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# Colombia Economic and Social Development Issues for the Short and Medium Term

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## CURRENCY EQUIVALENT

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US\$1: 1,562

## FISCAL YEAR

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## ACRONYMS

CAS	Country Assistance Strategy
GDP	Gross Domestic Product
NFPS	Non Financial Public Sector
SIIF	<i>Sistema Integrado de Información Financiera</i>
FARC	<i>Fuerzas Armadas Revolucionarias de Colombia</i>
EPL	<i>Ejército Popular de Liberación</i>
ELN	<i>Ejército de Liberación Nacional</i>
GNP	Gross National Product
CONPAPI	National Commission on Indegenous Policy
DGAI	<i>Dirección General de Asuntos Indígenas</i>
DESEPAZ	<i>Programa de Desarrollo, Salud y Paz</i>
IDB	Inter-American Development Bank
USAID	United States Assistance for International Development
NGOs	Non Government Organizations
PEI	<i>Proyecto Educativo Institucional</i>
EPS	<i>Entidad Promotora de Salud</i>
POS-S	<i>Plan Obligatorio de Salud – Régimen Subsidiado</i>
PAB	<i>Plan de Atención Básica</i>
OECD	Organization for Economic Co-Operation and Development
DRG	Diagnosis-related groups
INCORA	<i>Instituto Colombiano de la Reforma Agraria</i> (Colombia Land Reform Institute)
SNRA	National Land Reform System
CA	<i>Caja Agraria</i>

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FINAGRO	Fund for Financing the Agricultural Sector ( <i>Fondo para el Financiamiento del Sector Agropecuario</i> )
FOGAFIN	<i>Fondo de Garantía Financiera</i> (Financial Guarantees Fund)
UMATAs	<i>Unidad Municipal para Asistencia Agropecuaria</i> (Municipal Unit for Agricultural Assistance)
PRONATA	National Program for Agricultural Technology
FINDETER	<i>Fondo de Desarrollo Territorial</i>
BANCOLDEX	<i>Banco de Comercio Exterior de Colombia</i>
NCS	National Co-Financing System
PGRs	<i>Plan de Gestión y Resultados</i>
ECOGAS	<i>Empresa Colombiana de Gas</i>
ECOPETROL	<i>Empresa Colombiana de Petroleo</i>
CREG	<i>Comisión Regulatoria de Electricidad y Gas</i>
OPEC	Organization of Petroleum Exporting Countries
MOPT	Ministry of Public Works and Transport
MOT	Ministry of Transport
SAL	<i>Servicio de Adaptación Laboral</i>
MOT	Ministry of Transport
INVIAS	<i>Instituto Nacional de Vías</i>
FVN	National Highway Fund
INTRA	National Institute for Transport
FNCV	Rural Roads National Fund
PROVIAL	Road Maintenance Program
CAA	Civil Aviation Authority
CREMA	Contracts for Rehabilitation and Maintenance
CONPES	National Council for Economic and Social Policy
INDERENA	<i>Instituto Nacional de Recursos Naturales y del Medio Ambiente</i>
CAR	<i>Corporación Autónoma Regional</i>
CMA	<i>Corporación del Medio Ambiente</i>

# COLOMBIA: POLICY NOTES

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## OVERVIEW

1. These Policy Notes cover a set of priority development issues, drawing from the Country Assistance Strategy (CAS) which was prepared jointly with the Colombian authorities and civil society last year. While this is not an exhaustive list of all the issues in Colombia's development agenda, it could serve to stimulate debate with the new government and civil society on how to best help Colombia achieve its development potential.
2. Colombia, one of South America's oldest, middle-income democracies, has developed rapidly despite a fifty year 'simmering' civil war and increasing levels of urban and rural crime and violence. In the past decade, however, the scale and intensity of violence has changed from a marginal conflict to generalized violence that now affects the daily lives of most citizens. Today, government and civil society alike recognize that violence is a key development constraint, which therefore needs to be understood in its various types and causes. It affects the country's macro-and micro-economic growth and productivity, as well as impacting on the government's capacity to reduce the poverty, inequality and exclusion experienced by large segments of its urban and rural population. The election of the new government in August 1998 provides a window of opportunity for refocusing the peace and development initiatives begun by previous administrations
3. Achieving peace would require a comprehensive strategy that: (i) prioritizes political, economic, and social policies for peace and development; (ii) encourages the creation of state, civil society and private sector partnerships for peace as the basis of national dialogue; (iii) develops participatory local-level solutions that consolidate social capital and citizenship, focusing on the perceived needs of priority target groups, such as displaced populations, demobilized combatants (when peace agreements are reached) and excluded urban youth; and (iv) emphasizes rural development, including land reform. On the latter, the institutional framework for implementing land reform needs to be restructured, and Law 160 needs to be amended so that it applies to individuals and their subprojects, with the subsidies on a progressive basis with respect to income. Moreover, the Government should identify the obstacles which prevent the private sector from providing more financial services in rural areas, carry out a plan to eliminate those obstacles, and, if justified, develop incentives for further expansion of financial services in underserved areas. Overall, rural development should be consistent with natural resource management and longer term environmental sustainability
4. Achieving peace and reducing the overall level of violence are essential for restoring the social fabric and establishing a proper environment for social and economic development. Peace could have an enormous impact on economic activity. At the same time, it requires a growing and dynamic economy, to provide a rising standard of living and the resources needed to support the peace process. Thus, economic and social development go hand in hand with, and are supported by, peace and the reduction of violence. All these are essential elements in the overall effort to reduce poverty, the key development priority.
5. On the economic front, the key strategic objectives of the new government's policy are to restore high rates of economic growth and reduce the rate of unemployment within the

context of longer-term fiscal and external sustainability. Achieving these objectives in the medium and longer-term requires both stabilization and structural adjustment measures. In particular, reducing the fiscal deficit is a necessary condition for bringing real interest rates and inflation down, and for curtailing the growing current account deficit, which undermines Colombia's stance in international credit markets. For these conditions to be sustainable over time, however, the improvements in the fiscal accounts must be achieved through a coherent set of structural changes, rather than with sporadic ad hoc measures. Thus, after cutting budgeted expenditures by 0.5% of GDP and launching a program to improve revenue collection immediately after taking office, the new government also sent to Congress a set of proposals to address structural problems in the public sector accounts. Among other things, these proposals would reform the budgetary process, the mandated transfers to local governments, the *fondos de cofinanciación*, the *Fondo Nacional de Regalías* from oil and other exports, and would advance the social security reform. After these proposals are approved by Congress, the test would be in their implementation. The government should follow closely the results of these reforms, and prepare contingency plans to be ready in the event that outcomes fall short of expectations.

6. Restoring fiscal balance, boosting external competitiveness, and reducing the rate of inflation are necessary conditions for reaching higher and sustainable rates of growth -- but they may not be sufficient. Openness to international trade should be expanded to encourage the growth of exports. Infrastructure needs to be modernized and expanded. The financial sector's efficiency and effectiveness can be enhanced by continued withdrawal of the public sector from the banking and financial sectors, and by improving the quality of supervision of financial institutions. Such withdrawal will also defuse a potential liability for public accounts. Reduction of the high unemployment rate will require structural reforms aimed at lowering labor costs and increasing flexibility in the labor market. Improving the education system would help make workers more employable and trainable, as well as provide a constructive vehicle of social mobility, thus helping defuse social tensions and contributing to social peace.

7. Good governance and transparency are essential for boosting the legitimacy of public institutions. In particular, judicial reform will contribute to good governance and is also a key element in the Government's peace strategy. The proposed reform program, aimed at improving peaceful conflict resolution, would seek three strategic objectives: (i) introducing community-based conflict resolution mechanisms; (ii) improving the judiciary's capacity to contribute to peaceful resolution of conflicts; and (iii) improving the judiciary's governance and managerial capacity.

8. A better education system is essential for peace, economic growth and improved quality of life of the population. The main reforms needed to improve the system within the decentralization model are: (i) establishing of a new model of organization and management of the sector, based on the school and its immediate community, and supporting institutional development at the school level, with clearly defined responsibilities of the municipal, departmental and national levels; (ii) restructuring of the transfer system to eliminate duplications and ensure that resources are distributed on an equitable basis; (iii) strengthening the teaching force; and (iv) expansion of the coverage, especially at the pre-primary level, which is now only 23 percent.

9. In the infrastructure and energy sectors, Colombia will need large investments over the next decade. Preliminary estimates based on experience in countries at comparable stage of development both in Latin America and world-wide, together with available information on the current state of Colombia's infrastructure (including water & sanitation, transport, energy/power, telecommunications, and urban development) suggest that average annual investments in the US\$3-4 billion range will be needed over the coming decade, even before taking account of special projects such as the urban metro-rail systems that are under consideration. The magnitude of these resource requirements, together with the fiscal challenge facing the Government, make it imperative for Colombia to take all steps to attract the maximum private sector investment. It would be critical to create well-thought-out sector structures conducive to competition, an enabling regulatory and investment environment, and capital market linkages and instruments that promote vigorous private sector participation in infrastructure provision.

10. Pursuing all these objectives, including implementation of the Government's peace initiative, will place additional demands on scarce fiscal resources, requiring a stricter prioritization of expenditures to keep their total within the envelope of available resources. In all these areas, inauguration of a new Government with a fresh mandate from the voters, presents a window of opportunity for Colombia to break with the past and enter the 21st century with social peace and a more solid basis for economic and social development.

## MACROECONOMIC PRIORITIES IN THE SHORT AND MEDIUM TERM

### A. Introduction

1. The Colombian economy's performance has deteriorated sharply in the last three years: (i) the GDP growth rate has dropped from an average of 4.6% per year in 1991-95 to 2.7% in 1996-98. This has been accompanied by a sharp increase in unemployment, which reached 15.8% in mid-1998; (ii) the fiscal accounts of the non-financial public sector, which were roughly balanced in the first half of this decade, showed a deficit of 4.3% of GDP in 1997 and it is projected to be 3.7-4.5 % of GDP in 1998 (Table 1); and (iii) the current account of the balance of payments, which deteriorated sharply in 1993, reached a deficit of nearly 6% of GDP in 1997 and is projected to stay at about that level in 1998. In all these areas, as well as in the inflation front, Colombia's economy underperformed compared to the rest of Latin America – a drastic reversal from its much better relative performance in the 1980s. While most other Latin American countries underwent sweeping stabilization and adjustment programs in the last 10 years, Colombia lost its reform momentum of the early 1990s. Those trends are clearly unsustainable, both in terms of financing the widening fiscal and external gaps as well as in terms of achieving Colombia's objectives of growth and poverty reduction.

**Table 1: Selected Economic Indicators**

	1980-85	1986-90	1991	1993	1995	1996	Prel. 1997	Proj. 1998
<b>Real GDP Growth</b>								
Colombia	2.6	4.6	2.0	5.4	5.7	2.0	3.1	2.0-3.0
LAC: Mean	1.8	3.4	3.3	2.8	2.9	3.3	4.4	3.4
<b>Rate of Unemployment</b>								
Colombia	11.0	10.6	10.2	8.6	9.5	11.3	12.0	15.0-16.0
LAC: Mean	10.5	10.2	9.4	10.0	8.7	9.6	9.4	
<b>Non-Fin. Public Sector Balance</b>								
Colombia	-5.4	-0.3	-0.3	0.0	-1.4	-2.9	-4.3	-3.7 to -4.5
LAC: Mean	-8.6	-7.0	-3.1	-2.4	-2.2	-2.6	-1.1	-2.6
<b>Current Account Balance</b>								
Colombia	-5.1	0.5	5.6	-4.4	-5.1	-5.6	-5.9	-6.3 to -6.6
LAC: Mean	-5.8	-3.7	-6.8	-7.8	-5.8	-4.5	-5.2	-5.4
<b>Inflation</b>								
Colombia	22.3	26.3	30.0	22.6	19.5	21.6	17.7	17.0-18.0
LAC: Mean	107.1	321.9	150.7	88.0	24.1	13.3	10.0	10.0

Source: Colombian authorities; and IMF and World Bank staff estimates and projections

2. The deterioration of the fundamentals also increases the uncertainty and fragility of the economy as a whole. In late May/June 1998, following exchange rate pressures that started in the second half of 1997, there was a strong attack on the Colombian peso. The authorities reacted swiftly to defend the exchange rate band, nearly doubling interest rates and restating their commitment to the existing exchange rate regime. While the attack subsided within a few weeks, it cost the Bank of the Republic around \$250 million. Altogether, the cumulative loss of net international reserves from August 1997 through mid-September was about \$1.8 billion. While both the loss of reserves and the attack on the currency were associated with external shocks, they reflected the perception of the markets that the fiscal and external imbalances in Colombia were not sustainable.

3. Balanced fiscal accounts are the fundamental pillar of macroeconomic stability, which is a necessary condition for the resumption of growth and lower unemployment. Fiscal deficits exert an upward pressure on interest rates that crowd out private investment and ultimately conduce to a slow down in economic growth. Further, fiscal imbalances put pressure on the exchange rate and/or international reserves, and lead to the real appreciation of the domestic currency, which is detrimental to the international competitiveness of the country. Also, since the room for closing the fiscal gap with domestic and/or foreign debt is limited (or it becomes too expensive), large fiscal deficits are usually associated with high inflation rates. In addition, restoring fiscal discipline is crucial for the successful implementation of the Government's peace strategy, since it is likely to require substantial public resources, which would have to be found within the overall budget constraint that is consistent with macroeconomic stability.

4. The worrisome current account deficit, which in 1998 would be in the 5-6% of GDP range for the fourth year, mirrors to a large extent the imbalance in the fiscal accounts. The deterioration started in 1993 largely as a result of growing private investment, and it aggravated in the last few years as a result of growing public expenditures. In addition, in 1997 and 1998, exports revenues were negatively affected by the drop in oil and coffee prices, while interest payments increased from 13.7% of exports of goods and non-factor services in 1996 to a projected 16.4% in 1998. The deteriorating macroeconomic situation and the resulting increase in Colombia's country risk are behind the sharp drop in the domestic stock market and the increase in the cost of borrowing abroad. Moreover, they make the country more vulnerable to external shocks and could endanger Colombia's traditionally good access to international credit markets.

5. This Note discusses key macroeconomic issues which face the new Colombian Government at the inception of its administration. The emphasis is on the complementarity between short term stabilization measures and longer term structural changes. Stabilization is an essential first step when facing domestic and external imbalances, but it is credible only when accompanied by consistent structural changes that ensure sustainability in the medium and longer term. This Note focuses on three central aspects of macroeconomic management, which are closely interrelated: (i) structural measures to reduce the public sector deficit, which is the most fundamental element of macroeconomic stability; (ii) the costs and benefits of reducing inflation, including international evidence on the costs of disinflation; and (iii) policies to encourage economic growth.

**B. Fiscal Adjustment - a Medium and Longer Term Perspective**

6. As mentioned above, the deficit of the Non Financial Public Sector (NFPS), which was virtually nil in the early 1990s, reached 4.3% of GDP in 1997. The Central Government had larger deficits during this period, which were partly offset by surpluses in the rest of NFPS, particularly the social security system. Total Central Government expenditures increased by 6.4% of GDP in 1991-97, while its revenues increased only by 2% of GDP. The former is explained mostly by the growth of operating expenditures and interest payments, while investment increased only by 0.5% of GDP.

7. The main source of increase in operating expenditures were transfers to local governments and pensions, which increased by 2.5% of GDP and by 1% of GDP respectively between 1991 and 1997. The wage bill decreased as a fraction of operating expenditures, but the share of the Justice and Defense sectors increased from 64% to 80% of personnel expenditures in the same period. Interest payments increased both because of the larger volume of debt, and because of the shift of public debt to market interest rates. Today, for an internal debt equivalent to about 9% of the GDP, interest payments are about 2.5% of GDP, of which 1.5% of GDP is due to inflation. This illustrates an important channel through which inflation contributes to the deterioration of the fiscal accounts.<sup>1</sup>

8. The new Government that took office on August 7, 1998, inherited a very difficult fiscal situation. Under a passive scenario, the deficit of the non-financial public sector was projected to reach nearly 5% of GDP in 1998. Moreover, the fiscal outlook was aggravated by the crisis in international capital markets, which made it much more difficult and expensive to obtain external financing to close the fiscal and balance of payments gaps. Thus, the Government made reducing the fiscal deficit one of its key macroeconomic objectives. It recognized that urgent measures are required on both the expenditure and the revenue sides, and for these adjustments to endure they will have to be complemented by structural changes. Thus, upon taking office, the Government cut budgeted expenditures for 1998 by 0.5% of GDP and increased gasoline prices, and it started to prepare a package of structural reforms in the public sector.

9. A few weeks later, on September 2, 1998, the Government announced the fiscal package, which included proposals for legislation on tax reform at the central and local levels, revenue sharing procedures, budgetary reform and solidarity peace bonds.<sup>2</sup> The objective of the Government is to cut the deficit of the non-financial public sector to 2% of GDP in 1999 and to balance the fiscal accounts by year 2001. On taxation at the central level, the proposal included widening the base of the VAT combined with a reduction of its rate (currently 16%), changes in income taxation to eliminate the

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<sup>1</sup> The part of interest payments that compensates bond holders for inflation is, in fact, amortization of the public debt, and as such it is not part of the operational deficit of the Government. But if at some point in time the public would not be willing to maintain at least a constant real level of public debt, pressures in bond markets would be higher because of these payments.

<sup>2</sup> In parallel, the Central Bank announced an upward shift of the exchange rate bond by 9%, allowing for a larger depreciation of the currency, and an inflation target for 1999 of 15%.

presumptive tax based on gross assets and to increase tax withholding, and measures to fight tax evasion and smuggling. At the local level, the proposal calls for simplifying the tax structure through uniform tax bases, with greater local autonomy in setting tax rates. On revenue sharing with local governments, the Government proposed a Constitutional amendment which would lead to the saving of part of the transfers to help meet future pension obligations of local governments. On budgetary procedures, the proposal aims at improving control over expenditures, reducing earmarking, eliminating the carryover of expenditures from year to year, and increasing the accountability of government employees. Finally, the Government package includes a compulsory purchase of Solidarity Peace bonds in years 1999 and 2000 by persons and companies with a net worth of more than Col\$210 million. In addition, the Government is preparing a National Development Plan for 1999-2002 as well as detailed plans for structural reforms in the central administration and for completing the reform of the social security system.

10. As can be seen, the Government has moved quickly both in terms of stabilization measures to trim the fiscal deficit this year as well as in putting together a package of structural reforms to achieve longer term fiscal sustainability. The latter are being discussed in Congress, and it remains to be seen whether and in what shape the proposals will be approved. Eventually, the key will be implementation. The new *Sistema Integrado de Información Financiera (SIIF)*, which is now being piloted, will help to improve the control over public expenditures. At the same time, to achieve the desired outcomes within tighter budgetary constraints, the government would have to improve the efficiency of public spending. The following paragraphs describe in more detail several outstanding issues.<sup>3</sup>

11. The **public administration** would be streamlined by consolidating Ministries and agencies, with a view to eliminate duplications and improve operational efficiency. That should be done with three main considerations in mind: (i) a reassessment of the role of the public sector in the economy, namely, ascertaining what the public sector should do, and what can be left to the private sector; (ii) the ongoing decentralization process, which implies a smaller administration at the central level; and (iii) the resource constraint facing the public sector, which is determined by the level of taxation that can be raised while minimizing its distortionary effects, and by its strategy regarding both domestic and external debt.

12. **Total transfers to local governments** were set by the Constitution as a fraction of government revenues, which would grow from 43.5% in 1998 to 46.5% by 2001. This link precludes the local government from any concerted effort to reduce public expenditures and it undermines Central Government's efforts to increase its revenues.<sup>3</sup> As mentioned above, the government brought before Congress a Constitutional amendment that would set aside part of the constitutionally mandated transfers (equivalent to the fraction of current revenues that is allocated to interest payments) to be

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<sup>3</sup> For a more detailed discussion of these issues, see Juan Pablo Cordoba "Ajuste Fiscal: Cuando y Como?", monograph, Santafé de Bogotá, April 1997.

saved by local governments to help meet their future pension liabilities. While at the margin the Central Government will still need to raise nearly two pesos to keep one, this amendment will help defuse a growing fiscal liability of the public sector. Further, local governments will have a stake in the reduction of fiscal deficits, since that would lead to lower public debt and lower interest payments, thereby increasing the part of the transfers that they can actually spend. Meanwhile, the allocation of transfers could be improved. The justification for the various components of the transfers should be reassessed and some could be curtailed. More generally, what is needed is a clear-cut definition of the responsibilities of local governments and their accountability to the citizens. In addition, the current system for the distribution of royalties (regalias) of oil and other exports could be restructured, bringing those revenues back to the national treasury in order to address investment priorities and to ensure an equitable distribution among all regions.

13. The problem for public finances arises because the actual responsibilities for executing expenditures are not being transferred jointly with the resources. Thus, as the Central Government continues to spend in areas that should be the domain of territorial governments, duplications arise and total public expenditures increase. Therefore, as capacity at the local level improves, the **Central Government should rationalize its regional spending**, in particular: (i) phase out the *fondos de cofinanciación*, specially those that support programs that are the responsibility of local governments, while ensuring that programs of national priority are maintained; (ii) spending in the education sector, which appears to be inflated by duplications and inflexibilities in the current system of allocating the transfers. As the *Comisión de Racionalización del Gasto y Finanzas Públicas* suggested, the solution here could be to shift to a capitation system, with enhanced flexibility to allocate resources on a more equitable base; and (iii) spending on secondary and tertiary roads, which are the sole responsibility of local governments.

14. This should be supported by an effort to build an **independent tax base at the local level**. The Government proposal for simplifying the local tax structure is an important step in that direction. In addition, local governments need to strengthen tax administration and collection, to ensure that they actually collect the taxes that they are entitled to. A case in point is the land tax: the actual tax rate is about 0.4%, although Laws 14 and 44 allow a rate of 1.6%. Moreover, the "avaluo catastral" is typically only 40% of the "avaluo comercial", and only 60% of the respondents in a recent survey<sup>4</sup> indicated that they in fact pay the land tax. That means that municipalities currently collect only 6% of the potential revenues to be obtained from collecting the land tax. Interestingly, 74% of the respondents to that survey indicated that they would be willing to pay more if these revenues would result in improved services by the municipalities.

15. Since the room for expenditure cuts is limited, closing the fiscal gap also requires an **increase in revenues** at the national level too. As mentioned above, the government's proposals are based on: (i) expanding the tax base rather than increasing tax rates; (ii) improving administration and collection of taxes; and (iii) reducing earmarking. That is

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<sup>4</sup> La Incidencia del Catastro en las Finanzas Municipales y el Mercado de Tierras, Land Reform Support Project Files, October 1997.

the right approach, since both the income tax and the VAT have numerous exemptions and exceptions that not only represent a loss of revenue but also make the tax system more distortionary, and should therefore be abolished. In the medium term, following the numerous tax measures of the past few years, a more comprehensive tax reform is required. The new system should be based on 4-5 taxes only, with no exemptions and low rates. That would encourage economic activity, it would simplify tax administration and it would also help increase efficiency in the collection of taxes. On the latter, the World Bank is assisting DIAN in modernizing its informatics infrastructure and improving its effectiveness in various functional areas. Additional initiatives will be needed to address organization and management deficiencies in the DIAN, to carry out second generation reforms, and to strengthen customs operations.

16. On **social security**, the 1993 Law was a major step forward because it recognized the contingent liabilities of the system and created a new system that is actuarially sound. The main problems after that landmark reform are: (i) the transition between the old and the new regimes; and (ii) the sectors that maintain special benefits after the reform. On the transition issue, the Law allows for a 20-year transition period, during which certain types of beneficiaries can maintain the benefits of the old regime. Since the old regime was not financially sound, the contingent liability of the public sector is still growing. Therefore, there is a need to shorten the transition period substantially as soon as possible. In addition, the 1993 Law excluded from the reform three important sectors: defense, teachers and Ecopetrol. These sectors kept special retirement benefits, and their contributions are well below what is required to finance those benefits. Consequently, the outstanding fiscal debt on account on those pensions, which is now estimated at about 10% of GDP, keeps growing. Thus, for both fiscal reasons as well as for equity considerations, these sectors should be included in the system that covers the rest of the population.

