the incidence of gender based violence. In order to better understand the impact of the implementation of the policy that mandates the provision of temporary housing, feeding and transportation for treatment of women victims of violence and/or her children, qualitative work is planned. In particular, the objective of the analysis will be to identify which strategies in implementation have
proven successful so far and where there might be potential bottlenecks to be addressed. The analysis will be based on in-depth interviews to recipients of these services from various socio-economic groups in selected regions as well as to service providers and those from the implementation agencies (health sector staff, Comisarias de Familia, and others). Evidence from a similar study in Brazil suggests that measures directly aimed at domestic violence are more effective in settings where economic opportunities are greater and social norms are less stringent.

The proposed operation is not likely to have any significant effects on the environment, forests, and other natural resources. As this operation focuses on tax reform, transfers to Subnational Governments, improvement in coverage and transparency of social spending and financial management and gender equity, it is not expected to have any impact on the environment. However, to the extent that actions supported by the loan program are successful, over time, in attracting new private investment, there will be need to continue strengthening Colombia’s institutional capacity to identify and address environmental policy and regulatory issues.

VIII. Contact point

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