Fiscal risk management for development: The case of Colombia

Natalia Salazar
Fedesarrollo
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1. Colombia has a strong fiscal-institutional framework (OECD, 2010 and IMF, 2011). This has been one of the main elements that explains the resilience of the Colombian economy to the global economic turbulence. The consolidation of the fiscal framework has been a gradual process over the last 15 years and was strengthened with the enactment of the Responsibility and Transparency Law in 2003. Through the establishment of the Medium Term Fiscal Plan (MTFF), this law introduced a useful tool for macro-fiscal programming and set high standards for the transparency of fiscal policies and assessment and management of fiscal risks.

I. Forces that threatened fiscal sustainability in the 90’s and triggered the implementation of important structural fiscal reforms

2. During the 1990s Colombia exhibited growing fiscal imbalances at different levels of the public sector, which worsened at the end of the decade as the economy was hit by the Asian and Russian crises.

Central Government (CG) fiscal imbalances

3. The new rights and entitlements created by the 1991 Constitution caused a strong pressure on central government (CG) social expenditures. The acceleration of political, fiscal and administrative decentralization also contributed significantly to the sharp increase in public spending given that the new constitution defined that transfers to subnational governments (SNGs) should represent a rising proportion of CG current revenues. Since revenues resulting from consecutive tax reforms were not able to grow as fast as expenses, CG fiscal balance deteriorated sharply. CG primary expenditures increased from 7.7% to 12.5% of GDP between 1991 and 1999 while total revenues rose only from 8.3% to 9.3% of GDP in the same time period.

Subnational governments fiscal imbalances

4. The decentralization process carried out between 1991 and 1999 took place in the absence of an adequate fiscal framework able to ensure its financial viability (Ministry of Finance, 2009). Under this scenario, the increasing trend of resources transferred from CG to finance regional delivery of social services, diminished incentives to local tax

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1 Law 819 of 2003.
2 The main element of the political decentralization process was the establishment of popular election of mayors and governors. Before they were appointed by the president.
3 Articles 356 and 357 of the Constitution established that transfers should increase from 32% of CG current revenues in 1992 to 46.5% in 2001.
4 In addition the transfers formula demanded that any effort in CG to increase its revenue had to be shared with SG.
5 In particular, health, education and basic sanitation services.
collection, stimulated a sharp rise of inflexible operating expenses, and leveraged high levels of indebtedness. Borrowing was also favored by abundant financial sector credit. Fiscal indiscipline produced a notable fiscal deterioration at the subnational level of the public sector. An important number of SNGs entered in severe financial insolvency problems.

**Pension system unsustainability**

5. At the beginning of the 90’s the pay-as-you-go pension system was characterized by low coverage. In addition, it suffered from a large financial strain explained by the interaction of generous benefits and low contributions in an environment of demographic changes. This culminated in the passage of an important pension reform in 1993 that created a new fully funded private pension regime and adjusted some parameters of the pay-as-you-go system. The two systems were deemed to coexist and compete with each other. Nevertheless the reform defined a long transition period and kept alive various generous special public regimes, maintaining unsustainable pension conditions for an important number of affiliates (Muñoz et al., 2009 and Santamaría et al., 2010). The economic deceleration of the end of the 90’s generated a decline in pension contributions and made evident its financial unsustainable and the need for further adjustments. In 2000, the unfunded actuarial pension liability was estimated for the first time at around 200% of GDP (Parra, 2000).

**Impact of materialization of contingent liabilities**

6. The 1991 Constitution and other economic reforms promoted private sector participation in activities traditionally managed by the state. Emerging PPP schemes in different sectors, especially in electrical power generation and distribution, transport and telecommunications, which generally involved state guarantees, entailed large government payments when demand dropped below projections established in contracts. Additional problems arose from the fact that there was not a systematic assessment of these contingencies and their payments were not included in budgets (Ministry of Finance, 2011).

**Fiscal sustainability at risk**

7. In the second half of the nineties, the economy suffered from the effects of internal and external shocks. On the domestic front, the country’s violence situation worsened and successive events of political tension occurred. On the external side, there was a growing unfavorable perception of fragile emerging economies by global financial

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6 The proportion of transfers in SNGs current income augmented from 56% in 1990 to 65% in 1999.
7 Between 1990 and 1999, SNGs operating expenses rose at an average real rate of 17%.
8 Total debt of SNGs expanded from 1.1% to 3.5% of GDP between 1990 and 1999.
9 Law 100 of 1993.
10 The conditions of the previous regime would be kept for women older than 35 years; men older than 40 years and affiliates who had contributed to the system for at least 15 years.
11 The more important were the army-and-police forces’ and the teachers’ regime.
12 The main problem was that there were not provisions to cover materialized risks causing liquidity problems to the CG or the necessity of increasing public indebtedness.
markets when the Russian and Asian economic crises occurred. These factors generated capital outflows that put under stress the existing crawling exchange rate band regime. At the same time, the accumulated indebtedness levels of both private and public sectors, the rapid devaluation process and the drastic increases in local and international interest rates produced a significant deterioration of financial institutions’ balance sheets and a stagnation of bank credit flows. Fiscal outcomes, already weak, further worsened. In 1999 CG and consolidated public sector deficits reached 6% and 4.9% of GDP, respectively. In that year an abrupt current account adjustment took place and for the first time, since the national and income accounts are produced, real GDP growth turned negative (-4.2%). In 2000 Colombian sovereign debt lost its investment grade status. All this forced the Colombian government to adopt a structural adjustment program supported by the IMF in that same year.