17. While the fiscal situation may not have been a driving force behind the persistence of inflation in the past, putting the fiscal accounts in order is a necessary condition for bringing down inflation. A meaningful fiscal adjustment provides a clear signal that the authorities are serious about reducing inflation and it adds to their credibility. Moreover, as pressure on domestic interest rates declines, the costs of disinflation in terms of investment, output and employment losses decline as well. Both elements are important because it would be very hard to eliminate all indexation mechanisms, since most of them are informal, and thus inflation cannot be brought down by anchoring the exchange rate and/or by using monetary policy alone.

**C. Reducing Inflation and the Costs of Disinflation - The International Experience**

18. As seen in Table 1, inflation rates in Colombia were in the range 20-30% for most of the past 25 years. Maintaining inflation within this range reflects the perception of successive Colombian authorities that while higher inflation rates may entail economic and social costs, the country had learned to live with moderate and stable inflation. Furthermore, the costs of lowering inflation below that level were considered to be very high indeed. As we will see below, however, the international experience of countries with moderate inflation rates shows that the costs of reducing inflation in terms of output loss are, on average, lower than is commonly believed. Moreover, in LAC, stabilization programs brought about, on average, an increase in production rather than an output loss.

19. Inflation has tangible costs because of: (i) increased uncertainty about the outcome of business decisions and profitability, resulting in lower private investment and growth; (ii) negative effects on the costs of capital resulting from the interaction of inflation and the tax system; (iii) reduced effectiveness of the price and market systems, which results in an inefficient allocation of resources; and (iv) distortions that create perverse incentives to engage in non productive activities. On the last point, for example, inflation leads to overinvestment of resources in the financial sector, which diverts resources better employed in production and innovation activities. In addition, inflation is anti-poor, and tends to worsen the distribution of income in the economy.

20. Several studies estimate the costs of inflation. Barro (1996), using data from approximately 100 countries from 1960-90, finds that an increase of 10 percentage points in the annual inflation rate is associated with a decline of 0.3-0.4 percentage points in the annual growth rate of GDP.<sup>5</sup> For Colombia, Uribe (1994) finds that inflation had, particularly when it reached the two digit level, a negative and direct impact on growth, mainly by affecting the efficiency in the allocation of resources.<sup>6</sup> Furthermore, he estimates that reducing inflation by 10 percentage points leads to an increase in the GDP growth rate of 0.5%, and that the costs of maintaining a two digit inflation rate in Colombia appear to be increasing over time.

21. Feldstein (1997) calculates the present value of the benefits of reducing inflation.<sup>7</sup> He indicates that by discounting an annual benefit of  $x\%$  of GDP at a discount rate of  $d\%$  in an economy that grows at  $g\%$  per year -- yields a present value of  $x/(d-g)$ . In Colombia, for example, whose GDP grew at an average 4.6% per year between 1970-95, assuming that the benefit of reducing inflation by 10 percentage points was 0.5% of GDP

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<sup>5</sup> Robert J. Barro "Determinants of Economic Growth: A Cross-country Empirical Study", NBER Working Paper No. 5698, May 1996.

<sup>6</sup> Jose Dario Uribe "Inflación y Crecimiento Económico en Colombia: 1951-1992", Borradores Semanales de Economía No.1, 1994, Banco de la República, Santafé de Bogotá.

<sup>7</sup> Martin Feldstein "The Costs and Benefits of Going from Low Inflation to Price Stability", in Reducing Inflation - Motivation and Strategy, ed. By C. Romer and D. Romer, 1997, The University of Chicago Press.

per year (Uribe, 1994), and using a very conservative real discount rate of 10%, the net present value of the benefits would be  $0.5/(0.1-0.046) = 9.3$  percent of GDP. Using a real discount rate of 8%, or if the economy would grow on average (in a less distortionary environment) at 6.5% per year, the present value of the benefits from reducing inflation by 10 percentage points would rise to 14% of GDP. In addition, as mentioned above, reducing inflation is bound to be beneficial for the poor, who cannot protect themselves from rising prices, with positive effects on the distribution of income.

22. These benefits should be compared with the costs of bringing inflation down. Is it really very costly, in terms of output loss, to reduce inflation from intermediate rates, as Colombian authorities have assumed in the past? In order to check the international experience, we estimated "sacrifice ratios" for 41 episodes in 30 countries, between 1970 and the present, which lowered inflation from an intermediate range of 15-50% by at least 10 percentage points or to rates below 15%. The numerator of the sacrifice ratio is the sum of output losses; that is, the deviations between actual output and its trend level. The denominator is the change in trend inflation between a peak and a trough. Thus, sacrifice ratios measure the cost in terms of output of reducing inflation by one point.<sup>8</sup>

**Table 2: Sacrifice Ratios in Latin America**

	Disinflationary Episode	Sacrifice Ratio*	Peak Inflation	Drop in Inflation	Output Loss
Chile	1979-1982	-1.42%	35.0	19.6	-27.87%
	1985-1988	1.10%	25.8	10.8	11.91%
	1990-1997	-0.09%	21.4	15.4	-1.32%
Colombia	1991-1997	0.03%	26.0	8.6	0.24%
Costa Rica	1991-1993	-0.11%	23.4	11.8	-1.35%
Dominican Republic	1990-1993	0.30%	41.1	36.0	10.71%
Ecuador	1974-1976	-0.46%	20.4	8.6	-3.93%
	1983-1986	0.16%	38.7	14.6	2.33%
	1992-1995	-0.07%	42.8	21.6	-1.58%
Paraguay	1990-1992	-0.01%	30.0	15.4	-0.19%
El Salvador	1990-1997	-0.32%	18.8	14.3	-4.57%
Guatemala	1986-1988	0.64%	29.8	20.2	12.84%
Mexico	1989-1993	-0.21%	30.2	20.5	-4.37%
Venezuela	1989-1992	0.09%	46.8	18.7	1.61%
Average Latin America		-0.03%	30.7	16.9	-0.39%

\* % drop in output per % drop in inflation.

Negative sacrifice ratios indicate a gain in output, relative to potential, per point reduction in inflation.

<sup>8</sup> For more complete discussion of the methodology, see Zeinab Partow and David E. Yuravlivker "Intermediate Inflation in the Northern Andean Countries and the Costs of Disinflation: The International Experience", presented at the Conference Why is it Important to Reduce Inflation and How to do it. The International Experience and Lessons for Colombia, Bogota, May 1998.

23. Table 2 shows the sacrifice ratios for a subset of fourteen episodes of disinflation in ten Latin American countries. The ratios range from a *negative* ratio (i.e. a *gain* in output relative to potential) of -1.42% to +1.10%, with an average of -0.03%. That basically means that, on average, there was a small gain in output during the disinflation periods, as in eight of the fourteen episodes output did actually rise during the stabilization period. Of the remaining cases, all but one have had costs of less than 1% (results for the whole sample are presented in the Annex).

24. These results show that output does not seem to suffer as a result of disinflation in all countries, and it actually increased during stabilization periods in most episodes. Moreover, while output does, on average, fall in the full sample, there is an almost immediate rise back to pre-stabilization levels. Enhanced government credibility and greater financial depth appear to contribute to reducing the sacrifice ratio in our sample, thereby suggesting ways in which governments can reduce the costs of bringing down inflation.

25. Choosing the speed of disinflation will be a key strategic decision for the new Colombian Government. While gradualism has generally been the rule in Colombia, reducing the target by say 2 percentage points per year may not be a viable strategy for the following reasons: (i) it is within the width of the monetary band, i.e., people would not be able to identify the change in policy; and (ii) it lengthens the process too much, undermining its credibility and allowing blocking coalitions to form and resist the change. Thus, the two realistic options seem to be either an "accelerated gradualism", i.e., lowering inflation by 4-5 percentage points per year for 3-4 years, or alternatively a more drastic adjustment that would bring inflation down in 1-2 years. While the first option is less dramatic, it would still entail a break from the past, and thus it would require a very strong commitment by the economic authorities and by the top levels of Government.

#### **D. Policies to Encourage Economic Growth**

26. As mentioned above, restoring fiscal balance, boosting external competitiveness, and reducing inflation to single digits are central components of a comprehensive growth strategy. The recent deterioration in the fiscal accounts had both a direct and an indirect negative impact on GDP growth. First, investment expenditures have been the primary candidate for quick cuts when those were called for. Second, the pressures of government borrowing on domestic credit markets and resulting increase in interest rates had a negative impact on private investment. And third, the latter was also discouraged by the increased uncertainty generated by growing fiscal imbalances. Thus, restoring fiscal balance would reverse those trends, leading to higher investment and GDP growth.

27. Reducing inflation would also have a positive effect on GDP growth. International experience shows that while inflating may stimulate growth in the short run, the relationship is clearly negative in the longer run, as discussed in paragraphs 17-18 above. Moreover, since inflation is a regressive tax and the poor are less able to protect themselves from it, reducing the rate of inflation to single digits is also likely to have a positive effect on the distribution of income in society.

28. Stabilization, however, is a necessary condition for higher and sustainable growth but it is not sufficient. Modernization of infrastructure, an improved legal system and a solid financial sector would lower total production costs and facilitate internal and external exchange, thereby contributing to economic growth and social development (see respective Policy Notes below). Reducing the level and dispersion of import protection will improve the incentive system for the expansion of exports. Further, structural reforms are needed to bring the economy to a higher growth path on a sustainable basis. In particular, reforms are needed in the labor markets and in the education system. In addition, an improvement in the security situation is likely to have a very substantial impact on GDP growth.

29. The slowdown in economic activity and the sharp increase in interest rates are having a toll on the financial sector: profits dropped from Col\$460b. in January-May 1997 to Col\$48b. in Jan.-May 1998, the share of non-performing loans has increased from 6.7% of the portfolio at end-1997 to 8% in June 1998, and 8 institutions (of the total 130) have had to access special liquidity facilities at the Central Bank. While at this time there seems to be no systemic risk but rather localized problems, it is important to strengthen the supervision of financial institutions. Currently, several public financial institutions appear to be in worse shape than the rest of the sector. Although their relative importance is nowadays much smaller than in the past (less than 25% of the assets of the banking system compared to about 70% in the early 1980s), their weight is not negligible, some draw on public resources, and they could become a substantial liability for the fiscal accounts. Thus, the government should consider: (i) closing the Caja Agraria, while ensuring that an alternative market based system for the provision of credit to small farmers is in place; (ii) encouraging the Institute of Social Security to divest from BCH, as it was originally intended; and (iii) consolidate the public second tier banks, with participation of the private sector, to make them more efficient and effective institutions.

30. As mentioned above, the unemployment rate has reached 15.8% of the labor force, the highest rate since the early 1980s. Among the factors that led to this increase, apart from the slow-down in the rate of growth, are the high costs of labor resulting from social security contributions and other charges, which amount to over 50% of the wage costs. One way of dealing with this problem is to expand the use of the *salario integral*, based on Law 50, which would reduce labor costs by nearly 20% and thereby encourage the hiring of workers. In addition, a review of labor regulations could identify those that are detrimental to labor mobility and to a more efficient clearing of labor markets.

31. As for education, investment in human capital is the key to development and higher living standards in the longer term. In addition, the nature and composition of this investment could have a direct impact on employment levels in the short and medium term. Recent work by Mauricio Cardenas shows that the rate of unemployment is relatively higher for secondary school graduates. Therefore, specific programs of technical education for these graduates would enhance their chances of finding employment as well as respond to an increasing market need. He also suggests various measures to improve the quality of basic education within the decentralized school system. (see Policy Note on Education). In addition, the education system has to improve in all areas of the country and for all segments of the population to become a true vehicle

of social mobility, which by providing a real opportunity to the disadvantaged would help defuse social tensions and contribute to social peace.

32. Last, but certainly not least, reduction in the high level of violence could have an huge impact on economic growth and social development in Colombia. Various studies estimate that the country loses between 1 and 4 percent of GDP annually because of violence (see Policy Note on Peace and Development). Public spending on security and judicial systems is currently 5% of GDP, while estimated expenditures on private security total 1.4% of GDP. Violence has a negative impact on investment, and it erodes productive assets as well as human capital. For these and other reasons, Colombians put peace at the top of their national priorities for both economic and social development.

### **E. Summary and Conclusions**

33. The key strategic objectives of the new government's economic policy is to restore high rates of economic growth and to reduce the rate of unemployment within the context of longer term fiscal and external sustainability. Achieving these objectives in the medium and longer term requires both stabilization and structural adjustment measures. In particular, reducing the fiscal deficit is a necessary condition for bringing inflation down and for achieving macroeconomic stability. Also, restoring fiscal control and regaining external competitiveness are necessary conditions for curtailing the growing current account deficit, which undermines Colombia's stance in international credit markets. For these conditions to be sustainable over time, however, the improvements in the fiscal accounts must be achieved through a coherent set of structural changes, rather than with sporadic ad-hock measures. That is especially true since the peace initiative of the new Government is likely to require substantial fiscal resources, which would have to come from the rationalization of expenditures and the possible expansion of the available resource envelope. This note has discussed such changes both on the expenditure and revenue sides of the fiscal accounts, including streamlining the public administration, rationalizing transfers to local governments, eliminating duplications in central and local governments functions, increasing central as well as local revenues, and completing the reform of the social security system.

34. The Colombian model of moderate and stable inflation has become unworkable: in the external front, larger and faster capital flows require more flexibility of the exchange rate, allowing for swifter adjustment of relative prices but increasing price volatility. In the internal front, the environment has changed (independence of the Central Bank) and the incentives have changed (the Government virtually ceased receiving any revenue from inflation tax). Moreover, to be on an equal footing with other countries in an increasingly globalized economy, Colombia's inflation rate would have to converge to international rates. Thus, the question is not whether but rather how and when to do it. The "how" is well known to the monetary authorities, from their own as well as from international experience. The "when" is now, for Colombia to join the group of countries in the hemisphere which have already brought inflation under control and are now growing at much higher rates.

35. With regard to the costs of bringing inflation down, the cross-country analysis of 41 episodes of disinflation from intermediate rates discussed above demonstrates that the sacrifice ratio, or output foregone per one point drop in inflation, was relatively small. It shows that, on average, the sacrifice ratio was 0.14%, resulting (for an average drop in inflation of 17.3 percentage points) in a total output loss of 2.7% of GDP during the stabilization period (see Annex). On the other hand, the present value of the benefits from reducing inflation by 10 percentage points would be, in the case of Colombia, between 9-14% of GDP. At the same time, notwithstanding this overwhelming cost-benefit indicator, an effective and efficient safety net should help alleviate the temporary costs of the poorest segments of the population during the stabilization period.

36. Restoring fiscal balance and reducing the rate of inflation are necessary conditions for reaching higher and sustainable rates of growth but they may not be sufficient. The financial sector's efficiency and effectiveness can be enhanced by the public sector continuing to reduce its relative weight in the banking and financial sectors, which may also defuse a potential liability for the public accounts. Infrastructure needs to be modernized and the judicial system improved. Expanding the openness of the economy to imports will, in turn, improve external competitiveness and encourage the expansion of exports. Structural reforms are needed to reduce labor costs and to make the labor market more flexible in order to reduce the high unemployment rate. Improving the education system would help make workers more employable as well as provide a constructive vehicle of social mobility, which would help defuse social tensions and contribute to social peace. More generally, a concerted effort to reduce the level of violence could have a huge impact on the rate of economic growth and the quality of life of all Colombians. However, pursuing the Government's peace initiative will place additional demands on scarce fiscal resources, requiring a stricter prioritization of expenditures to keep their total within the envelope of available resources. In all these areas, the election of a new Government with a fresh mandate from the voters presents a window of opportunity for Colombia to break with the recent past and enter the 21st century with a more solid basis for economic and social development.

## Annex: Sacrifice Ratios

	Disinflationary Episode	Sacrifice Ratio*	Peak Inflation	Trough Inflation	Drop in Inflation	Total Output Loss
Chile	1979-1982	-1.42%	35.0	15.4	19.6	-27.8%
	1985-1988	1.10%	25.8	15.0	10.8	11.9%
	1990-1997	-0.09%	21.4	6.0	15.4	-1.3%
Côte d'Ivoire	1977-1985	-1.11%	20.4	3.8	16.6	-18.42%
Colombia	1991-1997	0.03%	26.0	17.4	8.6	0.2%
Costa Rica	1991-1993	-0.11%	23.4	11.6	11.8	-1.3%
Dominican Republic	1990-1993	0.30%	41.1	5.1	36.0	10.7%
Ecuador	1974-1976	-0.46%	20.4	11.8	8.6	-3.9%
	1983-1986	0.16%	38.7	24.1	14.6	2.3%
	1992-1995	-0.07%	42.8	21.2	21.6	-1.6%
Egypt	1989-1993	0.14%	18.8	9.6	9.2	1.3%
Spain	1977-1988	0.77%	22.7	5.1	17.6	13.5%
United Kingdom	1975-1978	-0.10%	21.3	10.4	10.9	-1.1%
Greece	1974-1977	0.63%	22.4	12.6	9.8	6.1%
	1986-1988	0.34%	20.8	13.1	7.7	2.7%
	1991-1997	0.03%	17.8	5.4	12.4	0.4%
Guatemala	1986-1988	0.64%	29.8	9.6	20.2	12.8%
Indonesia	1974-1978	0.03%	33.3	10.3	23.0	0.7%
Ireland	1975-1978	-0.18%	19.3	9.8	9.5	-1.7%
	1981-1988	0.22%	19.8	2.7	17.1	3.7%
Iceland	1988-1995	0.26%	21.0	1.5	19.5	5.1%
Israel	1989-1993	1.46%	17.7	9.8	7.9	11.5%
Italy	1980-1987	0.26%	19.3	4.9	14.4	3.8%
Jamaica	1974-1976	-0.63%	23.7	11.7	12.0	-7.6%
	1979-1982	0.47%	33.2	7.6	25.6	12.0%
	1985-1987	0.91%	25.7	7.5	18.2	16.6%
	1992-1996	-0.27%	46.8	19.9	26.9	-7.3%
Kenya	1993-1995	0.23%	35.9	5.4	30.5	6.9%
Korea	1975-1977	-0.40%	24.7	10.9	13.8	-5.5%
	1980-1984	0.80%	26.0	2.3	23.7	19.0%
Sri Lanka	1980-1986	-0.71%	20.8	4.9	15.9	-11.3%
Madagascar	1982-1984	0.78%	26.1	10.3	15.8	12.4%
Mexico	1989-1993	-0.21%	30.2	9.7	20.5	-4.4%
Pakistan	1974-1978	0.44%	27.8	7.6	20.2	8.9%
Philippines	1984-1986	0.60%	37.7	4.1	33.6	20.2%
Poland	1993-1997	0.04%	32.2	14.6	17.6	0.6%
Portugal	1984-1987	0.97%	27.6	9.1	18.5	18.0%
Paraguay	1990-1992	-0.01%	30.0	14.6	15.4	-0.2%
El Salvador	1990-1997	-0.32%	18.8	4.5	14.3	-4.6%
Uganda	1992-1994	0.22%	30.5	6.9	23.6	5.2%
Venezuela	1989-1992	0.09%	46.8	28.1	18.7	1.6%
Average		0.14%	27.4	10.1	17.3	2.7%

\* % drop in output per % drop in inflation.

Negative sacrifice ratios indicate a gain in output, relative to potential, per point reduction in inflation.

## PEACE AND DEVELOPMENT

### Introduction

1. Colombia, one of South America's oldest, middle-income democracies, has developed rapidly *despite* a fifty year 'simmering' civil war and increasing levels of urban and rural crime and violence. In the past decade, however, the scale and intensity of violence has changed from a marginal conflict to generalized violence that now dominates the daily lives of most citizens. As remote guerrilla activity has turned into country-wide 'war', bringing in paramilitary groups, drug cartels, and other social actors, so too the causes of violence have changed. These have included both external events such as the collapse of the Cold War, as well as internal changes relating to economic liberalization, coal and oil developments and the impact of the global trade in illicit narcotics.

2. Today government and civil society alike recognize that violence is *the* key development constraint. It affects the country's macro- and micro-economic growth and productivity, as well as impacting on the government's capacity to reduce the poverty, inequality and exclusion experienced by the majority of its urban and rural population. The election of the new government in August 1998 provides an important impetus to consolidate further the critical peace and development initiative begun by previous administrations. At the same time, it raises fiscal and financial questions in terms of paying for peace.

3. This policy note is intended to contribute to Colombia's effort to address the country's fundamental problem of violence. It addresses three critical themes. First, as a background to the issues, it outlines a conceptual framework useful for the Colombian context; this identifies a continuum of violence, including political, economic and social violence. Second, it provides a brief assessment of the costs of violence, highlighting how violence erodes the country's capital and associated assets, as well as noting the extensive interventions to reduce violence. Finally, it outlines recommendations for a National Strategy for Peace and Development, comprising components at three levels – a **national** level peace program, **sector** level initiatives to integrate violence reduction into priority sectors, and **municipal** level social capital projects.

### Background

#### *(i) A conceptual framework for categorizing violence in Colombia*

4. A conceptual framework that categorizes violence is a critical first stage in systematically understanding violence and formulating initiatives for sustainable peace in Colombia. Important constraints include the fact that violence is highly complex and context specific, that perceptions about violence affect citizen well-being even when they are not borne out by statistical evidence, and finally, that community priorities about violence may differ from those of policy-makers. Building on the work of Colombian *violentólogos* and others, the conceptual framework introduces a threefold categorization

of *political, economic and social violence*. Each is identified in terms of the primary motivating factor, for gaining or maintaining power through violent means, with the categories not mutually exclusive, but overlapping.

5. A framework that distinguishes three types of violence is critically important for a number of reasons. First, is its capacity to provide an *integrated* approach, both conceptually and operationally, that recognizes the connections between the dynamics of different types of violence. Second, this framework highlights the need for *different approaches to violence reduction* based on the differing motivations of the perpetrators. Finally, this framework assists in explaining *why interventions to reduce one type of violence may not yield results in relation to other types of violence*. Reductions in one sphere of violence can be accompanied by increases in another. For example, in the wake of El Salvador's peace accords and reduction in political violence, post-conflict rates of homicide and economic crime increased.

*(ii) Violence trends and characteristics*

6. By way of background, it is also important to briefly outline the most salient trends in violence in Colombia that include the following:

- **Some trends in violence have worsened.** Using homicide rates<sup>9</sup> as a proxy for violence levels, officially reported figures increased from 15 to 92 per 100,000 inhabitants between 1974 and 1995,<sup>10</sup> with levels growing dramatically in the post-1985 period. Less than 20 percent of homicides are categorized as 'political' in nature; the remaining 'non-political' homicides are the consequence of economic violence, both organized crime and unorganized delinquency, as well as social violence, particularly alcohol and firearm related deaths.
- **Insurgent armed conflict is more entrenched and widespread than at any point in the past three decades.** During the past five decades the number of social actors involved in armed conflict has expanded from the guerrilla and armed forces to include drug cartels and right-wing armed paramilitary groups. This has been accompanied by increasing density - both spatially and in terms of interdependent reciprocal networks - between different actors involved.
- **Spatial areas with limited state presence have increased.** Municipalities with some type of guerrilla presence increased from 17 percent in 1985 to 58 percent in 1995. If areas experiencing paramilitary, drug and armed force conflict are added, approximately 75 percent of the country is experiencing some level of armed conflict.

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<sup>9</sup> The Homicide rate, expressed as the number of deaths per 100,000 inhabitants, is the most commonly used indicator for crime and violence both in Colombia and internationally, despite numerous limitations.

<sup>10</sup> These numbers are based on government statistical sources; CISALVA, a research NGO that collects its own data reports rates of 50/100,000 in 1980; 219.3/100,000 in 1993, and 179.9/100,000 in 1995.

- **Violence increasingly affects some groups disproportionately.** Younger, lower-income, and less educated men, are more likely to be both perpetrators and victims of homicide. National homicide rates between 1980-1995 for males aged 15-44 years increased from 29 to 394 homicides per 100,000; for females the increase was from 2-3 to 30 per 100,000. Indigenous communities have also been disproportionately affected by armed conflict throughout the country.
- **The brutality of recent political violence obscures other types of violence.** The severity of mass politically motivated killings and human rights abuses means that economic and social violence have received less attention. Of these, economic violence is arguably more severe and is overwhelmingly an urban problem. Reported 1996 figures from Bogotá, for instance, include homicides (65 percent), traffic accidents (20 percent) and suicides (6 percent) as causes of death.
- **The drug industry exacerbates levels of violence.** First, violence is linked to the organized crime around drug production and trafficking; second, violence is linked to the militarization of the fight against drugs; third, disorganized violence occurs around distribution and consumption when drug addicts need money for their drug habit or street dealers are challenged for their profits.
- **“Social cleansing” is considered by some as the fastest and most effective approach to eliminate delinquents and other undesirables.** “Social cleansing”, defined as the eradication of an identity type to reduce crime, targets criminals, drug addicts, youth gangs, street children, garbage-pickers, homosexuals, prostitutes, and homeless people. During 1988-93, 183 victims of “social cleansing” were reported in Bogotá. At least 40 groups responsible for “social cleansing” have been identified in Colombia; these organized groups reportedly account for 81 percent of “social cleansing homicide,” while police account for the remaining 19 percent.
- **The number of internally displaced people has increased over the last decade and is still growing.** Displaced people fleeing from political violence – relating to the guerrillas, paramilitary groups and the armed forces – contribute significantly to rapid urban expansion. Displacement occurs throughout the country, but levels are highest in the areas of Urabá, Magdalena Medio, and Ariari – all localities with high levels of conflict. The Presidential Council for Human Rights assesses that the current number of displaced has reached one million, about 2.5 percent of country’s population.

### *iii) The causes of violence in Colombia*

7. Violence in Colombia is highly complex not only because of the different categories, but also due to its multiple causes. This policy note combines disparate existing theories to develop an integrated framework that identifies four different levels of causality - *structural, institutional, interpersonal and individual* - and that recognizes the mutually reinforcing role played by factors at different levels of causality. Underpinning the causes of violence in Colombia are a range of conditions: first, is the minimal presence of the state throughout much of the national territory; second, the state has arguably criminalized some forms of social and political protest, while simultaneously being inconsistent in dealing with violence; third, high levels of corruption and impunity exist within state institutions; fourth, there are high levels of

societal acceptance of violence as a means to resolve disputes; fifth, Colombian society is regionally focused, historically and geographically, resulting in economic, political and social fragmentation; sixth, the state has delegated authority to local power holders even where there is limited state presence; finally, there is the complex interplay between rural and urban violence.

8. Considering **political violence** in Colombia, the causes are manifold. Stated simplistically, they tend to revolve around the following factors:

- **Historical legacy of violence** relating to the political conflict of the 19<sup>th</sup> century with the violent confrontations between the Conservative and Liberal Parties, as well as the 1948 *El Bogotazo*, and *La Violencia*.
- **Unequal access to economic resources, including land and natural resources** relating to the steady expansion of left-wing guerrilla activity – especially among the ‘first generation’ guerrilla groups such as the FARC (*Fuerzas Armadas Revolucionarias de Colombia*), the EPL (*Ejército Popular de Liberación*), and the ELN (*Ejército de Liberación Nacional*).
- **Unequal access to political power** resulting, for instance, from the establishment of the Frente Nacional that excluded non-traditional political groups. Important among ‘second generation’ guerrilla groups, were the M-19, and the *Movimiento Armado Quintín Lame* in Cauca. To address this inequality, various governments have negotiated numerous peace agreements, as well as made significant efforts to widen political participation, for instance, through the 1991 Constitutional Reforms.
- **The role of drug-related, guerrilla and paramilitary violence** at the institutional level, and the interrelationships among them. The FARC and the ELN, for example, have regulated the market of coca by imposing obligations and taxes upon farmers and a range of intermediary production processes and shipping, earning them millions of dollars annually. Paramilitary forces have also grown, especially the civil defense groups funded by landowners.

9. The causes of economic and social violence in Colombia have received less attention than the political causes. These revolve around the following:

- **Poverty, inequality, and rapid growth** at the structural level, with poverty potentially acting as a precursor to violence, in which the poor may resort to violent action for material gain. However, inequality, not poverty, is arguably more important in that the most violent areas in Colombia are those of greatest wealth, especially in natural resources. Violence is also exacerbated by rapid economic growth, population change, urbanization and industrialization. This is particularly important in areas with dramatic population increase due to internal displacement.
- **High levels of impunity within the justice system** at the institutional level, among formal and informal institutions. When the system is weak, then deterrence fails to prevent violent crimes - deterrence has been shown to have a significant inverse relationship to Colombia’s levels of violent crime both at macro- and micro-levels.
- **Lack of educational and employment opportunities** at the institutional level, have contributed to a burgeoning criminal market and violence among youth in particular.

In rural areas, under-resourced schools offer few incentives for youth, with many turning to the guerrilla for employment. In urban areas, drug traffickers recruit successful secondary school students from poor neighborhoods, exploiting their inability to secure legitimate employment.

- **The role of the family in violence reproduction**, at the interpersonal and individual levels, is important as the primary institution for the transmission of social norms. Abusive child-rearing patterns, for example, may be responsible for transmission of trauma, the growth of a sub-culture of violence through socialization, and interpersonal relationships of individuals living in similar conditions. This may lead to fragmentation of household structures, and to the loss of support functions.
- **Situational precipitators such as alcohol, drugs and firearms**, dealing with individual and interpersonal levels, may act as catalysts in potentially violent situations. Especially important is alcohol consumption, more common among men, yet increasing among women and the very young. Gun ownership or carrying a gun may also lead to violence or at least to a fatal outcome in a violent situation.

*iv) The costs of violence in Colombia: Eroding the country's capital and associated assets*

10. As identified by government and civil society in the World Bank's 1997 Country Assistance Strategy, the economic and social costs of violence are a burden for all Colombians. Despite more than a decade of research by *violentólogos*, these remain difficult to measure, with extensive debate over the accuracy of the different cost estimates. Although accurate measurements of the costs of violence are critical, assessments of the impact of violence on the country's capital – its stocks of assets – can also facilitate a more comprehensive understanding of the situation.

11. In terms of measuring the economic costs of violence, during the last two decades Colombia has sustained significant losses due to deaths, disabilities, and “transfers” resulting from property crimes. Although many of these results are expressed as percentages of GNP or GDP, they do not imply that, had these losses not occurred, GNP would have increased by that percentage. Rather, these figures are useful for assessing the magnitude of loss in terms relative to total GNP. For example, one estimate suggests that between 1991 and 1996, net costs associated with urban violence and armed conflict, totaled 18.5 percent of GDP, representing an annual average of 3.1 percent of GDP. Violence, primarily homicide and kidnapping, also has a negative impact on investment. In particular, violence has a greater effect on investment decisions than on production decisions. When indicators for human capital and homicide rates are factored into the traditional equations for calculating inflation and the capital costs of investment, there was a negative and significant impact of violence on investment in Colombia. For example, if Colombia's violence could be reduced to levels comparable to those throughout Latin America, the relationship between investment and GNP could reach levels now seen in countries with high levels (i.e. 30 percent) of economic growth.

12. This policy note distinguishes between four types of capital and highlights the way violence, by eroding the stocks of assets, increases the insecurity and vulnerability of Colombia's population.

13. Violence erodes *physical capital* (also known as man-made or produced capital) when it reduces the country's stocks of plant, equipment, infrastructure, and other productive resources owned by individuals, businesses or the country itself. Banking and taxation are influenced indirectly by illegal violence linked to the drug industry. Drug syndicates generate profits in enormous amounts of cash, which, to be useful, must pass through legitimate international banking or commercial channels. Costs associated with violent attacks on infrastructure, especially petroleum and electrical installations, roads and airports, are also mounting. Finally, as Colombia's police and judicial institutions weaken, the privatization of security is a growing phenomenon in both rural and urban areas, increasing production costs to the private sector.

14. Violence erodes *human capital* when it limits access to education or health facilities by both users and providers. Violence also affects the capacity of individuals to use their human capital by entering the labor market. For example, death threats and killing has led to teachers and rural health workers abandoning facilities. The human capital of displaced populations can also be seriously eroded; many lose access to health and social services when they move to the big cities and their labor as an asset is also eroded.

15. Violence erodes *social capital* when it reduces trust and cooperation within formal and informal social organizations and their members. Social capital refers to the rules, norms, obligations, reciprocity, and trust embedded in social relations, social structures, and societies' institutional arrangements that enable its members to achieve their individual and community objectives. Among **formal social institutions**, violence has severely eroded faith in the relevance and governability of many social institutions as a consequence of both human rights violations and a reported 98 percent impunity rate. Drug trafficking in particular, affects the judicial system where narco-terrorism, threats and acts of kidnapping and assassination have influenced the administration of justice and changes to the penal code to benefit them. Among civil society actors, continued violence in the form of death threats, kidnappings and assassinations has created an understandable climate of fear, anxiety and mutual distrust. This has been exacerbated by systematic threats and attacks against the media that have aimed to alter media behavior and information content. Among **informal institutions**, the capacity for community-level organizations to function depends on levels of cohesion as well as personal safety and the ability to meet locally; violence has increasingly eroded this. Finally, in some instances, violence seems to contribute to the creation of "perverse" social capital, in which networks, contacts and associations are created in the service of illegal activities. Gang involvement is one such example where young people, bereft of strong family and community support form mutually reinforcing groups.

16. Violence has eroded *household relations* as an asset when it reduces the capacity of households to effectively function as a unit. For example, in rural conflict zones

where many men have joined illegal groups, whether the guerrilla or paramilitary, family life is seriously disrupted with high levels of stress. Also, in poor urban poor communities many women have identified a direct link between male unemployment, alcohol abuse, and increased domestic violence. In the case of internally displaced populations, research shows that women are more vulnerable than men at the moment of eviction, yet women seem better equipped to develop support networks to continue the routines of daily survival once established, creating social capital with others sharing the same history of displacement. Finally, sustained conflict, arbitrary killings of suspected guerrilla sympathizers and widespread death threats have systematically reduced trust between neighbors and communities across the country – further eroding social capital.

17. Violence erodes *natural capital* when it destroys or damages the country's stocks of environmentally provided assets such as soil, forests, water and wetlands. In rural areas land is a critical productive asset for the poor, while in urban areas land is equally important for the provision of shelter. While historically Colombia is exceedingly rich in such assets, the devastating effects on the environment have only recently been recognized as a significant cost of violence, particularly political violence. For example, environmental damage due to oil spills from terrorism has been increasing. Additional contamination of soil and groundwater has resulted from aerial spraying of illicit crops, rendering these lands unusable for many years. Furthermore, deforestation rates increase when peasants, driven from their lands after the spraying, raze nearby forests for planting. Destruction of the fragile highland *páramo* habitat has been accelerated by the drug cartels' recently increased diversification into heroin poppy cultivation. Environmental degradation also affects urban areas, especially exacerbated by the influx of displaced populations. Finally, land degradation and inappropriate land use has intensified due to high levels of political violence - when peasants have been forcibly evicted by the competing interests of guerrillas, paramilitaries, and drug traffickers, or voluntarily fled to escape death threats, joining the thousands of rootless displaced people on the edges of cities.

#### v) *Interventions to reduce violence in Colombia*

18. Throughout Colombia, there have been extensive, highly innovative interventions implemented to address violence. However, the tendency has been to target either political violence, or economic and social violence. There have also been few evaluations of existing interventions, or attempts to look across the policy spectrum, or to coordinate individual projects.

19. Drawing on the dominant violence reduction policy approaches, the policy note outlines a framework for intervention. It identifies a shift from interventions that emphasize **control**, such as the *criminal justice* approach, to those that stress **prevention**, such as the *public health* perspective, to more recent approaches that focus on **rebuilding social capital and trust** through *conflict transformation*, *human rights* and finally, the *social capital* approach. This framework is intended to assist policymakers to shift from menu-like checklists of interventions towards an interdisciplinary approach that

recognizes a continuum of violence, and addresses simultaneously the reduction of different categories of violence.

**20. Interventions to address political violence and negotiate peace** in Colombia are closely associated with government endeavors to establish peace agreements. Since the renewed escalation of political violence in the 1980s, successive presidential administrations have shifted their strategies from partial military solutions, to negotiation of demobilization and reincorporation agendas. Concerted efforts to reach peace have straddled different political administrations, with a consolidation over time. For example, while the Betancur administration opened the door to negotiations with the guerrilla, and the M-19 in particular, it was under the Barco administration that a political accord was established. Yet it was the Gaviria administration who developed the Reinsertion Program for the M-19.

**21. Conflict transformation** strategies have influenced negotiations with the guerrilla since the early 1980s. Instigated by Betancur, who was the first to recognize the severity of the guerrilla issue, and to negotiate a temporary cease-fire in 1984, each subsequent government has attempted some form of conflict transformation method. However, this dialogue has not been confined to negotiating solely with the guerrilla, but has also included the intervention of other actors. For example, Betancur established a 'national dialogue' among members of the armed forces, government and civil society, and Samper authorized regional dialogues between governors and armed groups. Rebuilding social and community institutions, or **social capital**, also runs through peace endeavors since 1982. Betancur's National Plan for Rehabilitation, for example, directed funds to areas most affected by political violence in order to rebuild the social and economic fabric, which was reinforced by Barco's Policy of Reconciliation, Normalization and Rehabilitation. In an effort to build capacity at the local level, various governments have instituted a range of constitutional decentralization measures. Perhaps most important were Barco and Gaviria's Constitutional Reforms that firmly established the importance of decentralized state functions and of community participation at the local level.

**22.** Finally, a **human rights** perspective was significant during the Gaviria and Samper governments. As in other countries, Colombia has shifted in its approach to human rights from viewing the state as perpetrator, to recognition of human rights abuses by other social actors. In addition, the issue of exclusion of minorities has also been addressed, especially through the 1991 Constitutional Reform and the subsequent National Commission on Indigenous Policy (CONPAPI) within the office of indigenous affairs (DGAI), and the Special Commission for Black Communities. The most systematic use of the human rights approach has been by the Samper administration. Among other things, this has included the creation of the Office of the High Commissioner for Human Rights of the UN in 1997, as well as the provision in the Law 418 outlining norms for the protection of children from the effects of conflict.

**23. Interventions to address economic and social violence** have included an enormous range of innovative initiatives by the Colombian government and NGOs,

encompassing a broad array of approaches. However, they have usually been implemented separately from interventions dealing with political violence. While some have focused independently on economic or social violence, others have addressed both types together. Interventions have drawn on all policy approaches, with particular emphasis on the criminal justice, public health, and social capital perspectives.

24. An important example based on the criminal justice approach includes the *Casas de Justicia* program. Although it focuses primarily on social violence, the program also deals indirectly with the issue of economic violence since it is implemented within low-income communities with high rates of violence. The *Casas de Justicia* are particularly important in that they promote new forms of conciliation mechanisms beyond the traditional judicial procedures. For example, they are designed to improve poor communities' access to conciliation, legal and human rights services, drawing on various types of conflict transformation tools such as manuals of 'Conciliation Techniques'.

25. Another important example informed by the public health perspective is the well-known DESEPAZ Program (*Programa Desarrollo, Salud y Paz*) in Cali. This employs public health tools such as epidemiological surveillance, environmental manipulation, and behavioral modification to achieve measurable reductions in homicide. It identifies risk factors, such as alcohol use and gun ownership, and then attempts to limit exposure to these risks. The DESEPAZ program is notable in that it focuses on economic violence using a number of approaches to the problem. For instance, its emphasis on community-level solutions indicates that rebuilding community and social institutions is also important. In addition, some of its interventions have direct and indirect implications for social violence reduction.

26. Despite a wealth of extensive and innovative efforts to address violence reduction in Colombia, success has been limited by the fact that most interventions have tended to focus on one particular issue, often at a small scale, with little national coordination and limited evaluation. Yet Colombia has the potential to meet these challenges through a range of recommendations for meeting the goal of building sustainable peace and social capital.

***vi) Recommendations: Building sustainable peace and social capital***

27. The evidence presented in this policy note indicates the urgent need for the new Pastrana government to prioritize peace and development, demonstrating this commitment through negotiation of the appropriate peace agreements as well as the design and implementation of a comprehensive National Strategy for Peace and Development. Experience to date suggests that resolving armed conflict is a precondition for sustained peace and development. However, to ensure sustainability the causes of violence also need to be addressed, otherwise extensive interventions, however important and costly, can only be piecemeal, and are easily undermined. At the same time, it is critical for the government to recognize that solving political violence – through a negotiated peace – will not automatically solve other, more prevalent forms of violence.

Recent post-conflict experience from El Salvador, for instance, demonstrates that a peace accord in itself, may, at least in the short-term, increase economic and social violence.

28. Developing a National Strategy for Peace and Development should be based on a number of important principles, which include the following: first, *develop a fiscal policy to pay for peace*. Any sustainable peace initiative will bear a significant financial cost, with peace bonds, taxation and external donor assistance some important interventions to be considered; second, *create partnerships for sustainable development*. This may include links with civil society, and the business community; third, *promote participatory debate about local-level causes and solutions to violence*. This would facilitate open debate among the major social actors on the causes of the conflict and assist in identifying local level solutions to rebuild social capital and citizenship; fourth, *develop a coordinated approach to economic and social violence reduction*. Despite the range of initiatives already implemented, a national level coordinated approach does not exist.

29. A National Strategy for Peace and Development therefore seeks to control the symptoms of violence, to introduce preventative measures and to rebuild the fabric of society, particularly strengthening social capital. The Strategy has the following three critical components, or building blocks, that address the continuum of violence at different levels of causality:

**1) National level: Peace Program**

30. A Peace Program can contain an extensive number of components, to be implemented at different stages of the peace process. Prior to the actual peace agreement, for instance, one important component may be pre-accord innovative project support as a form of venture capital in support of building social capital in conflict zones - that provides incentives for peace as well as helping preempt "spoilers". During the actual peace process the timing and sequencing for other aspects of a Peace Program will require careful consideration at the local level. Some of the other important components of such a program may include:

- ***Demobilization and reintegration of ex-combatants*** that should include bringing guerrilla and paramilitary proposals to the negotiating table. Reintegration of ex-combatants should include social programs for ex-combatants, and initiatives to address human rights violations.
- ***Reconstruction measures*** that should focus on regions most adversely affected by armed conflict and address social, political and economic causes of violence. As well as the negotiation of peace, subsequent measures are essential.
- ***Programs for internally displaced people*** are critical because even with a negotiated peace, it is not certain whether the displaced will return to their rural communities. Although the Colombian government has taken important steps to recognize violence-related displacement as a structural problem by adopting 1997 Law #387, it does not contain tools for addressing future relocations.

**2) Sector level: Mainstreaming violence reduction into priority sector policies and programs**

31. A National Peace and Development Strategy needs to mainstream, or integrate, violence reduction measures into sector policy. This involves, first, the prioritization of sectors central to violence reduction – such as education, the judiciary, sectors concerned with livelihood and job creation and the environment; second, within these sectors, it requires the identification of those interventions that will most effectively reduce violence. Simultaneously, far greater inter-sector coordination and collaboration is essential if the maximum synergy from sector specific interventions is to be translated into sustainable peace strategies. The following sectors should be prioritized:

- **Education sector:** Strengthening the education sector provides youth with viable alternatives to delinquency, criminal behavior and guerrilla group membership. This requires the provision of high quality education and training for all age groups in both rural and urban areas, going beyond mandates for universal enrollment or access to literacy skills, is required. This combines infrastructure investment, curriculum review and improved management. It involves building more schools, training more teachers and administrators, and designing materials that impart substantive knowledge relating to issues of violence and peace.
- **Judicial sector:** Corruption, impunity, congestion, abuse, procedural delay and administrative inefficiency have undermined public confidence in the judiciary's ability to penalize criminal behavior and provide effective conflict resolution mechanisms at a community level. Recent recommendations to address these problems include, increasing community-based conflict resolution mechanisms, reducing levels of congestion and process delay, and strengthening managerial capacity and key organizational functions.
- **Livelihood and job creation:** A number of different state sectors, with links to civil society and private businesses, have responsibility for the creation of jobs and livelihood opportunities. In rural areas, one potential initiative relates to the government's recommendation for market-based agrarian reform through the implementation of Law 160. Job creation in urban areas must target not only areas of high unemployment, but also areas of high violence. These would preferably be linked to education and training initiatives.
- **Environmental sector:** The Ministry of the Environment, the private sector (both national and multi-national) and civil society should participate in public debate, identify and reach agreement on future national policy concerning the country's natural resources. In addition, monitoring of environmental policy should be strengthened. Of particular importance is the issue of indigenous people's land rights; while the government has already made provisions for such rights, these should be reinforced. In urban areas, attention should be paid to potable water and sanitation systems through infrastructure projects, especially in cities with high proportions of displaced people.

### 3) Municipal level: Social capital projects

32. The rebuilding of trust and cohesion is a critical priority, especially when the erosion of social capital, resulting from high levels of violence, continues to fragment poor communities. Therefore large-scale 'top-down' sector level interventions should be complimented by small-scale 'bottom-up' municipal level projects. The objectives of

such projects will obviously vary depending on the context. Nevertheless, they may include the development of municipal-level *strategic plans* for peace and reconstruction. These will identify priority objectives, resources, needs, and benchmarks to strengthen local level institutions, reaffirm citizenship and provide mechanisms for the negotiation of conflict. Such plans should be developed in an interactive, and participatory process, to involve as many stakeholders as possible. Such a project could include the following components (i) *community-level assessments* to identify perceptions of the causes of violence, its costs for the community and the priorities for community-level solutions (ii) a small number of *focused pilot projects* designed to consolidate social capital and help vulnerable members of the community, such as youth, feel less excluded (iii) the incorporation of an appropriate *evaluation component* for all interventions to allow for more effective resource allocation and replication of best practices, and (iv) the creation of *municipal-level task forces for peace and development* to monitor the process, consult regularly with civil society and facilitate the dissemination of information.

### **Summary of Recommendations: Building Sustainable Peace and Social Capital**

33. In conclusion, the following policies and actions are recommended to government:

- **National Level: Peace Program** that includes a pre-accord program to provide incentives for peace, as well as interventions for demobilization and reintegration of ex-combatants, reconstruction measures, and those to assist displaced populations.
- **Sector Level: Mainstreaming violence reduction into priority sector policies and programs** focusing on such sectors as *education*, involving, for example, curriculum review and conflict resolution programs, and the *judiciary*, to strengthen the justice system through, for instance, community based conflict resolutions programs and tribunals. Other important sectors include the *environment*, and *livelihood and job creation*, involving both rural and urban populations and dealing with issues of land, security and making a living.
- **Municipal Level: Social capital projects** to rebuild trust and social cohesion and reduce violence through small-scale participatory ‘bottom-up’ projects. This may include the formulation of municipal-level strategic plans for peace and reconstruction, community-level needs assessments, as well as focused pilot projects, and the creation of municipal level task forces for peace and development to monitor the process.

## JUDICIAL REFORM IN COLOMBIA

### Background

1. The strengthening of the Judiciary has been identified as a crucial element in addressing the structural socio-economic determinants of violence in Colombia. The lack of expedient access of the population to conflict resolution mechanisms and the inability of the Judiciary to effectively penalize criminal violations have been identified as important contributors to the encompassing violence affecting Colombian society.

2. During the recent decades, the Judiciary in Colombia -as is the case in most countries in the Region- has been subjected to mounting pressures for reform. These pressures are derived, inter alia, from a deterioration of the judiciary's standing in public opinion as a bulwark for the protection of human and social rights, as a forum for the fair and effective resolution of disputes and the penalization of criminal behavior. Moreover, the high level of violence prevalent in Colombia, and the associated high levels of impunity, have generated a particularly perverse tendency towards different forms of private justice that contribute, in turn, to reproduce and exacerbate highly abnormal levels of conflict in the various spheres of Colombian society.

3. The principal efforts undertaken by Colombia in this field have focused on improving the criminal facet of the judicial function. As part of a comprehensive Constitutional reform approved in 1991, Colombians undertook a wholesale restructuring of its criminal justice system via the establishment of an autonomous Attorney General's Office and the revamping of the inquisitorial process and its replacement with an accusatory system which would provide a better balance between due process and expediency considerations.

4. There have been efforts also to improve the governance and organizational structure of the judiciary through the establishment of a separate constitutional jurisdiction and the transfer of all planning, human resource and administration functions to a Judicial Council, which has concentrated for the first time all judicial government functions in a judicial organization, except for some restrictions in the budgetary function.

5. These efforts have been accompanied with a strong build-up of justice expenditures. Public expenditures on justice increased from 0.65% of GDP in 1990 to 1.14 of GDP in 1996, reflecting an average real annual increase in justice expenditures of 17% during the last five years.<sup>11</sup> This increment reflects mostly salary increases and hiring of personnel linked to the establishment of the Attorney General's Office. Investment expenditures represent about 10% of the total sector budget which is heavily concentrated in physical infrastructure, thus, with virtually no room left for investments promoting institutional and organizational change.

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<sup>11</sup> Comisión de Racionalización del Gasto y de las Finanzas Públicas, Informe Final, Tema V, Justicia y Derechos Civiles, Santafé de Bogotá, Colombia, 1997.

6. The corollary of this last five years of significant fiscal and political efforts to improve justice administration in Colombia is that there has been no appreciable improvement in the performance of the justice sector:

- \* there has been limited progress in reducing the rampant impunity problem that plagues Colombia. A calculation of the rate of impunity of the criminal justice system for the year 1995 indicates that only 0.1% of the cases processed by the system ended up in conviction.<sup>12</sup> If the general assumption that only one third of criminal activities are actually denounced before the authorities, the level of impunity prevalent in Colombia would continue to be aberrantly high. These poor results seem to be related mostly to bottlenecks in investigative capacity and poor use of the state attorney's office prosecuting capacity. This is despite the fact that the criminal justice system absorbs over 50% of the judiciary's budget and personnel and monopolizes all sources of external assistance, including IDB and USAID funding. The only good news are coming from the congestion side since the criminal justice system seems to be the only judicial sector being able to reduce the net stock of cases.<sup>13</sup> This may be directly related to the reduction in the workload ratio of cases to employees in the criminal sphere which has gone down to 91.6 cases per employee compared with a ratio of 418 cases in the civil justice area.
- \* there has been virtually no efforts to improve the quality and expediency of the other areas of justice administration, including areas such as civil and commercial law, family and labor law, etc. This neglect would seem unwarranted since a strong majority of the justice demands is directed, precisely, towards, those sectors. The main source of judicial congestion is concentrated in Colombian in the Civil Justice System. By end 1995 there were over 1.85 million active civil cases in process with a total adjudication capacity per year of only .25 million. The consequence of this disparity between demand and the systems ability to resolve conflicts has been growing congestion.
- \* there were no significant efforts promoted by the Judicature in order to improve access to justice by the poor, notwithstanding their growing demands and needs. The constitutional mandate to establish community based tribunals headed by lay judges selected via popular elections and deciding on equity grounds has not been acted upon.
- \* there have been some limited and protracted efforts to improve the Judiciary's governance and administrative structure, i.e., the issuance of a new judicial map aimed at balancing judicial resources with demand and of a performance evaluation system. The results of these measures have not produced a significant impact yet on the overall judiciary's performance. The protracted

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<sup>12</sup> Situación de la Justicia en Colombia: incidencia sobre el gasto público e indicadores de desempeño, Sergio Clavijo; Debates Justicia y Desarrollo, Corporación Excelencia en la Justicia, Agosto de 1997, pgs. 63-67.

<sup>13</sup> For the period October 93 to September 94 the criminal justice system reduce the stock of cases by 18% ending with a final stock of 351,522, while the civil justice system increased the overload stock by 11% to 1,359,970 cases, Op. cit. Pg. 58.

and timid actions in this field have been a consequence of the drastic changes introduced in the judicial institutionality and the high potential for conflict or, at least, less than efficient coordination among the various judicial government bodies.

- \* finally, there has been no improvement in the productivity of judicial expenditures. In view of the poor results derived from the changes and significantly increased expenditures of the criminal justice system, there are clear indications that productivity --in terms of judicial output-- may have worsened since the beginning of the decade.

7. In view of the rather discouraging judicial performance, the high priority assigned to the strengthening of the Judiciary as a major initiative underpinning the efforts towards peace and development and the lack of significant initiatives in the area of civil justice reform, the authorities have requested Bank support for a program of judicial reform. A concerted effort has been made both by the Government and the Bank to ensure strong commitment and participation of the judicial leadership in the identification of the operation and definition of the project preparation initiative. At this stage, there is full commitment and agreement from the Supreme Court and the Judicature Council, on behalf of the Judiciary, and the Executive Branch, to initiate the preparation of a Judicial Reform Program.

8. The main principles agreed with the Judicial leadership and the Executive Branch to initiate the preparation of a Judicial Reform Program are the following:

- \* the effort of defining the main challenges faced by the Colombian Judiciary and the formulation of a strategy of judicial reform should be undertaken through a participatory process;
- \* the recognition of a protagonic role of the judicial branch in the participatory process; while, at the same time, enabling an open and constructive participation of other actors (such as the academia, the legal profession, NGOs, etc.) with an interest in justice administration;
- \* the recognition that the justice administration reform comprehends a multiplicity of inter-related institutional and organizational elements that should be addressed in an integrated approach to ensure impact and on the ground;
- \* the need to incorporate as one of the objectives of this program, an improvement in the productivity of judicial expenditures;
- \* the preparation process should aim at defining intervention strategies and their associated results which would be tried initially at a pilot scale to ensure the relevance and impact of the proposed strategies.

9. An initial workshop to agree on a diagnosis and the key strategic objectives of a judicial reform program in Colombia was carried out in late April. The workshop enabled the judiciary's and national government's leadership and relevant academic and civil society representatives to reach consensus on: (i) the principal problems faced by the justice system in Colombia and its potential contribution towards the peaceful resolution of conflicts and the reduction of violent confrontation in Colombian society; and (ii) the

key strategic objectives that should be pursued in improving peaceful conflict resolution. The diagnosis and recommendations of this paper are largely derived from the analysis and conclusions of the workshop, however, it reflects also analytical work conducted by various academic and civil society groups in Colombia.

### **Overview of the key issues**

10. The following provides an overview of the key issues identified in the workshop affecting the capacity of Colombian society to promote the peaceful resolution of interpersonal and social conflicts. For analytical purposes we have grouped these issues into three main categories, namely, those issues related to cultural and institutional traits of Colombian society, those pertaining to the judiciary's ability to perform its main social utility functions of conflict resolution and criminal penalization and those related to the governance structure of the Judiciary and its relationship with other government branches.

### **Issues related to conflict resolution in Colombian society.**

11. The high incidence of all forms of violence in Colombian society has been associated in part to the lack of a citizen culture that promotes the peaceful resolution of conflict. This cultural idiosyncrasy is linked to the a number of institutional and organizational characteristics of the Colombian society:

- there is very limited development of social practices and institutions --other than the Judiciary-- geared towards the settlement of disputes via adjudication or conciliation. This limited access to dispute resolution mechanisms generates an excessive dependence on the judicial system and the inability of the latter to respond effectively to the social demand for conflict resolution. Thus, all indications are that there is high pent-up demand for conflict resolution in Colombia that is not being adequately dealt with and which contributes to the prevailing high violence level.
- the high costs associated with seeking remedial action from the judiciary --together with the very low level of confidence and legitimacy of the judiciary within the public-- leaves significant sectors of the population with no recourse to an effective dispute resolution mechanism. In addition to the congestion phenomenon referred above, a major cost in seeking judicial adjudication of disputes is the extreme delays in obtaining judicial relief. Although there are strong regional disparities, the duration of the first phase of civil procedures ranges from a total of 563 days in the Coffee Region to about 813 days in the Atlantic Region.
- there is very limited knowledge and trust by the public on dispute resolution mechanisms, either of a voluntary nature --conciliation, arbitration, etc-- or of an adjudicatory nature --justice of peace, regular judicial procedures, etc. The failure to obtain effective and prompt enforcement of rights originates a strong disincentive for the defaulting party to agree on voluntary dispute resolution mechanisms. In fact, the lack of an effective judicial dispute resolution

mechanism generates perverse incentives for the defaulting party to take advantage of those procedures to delay the prompt enforcement of rights.

**Issues related to the capacity of the Judiciary to respond effectively to the conflict resolution demand.**

12. The ability of the Colombian Judiciary to contribute effectively to conflict resolution is seriously compromised by the high levels of judicial congestion and process delay prevailing in most of the judiciary's operations. These two phenomena --as referred above-- are contributing to high levels of impunity in the criminal justice sphere and virtual denial of justice in the civil justice sphere for many sectors of society that cannot afford the costs of litigation in terms of time and financial costs.

13. The weaknesses in the provision of judicial services to the public has been associated with a number of factors:

- the lack of rationality of the prevailing judicial procedures. Current procedures, based on the colonial tradition of written forms, formalism and a passive role of judges, are conducive to abuse by the litigants with the objective of delaying the resolution of disputes. The result is that civil cases last three or four times more than prescribed in the procedural codes and most discussions are centered on forms and procedural issues rather than an early and direct discussion of the substantive controversy.
- the provision of the justice service is highly bureaucratized as the requirements and interests of the judicial organizations prevail over the demands of the clients. There are very limited incentives towards improved productivity and the generation of efficient results among judicial personnel.
- lack of responsiveness of judicial staff is compounded by the lack of modern information systems and computerized equipment and software to ensure a more efficient processing of cases.
- inefficiencies in the allocation of judicial resources.
  - \* there is conclusive evidence that the phenomenon of congestion is particularly acute in the principal urban centers while the workload ratio in provincial cities is significantly lighter. This same evidence shows that the productivity of the provincial courts is much lower than those in the urban centers, thus, compensating for their relative affluence of resources. There seems to be strong inflexibilities within the judicial organization preventing allocation efficiencies, however, there are initial efforts to rectify this situation with the issuance of a Judicial Map in 1997.
  - \* most available budgetary resources are assigned to recurrent costs, leaving very limited room for investments in qualifying the human factor and improving the efficiency of the tribunal's operations.
- during the latter years, the introduction of new judicial instruments (*the acción de tutela*) aimed at providing a more expeditious access to the public for the protection of individual and social rights has increased significantly judicial

demand without a corresponding increase in judicial capacity. The priority assigned to the processing and prompt resolution of *tutelas* has relegated the regular judicial docket to an inferior status.

#### **Issues related to the Judiciary's governance structure**

14. The ability of the Colombian Judiciary to contribute effectively to conflict resolution is also being compromised by deficiencies in the management of its human and material resources. There are many factors contributing to these deficiencies:

- in the field of human resource management, the recruitment, performance evaluation and training systems in place are not contributing to promote professional excellence, productivity and an attitude supportive of institutional change and quality delivery of judicial services. The judicial leadership faces significant inflexibilities in promoting corporate improvements because of the defensive nature of demands by most judicial staff unions.
- lack of coordination among the various authorities contributing to set judicial policy. This lack of coordination is reflected in the relations among the various government branches in ensuring coherence and sustainability of specific policy objectives, i.e., reducing criminal impunity or setting and implementing investment priorities in the judicial sector. It is also reflected in the relations among the various judicial bodies established by the 1991 Constitution, i.e., the allocation of resources among the various judicial bodies to ensure effective delivery of justice services. This lack of external and internal coordination of the bodies involved in the Judiciary's government constitutes a substantial inflexibility in the promotion of institutional change. This inflexibility is particularly critical in view of the substantial fiscal restrictions faced in promoting judicial reform since it inhibits the opportunities for improved resource allocation among the various judicial services and bodies.
- there is significant lack of autonomy of the Judiciary in the management of its financial affairs. The strong dependence of the Judiciary from budgetary transfers from the Central Government's budget and in the actual execution of the budget has implied a highly unpredictable environment for the judicial leadership for developing and implementing its investment program.

#### **Strategic objectives for improving peaceful conflict resolution in Colombian society.**

15. The proposed Judicial Reform Program aimed at improving peaceful conflict resolution in Colombia would seek three key strategic objectives which are closely related to the three categories of issues referred above. Following is a description of the three strategic objectives agreed with the judiciary's leadership, governmental authorities and representatives of the academy and civil society.

*Introducing community based conflict resolution capacity.*

16. A key strategic objective to be pursued in a program to improve peaceful conflict resolution should consist in **increasing the supply of community-based conflict resolution mechanisms**. The barriers to access by most sectors of Colombian society to effective dispute resolution services are so significant that there is a need to promote forms of lay justice and alternative dispute resolution mechanisms rather than seek an incremental supply of judicial services. The benefits of instituting non-judiciary mechanisms can be summarized in the following:

- by introducing procedures based on oral arguments and less formality it would substantially reduce the cost --economic and time wise-- and lower the entry barriers to conflict resolution services
- by introducing in the decision making process predominant social values over pure legal technical reasoning it would increase the legitimacy of decisions and reinforce within the communities the values and benefits of peaceful conflict resolution
- by introducing forms of lay justice there would be a de-bureaucratization of justice services and the opportunity by the state to provide those at a lower cost and reach a more extensive coverage.

17. A key consideration in deciding the form this conflict resolution services should take is whether the impartial third party providing the services should adopt a mediating or conciliatory role (thus, relying in the ability of the parties to reach a consensual agreement over the dispute) or an adjudicatory role. In this latter case, the impartial third party has the ultimate authority to decide the case and has some form of coercive powers to ensure compliance with the decision. In view of the level of conflict prevailing in the Colombian society and the need to build into the social fabric the values of peaceful conflict resolution, it would seem preferable to adopt initially a strict adjudicatory type of conflict resolution<sup>14</sup>. This would not preclude the possibility for the impartial third party in the preliminary stages of the process to attempt conciliatory or mediating solutions to the conflict.

18. Another critical element of this proposal is to ensure the linkages between the community justice mechanisms and those of the Judiciary. To the extent that community justice would have a limited scope of activities, it would be crucial to ensure clear points of contact between the two mechanisms, including the ability of the formal judicial system to review some decisions of the community-based justice and to support the enforceability of its decisions.

19. The Constitution of 1991 provided a clear mandate for the establishment of some form of community-based justice system through the establishment of the Jueces de Paz. The Constitution defined the main characteristics of the Jueces de Paz, namely (a) that

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<sup>14</sup> This would be fully consistent with North's views that effective third party enforcement constitutes the cornerstone for ensuring sustained social cooperation among individuals. *Institutions, Institutional change and Economic Performance*, Douglas C. North, Cambridge University Press, pgs. 54-60.

they would exercise an adjudicatory function and, thus, be able to decide on the cases brought before them; (b) to ensure their closeness to community values, that these judges could be popularly elected; (c) that they could base their decisions on equity grounds, rather than the literal interpretation of legal statutes; and (d) that they could deal both with individual and community conflicts.<sup>15</sup>

20. Despite the clear constitutional mandate to promote this community-based form of justice, little progress has been made in its implementation. Conditions in Colombia would certainly warrant making the Jueces de paz a reality.

*Improving the Judiciary's capacity to contribute to peaceful conflict resolution.*

21. A central objective to be pursued in the performance by the Judiciary of its critical conflict resolution social utility function would consist in the **drastic reduction of the prevailing levels of congestion and process delay**. This strategic objective would be designed in accordance with the following features:

- the targets in terms of congestion and process delay would be focussed in the principal urban centers, where these problems are more critical. This would contribute to redress the significant imbalances in resource allocation which is benefiting intermediate and small urban areas.
- the improvements in congestion and process delay will be undertaken mostly through institutional and organizational changes --rather than increase in supply-- in the following areas:
  - \* judicial process reforms aimed at, inter alia, promoting a more active role of judges in the direction of judicial procedures, the introduction of procedural transparency and orality and an objective-driven judicial reasoning both in deciding procedural and substantive controversial matters and the introduction of a proactive judicial role in the search for an early conciliation of the conflict.
  - \* initially no legislative changes would be sought to implement the desired changes, rather the reform objectives will be implemented within the space allowed under the current statutory framework;
  - \* there would be substantive investments in the training of judges in the handling of the process reforms as a central factor in achieving the process delay targets.
  - \* the modernization of the judicial office with an emphasis in process and information systematization to support -rather than as an autonomous component-- the proposed judicial process reforms.
- the formulation and implementation of an emergency congestion reduction program seeking an abrupt reduction of current caseloads stocks that would enable the sustained implementation of the judicial process reforms. This

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<sup>15</sup> A detailed analysis of the institution of Jueces de Paz and their comparative characteristics with other forms of community-based justice systems in the region can be found in *Justicia Comunitaria y Resolución Alternativa de Conflictos*, Rodrigo Uprimny, *Debates Justicia y Desarrollo*, Año II, No.3, Marzo 1998.

program would seek to balance due process and economic considerations and attempt to phase-in the style of judicial process reforms proposed above, i.e. mandatory conciliation of old cases, etc. This program would be accompanied with an intense communications campaign aimed at educating the public on the objectives and principal means to reform civil justice administration.

*Improving the Judiciary's Governance and Managerial Capacity*

22. The third strategic objective to be pursued in order to improve the Judiciary's conflict resolution performance would consist in **strengthening its managerial capacity and some key organizational functions**. This strategic objective would consist of the following:

- strengthening the mechanisms of institutional coordination with the other branches of government and within the judicial branch.
  - \* a clear understanding should be reached between the Judiciary and the Planning authorities in terms of the preparation and implementation of the Judiciary's budget. The current system does not enable the Judiciary an adequate level of autonomy to implement far reaching institutional reforms. Although the high level of dependence of the Judiciary from Central Government transfers would require that the Judiciary must abide to prevailing fiscal constraint, it would be expected that once an annual budgetary allocation is agreed the Judiciary will have full autonomy in its implementation.
  - \* in the medium term, serious consideration should be given to diversifying the sources of revenue for the judiciary, probably some form of user fee that would generate efficiency incentives to the litigants and the courts.
  - \* there should be stronger coordination between the legislative and judicial branches to ensure that there is consistency between the legislative initiatives related to the judiciary and the latter's policies and implementation capacity.
  - \* improved coordination among the various bodies that compose the Judiciary to ensure consistency and uniformity in the definition of judicial policies.
- improvements in the key human resource management functions of judicial personnel --including, selection of judges and administrative personnel, performance evaluation-- to ensure adequate incentives are generated towards professional excellence and efficiency in the discharge of the judicial functions.

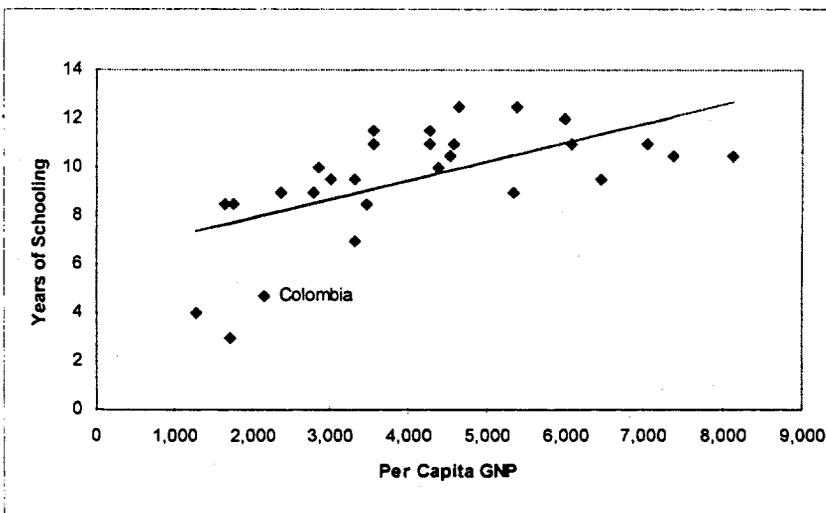
## HUMAN DEVELOPMENT

1. With per capita GNP of US\$2,140 (1996), much of Colombia's population enjoys a higher standard of living than average for Latin America. Advances in many social indicators over the past two decades, however, mask serious problems of inequities of distribution of wealth and income. The wealthiest 20 percent of the population account for nearly 62 percent of all consumption, while the poorest 20 percent consume only 3.2 percent. Eighteen percent of Colombia's population (31 percent of the rural population) still lives in poverty; poverty rates are sharply higher in the poorer departments. The average adult has completed less than five years of education, having spent 7.5 years in school to achieve this level. About 9 percent of the adult population (23 percent in rural areas) is illiterate. Maternal and infant mortality rates are average for the income group (100 per 100,000 and 25 per 1,000 live births, respectively), but adult death rates are substantially higher than regional averages, reflecting the alarming level of violence currently gripping the country. The population growth rate averaged 1.8 percent from 1990-1995. The notes on education and health that follow highlight some of the important challenges facing the Government in the two sectors; they do not pretend to cover every important issue that may need to be tackled.

### Education

2. **The Education Deficit.** The above indicators suggest that Colombia's ability to regain and sustain robust economic growth is in jeopardy. International experience provides ample confirmation that a literate, trained, and trainable work force is indispensable in unleashing a country's potential. Increasing educational attainment has been found to be a necessary complement to physical capital accumulation in determining economic growth. The importance of education has grown, as competition in the international market has become technologically more demanding. Against international averages, however, Colombia's current average level of schooling of less than five years is at least three years less than expected for its current level of per capita income (Figure 1). If current trends continue, the prospects for correcting this problem are not bright. While school enrollments

Figure 1: Years of Schooling, Adult Population, by Per Capita GNP



Sample: Selected middle-income countries

have grown during the 1990s, actual coverage at primary level is far from universal and growth barely exceeds population growth. Moreover, quality is a problem at all levels, resulting in poor achievement and contributing to persistently high repetition and dropout rates. Developing and implementing a strategy to raise the average level of schooling of the population to at least ten years by the year 2010 should be at the top of the Government's policy agenda. Achievement of this objective will simultaneously serve the overarching goals of reducing structural poverty and correcting the extreme skewness of wealth distribution.

3. **Coverage and Efficiency.** Despite gross enrollment levels over 100 percent of the population aged 6-11, 15 percent of primary school-aged children (mainly the poorest) do not attend school, compared with 9 and 6 percent averages for Latin America and for countries in the lower-middle per capita income range, respectively. The difference between the gross and net enrollment rates is due to a large number of overage children—children who begin school late or repeat grades. In addition, over a quarter of children enrolled in first grade drop out before entering fourth grade. Only about 30 percent of children who enter first grade finish basic education (ninth grade); only 7 percent do so without repeating a grade. Those who drop out of school before finishing basic education are those most likely to live below the poverty level, suffer from ill health, die before reaching average expected life span, have large families (who are also at risk of ill health and early death), be unemployed, and participate in violence—whether organized, random, or domestic. Enrollment in pre-primary level, which has been shown to increase the probability that children will begin school on time, complete primary school and achieve at a satisfactory level, is only 23 percent. Enrollment rates are much lower in rural areas and in low-income urban communities, where families are unable to pay the direct costs (transportation, uniforms) or indirect costs (the need to work (about 7 percent of children from 10 to 14 work)) of education. Lack of access to infrastructure is not the key constraint to coverage at primary level.

4. While gross enrollment in secondary level is about 67 percent, only about 45 percent of the secondary-level age group is enrolled in secondary school. Both direct and indirect costs rise with the school level, and indirect (opportunity) costs of education become especially important factors contributing to dropouts as children grow older. Those who repeat several grades may drop out in frustration, or because their families refuse to continue support for their education if they do not succeed, even though they may not find employment.

5. **Quality.** National educational assessments indicate that the quality of both primary and secondary education is inadequate, and that quality is generally lower in poorer schools, which typically lack the supplemental funding needed to cover essential inputs. Over half the teaching force lack post-secondary degrees, and learning materials are inadequate both in quality and quantity. Differences in quality of education contribute as much or more to inequity as does lack of access to school. Therefore, reduction of inequities requires that quality of education services for poor populations be improved through targeted subsidies for needed inputs, as well as reduction of the barriers to demand that keep the poor out of school. Such measures might include targeted subsidies to cover transportation or other direct costs, provision of transportation services, and

vouchers to compensate for students' foregone income, among others. Solution of the problems of quality in basic education will require involvement at the higher education level (to prepare teachers, for example). Unfortunately, similar problems of deficient quality exist in higher education: 68 percent of tertiary-level teachers hold only an undergraduate university degree; only 25 percent work full time in teaching. Implementation of the reforms in university education, enacted in 1992, has been slow and incomplete, and evaluation mechanisms are inadequate to establish the quality of newly introduced programs.

6. **Public Spending and Resource Distribution.** During the past decade, spending on education overall rose from 1.9 percent of GNP in 1980 to 3.5 percent in 1995, with priority given to basic education. Despite this growth, education spending is still below the averages for lower-middle income countries (over 5 percent) and the Latin American region (nearly 4 percent). Expenditure per student at primary level more than doubled as a percentage of per capita GNP between 1980 and 1994 (Table 1). In contrast, spending

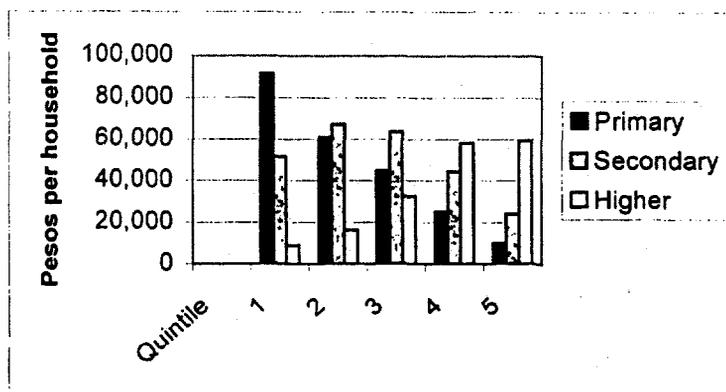
Table: Growth in Expenditures in Education, 1980-1994, Colombia and Comparator Countries

	Public expenditure on education, % of GNP		Expenditure per student, % of GNP per capita					
	1980	1994	Primary		Secondary		Tertiary	
			1980	1994 <sup>1</sup>	1980	1995 <sup>1</sup>	1980	1994
Colombia	1.9	3.5	5.2	10.5	-	11.0	41.1	29.0
Latin America, average	3.9	3.9	8.7	8.5	-	12.5	55.1	39.0
Lower middle income	4.5	5.2	10.4	12.4	-	13.0	49.8	40.0

<sup>1</sup> May not include spending by provincial and municipal governments.

per student at tertiary level fell by 10 percentage points of GNP per capita over the same period, below the average for comparator countries. Since public spending on primary education benefits the poor relatively more than the rich (Figure 2), public spending on education overall has become more progressive. Nevertheless, overall public spending on education, and particularly on basic education may be insufficient to achieve its goals of improving coverage and quality. In addition, the distribution of both enrollments and education spending mirror the inequities in wealth and income distribution within the country, with urban centers and wealthier

Figure 2: Colombia: Distribution of Public Subsidy to Education, by Income Quintile and Education Level, 1992



departments receiving a disproportionate share.

7. The inequities in distribution of resources for education (and the concomitant differences in school enrollments, attendance, educational attainment, and achievement) are troublesome for two reasons. The first is evident—they represent an obstacle to the achievement of coverage and quality goals, and the importance of education in breaking the vicious cycle of poverty is well known. Of equal importance, however, is the link found by several recent studies between inequities in distribution (rather than absolute levels of poverty) and high levels of violence. A number of studies suggest that education holds the key to a long-term sustainable solution to the endemic problems of violence, which have been identified as a key concern to a majority of Colombians and a major constraint to economic growth. In view of the alarming level of violence that continues to grip Colombian society, this link between education and reduction of violence—in addition to the better-known links between education and economic growth and diversification, quality of life, public health, and social welfare in general—gives added urgency to the need to solve the problems that currently impede achievement of universal basic education in Colombia. While the skewness of resource distribution has become more marked since education was re-decentralized, this does not imply that decentralization itself necessarily exacerbates inequities. Rather, it reflects the fact that the formulas for calculation of resource transfers (based on student enrollments in schools) has not yet been implemented. Correction of the transfer formula should be assigned first priority.

8. **Organization, Management and Governance.** Following decades of centralization of many responsibilities in education, Colombia began a process of re-decentralization in the late 1980s as part of an overall political decentralization process. Through this process, allocation of responsibilities in education resulted from political negotiations among entities and levels concerned with overall gains (or losses) in power, rather than from a carefully conceived vision of how the functions needed in education should be assigned. As a result, responsibilities for some essential functions are not clearly assigned at all, others seem to be allocated to more than one level or entity, while still others have been assigned to levels far from the level where the effects of actions and decisions will be felt. In the process, the level of key importance—the school and school community—lacks the possibility to make optimal use of its resources (especially its human resources) and lacks a framework and the incentive to be accountable for its actions, use of resources and results achieved. Since most of the resources in the education system are found at the school level, this will necessarily result in serious inefficiencies overall. The evidence of increasing inequities in resource distribution, as well as indicators of low quality overall and increased skewness in the incidence of low quality, point to the need for establishment of an integrated approach to the policy and institutional framework for education within the context of decentralization. The new overall framework should include a new framework for distribution of resource transfers, as well as a reconsideration of the definition of functions and responsibilities at each level. The feasibility of the new framework will depend on the extent to which stakeholders (not only political power brokers) are involved in its development.

## Recommendations

9. **Organization and Management.** Solutions to the problems of coverage, quality, equity and efficiency in the education system turn on a solution to the inconsistencies in organization mentioned above, as a necessary complement to increases in spending on education at the national level. It is unlikely that further increases in aggregate spending would achieve the results desired without solving the organizational and distributive problems. In developing an integrated framework, the following principles are proposed:

- Establish a new model of organization based on the school and its immediate community, with adequate autonomy to permit efficient and appropriate decisions to meet its needs and accountability to its community, the funding entity, and society as a whole. All other levels and entities should be designed to support the needs and objectives of the school. The introduction of the *Proyecto Educativo Institucional* (PEI), which focused on an action plan for quality improvement, was a first step in this direction. Much more could be done, however, to develop the PEI as a tool to foster development of capacity and responsibility at the school community level. Expansion of the PEI to include an overall statement of objectives and strategy, budget, and plan for institutional development and administration would provide the basis for delegation of increased responsibility to the school, along with the corresponding accountability for use of resources and achievement of results. These arrangements would allow selection of teachers (according to a pre-qualified list), and management and execution of its budget, including payment to teachers. School communities should be responsible for maintaining infrastructure, furniture, and equipment within overall their budget allocations. In this way, authority for taking decisions is aligned with the level where the consequences of the decision are felt, thus ensuring better responsiveness to beneficiaries' concerns and needs, and permitting school authorities to be held accountable for performance. A clearer definition of responsibilities of the participants at the school community level, particularly those of parents, is needed in the governance and supervision of the school performance.
- The municipal level has the key responsibility for assessing needs for resources within its area and planning the most efficient ways to meet them, maintaining an information system, and supervising and evaluating schools. School infrastructure and equipment belongs to the municipality, which has the responsibility to provide for construction and maintenance. Nevertheless, it has been found more effective in many systems for municipalities to delegate the responsibility for planning and administration of resources *within* a school to the school (or school council) itself. This allows the school to be held accountable for maintaining the assets and provides incentive for greater efficiency, while allowing the municipality to focus on overall planning issues (such as the need for closing or combining schools, or establishing new ones).
- The departmental level is responsible for providing technical assistance to municipalities in planning and evaluating quality improvement and the development of human resources. It is also responsible for the distribution of the *situación fiscal* and evaluation of municipal management, as well as for providing certain "administrative

support". In practice, the departments have generally assumed responsibility for appointment and payment of teachers. Since departmental authorities are distant from the school, they are not in a position to know or appreciate the problems it faces. Their decisions are therefore more likely to be affected by factors other than local needs. Delegating this responsibility to school level would enable the department to focus on establishing quality standards for the department to complement national standards, and evaluating teachers and schools against these standards. Most departments are in need of strengthening of their technical capacity in order to discharge these functions effectively.

- The national level is responsible for policy-making, establishing national objectives, norms and standards, strategic planning, and evaluating the performance of the system. It must define guidelines for a national core curriculum and for the selection of textbooks and teaching materials consistent with the guidelines, establish national requirements for teachers, and evaluate the performance of the system as a whole against quality standards. It may also be responsible, as in Colombia, for establishing a consistent framework for teacher employment, management, and compensation. The national government must also set policies for distribution of resources in line with goals of equity and efficiency; this may require establishment of compensatory mechanisms for disadvantaged regions or populations. To implement policies related to equity of resource distribution, the national level establishes criteria for distribution of resources to sub-national entities, and may need to incorporate guidelines (or incentive mechanisms) for their use. It must also establish a framework for accountability, require compliance with its application, and provide relevant information to participants, beneficiaries, and society as a whole.

10. **Framework for Equitable Resource Distribution.** While overall spending on basic education has grown under the framework of decentralization, spending has become more unevenly distributed across departments and municipalities, and between urban and rural areas, worsening the inequities in the system. The mechanisms currently applied have introduced perverse incentives that have worsened inefficiencies in the system (for example, transfer formulas are still based on the distribution of teachers in 1992, rather than on student enrollments). In Colombia, the clearest example of the need for improved transfer mechanisms in line with equitable distributive policy is that of rural education. The constituencies of political authorities in sub-national entities responsible for distribution of resources are concentrated in urban areas, where they have greater influence on distributive decisions than do rural residents. One of national government's key roles in a decentralized context is to establish policies, transfer formulae and mechanisms—as well as incentives and sanctions, where necessary—to ensure that those policies are applied. Simple capitation formulae may be complemented by use of supplemental, or compensatory, funding mechanisms based on criteria such as school location (distance from an urban center, for example) or service to groups with special needs (for example, groups in poverty, bilingual groups, or those with learning difficulties).

11. **Development of the Teaching Force.** The fact that half the teaching force has no post-secondary training reflects the anomalies and inconsistencies of the framework for management and development of teachers and other professionals working in

education and the urgency of correcting them. The fact that most of the unqualified teachers are assigned to poor—and often rural—areas is an important source of inequity. Solution of the overall problem of stagnant or declining quality in basic education requires that a framework be developed to deal with all aspects of management of the most important element in provision of education: policies and standards for pre-service training; selection, qualification and evaluation criteria; a framework for screening qualified teachers; a compensation system that links advancement to excellent classroom performance, while protecting teachers from politically based appointment decisions; a framework, together with provision of resources, for in-service training; and a framework for preparing and developing managers and leaders in the system. The prevalence of unqualified teachers may indicate that standards for preparation have been not been applied. It may also indicate that inadequate attention has been given to provision of financial support for such preparation and/or that the teaching profession has become less attractive due to inadequate remuneration, perceived loss of job security, declining prestige, or other reasons. The need for a national program to support development of a new framework for pre-service teacher training should be considered, with appropriate participation by departmental and local authorities.

**12. Support for Institutional Development at School Level.** Most efforts to strengthen educational quality have produced disappointing results because they entailed centralized decisions regarding what inputs were needed and how they would be purchased and distributed. Teachers were not encouraged to take initiative or responsibility. The introduction of the PEI offers a new model for quality strengthening, as well as for improvement of operational and administrative efficiency. In its PEI, each school assesses its own needs (human, financial and physical resources, training) and identifies an action plan for achieving its objectives. It is clear, however, that many schools require financial assistance not only to provide for the needs they identify but also technical assistance to carry out their self-assessment and develop strategies for achieving their goals. Such assistance can be provided through a network of pedagogical advisers (to replace the traditional supervision system, which is no longer relevant in a decentralized system). Care should be taken to avoid “transitional arrangements” that would replace the responsibility of the school level with more centralized provision of resources until schools develop sufficient capacity. Such arrangements are costly and inefficient, often delay or frustrate the development of local capacity, and tend to be self-perpetuating. The challenge is to find the appropriate roles for the national, departmental and municipal governments in providing support for school development while fostering autonomy and responsibility.

**13. Expansion of Coverage.** With 85-percent coverage of the primary school-aged population and gross enrollment rates well over 100 percent, it would appear that most of the supply-side measures (provision of infrastructure and teachers) have already been applied. Nevertheless, there is much room for expansion at pre-primary level, where coverage is only 23 percent. Increasing enrollments at pre-primary level would alleviate the efficiency problems that result from high rates of over-age children in primary level, improve the developmental potential of all children, and improve the completion rates for basic education, all of which would directly benefit poor children. By increasing the chances of success in school, pre-primary education can contribute to reduction of both

repetition and dropout rates, improving both efficiency and coverage in later grades. To achieve further increases in coverage, however, it will be necessary to tackle the barriers to demand (inability to cover direct or indirect costs that keep many poor children out of school). Colombia has already gained some experience with voucher programs at the secondary level. Their potential usefulness and cost-effectiveness at primary level should also be evaluated. At secondary level, existing capacity is insufficient to achieve the enrollment goals set (gross enrollments are 65 percent), suggesting that investment in infrastructure will be needed to permit coverage of the entire secondary-level population through age 15. At the same time, demand barriers are even more important at secondary level than at primary level. Some of the voucher programs tried show promise and should be carefully evaluated for possible application more generally. More analysis is required, however, to determine the specific nature of the factors causing students to drop out of school, and well-targeted programs should be designed to address these factors directly.

**14. Solutions for Higher Education.** Higher-education institutions are autonomous and therefore not subject to direct policy intervention by the national government. Nevertheless, they are an important part of the education sector and should play a role in solving many of the key problems facing the sector as a whole. In particular, universities should be involved in helping to define academic standards for secondary level, as well as in providing appropriate pre-service training for primary and secondary school teachers. In addition, good-quality higher education is essential to supply the qualified professionals and research needed to support dynamic economic development. Several institutions have expressed an interest in undertaking reforms in their policies (both academic and financial), programs, and management. The Government should encourage and support such initiatives, as they may provide valuable experience that could offer ways to strengthen the higher education subsector generally.

**15. Present and Potential World Bank Assistance.** The World Bank is currently supporting a project in secondary education, as well as two projects administered directly by decentralized territorial entities (the Department of Antioquia and the Municipality of Pasto). The two recent projects were designed to develop more effective mechanisms for channeling investment funding to education in the existing decentralized context. The Bank has received requests from several other municipalities and departments for funding of similar projects. The Bank is conducting an evaluation of the experience of preparation and early implementation of these projects and will assess indications of their likely results and cost-effectiveness. The results of this evaluation will be important to inform a decision on the most cost-effective approach to financing urgently needed investments for basic education in the future. Preparation is underway for a project to support expansion and quality improvement of education in rural areas. The ongoing secondary education project is yielding lessons that will be valuable in determining appropriate forms of support for expansion and improvement of quality of secondary education. Future areas of assistance might include: (i) support for continued development of basic education by decentralized territorial entities; (ii) establishment of a framework for human resource development and management (including special support for transformation of the framework for pre-service and in-service teacher training and

leadership training in education); and (iii) development of alternatives for overcoming the barriers to demand at secondary level.

## The Challenge of Health and Sector Reform

16. Law 100, enacted by the Colombian legislature in December 1993, mandates radical changes in the way health care services are organized, financed and delivered. Despite significant achievements in the implementation of the health reform since 1995, it is clear that much remains to be worked out to translate the law into operational reality. The new Administration may consider concentrating on three overriding issues to consolidate implementation of the reforms envisaged in Law 100:

- **Affiliation and Collection Mechanisms for the *Regimen Contributivo*:** In order to attain the goal of universal coverage under Law 100, all Colombians must enroll with a health insurance administrator, such as an EPS (*Entidad Promotora de Salud*), to receive health services. In order to achieve the goal of solidarity, non-poor Colombians must pay wage taxes to subsidize the poor. To date, the Ministry of Health estimates that more than 30 percent of the target population of the *Regimen Contributivo*—both formal sector workers who earn at least one minimum salary and independent workers who earn at least two minimum salaries—have not yet enrolled with an EPS; they remain outside the system. This situation has resulted in delay in achievement of the goals of universal coverage and cross-subsidization. Another portion of the population is enrolled with an EPS, but is under-reporting its income and, therefore, under-paying its taxes. Collecting the correct amount of taxes to fund the system is vital to establishing financial balance for the *Regimen Contributivo* and to subsidizing the poor. Mechanisms and incentives are needed to affiliate workers (particularly the self-employed and workers in the non-formal sector) who are currently evading the system, as well as to minimize under-reporting of income and the consequent under-collection of taxes.
  
- **Adjustments to the Intergovernmental Transfer System for Health:** It is of utmost importance that intergovernmental transfers related to health be adjusted to work with, rather than against, the move from supply- to demand-based subsidies mandated by Law 100. To this end, the cost associated with the provision of minimum levels of health services for the poor should be financed through a specific-purpose transfer calculated on the basis of costs and number of beneficiaries. This approach could involve changes to the use and distribution of the *Situado Fiscal* for health. Currently the *Situado Fiscal* is used to fund public hospitals and health posts (approximately 50 percent to level 1, and 50 percent to levels 2 and 3) together with other sources of funds. If the payment of demand subsidies is excluded which should cover all public financing of the basic health service package (*Plan Obligatorio de Salud-Régimen Subsidiado* (POS-S)) for the poor, the *Situado Fiscal* for health must partially cover (at least during a transitional period) two types of expenditures: (i) the provision (probably by public hospitals) of level 2 and 3 services to the poor; and (ii) the cost of basic public health interventions by territorial entities, known generically as the PAB (*Plan de Atención Básica*). The specific character of these two expenditures and the rules by which the national level should finance them need to be defined. However, as in OECD countries, payments to hospitals and medical practitioners may follow a clear and explicit rationing system. This probably would mean moving from a provider-determined, fee-for-service system with resource allo-

cations based on historical budgets to a reimbursement system designed to constrain unnecessary services and expenditures, such as the DRG (diagnosis-related groups). Government transfers for health should be used along with other revenue sources to partially pay the cost of demand subsidies for the poor (for example, to cover the health insurance premiums of poor individuals). Again, clear rules must be established to determine the amount of this transfer, as well as to ensure its use for coverage of health premiums for the poor. In addition, a practical and efficient mechanism for guaranteeing that the funds are used for the purpose intended would be to deposit the POS-S subsidy for the poor of each *municipio* directly into a municipal sub-account to be established within the *Fondo de Solidaridad*, instead of transferring the corresponding amounts to the municipalities for subsequent payment of premiums to different EPSs.

- **Transformation of Public Facilities into Autonomous Entities:** The principal difficulty laid down in Law 100, as has been clear from the start, is the transition from a supply-based subsidy system to one of subsidies to demand via explicit individual insurance. On the supply side, this implies major efforts to develop new contracting and payment mechanisms and to help prepare public hospitals and clinics to compete for demand-based subsidies. Extra emphasis continues to be needed in small, poor municipalities where such competition is not feasible at the moment, so that improvements in management and better, more efficient services can be achieved even without the threat of competition from private providers. In municipalities where such competition already exists and will grow as demand-side financing expands, efforts are needed to help convert public facilities into autonomous and financial independent entities. As part of this institutional strengthening of public health facilities, highest priority should be assigned to human resources and systems development (management information and medical quality assurance systems).

17. **Present and Potential World Bank Assistance.** The ongoing Municipal Health Services Project (Ln. 3615-CO) is supporting implementation of Law 100 in 220 poor municipalities. Future areas of assistance might support implementation of Law 100 in additional geographical areas not included under the ongoing project, as well as development of new institutional and financial policies and instruments needed to fully achieve the objectives of the Law.

## SUSTAINABLE DEVELOPMENT AND

### RURAL ISSUES

#### Background

1. While the country's overall social and economic indicators of progress have shown solid growth over the past decades, those for rural areas have not kept pace. In addition, some regions of the country have remained significantly behind. Poverty is increasingly a rural phenomenon and the rural-urban gap has been widening: 70% of the people with incomes below subsistence live in rural areas and 31% of the rural population are defined as extremely poor. There is more poverty in rural areas than would be expected in a country of Colombia's level of development, and the incidence of rural poverty exceeds the incidence of urban poverty by a factor of 3.6, much higher than for most other countries in the region.

2. As explained in the attached policy note on Peace and Development, violence in the countryside is particularly acute with up to one million persons displaced over the last decade. Growth of the drug trade in the last twenty years has complicated the situation. Large parts of the national territory are being controlled by shifting alliances between guerrilla groups, drug lords and private armies, where rural residents appear to be the continual losers. Out of the total of 970 municipalities in Colombia, 36% are directly involved in or subject to the armed conflict. Although there is no simple causal relationship between poverty and violence in rural areas, limited access to land and employment do raise the propensity for violence, and violence has a negative feedback on investment and employment. Rural insecurity reduces the incentive to invest in agriculture and, more importantly causes a skew in the pattern of investment towards activities that are relatively non-intensive in the use of labor which may encourage landowners to invest in livestock rather than crops. With the growth of the paramilitary movement and increased buying up of land in rural areas by drug traffickers, the problem has become increasingly complex. Land has been further concentrated in the hands of the old elite and drug traffickers; the distribution of large land holdings over 500 hectares increased from 32% of the total in 1984 to 45% in 1997. Given the highly unequal distribution of land and the skewed pattern of investment, land reform under the current circumstances has the potential to increase both equality and output, as well as addressing a long-standing source of conflict in many rural areas.<sup>16</sup>

3. Trade reforms in the last decade have opened up previously protected markets for some agricultural products and lowered their price. This together with the large land owner's preference for cattle ranching has subverted the traditional agricultural development model in many rural areas, reducing the land planted to food crops, altering the ecological balance, and lowering rural employment opportunities. At the same time,

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<sup>16</sup> Preliminary results of a recent study indicate a strong, statistically significant, negative farm size-productivity relationship. The Farm productivity study (1998) was conducted among 3,000 households as part of the design of a World Bank assisted Land Reform Project in Colombia.

those peasants who move to remote and marginal areas such as the Amazon to avoid the violence, often participate in growing illicit crops there. These in turn are sprayed with chemicals that harm the environment and damage health. Such expansion into marginal land is a result of the high prices for illegal drugs, without which the cultivation of these lands would not be economically viable.

4. With 10% of the world's flora and fauna, Colombia has been identified as a global priority for biodiversity conservation. Critical ecosystems account for forty percent of the country's area, and the agricultural frontier zones which are characterized by high levels of conflict are also zones of great fragility and biological importance. Deforestation due to the expansion of extensive livestock ranching and cultivation of illicit crops, and violent acts, such as destruction of oil pipelines, have had strong negative environmental impacts as well as adversely affecting the livelihood of poorer rural residents. Thus, rural development and peace are closely linked with concerns about preserving Colombia's exceptional natural resource base.

5. Over the last ten years the Colombian political system has sought to decentralize its democracy to the municipal level with the popular election of mayors and governors in 1988-1991, and the adoption of the new Constitution in 1991. Responsibilities for many services have been devolved to these levels of government along with the tax revenues to finance them. Major reforms in most sectors (education, health, water supply and sanitation, roads, etc.) have moved the locus of responsibility to departments and municipalities, and created mechanisms for citizen participation and oversight. However, in much of Colombia, especially the rural areas, these reforms have not been translated into reality. Public sector entities at the central level have resisted this change, and the size of the central administration has not been reduced to a level appropriate for its changed functions. In addition, capacity-building and reduction of armed conflict are needed to enable local governments and citizens to assume their new rights and responsibilities.

### **Broad Strategic Approach**

6. The new Government recognizes that resolving this complex set of problems depends first and foremost on establishing peace in the countryside. Without a general peace settlement, the options for progress on rural development in Colombia would seem to be very limited, and progress could be quickly reversed by a renewal of violence. Without a settlement, it will be difficult to promote increased legitimate private sector investment in rural areas, consolidate and deepen the decentralization process, and traditional central government programs are unlikely to work in much of the country where the central government does not have an effective presence and where municipalities are held hostage to the armed conflict. However, for a political solution of the armed conflict at the national level to succeed, we believe it is necessary to simultaneously develop more effective ways of promoting increased citizen participation and better governance at lower levels of government. Municipalities are often controlled by a dominant group that may not be interested in the welfare of the population as a whole. Citizens are often uninformed about their rights and may fear exercising them.

The challenge is to initiate and sustain changes at the grassroots level that support and reinforce any national peace settlement that may occur.

7. In our view, rural development should be the centerpiece of Colombia's program to reduce poverty and promote peace. An integrated strategy is needed which goes beyond agriculture to promote a broad range of income generating activities, promotes improved quality and access to education and health services, strengthens and gives a central role to communities, supports sustainable use, conservation and recuperation of natural resources, and addresses the root causes of conflict such as unequal access to productive resources particularly land and capital. Over the last two years, the Government with the World Bank's help has developed two pilot projects--Magdalena Medio Regional Development and Reservas Campesinas--which embody this approach, as does the Sustainable Development Plan for the Sierra Nevada de Santa Marta for which a third project is being developed. These projects rely on a "bottom up" approach with non-traditional social actors from the private sector and NGO community playing a critical role; they all have a strong emphasis on building trust and strengthening social capital through working with the key stakeholders in a particular geographic area.

### **Agrarian Reform**

8. Agrarian Reform is a key element of any strategy to create conditions for peace in the rural areas. By passing Law 160 in 1994, Colombia embarked on a new strategy of agrarian reform that provides the poor with grant and loan assistance to buy the land that they themselves have identified and negotiated and which gives greater power to local institutions, reducing the role of INCORA. With the assistance of the World Bank, this new approach towards land reform has been tested in five municipalities (Montelíbano, San Benito Abad, Puerto Wilches, Fuentedeoro and Rivera) in 1997 and 1998 with encouraging results. The cost of land per beneficiary family is significantly lower (US\$13,084 in the pilot area, US\$25,177 outside the pilot area); crucial support programs accompanying land reform are much more effective (67% satisfactory rate inside pilot vs. 34% outside pilot); and the process is much faster (12 vs. 22 months) which is important given the high level of demand (100,000 families). However, in order to respond to this demand and upscale the pilot to the national level, the Government should put measures in place to ensure: (i) that land reform is truly oriented at establishing viable family farms rather than just facilitating the transfer of pieces of land; (ii) that local institutions take a lead in implementing land reform; and (iii) that disadvantaged groups, which currently are not in a position to obtain credit from commercial banks, are included in the program.

9. Integrated nature of land reform. The approach tested in the pilot program recognizes that land reform is more than just the mere transfer of land. The objective is to establish viable family farms. For this purpose, an integrated package of services is provided to land reform beneficiaries, including land, on-farm complementary investments, training, technical assistance and financial assistance to ease the hardship of

the start-up phase.<sup>17</sup> To institutionalize the integrated nature of the approach, the land reform subsidy, as stipulated in Law 160, should not only be applied to the cost of purchasing land, but to the whole package of investments based on a ceiling reflecting the costs of establishing a *Unidad Agrícola Familiar*.

10. Decentralized institutional framework. Recognizing that colonization and redistribution of land to small farmers by INCORA has done little to change the unequal distribution of land, Law 160 correctly puts many more responsibilities in the hands of local institutions, especially the *Consejo Municipal de Desarrollo Rural*. However, in practice little has been done by public sector entities at the central level to share power at the local level. A recent report prepared by McKinsey<sup>18</sup> clearly shows that the actual institutional framework is totally inadequate to effectively and efficiently implement agrarian reform in an integrated fashion in Colombia. Of the various options presented in the report to go about solving the institutional problem, bringing all the functions provided by the National Land Reform System (SNRA) institutions under one roof in a decentralized fashion which relies heavily on private service providers makes the most sense. By doing so, services related to land purchase, technical assistance, training, on-farm complimentary investments, commercialization etc. can be provided to farmers in an integrated manner, taking into account the existing capacity of the private sector in the respective regions and reflecting the successful approach adopted under the pilot. A truly decentralized approach would also permit tailoring of services to farmers, particularly the mix, to local realities as indicated in the participatory municipal development plans for land reform. It would be likely to generate substantial cost savings as well. It would be advisable to keep a firm like McKinsey on board to guide and accompany any institutional transformation in this direction.

11. Financing land reform. Unfortunately, not all those individuals or groups in need of land are likely to qualify for private financing as stipulated in Law 160.<sup>19</sup> Only a limited number of individuals would have the work experience, education or personality to be successful rural entrepreneurs and obtain a loan from a private bank. Furthermore the Law requires that the land revert to INCORA to reclaim the subsidy in the event of a change of ownership. This would not permit the holder of a mortgage to execute the collateral in a case of default. The private financial market also does not commonly provide financing of 10-12 years as required by the Law. Under these circumstances, it seems that the only way to provide credit to this target group would be through Caja Agraria (CA), at least in the initial stages of the land reform program. Hence, if the objective is to ensure access to land by all of those in need, market-assisted land reform might not be the blueprint solution. This, in combination with the challenges arising from any peace settlement, supports an approach which tailors the different modes of

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<sup>17</sup> Detailed design features are described in: "Manual Operativo de la Reforma Agraria por Negociación Voluntaria"; 1998, Ministerio de Agricultura y Desarrollo Rural.

<sup>18</sup> "Apoyando en la Preparación y Ejecución de un Plan de Modernización; Diagnóstico y Recomendaciones"; 1998, McKinsey & Company, Inc.

<sup>19</sup> "Acceso al Crédito de los Beneficiarios de la Reforma Agraria"; 1998, Dra. Beatriz Marulando de García bajo contrato de consultoría con el Banco Mundial.

land reform contemplated under Law 160<sup>20</sup> to different target groups including: *aspirantes en la frontera económica, mujeres cabeza de hogar, desplazados, reinsertados, poseedores de baldíos, personas sin tierra en zonas de ampliación de frontera* etc. A peace settlement might also involve a “guns for land” deal for large numbers of guerrilla fighters. The large tracts of land owned by drug traffickers, which can be expropriated under existing law, could be an important source of good quality land to be redistributed under the land reform. However, to apply expropriation on a large scale requires changing the current juridical procedures into truly administrative ones.

12. Given its importance in the peace process and its potential to increase both equality and output, the World Bank is in principle willing and interested to continue to provide support to Colombia in the design and implementation of a land reform program. However, in order to ensure positive impact on a large scale and finally break away from the failures of the past, we believe that it is crucial that the Government implements the recommendations mentioned in preceding paragraphs. By doing so, the Government would provide a credible framework which would allow the Bank to commit considerable time and resources to work in partnership with the Government in order to achieve concrete results on the ground.

### **Rural Finance**

13. In order to promote rural development, rural residents need access to a full array of financial services. Up to now, the debate on this issue in Colombia has focussed primarily on the issue of small farmer access to credit and high interest rates for these loans. Much of the analysis and discussion has been about the chronic problems of the Caja Agraria (CA), the key institution relied on by the Government to provide short and long term credit in rural areas. Much of this credit is subsidized either directly by CA or through its second tier rediscount agency FINAGRO. The World Bank has worked with the Government for many years to reform and strengthen the CA, but this effort has been judged a failure (the last in a series of Bank financed projects to reform the CA closed in 1996). Years of experience have proven that CA is not a financially sustainable operation, due to its high costs, below market lending rates, and high loan losses. Its clients view CA as a benevolent lender, and politicians are inclined to declare moratoriums or debt forgiveness when interest groups press enough. As a result CA shows periodic accounting losses and gradually becomes decapitalized or bankrupt. Government then adds capital in various forms and the cycle begins again. The extent of CA's losses annually are largely understated, as the true extent including opportunity costs and inflation are not known.

14. Arguments for maintaining the CA normally revolve around the view that without it small farmers will not have access to credit because private banks are not interested in lending to them. However, at present there is little knowledge of the economic impact of Government's intervention in rural credit markets through CA and FINAGRO. What

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<sup>20</sup> The land reform modalities provided for by the law include: *negociación voluntaria, intervención directa, extinción del derecho de dominio, titulación y recuperación de baldíos*, etc. The target groups include *personas sin tierras en zonas de ampliación de frontera*, etc.

percentage of peasants presently receives government sponsored finance? In Mexico, which has a comparatively large official credit program, a field survey determined that less than 3% of peasants were recipients. In countries such as Bolivia and Peru, where official credit programs have ended, there is no correlation between the availability of this credit and changes in agricultural production. This is because non-formal and commercial sources have proven to be so much more important.

15. Another critical issue, particularly at this time of fiscal austerity, is the fiscal and quasi-fiscal cost to the Government of its official credit programs in rural areas which to our knowledge has not been examined. At the request of the previous administration, the World Bank had shared with the *Misión Rural* team an analytical methodology to estimate a subsidy dependence ratio which would provide an estimate of this cost. The balance sheet of a financial institution such as CA can be shadow priced using market interest rates and loan loss data. The subsidy actually received by various client groups can be determined. The extent of the subsidy, its relation to the government's fiscal deficit and inflation will then become more transparent. Tradeoffs between fiscal management and rural subsidies can follow.

16. We recommend that the Government explores a new approach to rural finance which we believe--based on analysis of international experience--could be more effective at reducing poverty.<sup>21</sup> There is growing evidence that subsidized credit programs to promote agricultural growth have generally failed to improve incomes and alleviate poverty in rural areas. The Bank recommends a new approach in which the Government's role is to set a favorable legal and policy environment for rural financial markets and address specific market failures cost-effectively through well-designed and self-sustaining interventions. The starting point for moving to this new approach would be the analytical work mentioned above concerning the efficiency of rural financial markets, and the cost-effectiveness of the existing system. We believe it is an excellent time for the Government to undertake this work and consider new approaches as there have been important changes in the financial markets in recent years with the entrance of more aggressive foreign banks, the strengthening of credit cooperatives which now answer to the Superintendent of Banks, and the development of more modern technology. The Bank would be interested in supporting this work.

### **Sustainable Development: Natural Resource Management Dimensions**

17. Since the passage of Law 99 in late 1993, significant progress has been made to put in place the new, decentralized institutional framework for environmental management, and new policies and regulations for promoting sustainable development. The Bank has been supporting this effort through the Natural Resource Management Program and the Urban Environment project. As mentioned above, issues of rural development and peace are closely linked with preservation of Colombia's unique natural resources and cultural heritage as well (many of the most environmentally important areas, such as the Pacific Coast, are inhabited by indigenous and black communities).

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<sup>21</sup> Yaron, McDonald and Charitonenko, "Promoting Efficient Rural Financial Intermediation", *The World Bank Research Observer*, Vol. 13, No.2, August 1998.

The Bank would like to continue supporting the Government's efforts in this area, and particularly those which take an integrated, participatory approach of working to address environmental, development, and peace issues. In addition, through its role as a manager of the Global Environmental Facility, the Bank encourages and would like to support Colombia's efforts to obtain increased grant resources commensurate with the importance of the biodiversity within its boundaries and the many innovative initiatives underway.

### Recommendations

18. Based on the discussion above and in the other policy notes, the Bank can make the following policy and action recommendations to the new Government:

(a) putting in place an integrated land reform program which links different target groups with specific instruments in a decentralized context with ample scope for participation of *campesino* organizations and other civil society groups is of the highest priority to create the conditions for peace in countryside. In order to ensure the integrated nature of any land reform program, Law 160 should be amended to apply the subsidy not only to land but also to an integrated set of services, aimed at establishing viable family farms.

(b) it should be clarified that in case land reform beneficiaries default on their mortgage, credit providers have the first right (before INCORA) to execute the collateral.

(c) in order to apply expropriation (*extinción del derecho de dominio*) on a large scale, it should be made a truly administrative procedure.

(d) consolidation of the SNRA along the lines recommended by the McKinsey Study is essential to make land reform work in an integrated and decentralized manner.

(e) FOGAFIN or the Central Bank should carry out a subsidy dependence study of Caja Agraria and FINAGRO (with Bank support) to determine their true contribution to the quasi-fiscal deficit;

(f) carry out a rural financial services survey to evaluate the functioning of rural financial markets including an analysis of how and where farmers and other rural resident obtain credit and other financial services, the obstacles which prevent the private sector from providing more financial services to rural areas and, if justified, develop preliminary proposals to address market failures;

(g) if justified by the above studies, close the Caja Agraria.

(h) strongly support and build on the positive accomplishments in the decentralization to the municipality level of extension services for small farmers (UMATAs), and putting in place new institutional and financial mechanisms

(PRONATTA) for stimulating applied research in order to improve the sustainability and productivity of agricultural sector.

## INFRASTRUCTURE AND ENERGY

1. Over the next decade, Colombia is going to face the need for large investments in the infrastructure and energy sectors. Preliminary estimates based on experience elsewhere in Latin America and world-wide in countries at comparable stage of development, together with available information on the current state of Colombia's infrastructure (including water & sanitation, transport, energy/power, telecommunications and urban development) suggest that average annual investments of in the US\$ 3-4 billion range will be needed over the coming decade, even before taking account of special projects such as urban metro-rail systems that are under consideration. The magnitude of these resource requirements together with the fiscal challenge facing the government at the macro-level make it imperative for Colombia to take all steps to attract the maximum private sector investment and participation in the next decade's infrastructure development. It would be critical to create well thought out sector structures conducive to competition, enabling regulatory and investment environment, and capital market linkages and instruments that promote vigorous private sector participation in infrastructure provision. The following discussion highlights the issues and actions needed in several specific infrastructure areas.

### I. URBAN AND MUNICIPAL DEVELOPMENT

#### Sector Background

2. Like many other countries in Latin America, Colombia has been experiencing rapid urbanization in recent decades. In meeting the challenges created by urbanization, Colombia has over the past fifteen years, aggressively pursued political, economic and administrative decentralization of urban and municipal development, as a means to improve the quality and efficiency of services, and make the services more responsive to local needs. Successive governments have taken a variety of legal measures to empower municipalities, through reforms of local taxation and legal stature of local governments (Laws 14 of 1983 and 11 of 1986), allocation of increased shares of central government revenues to municipalities (Law 12 of 1986), and transfer of responsibility for providing local services from the center to municipalities (Decrees 77, 78 and 80 of 1987). These changes have had a dramatic impact on municipal revenues and expenditures, allowing municipal investments, to grow from 0.7 percent in 1988 to 1.8 percent of GDP in 1994. Transfers have doubled from 1988 to 1994, from 0.76 percent to 1.49 percent of GDP; these have been matched by a commensurate local fiscal effort, with locally mobilized municipal revenues increasing from 1.13 percent to 2.05 percent of GDP.

3. Law 142 of 1994, which operationalized the mandate provided by the 1991 Constitution for municipalities to assume responsibility for urban services, pushed further the decentralization and modernization of urban public services by requiring major service providers to become self financing and financially autonomous companies. Local governments in Colombia have become increasingly responsible for the provision of a wide range of public services including water and sanitation, solid waste disposal, health,

education, urban transport, market places. The Government has placed a special emphasis in this regard on water utilities, requiring them to develop management strategies and operate essentially as independent businesses. Regulatory institutions were established to oversee public service providers and steps are being taken to upgrade the institutional capacities of these and other local government entities to enable them to meet the new requirements.

#### **Issues and Recommendations for Future Strategy**

4. Notwithstanding the considerable effort past administrations have put into decentralization, several issues of urban and municipal development need urgent further attention:

5. **Low coverage and inadequate service delivery capacity of municipalities.** Coverage of municipal services varies considerably with city and region. Smaller cities and towns, as well as low-income areas in larger cities, still lack even the most basic infrastructure: over 40 percent of urban streets nationwide are unpaved; street maintenance and traffic management is neglected; and at least 30 percent of solid waste in most cities remains uncollected.

6. **Weak institutional capacity.** Of the 1,060 municipalities in Colombia, the larger, fiscally strong municipalities have generally moved quickly to take up new responsibilities and utilize their new resources. Smaller municipalities, on the other hand, are hampered by weaknesses in managerial, technical and financial capacity. Despite the strong modernization efforts, they continue to be unable to adequately discharge their new responsibilities. The Colombia - Local Government Capacity Study (Report No. 14085-CO) carried out by the Bank in 1995 proposes a new approach to municipal capacity building which goes beyond traditional technical assistance programs. The study calls for enhancing the incentives for local governments to find and adapt innovations, improve information on sectoral benchmarks, best practices and available options, encourage community participation, and strengthen mechanisms for voters to voice their views and provide feedback on public performance

7. **Slow progress in promoting private sector participation and modernization of services.** Law 142 of 1994 required that service companies adopt business accounting and management practices, including self-financing of capital investments; set deadlines for conversion of urban service providers into public-, mixed-, or private-sector enterprises, and established regulatory commissions for each service. However, institutions to assist local governments in complying with this key law are largely missing. FINDETER, Colombia's Local Development Bank, which is a key financier of local capital investments has lent overwhelmingly to support core municipal administration functions rather than autonomous (public or private) urban service companies. The recently approved Urban Infrastructure Services Development Project (Loan 4345-CO) will help correct this situation by funding on a priority basis private and autonomous public providers of urban and municipal services

8. **Distortions in the Allocation of Municipal Resources.** Resource allocation at the local level continues to be distorted by mandatory sector-wise minimum expenditure levels dictated by Law 60/93, and the poor correspondence between stated national investment priorities and the allocation criteria defined under the Colombia's NCS (National Cofinancing System) grant system. A complex, centralized administration of the NCS and unclear division of responsibilities among the various entities involved in administering the system also contribute to their far from satisfactory performance

9. **Deficiencies in the Municipal Credit Market.** The Colombian municipal credit market has evolved favorably since the inception of FINDETER in 1990, with commercial banks providing substantial amounts of financing and a few bond issues by larger municipalities. However, there is very little financing available on longer term maturities as would be needed for most infrastructure investments. FINDETER, BANCOLDEX or other sector or financial institutions should strive for a more proactive role in creating a market for longer term instruments and achieving a more diversified set of financial products (e.g., contingent lending instruments such as stake-out financing or put options) suitable for infrastructure financing, better risk management capabilities (including term risk, liquidity risk and foreign exchange risk). These issues are being addressed under a Second Municipal Development Project financed by the Inter-American Development Bank, in parallel with the Urban Infrastructure Services Development Project and by the proposed Infrastructure Finance Facility which has been prepared with Bank support and is ready for negotiation.

### **Recommendations**

10. The administration should consider comprehensive further reforms to consolidate and facilitate effective implementation of the impressive efforts undertaken towards decentralization. Of urban and municipal services. A multi-pronged approach is suggested, encompassing:

- (a) a more activist strategy to increase the participation of the private sector and, where appropriate, autonomous public service companies, in the provision of public services and "operator" functions, while focusing local government functions in creating and overseeing appropriate regulatory and competition regimes related to service provision; the private sector can increasingly take over most functions related to water supply, garbage collection and other local services, as well as municipal functions such as completing cadasters, accounting, and possibly even tax collection, giving room to for municipal governments to concentrate on strategy, policy and monitoring and regulatory oversight of service providers. Entities such as municipal slaughterhouses, marketplaces and bus terminals could be put up for sale for private sector operation.
- (b) an action strategy under the leadership of national and departmental governments to enhance the core administrative capacities of the smaller and medium size municipalities through technical assistance, technical and administrative training and more effective use of information technology.

- (c) correction of the distortions and complexity of administration of the revenue sharing and NCS grants system referred to above; and
- (d) strengthening of municipal finances through increased linkages of municipal finances to capital market instruments, and increasing shares of market based resource mobilization by the municipalities, better information, accounting and financial management

### **Role of the World Bank**

11. The recently signed Urban Infrastructure Services Development Project can provide support in a number of areas noted above. In addition, the proposed Bank operation to support the establishment of an Infrastructure Finance facility would make available new financial instruments to facilitate private sector financing of public services at all levels. The Bank would also be willing to undertake a more in-depth study on specific options to implement an effective decentralization and municipal development to meet the objectives stated above, if the government so desires.

## **II. WATER SUPPLY AND WASTEWATER**

### **Sector Background**

12. **Sector Legislation and Organization.** Individual municipalities and departmental or central government agencies have traditionally shared the task of providing water supply and sanitation services in Colombia. The 1991 Constitution and Law 142 of 1994 gave responsibility to for provision of these services to the municipalities. The sharing of duties and rights between the three levels of government - national, departmental, and municipal - is detailed in Law 142 of 1994. Based on the guiding criteria of efficiency and quality of service, the Law also establishes the principles of competition and regulation of monopolies in the provision of services, free entry of competing service providers, and on-par treatment of private, public, or mixed operators.

13. Under the Law, the Ministerio de Desarrollo Económico sets sector policy and plans sector development, and the newly created Comisión de Regulación de Agua Potable y Saneamiento Básico provides guidelines and authorizes tariffs based on standard formulas and investment plans submitted by the operating companies. Environmental regulation is handled by the Ministry of Environment through the Corporaciones Autónomas Regionales under the Law 99 of 1993, creating a potential overlap or source of conflict with the agencies in charge of the water supply and wastewater sector development and regulation. Finally, the Superintendencia de Servicios Públicos monitors and supervises the adequacy and efficiency of the operations.

14. **Coverage and Quality of Water Supply and Sanitation Services.** The 1993 Census reported an urban population of some 26 million, residing in some 1,060 municipalities of widely varying size:

## Colombia: Policy Notes

Size of Population	No of Municipalities	Population	Percentage of Total
Above 500,000	6	11.3 million	44%
50,000-500,000	92	8.0 million	30%
12,000-50,000	476	3.7 million	14%
Below 12,000	486	3.0 million	12%
Total	1,060	26.0 million	100%

15. Approximately 88% of the 1996 urban population of 27 million were connected to public water supplies. About 75% were either connected to public sewerage or had individual septic tanks.<sup>22</sup> Rural coverage was lower with about 31% of the 10 million strong rural population connected to public water supplies. Some 10% of rural dwellers were connected to sewerage systems. Service quality has lagged connection rates. A 1997 survey by the Ministry of Health reported that some 70 % of the surveyed systems supplied water with low or no risk to the population's health. Slightly less than 50% of all water was supplied from treatment plants. On average the same survey estimated that the average availability of potable public water supply was 70%. This degree of intermittence poses a substantial risk of bacteriological contamination resulting from intrusion of untreated and inadequately disposed sanitary wastewater.

16. The share of collected sanitary sewage receiving any treatment whatever is below 5%. Municipal and industrial point source pollution account for about 20% of the total organic load to the recipients, whereas agricultural non-point source pollution accounts for the balance of 80%. Treatment of sanitary wastewater will thus need to be complemented by efforts to reduce non-point source pollution in addressing issues of public health and environmental degradation in each river basin.

17. **Operating companies.** Law 142 envisages the incorporation of municipal water supply and wastewater services including the establishment of share companies as the preferred option. The Superintendencia lists a total of some 1,400 established *empresas* at present but it is not clear how many conform to the provisions of the Law or even what the geographical coverage of each company is. It is clear, however, that many municipalities have operators that are struggling to provide satisfactory service. What is lacking at the local level is the political commitment and human and financial resources to carry out structural reform to meet the stated objectives of efficiency and autonomy. Follow-up on this has, however, been negligible due to a lack of staff and budgetary resources.

18. **The Comisión de Regulación.** The Comisión de Regulación de Agua Potable y Saneamiento Básico has embarked on its main mandate of authorizing and regulating tariffs, using an agreed criteria and standard formulas. The authorization is linked to the operators submitting and receiving approval of a *Plan de Gestión y Resultados* (PGRs) and an investment plan. However, the PGRs seem to contribute little to their original

<sup>22</sup> While the larger municipalities with more than 100,000 inhabitants each have an average of 93% water supply coverage and sewerage coverage of 77%, municipalities with 50,000 inhabitants or less have water and sewerage coverages of only about 60% and 30% respectively.

purpose of improving operational efficiency and service quality. The Comisión is funded through a surcharge of up to 1% levied on operating costs of the regulated operators reasonably well. However, it has not been able to duly carry out its mandate, as a result of a number of constraints:

- Lack of autonomy of its members - *expertos*. In practice, autonomy to approve tariffs is influenced and frequently curtailed by political decisions, especially from the executive branch, frequently driven by macroeconomic policies (inflation goals);
- Lack of coordination and overlapping with other regulatory bodies, such as the Ministry of the Environment, and with public control institutions. Insufficient coordination with the sector control institution, the *Superintendencia de Servicios Públicos*, has created an overlapping situation in which the Superintendencia is de facto regulating, by imposing controls on utilities on efficiency aspects not addressed by the *Comisión*. This could lead to a conflictive situation and loss of credibility over the whole regulatory system; and
- While the *Comisión* has rightly focused on economic regulation and tariffs, it has paid limited attention to efficiency matters within utilities, thus distorting the tariffs outcome. In addition, other instruments designed by the *Comisión*, such as the Results and Management Plans (*Planes de Gestión y Resultados*), have been largely ineffective in improving corporate planning and overall efficiency among sector operators and are viewed as another bureaucratic burden.

19. **The Legislated Tariff Formulas.** The tariff formulas distinguish between four components of the water supply and wastewater tariff: the average fixed administration cost; the average operating cost; the average incremental cost of new capacity; and the average replacement cost of existing assets. Based on a sample of 26 large *empresas* administration costs account for about 10%, the operating costs for about 30%, the average incremental costs for about 15%, and the replacement costs for about 45% of total costs. Both the calculation and the tariff structures based on six consumer categories would benefit from simplification.

20. The relative shares of the four components vary widely between *empresas* which indicates the scope for improved efficiency. The average relative share for replacement of 45% appears overestimated. In practice, actual tariffs lag the authorized levels which has arguably affected the quality of operations and maintenance. The gap between legally mandated levels and actual levels is particularly wide for the three lower income consumer categories. Actual tariffs lag mandated levels even allowing for the stipulated subsidies of 50%, 40% and 15% for the lowest income consumer categories 1, 2 and 3, respectively. In contrast, the two wealthiest categories 5 and 6 pay tariffs in line with the level mandated by the law, including a surcharge of 20% for purposes of income distribution.

21. **The Superintendencia de Servicios Públicos.** The Superintendencia, also funded through a 1% surcharge on operators, supervises the operators' compliance with the norms, decrees and regulations promulgated by itself and by the Comisión de Regulación. It is dispatching this duty in a largely formal sense. On an annual basis its staff (of about 10) make some 80 visits that may be as short as a few days. Yet, on the

basis of such brief and infrequent visits the Superintendencia issues lists of infractions, plans of compliance, and fines on account of lack of compliance. The effect of these endeavors is uncertain. Reportedly, the fines are rarely paid but are often contested in court. The upshot is that the Superintendencia has been criticized for lack of professionalism, for acting with political considerations in mind, and for submitting itself to the risk of losing sight of its *raison d'etre* of assisting the municipalities to improve service.

22. Recent efforts to mend the situation have tended to focus on the control side, rather than improving service provision. The premise seems to be that the water and sanitation sector can be developed by imposing generalized controls and penalties, rather than through well targeted regulation, incentives and technical assistance. While such an approach might be effective in the 100 or so municipalities, the remaining 960 municipalities with less than 50,000 inhabitants each (representing 26% of the total population), where coverage and service quality are well below the national average, will not be able to respond satisfactorily.

23. **Financial Condition and Funding of Water Utilities.** The financial situation of water utilities is mixed. Most medium-size and large companies (40 largest municipalities) meet operation and maintenance costs and a handful can finance expansion through internal cash generation. In contrast, with few exceptions, tariffs do not even cover operations and maintenance costs in the smaller municipalities and in rural areas. This situation is clearly unsustainable and undermines the effort to improve service and increase coverage. International experience shows that it is possible to cover operations and maintenance costs through tariffs in even smaller and poorer communities.

24. Financial policies are currently unclear. Financial conditions for funding from different domestic sources are uncoordinated. As a result, water utilities and municipalities receive different and often contradictory signals. Even tariff structures with conceptually sound designs are in practice often overridden by political considerations. For instance, over time the tariff conditionality of FINDETER's domestic financing has weakened. Similarly, as noted above, co-financing funds are specifically allocated by Congress using political criteria that disregard the *empresas'* financial situation. Today, any influential or sponsored municipality can finance a portion of its investment needs by lobbying in Congress without any commitment to needed improvements in tariffs or other policies. The absence of incentives to improve internal cash generation can delay and/or scare away private investors or lead them to demand high risk premiums or multiple guarantees before they commit themselves.

25. Funding earmarked for the sector has reportedly increased from US \$ 270 million in 1993 to US \$ 610 million in 1997, i.e., from 0.4% of GDP in 1994 to 0.8% in 1997 (see table). Most funding depends on government budget allocations. Grants account for the major share (varying between 50% and 60%) of the total funding, and include co-financing of different kinds, national budget revenue-sharing under Ley 60, and municipal funds. Loans from FINDETER and commercial banks also require the pledging of revenue sharing as a guarantee for repayment. Less than 30% of funding comes from tariffs. The roughly constant portion of financing originating or backed by

the government budget implies that no leveraging has resulted from increasing internal cash generation. Perhaps reflecting this, private sector investment has so far been negligible.

26. The application of the tariff formulas of the Comisión de Regulación, which are aimed at full cost recovery, should have increased the level of self-generated funds. The fact that this has not happened suggests that the tariff directives have not been implemented as envisaged. Moreover, the observed very rapid growth in centrally supported capital and operational funding raises the question as to why there is no corresponding spike in service coverage and quality -- and whether these funds may have been diverted to other municipal expenditures. This merits a closer review and corrective action as needed.

### **Issues and Recommendations for Future Strategy**

27. Several estimates indicate that at no less than US\$ 10.0 billion will be needed over the next 10-12 years in order to provide the minimum required increases in potable water supply and to treat wastewater. While these could conceivably be covered by the level of funding that the sector has been receiving in recent years, a much closer focus in managing future sector investments would be needed on achieving improvements in water quality, more efficient maintenance, rehabilitation and operation of systems, and on increasing coverage in small towns and rural areas. The treatment of wastewater, for example, should no longer be deferred. At the same time that, sector investments need to be maintained at high levels, government subsidies are expected to decline and be supplanted by increased internal cash generation through tariffs. In this light, it becomes very important for the central and local authorities to promote a vigorous participation of the private sector in financing and operating water and sanitation systems wherever possible -- for example by helping to mitigate policy and other risks to acceptable levels. There would seem to be particularly attractive opportunities to promote such participation in the larger municipal systems. Complementary external sources will continue to be needed even with an increased private sector role.

28. The existing legislation under Law 142 is in principle conducive to a more efficient sector development. However, its implementation has been characterized by a good deal of confusion, duplication, and an excessive focus on the control. To promote effective development of the sector, corrective actions are needed in three priority areas.

29. **Integrating Economic and Quality Regulation.** At present, there is a dichotomy between the economic regulation exercised by the Comisión de Regulación and the quality regulation exercised by the Superintendencia. The quickest way of resolving the inherent conflict and contradictions would be to merge the two agencies. This would follow the pattern in other countries where the norm-setting, economic regulation and quality regulation/control are kept under one entity. However, such a merger is said to be politically difficult for the time being given that 1991 Constitution and the Law 142 mandate the separate existence of the Comisión de Regulación and the Superintendencia.

30. If the government were to choose to keep the Comisión and the Superintendencia separate, it would be imperative to ensure better coordination of their activities. The Comisión should keep itself continuously informed of the actual operating and financial situation of the *empresas*. The Comisión should also regulate environmental aspects in proper coordination with the Ministerio del Medio Ambiente. The Superintendencia should focus on monitoring the indicators established by the Comisión de Regulación and suggest corrective measures for the deficiencies encountered. The Comisión and the Superintendencia need to maintain operating and financial monitoring indicators related to their respective areas of responsibility, analyze and use such data for yard-stick regulation, and require efficiency improvements from operators before authorizing tariff increases to meet costs. On the other hand, regulation so far has been designed for public institutions; therefore, there is a need to develop a regulatory scheme suited to the sector private operators.

31. **Introducing Transparent and Sustainable Financing Policies.** Reordering the financial policies in the sector could be achieved by minimizing earmarked funds (*cofinanciaciones*) and unifying financing criteria with those under Law 60. Financing from the central government should be used exclusively to enable the transition of operators to financial self-sufficiency through the application of appropriate tariff policies, and any justified direct subsidies to consumers that are too poor to afford the tariffs.

32. Available concessionary or grant funds should be used as the lever to move the *empresas* towards financial self-sufficiency within a specified period rather than continue taking grants for granted. After this transition period grant funds should be limited to subsidizing the consumption of the lowest-income consumer groups. The shift to subsidizing consumer *demand* directly or paying a share of the consumption of the lowest income segments is preferable to the current practice of subsidizing the *supply* of water by providing grant or subsidized financing of investment. The efficiency or effectiveness in improving service of many of the small investments financed under co-financing is not demonstrated.

33. **Promoting Greater Private Sector Participation.** In order to improve operations and maintenance Colombia should rely much more on private operators with proven track records of good performance. To create a minimum economic scale attractive to private operators, it may be necessary to promote the association of smaller systems. The departments should take the lead in promoting such associations as the Law 142 stipulates.

34. One way to promote investment in rehabilitation and demand management in existing systems, could be through lease contracts that would be awarded to the bidder offering the highest annual lease payments in return for the use of the existing facilities at the authorized tariff levels. Such annual lease payments could be contingent on the effective implementation of official tariff policies in order to mitigate the tariff risk for the private operator. Although the recipient of the annual lease payment would be the conceding municipality, the bulk of the annual payment would be redirected to investments in common agreement between the municipality and the operator.

## **Role of the World Bank**

35. The World Bank could play a role in assisting policy reform and in financing in three priority areas: (a) project(s) to provide technical assistance to improve the regulatory framework as well as financing to incorporate municipal operations in line with the Law 142 and expand private sector participation in medium and larger size water and sanitation systems; (b) technical assistance and financing of rural water supply and sanitation works – this requires building a suitable conduit for financing and rapprochement between the government and guerilla groups; and (c) treatment of urban wastewater in order to reduce the public health risks and reverse the environmental degradation stemming from raw sewage currently spilling into the country's watercourses, lakes and shorelines.

## **III. ENERGY SECTOR**

### **Sector Background**

36. The Colombian energy sector has undergone substantial changes during the 90s which have enhanced efficiency through greater private sector participation combined with regulation. After having restructured generation and transmission and having organized a wholesale power market, the focus of power sector issues has been transferred to the distribution companies which are expected to be privatized. This will require consolidating the regulatory agency's authority particularly vis-à-vis Congress and a number of Government agencies, which are reluctant to accept the concept of a regulatory Commission beyond their control. It is also time to address the neglected question of rural energy solutions to reach an estimated 10-20 percent of the population which still rely on traditional energy.

- In the **power sector**, there has been a dramatic evolution in the last three years with active participation of private investors both in new plants and as owners of privatized facilities: whereas as recently as 1995 practically 100 percent of an installed capacity of 10,600 MW was publicly owned (only 344 MW were owned by private operators), by the end of 1997 privately owned or controlled capacity amounted to around 58 percent of the total. As a consequence of these changes, the power sector (especially power generation) has ceased to be a sink of public funds which required massive transfers from the Central Government during all of the 80s and early 90s. The reasons behind this successful transformation can be ascribed to the power sector restructuring measures which were implemented starting in 1991. One of its major elements has been the organization of the Electricity and Gas Regulatory Commission (CREG)<sup>23</sup> which is perceived as the guarantor of rules in the competitive wholesale market.

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<sup>23</sup> Comisión Reguladora de Energía y Gas.

- Colombia has achieved a very successful **upstream hydrocarbon sector** strategy with more than 80 oil and gas exploration and production companies operating in the country. During the last few years Colombia has become a major non-OPEC oil exporting country and the discovery of large non associated gas reserves has allowed the expanded use of natural gas in the power sector , industrial as well as commercial and residential markets. Already Colombia appears poised for a natural gas export to the central American countries . In addition Colombia's downstream natural gas sector has been characterized by a large participation of the private sector in natural gas transport and distribution companies especially with the privatization of Ecopetrol's share in these companies. Colombia put in place a natural gas regulatory agency and framework and established a state natural gas transmission company, ECOGAS. Colombia is also moving towards a massive subsidized gasification program in low-income residential areas. Colombia is also subsidizing LPG distribution.
- In the **gas utilities sector**, massive demand from new power plants requires an intense exploration effort; the gas industry is likely to be dominated by a few large producers and competition may be more difficult to achieve compared to the power sector; however, with an expected 6-7 large producers, together with a number of smaller fields which will have access to the market through the ECOGAS network, regulation should be able to rely on market forces in the future. Gas regulation, which is performed by the same commission as in power, will require a similar consolidation.
- The **coal sector** is mainly in private sector hands; its perspectives do not appear to be too bright as low oil prices have kept coal prices down as well; a sensible coal policy would consist of continuing to allow private sector producers respond to market signals, and avoiding artificial stimuli such as a recent law which seeks to subsidize coal facilities at the expense of power consumers. Areas of public sector intervention consist of addressing matters such as mine safety and environmental effects.

37. The Bank is currently supporting the energy sector through the Energy Sector Technical Assistance Project (Loan 3827 CO, US\$ 11 million), the Power Market Development Project (Loans 3954/3955, US\$ 249 million), and the Regulatory Reform Technical Assistance Project (Loan 4138-CO, US\$ 12.5 million)

### **Current Issues and Options**

38. **Power Sector.** When compared to most regulatory bodies in the region, CREG exhibits a far greater degree of autonomy vis-à-vis Government and Congress; this independence is both a strength and a weakness. Whereas it has provided assurance to industry participants regarding policy stability, it has also deprived Government servants from exercising their discretionary power regarding power sector actions. As a consequence, CREG is periodically censored for its decisions by Government agencies and by special interest groups. It cannot be sufficiently emphasized that the economic and financial benefits which have indirectly been generated by CREG by enabling private

sector participation are far in excess of costs incurred in sustaining it, both in political and monetary terms.

39. Although the wholesale market has been a success, it has also accumulated debt to generators due to distribution companies which cannot honor their purchases. The level of debt has reached worrisome and, indeed, practically unsustainable levels (on the order of US\$ 200 million as of late 1997). The long-term solution to this problem is being implemented by the Government through a program for privatizing distribution companies. However, for this effort to be successful, prospective investors will require the assurance of even-handed regulation which can only be provided by a strong and independent CREG. Consequently, a continued support of CREG by enabling it to count on well qualified and well remunerated staff is a crucial condition for both sustaining the success which has been achieved in generation and extending it to distribution.

40. **Oil Sector.** The apparently successful overall strategy in identifying and developing hydrocarbons deposits contrasts starkly with operational inefficiencies in the sector, with the lack of efficiency in the hydrocarbon sector due to : (i) the dominant role that ECOPETROL (ECP) still plays in the oil and gas sector, ECP being both the required partner of private oil companies and their competitor in exploration and production activities and the required natural gas purchaser upstream from the companies at predetermined prices, (ii) the continued existence of a regulated petroleum products market with no freedom to import and export products and natural gas, (iii) the need for a new refinery to more efficiently supply the country's gasoline requirements, (iv) continued subsidies to LPG and certain gas distribution concessions, (v) environmental damage from continuing sabotage of the crude oil pipeline system , and (vi) the social environmental impact of hydrocarbon activities on indigenous people community areas.

41. Clearly, a prerequisite for healthy sector development is to stop acts of sabotage on oil pipelines and ensure an environment conducive to private investments. In addition, Colombia needs to focus on structural and regulatory reform of the sector to: (i) attract more private sector capital inflow not only in exploration , production and transport but also in refining, wholesale and retail distribution of petroleum products; (ii) improve the efficiency of ECP by establishing an open competitive framework for both upstream and downstream activities, requiring ECP to compete on an equal basis as the private companies, and allowing free imports and exports of products; and (iii) establish a policy on dealing with social environmental impact of the hydrocarbon sector and in particular dealing with indigenous people community areas.

42. **Gas sector.** Large natural gas deposits together with the construction of a gas pipeline network from the Atlantic Coast to the south of the country have had a major impact on energy use in Colombia. Major demand from new thermal power stations has helped to justify extending gas supply to many large cities. In order to provide incentives for its efficient functioning, CREG is in charge of regulating a producers market. At present large customers (e.g. power plants) can negotiate their supplies directly with gas producers; however, in contrast to the power sector, the gas industry is characterized by a few large suppliers (Texaco, BP, Ecopetrol and Amoco, at present); as a rule, small fields

are not profitable (although some of them have taken advantage of their proximity to the gas pipeline network and operate at a profit).

43. Although CREG has been cautious in allowing prices to respond to supply and demand due to fears about concentration of market power, in the near future this should be feasible, particularly if current exploration efforts (conducted by Amoco, Arco, Shell and Texaco) prove fruitful; with over 6-7 players, competition can usually be assured. An efficient gas market will require expanding the pipeline network by supporting ECOGAS and assuring competent regulation by CREG, which is another reason for strengthening this agency. The government should also consider putting in place policy measures to promote natural gas exports.

44. **Coal sector.** Colombia's coal reserves are among the largest in the world, and its exports account for over 10 percent of the international coal trade. However, the industry is afflicted by low prices and dim demand perspectives given increasing environmental constraints on its use (although Colombia's export coal has a premium due to its low sulfur content). The coal sector is mostly in private hands (the Cerrejón coal mine is partly owned by Carbocol, a Government company, but it is operated by Exxon).

45. The coal industry can be characterized by a number of large producers in the Atlantic Coast region, and multiple small and medium miners in the interior. The latter suffer from low productivity as well as appalling working conditions in many cases. Coal sector policy should be oriented towards improving the operation of small mines in regard to safety and appropriate techniques to avoid losing them to flooding or cave-ins.

46. **Rural energy.** Despite its abundance, there are still pockets of the population which lack access to modern forms of energy and continue to rely on biomass. Rather than single-sector efforts, such as rural electrification, a concerted approach will probably yield better results. This should emphasize appropriate technologies for delivering power, together with alternatives which will vary according to local conditions, to deliver other energy sources (e.g. LPG). Such an effort should seek to reach around 20 percent of the population, which is not served with grid power (because it would be inefficient) and which lives in areas where social unrest is more prominent. A feasible target in the medium term should be to reduce to less than 10 percent the population which still relies on traditional energy forms.

### **Recommendations for Future Strategy**

47. Priority action areas requiring early Government attention in the energy sector include:

- Consolidating the Government's regulatory role in the power and gas sectors through the Energy Regulatory Commission (CREG) and the Superintendency of Public Services.
- Bringing private capital and management to power distribution companies, in particular to Corelca distribution subsidiaries.

- Supporting the development of a competitive bulk natural gas market, including the consolidation of Ecogas as independent gas transporter, providing for open access and competition, and promoting natural gas exports.
- Improving the operating conditions, safety, and exploration techniques of small coal mines.
- Developing and implementing a strategy to deliver power and other forms of energy to rural and isolated areas.
- Defining clearly Ecopetrol's role as that of an oil company competing on even ground with the other oil companies, creating a separate competent agency to manage oil concessions and contracting, and improving the operation of downstream petroleum markets.
- Fostering oil exploration to maintain adequate reserve/production ratios.

### **Role of the World Bank**

48. Ongoing support under the Power Market Development Project and the Energy Sector Technical Assistance Project has focused mainly on improvement of the operation of power sector markets, establishing or improving regulatory and institutional frameworks in the power and natural gas sectors, and design and implementation of power or natural gas concessions. Bank support could be broadened considerably if needed to implement a broader sector reform agenda along the above lines through appropriate follow-up operations. Another high priority would be to develop more sustainable infrastructure financing mechanisms (covering potentially all infrastructure sectors) to promote greater linkages to domestic and international capital markets and to introduce new financing instruments suitable for maximizing private sector participation. Such mechanisms, supported under the proposed Infrastructure Finance Facility (with a proposed Bank loan ready for negotiation), could be of considerable long-term benefit to Colombia in promoting a vigorous private sector role and enabling sustainable long-term infrastructure development.

## **IV. TRANSPORTATION SECTOR**

### **Sector Background**

49. Between 1988-1993, the Colombian Government embarked on a series of reforms designed to modernize transportation operations through restructuring the management, planning, coordination and control functions in the transport sector, and reorganizing the execution of public works. These efforts were substantiated in support of the policies of opening up the economy to international competition, lowering protection for national industries and services, introducing greater private sector participation in the formal public sector, and decentralizing the provision of services to subnational governments in line with the mandate of the Constitution of 1991.

50. In the transport sector, the primary objective was to increase the competitiveness of tradable goods by lowering transportation costs. A recent analysis conducted by DNP

estimated that in the 30-year period between 1960-1993, the combination of low investment levels for infrastructure (below 1 percent of GDP in the case of transport) resulted in additional costs to the economy of 5.3 percent of GDP. Thus, the reforms were intended to: (i) modernize transport operations; (ii) improve management, planning, and coordination functions; (iii) restructure public entities; and (iv) increase public and private investment, and private delivery of transport operations.

51. **Restructuring MOPT.** Decree 2171, enacted in late 1992, transformed the Ministry of Public Works and Transport (MOPT) into the Ministry of Transport (MOT), an agency responsible for sector planning, policy making, and regulation and largely eliminated project execution functions. The restructuring of MOPT entailed the closure of 25 field districts and the retrenchment of about 10,000 employees. These reforms were coordinated under the ad-hoc Servicio de Adaptación Laboral (SAL) within MOT. The SAL supported the formation of 682 micro-enterprise firms for road maintenance and the creation of 2,454 jobs. With the exception of the Magdalena River, MOT has maintained full jurisdiction for river dredging works throughout Colombia.

52. **Roads.** Decree 2171 established INVIAS to manage a well-defined network of import/export corridors and trunk roads, eliminated the National Highway Fund (FVN), and the National Institute for Transport (INTRA), and slated for liquidation the Rural Roads National Fund (FNCV). Sector planning and execution functions within INVIAS have improved dramatically, as it is now able to prepare and undertake multi-year investment plans, and is strengthening its internal capacity to structure and oversee an ambitious road concession program.

53. INVIAS has developed the national Road Maintenance Program (PROVIAL) to arrest deterioration of the network, and has successfully contracted out planning and execution of all maintenance activities to the private operators and micro-enterprises. Moreover, funding for road maintenance from US\$72.0 million to US\$130.0 million during the last three years. In accordance with the 1991 Constitution, INVIAS has fulfilled its mandate of transferring close to 14,000 km to the 33 departments. The transfer of secondary roads to the departments markedly improved the condition of the national road network by limiting its scope to a smaller network of high volume and strategic transport corridors. Decentralization also improved resources utilization, which in the past had been spread too thin to satisfy regional balances. As a result of these efforts, the percentage of paved roads in good condition increased from about 37 to about 76 percent from 1994 to 1997.

54. Building on the expertise and exposure gained from previous concessions, INVIAS is attempting to gradually reduce the level of sovereign government exposure. At present, the toll road program envisions the rehabilitation and construction of nearly 4,900 km through some form of private sector participation. In undertaking these initiatives, greater emphasis will be given project preparation, e.g. traffic studies, to achieve higher potential revenue streams and attract private sector interest. The contracting out of maintenance activities to private enterprises and micro-enterprises is also expected to continue for roads that are not concessioned. Options for reviewing and revising the current systems of road user charges, which would eliminate distortions in

contributions by different vehicle classes and limiting intergovernmental allocations are currently being evaluated.

55. MOT together with the Road Cofinancing Fund are providing technical assistance and financing to the Departments under an IDB-funded transport project approved late last year. Furthermore, INVIAS has been providing technical assistance to a small number of departments to develop road maintenance programs at the departmental level since 1996. Although too early to tell, the results so far are mixed. Some departments have shown commitment to putting to work their own PROVIAL programs and building institutional capacity needed to implement these initiatives while others have not participated, or ignored the MOT recommendations. However, about 18,000 km of rural roads are still managed by FNCV, pending their transfer to local governments.

56. **Ports.** Through the Ports Law of 1991, the Government liquidated Colpuertos, the then national port company and replaced it with a three-tier structure defined as follows: (i) the Superintendencia de Puertos under the jurisdiction of MOT, was established as the subsector regulatory agency; (ii) *Sociedades Portuarias* as independent port administrators, which are more than 70 percent private; and (iii) *Operadores Portuarios*, or private companies to undertake port operations. The five major public ports (Barranquilla, Cartagena, Santa Marta, Buenaventura, and Tumaco) have been concessioned to the *Sociedades Portuarias*. As a result of these initiatives, stevedoring costs have dropped from US\$21 per ton to close to US\$7 per ton, and port tariffs have decreased by an estimated 52 percent. In addition, average turnaround time for docked ships decreased from 10 to 1.5 days. Attractive returns have allowed the concessionaires to modernize equipment and maintain assets, but the scheme has not jump-started larger investments, which may be needed to enhance international competitiveness. In addition, nine purely private *Sociedades Portuarias* are also providing public services, increasing competition with public ports. As a result, the movement of containers has substantially increased.

57. CorMagdalena, an autonomous public corporation, was created to coordinate development on the Magdalena River basin. In 1996, CorMagdalena initiated works which aimed at ensuring year-round navigability on the Magdalena River through dredging and closing of secondary channels from Barrancabermeja to La Gloria, and maintenance dredging of the Canal del Dique on the Atlantic Coast. To facilitate the movement of cargo, the Government has indicated that it will be necessary to expand the capacity of the Port of Buenaventura in conjunction with its managing *Sociedad Portuaria*. An additional priority involves improving road and rail access to ports, especially port facilities located along the Pacific Ocean, to better facilitate the shipment of tradable goods.

58. Building on the accomplishments achieved in the subsector, MOT has sought to continue the concessioning of port and canal dredging activities to the private sector. The primary role of the public sector would be limited to the provision of regulatory functions through the Superintendencia de Puertos and the maintenance of canal and waterways.

59. **Airports.** Colombia has 75 national airports, of which 8 serve at least 1,000 commercial passenger per day, and roughly 110 municipal airports. Law 105 established the legal framework for restructuring the subsector and Decree 2474 established the Civil Aviation Authority (CAA) as a separate corporate entity. The CAA, which is under the jurisdiction of MOT, is responsible for economic and technical regulation and the provision of air traffic control services. Furthermore, the Government awarded a BOT contract for the construction of a second (3,800 meters) runway and maintenance of the existing (3,800 meters) runway at El Dorado Airport in Bogotá. Recent initiatives in air transport have been to limit the role of the Civil Aviation Authority (CAA) to the provision of regulation and air navigation services and establish a new pricing policy for airport-related charges. The CAA, after an initial failed attempt owing to security concerns in April 1995, is reformulating the proposed concession of the Cali International Airport. Concession strategies for the airports in Barranquilla, and Cartagena, and the possible decentralization of regional airports to the departments are also being evaluated.

60. **Rail.** The Colombian National Railway was replaced with Ferrovias, a public entity responsible for the track infrastructure and rolling stock as well as awarding operating rights to private operators. MOT and Ferrovias share regulatory authority within the subsector. Both freight and passenger traffic decreased significantly after the 1992 restructuring. In 1996, an estimated 1.5 million tons were transported by rail, which represented less than 2 percent of the amount of goods transported over the national and regional road networks. Coal and coffee are the primary commodities that are transported by rail. Progress in the rail sector has been much slower, as the Ferrovias could not agree with winning bidders as to the concession terms for the Atlantic rail corridor. This delay resulted in the dissolution of the concessionaire and the invocation of the insurance policy. In the past few years, MOT has continued in its efforts in concessioning out to the private sector the rehabilitation and maintenance of track and rolling stock of the Atlantic and Pacific rail lines.

61. **Urban Transport.** Most planning functions are undertaken at the local level, where a high degree of institutional overlap exists. Medellín is the only city in Colombia with an operational commuter rail system to relieve traffic. Although it has experienced operational difficulties since its inception in the late 1980s, the urban bus system in Bogotá has been effective in accommodating a significant number of passengers. In the remaining Colombian cities, bus transit is operated exclusively by the private sector. The Government is attempting to develop cost-effective metro systems in Bogotá and Cali with the participation of the private sector. Public sector financing is expected to comprise 70 percent of the total cost (which may be reduced to 50 percent) of developing these systems with operation and maintenance of the new system(s) concessioned out to the private sector. In addition, the city of Bogotá is reviewing options for rationalizing parking policies and existing bus routes to better integrate transit modes. Finally, the city of Medellín has commenced the bidding process for the concession its metro under a BOT arrangement.

62. **Increased Sector Investment.** Investment expenditures in the transport sector have increased substantially during the last three years—from the historical average of 0.7 to 2.6 percent of GDP. The majority (82 percent) of the \$4.4 billion that has been

invested in the sector during this period has been used to expand and rehabilitate the primary road network. The remaining funds have been allocated in the following manner: railways (9 percent); airports (7 percent); ports (1 percent), and other (1 percent). In addition, an estimated \$857.0 million in private financing has been obtained during this same period, with most of this latter amount (71 percent) involving the concession for the rehabilitation and maintenance of 1,080 and 250 road km, respectively. The key policy initiatives and results achieved within each of the transport subsector are described below:

63. **Private Sector Participation.** Law 37, enacted in 1993, was significant in that it expanded the ability of the state to enter into concession contracts, establish joint ventures, and issue licenses for the provision of infrastructure services. Law 80 built on this initiative by mandating competitive bidding for all major projects as well as the completion of demand, feasibility and engineering studies prior to contract award. The 1993 Transport Act (Law 105) allowed private sector participation through concession contracts with terms of 20 years or more, refined revenue and traffic guarantees, and improved bidding procedures. During the first stages of the program an estimated \$1.0 billion dollars in private investment has been obtained, with the greatest activity taking place in the ports and roads.

#### **Issues and Recommendations for Future Strategy**

64. **Reducing Transportation Costs.** Critical weaknesses in the transportation system, particularly road infrastructure, have undermined the competitiveness of the Colombia economy and introduced higher than normal transport costs. The main problem continues to be the poor operating condition of the highways that serve the largest consumption and production centers on rugged mountain ranges. Moreover, the growth rate of new road construction has not been commensurate to the economic and population growth. This has stretched the ability of existing roads to accommodate traffic flows and increased the transportation costs, especially for tradable goods. Colombia has one of the lowest kilometers of paved roads per million inhabitants in the region. Years of chronic deficit in public funding, untimely implementation of investments as a result of mismanagement, and poor quality of maintenance have compounded these conditions. These factors have contributed heavily to greater transport costs, since more than 90 percent of freight transport (excluding pipelines) and passenger traffic are transported on the road system. Internal transport costs are an estimated 25 to 75 percent higher in Colombia than in other countries with comparable mountainous terrain in South America, e.g. Peru and Chile. Transport bottlenecks increase the cost of tradable goods by an average of 30 percent, compared to 10 to 20 percent in the US and Europe. To reduce transportation costs and improve the competitiveness of the Colombian economy, the following actions are recommended: (i) continue the modernization and routine maintenance of transport infrastructure to remove existing bottlenecks, with a focus on transport corridors to enhance economic development impact and better serve user demand; (ii) rely on public-private partnership to mobilize in less time the services that users are willing to pay and improve efficiency in project execution; and (iii) improve intermodal linkages to support just-in-time operations.

65. **Reducing Barriers for Private Financing and Management.** Although the Government has been successful in undertaking concessions in the road and ports, increased investment will be needed to modernize existing facilities, expand access, and increase operational efficiency. As opposed to other infrastructure sectors, most of the financing for privately funded transport projects in Colombia has come from local lending institutions, which due to liquidity reasons, can only offer debt financing with short maturities and at high interest rates. Greater effort should be given to project preparation and improving incentive structure to attract a greater mix of financing from local and foreign sources, longer term financing with innovative financing instruments (e.g., take-out finance), and lower financing costs (as was the case with the El Viño-San Alberto toll road concession). In structuring public-private partnership it is also necessary to: (i) expand the use of concessions to projects with robust economic justification, but not financially viable by the private sector alone (ii) limit government support to what is strictly necessary to mobilize private financing; and (iii) compensate for externalities in the most cost-effective manner.

66. For roads at the national and departmental levels, which do not have sufficient traffic levels (e.g. less than 3000 vehicles per day) to justify a concession contract with the private sector, multi-year, performance-based Contracts for Rehabilitation and Maintenance (CREMA) with the private sector can be introduced. These contractual mechanisms have already been instituted in Argentina and Uruguay, and have the advantage of providing regular road maintenance for an entire region, rather than a single road segment. The length of the CREMA networks can range between 150 to 250 km and can cover isolated areas, which makes these arrangements somewhat well-suited to the topographical conditions in Colombia. In ports, the difficulty has not been attracting private sector interest, but ensuring that the sociedades portuarias have not undertaken the prescribed investment levels anticipated in the concession.

67. **Strengthening MOT Institutional Capacity.** MOT needs to be more proactive in developing sector planning and intermodal transport strategies that are linked with economic and population growth patterns. To effectively achieve its mandate as the lead governing agency for transport, technical assistance is needed to: (i) increase the institutional capacity of MOT by clarifying its mission and improving asset use; (ii) improve its practices for strengthening the administrative and technical capacities of the departments; (iii) further elaborate transport sector regulation, e.g. establish fee structures and minimum service levels; (iv) revise the existing regulatory framework in rail and ports to further encourage private participation and delineate access rights; (v) modify Law 105 and Law 336 to better reflect specific conditions within the transport sector; and (vi) improve oversight over transport sector agencies and project implementation.

68. **Rationalizing User Charges.** Law 105 established that transport user charges should guarantee the full cost recovery of infrastructure operational and maintenance activities, improve the ability of the departments to assess tolls, betterment levies, and gas taxes, and allowed the departments to obtain private financing. Law 142 mandated that tariffs are linked to fixed and variable costs structures. Nevertheless, the main principles underlying this legislation have not been fully implemented. To ensure long-term sustainability, it is important to develop a commercial orientation in transport services,

especially roads, in which service provision is directly linked to user charges. This linkage would improve service quality and rationalize investment expenditures in accordance user willingness-to-pay.

69. The Road Funding Strategies and User Charges Study that was carried out independent consultants hired by MOT under the Third National Highway Project and was completed in 1997 has been a useful instrument to analyze sector financing policies and rationalize fee schedules. In particular the study found that: (i) cost recovery at the national level exceeded expenditures, but needed to be complemented to support the expansion and modernization of the network; (ii) cost recovery at subsovereign levels is about 15 percent of the anticipated needs; and (iii) the structure of road user charges should be revised to better reflect marginal cost pricing (underestimated in the case of heavy vehicles) and; (iv) a framework for its implementation conveniently delineated in line with the provisions of the Transport Law. To increase financial flows in the sector, improve existing facilities, and expand access to infrastructure services, it is necessary to develop stable, sustainable financing mechanisms with clear criteria aimed at maximizing the efficiency of the system. This mechanism should be developed in direct consultation with representative users.

70. Greater emphasis is also needed to balancing responsibilities, institutional capacity and financial resources at subsovereign levels, a key element initially overlooked by the reforms. In the absence of other explicit counterpart sources managed by the departments as part of a well-established road-user charges system, a co-financing fund would not address existing financing gaps at subnational levels nor put in place an adequate framework for financing road maintenance. For this reason, it is necessary to strengthen existing financing mechanisms to assist local governments as a complement to strengthening of financial instruments to attract the private sector.

71. **Developing INVIAS into a High Performance Agency.** Since its inception, the organizational structure of INVIAS has been revised several times until its current design was adopted. In overcoming this difficult transition, INVIAS has become more efficient and responsive institution. Nevertheless, the capacity of INVIAS should be further strengthened so that it can become a semi-autonomous, financially self-sufficient entity with revenues coming from toll collection of concessioned roads, as originally envisioned. At present, INVIAS remains heavily dependent on public outlays. Moreover, INVIAS needs to continue building its capacity in preparing concession documents and administering concessions, reviewing operational and financial performance of private and public-financed roads, performing traffic studies, and enforcing safety standards. Finally, The Environmental Subdirectorate within INVIAS, which has also developed into a skilled unit capable of addressing social and environmental issues in road projects, is attempting to become certified under the ISO 14001 Environmental Management System. To better transform INVIAS into a commercial entity, further strengthening is needed in the following areas: (i) enhancing project management capacity through certification of project managers, (ii) institutionalizing the use of performance indicators; (iii) increasing involvement of users and other key players in sector decisions; and (iv) strengthening INVIAS' capacity to implement "total quality management" system to monitor the

performance of contractors, road operators and consultants that undertake operations on behalf of INVIAS.

**72. Strengthening the Institutional Capacity of the Departments.** Although the departments became responsible for managing close 14,000 km, this increase in responsibility was not accompanied by a commensurate increase in administrative and technical capacity or financial resources. There is also a large degree of institutional overlap between regional roads administered by FNCV and municipal roads managed by local governments with partial funding from FCV. This situation combined with the weak institutional capacity of departmental road entities has led to deterioration in the physical condition of regional roads and political pressure to reverse decentralization. To improve the physical condition of the transferred roads and provide support for the on-going decentralization program, the following initiatives should be considered: (i) clarifying institutional and operational roles among departments, municipalities, and national agencies, e.g. FNCV, FCV, DRI, and the Fondo Nacional Regalías (ii) establishing stable sources of funding based on a system of charges managed with direct involvement of representative users (see para. 70 above); (iii) adopting institutional changes delineated in the departmental Provia and Infrastructure and Transport plans; (iv) accelerating the contracting out routine maintenance activities; and (v) providing technical and administrative assistance during the project cycle (e.g. identification, preparation, bidding, contract award, and execution).

**73.** As was the case with MOPT-FVN, the capacity of INVIAS in the sector has made it a potential target for inefficient departments to return roads to INVIAS. The National Council for Economic and Social Policy (CONPES) has already charged INVIAS with 2,576 km (nearly 20 percent increase in the national road network) of additional roads. To ensure long-term sustainability in the sector, it is important that the progress achieved in decentralization is not reversed. A structured technical assistance program to the departments designed to increase institutional capacity and technical expertise would assist in limiting the return of roads to INVIAS.

**74. Relieving Congestion in Urban Areas.** Increased automobile ownership and the inadequate delivery of urban transit services have worsened urban congestion during the last few years. In several municipalities, critical road access routes need to be expanded to accommodate increases in traffic. These factors have led to declines quality of life indexes as travel times along key urban corridors can take up to four hours each day and increase pollution. To improve the delivery of urban transit services, the following actions are recommended: (i) increase private sector participation in the development and management of urban bus, commuter rail, and metro systems; (ii) define the institutional roles of the local and national agencies involved in urban transport service delivery and strengthen their institutional capacities; and (iii) improve the coordination of responsible entities, especially in the planning of new investments, to better integrate with regional economic necessities as well as address social and environmental concerns.

**75. Improving Environmental Procedures.** Greater attention is also needed in streamlining the system for obtaining environmental clearances. The Ministry of Environment, a cabinet level agency, was created in 1993 to replace the then existing

oversight entity for natural and renewable resources, INDERENA. This new institutional framework led to the enactment of more stringent environmental regulation and the empowerment of *Corporaciones Autonomas Regionales* (CARs) for granting environmental permits. The current system includes the following steps: (i) the responsible government authority must request an environmental license to Corporación del Medio Ambiente (CMA), an administrative unit within the Ministry of Environment, which has 60 days to make its determination, if necessary; (ii) a second license must be obtained for the protection of water sources and use of quarries from the Corporación Autonoma Regional (CAR), which are under the jurisdiction of MOT; and (iii) local governments in the affected areas have a 30-day review period to grant a third license. However, most of the CARs are too weak institutionally to fulfill their duties in a timely and efficient manner, which has led to delays in granting clearances and execution of several road subprojects. Road construction subprojects along sensitive areas have also required complex environmental management plans and the addition of costly mitigation measures. To attract increase private investment, it may be necessary to streamline these procedures. Further strengthening the environment units within MOT, sector specific agencies, and departmental entities is also necessary.

76. **Improving road safety.** A recent comparison of road safety statistics shows that fatality rates in Colombia (about 111 deaths/10,000 vehicles) ranks among the highest in South America, and the highest in terms on fatalities being reported from road accidents (about 7870 in 1995). In comparison, Fatality rates in Argentina, Brazil, and Chile range between 6 to 10 deaths per 10,000 vehicles, and in Ecuador, Peru and Venezuela between 30-60 deaths per 10,000 vehicles. Insufficient awareness and lack of effective coordination mechanisms among the various sectors and agencies involved are some of the factors hindering the development of a comprehensive strategy to address this issue. Since the road safety problem extends beyond transport (it should also be seen as a health and education problem), a successful strategy entails: (i) strengthening coordination, by establishing a Road Safety Council for example, to design policies, integrate the various Ministries involved, ensure systematic road accident data collection and analysis, and mobilize private sector support to road safety programs; (ii) introducing road safety audits in road construction and rehabilitation programs to remove "blackspots" or high risk areas; (iii) reviewing traffic legislation to support coordination and introduce improved safety regulation; and (iv) increasing public awareness through dissemination campaigns and traffic education.

### **Role of the World Bank**

77. **Consolidating institutional gains.** The Bank has been supporting INVIAS in implementing commercial and user-oriented management practices and strengthening the road concession program. The outcome of institutional efforts under the Third Road Sector Project (Loan 3453-CO, closed in December 1997) was satisfactory, and the proposed National Roads Project in the pipeline can provide the venue to turn INVIAS into a best practice, high performance organization. Bank support could be extended to strengthen MOT so it can provide effective leadership in the sector.

**78. Deepening private sector financing and management.** The Bank also assisted INVIAS in structuring the El Vino-Pto. Salgar Toll Road Project as a model for a second generation of concessions. The Bank-supported instruments and the bid evaluation criteria provided incentives to minimize the level of enhancement requested from government to what each bidder considered strictly necessary, and led to a more robust competition for the project among bidders. In turn, this yielded significant economic savings to Colombia. The bidding process enabled INVIAS to award successfully this concession with much less exposure than initially envisaged and shift more financing risk to the private sector since the successful bidder asked for the lowest government capital contribution. While the successful bidder did not request the use of the Bank's Partial Risk Guarantee, two bidders out of the four who submitted bids, requested all of the instruments supported by the Bank (including the Partial Risk Guarantee) in their bids, and the third bidder requested one of the instruments backstopped by the Bank. This outcome reinforces the judgement that the support offered was necessary -- and in fact critical -- attracting vigorous private sector competition for the project. In the end, the project concessionaire was able to obtain debt financing from private lending institutions at more favorable markets terms than had been previously available for projects of this type and size, confirming the validity and success of the bidding mechanism that was used.

**79.** The proposed National Road Project would support the development of the Bogotá-Buenaventura road, which could potentially entail three to four concessions to private sector operators to restore, maintain, and operate the physical infrastructure. The concessions will be structured as public-private partnerships, building on the lessons learned from the El Vino-Pto. Salgar Toll Road Project. In addition, the project(s) would provide technical assistance to INVIAS in support of its private toll road program, which would attempt to strengthen the ability to (i) carry out financial, social, risk assessment, and environment impact studies; (ii) oversee the concessions and contract regulations, and (iii) deploy technical and financial expertise as needed to manage the concession program.

**80.** In addition, technical advice is being made available under the Regulatory Reform TA Project (Loan 4138-CO) to enhance the legal and regulatory framework, and design concession arrangements and BOT/BOO projects. The transport sector will also benefit from support under the proposed Infrastructure Finance Facility to build a sustainable institutional mechanism to attract private sector financing at attractive terms. This package of technical assistance and financing initiatives, together with the specific project opportunities discussed above, should help lay the basis for a healthy, private sector led development of transport infrastructure.

**81. Improved Modal Access and Poverty Reduction.** The proposed National Road Project would also support regional development and poverty reduction by addressing transport constraints along the Depresión Momposina area, which would improve access and spur economic growth within this isolated low-income area.

**82. Urban Transport.** The Bank has been supporting Bogotá in coping with prevailing challenges in urban transport. The Bogotá Urban Project is supporting

institutional building and investments for operation of more effective public transportation services, arresting road assets deterioration, and improving access to marginal areas. In addition, the Bank is providing technical assistance to evaluate financing options and structure private-public partnerships for development metro system Bogotá and Cali, and establish the institutional and regulatory framework to oversee these systems, especially in contract administration, while limiting government contingent liabilities.

## **V. TELECOM SECTOR**

### **Sector Background**

83. Colombia had 6.5 million telephone lines installed in 1997, for a density of 16.2 lines per 100 population. This is higher than the average for Latin America (10%), and a modern installed system provided fair quality service if compared with similar countries (61% call completion rates, 5.1 days average fault repair time, 3.3 months average waiting time for new installations) but lower than developed countries (75% call completion rates, 1 day to repair faults on average and one week to install a new line).

84. Service has improved as the Government in recent years opened the Sector to competition, beginning by the local service in 1994 (Law 142), and most recently by Decree 2542 of October 16, 1997, that liberalized long distance. Previously, local service was a monopoly of the municipal telephone companies (ETB, EMCali, EPM, etc.) and long distance service of TELECOM, the national company. Decree 2542 established that the local companies should form associations with private companies to have access to long distance service. Major companies are in the process of doing so.

### **Issues and Recommendations for Future Strategy**

85. However, TELECOM remains 100% owned by the State. With revenues of 1,142 million pesos in 1996, TELECOM is profitable. However, most of its revenues come from long distance service that will be subject to competition in 1998, and it has 905,000 local lines installed in the poorest parts of Colombia. Of those, 691,000 are residential lines and only 100,000 belong to First and Second Strata of the population. The rest belong to Third Stratum (533,000), and Fourth to Sixth strata. These correspond to the poorest population. Since local rates in Colombia are subsidized progressively in the higher Strata, this is that the higher the strata (poorer population) the lower the tariff, TELECOM faces a reducing revenue in the short term.

86. TELECOM expenses are high, if compared to other companies, due to two factors: the high employment and the pension obligation. This obligation is estimated at 2,900,000 million pesos in 1997. This liability has been accumulated through the years because the TELECOM pension plan is very generous, and TELECOM employees retirement age is much lower than the national average.

87. In order to restructure TELECOM, we believe the Government has several options. The one that would solve the problems of TELECOM includes 3 elements:

- (a) Private participation in the form of a new share issue for TELECOM S.A., a company that would be formed by the Government contributing the assets of TELECOM, its employees and a Strategic Investor, contributing cash. (Capitalization scheme)
- (b) Tariff restructuring, by increasing the local tariffs to eliminate the subsidies to the majority of the users, at the same time that long distance rates, especially international rates are reduced according to the international trends. The Government should create a mechanism to provide subsidy to develop the infrastructure in the rural areas or areas of special interest (erradication of coca production program).
- (c) Changing the pension scheme of the TELECOM S.A. employees to assimilate their terms to those of the private sector, including compensating their existing employees by giving them shares of the new company in exchange of their pension rights.

88. This reform will provide TELECOM the ability to compete with the new players in long distance, by bringing a strategic investor capacity to commercialize the service in a competitive marketplace, and its capital to compensate for the reduction in future revenues. It will also involve the employees of TELECOM in contributing to the improvement of their company as shareholders. It will solve the pension liabilities of the current enterprise without the need of a Government bail out.

89. The reform should be carried out sooner than later, to avoid the deterioration of the financial outlook of the company.