II. Facing fiscal challenges through structural fiscal reforms

8. The macroeconomic adjustment program undertaken by the government marked the beginning of a gradual process of fiscal reform devoted not only to increase revenue and control expenditures growth but also to introduce institutional changes so as to ensure that the fiscal decision-making process takes place within a framework of transparency, responsibility and sustainability. Several of these changes have been recent and it is expected that their effect on public finances will be consolidated in coming years.

Reforms to increase revenues and control public spending growth

9. In the period 1990-2012, twelve tax reforms were enacted.\(^\text{13}\) The main purpose of these reforms has been to increase CG revenues\(^\text{14}\) although the most recent ones also contain elements that look for a more efficient and equitable tax system.

10. On the expenditure side, in order to ensure sustainability, the more relevant measures were reforms to the intergovernmental transfers system, the pension regime and other actions tending to avoid excessive levels of indebtedness of subnational governments.

11. Regional transfers reforms: Constitutional reforms in 2001 and 2007\(^\text{15}\) introduced temporal\(^\text{16}\) changes to transfers growth formula. The main change was to decouple transfers evolution from CG current revenue. Specifically, the constitutional amendment of 2007 established that the growth rate of transfers should equal the previous year inflation rate plus a real growth percentage defined \textit{ex-ante} in the norm. On one hand, for the CG the new formula has been an important element to recover a sustainable path. On


\(^{14}\) At the local level, some of these reforms have sought mainly to organize and unify tax systems and in some cases, increase local tax revenue, as in the case of the 1998 Law 488 (Ministry of Finance, 2009).

\(^{15}\) Constitutional Amendments 1 of 2001 and 4 of 2007.

\(^{16}\) The changes made in 2007 will be in force until 2015. If a new change were not introduced, transfers would increase at a rate equivalent to the average growth of CG current income in the 4 previous years.
the other hand, for SNGs, the new transfer regime not only ensured a positive real growth of transfers but also decreased significantly the volatility and pro-cyclicality that characterized them until 2001, allowing a more adequate provision of essential services of health, education and basic sanitation services at regional level (Ministry of Finance, 2009).

12. **Pension system reforms**: To overcome financial problems, low coverage and inequitable characteristics of the pension system that persisted for a decade after the 1993 reform, additional adjustments were introduced through two subsequent reforms and a constitutional amendment. Within the measures aimed at improving the financial equilibrium of the system it is relevant to highlight: increases in contributions, expansion of contribution base, elimination of the generous special regimes, regulation of the transition phase and establishment of a ceiling to pension benefits for the pay-as-you-go system. Official estimations indicate that these reforms reduced the present value of pension liabilities in 43 percentage points of GDP. However, in a review proceeding by the Constitutional Court, some of the changes made in the transition regime were ruled unconstitutional, reversing part of this impact (Santamaría, 2010).

13. **Measures to control indebtedness at the SNG level**: limits to SNG borrowing were imposed in 1997. These limits are linked to operational savings, liquidity and solvency indicators calculated from official fiscal results. This set of indicators has allowed the Ministry of Finance to classify SNGs performance within a “traffic light” system. A red light indicates that the subnational government must ask for permission of the Ministry to increase borrowing. Other important measures were the prohibition on the issuance of debt to finance operating expenses, the requirement of a credit risk rating by a credit rating agency before issuing debt and the establishment of limits to the extension of CG guarantees on SNG credit operations.

14. **Fiscal responsibility and transparency laws, quantitative fiscal rules and other measures**: In addition to measures seeking increasing revenues and controlled public spending, the Colombian government has implemented other actions in order to improve its fiscal institutions and ensure that decisions are taken within a transparent and responsible framework. The more relevant arrangements have taken the form of laws or constitutional amendments.

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18 Law 797 of 2003 established that own-account workers must contribute to the system.
19 The limit was fixed at an amount equivalent to 25 legal minimum wages.
20 In the case of SNGs, Law 549 of 1999 created the FONPET (Fondo de Pensiones de Entidades Territoriales) in order to make gradual provisions of their pension liabilities. Local governments must make actuarial estimates of their pension liabilities (that are revised by the Ministry of Finance) and contribute to the FONPET. FONPET’s resources are managed and invested by private pension funds managers.
22 It is important to note that the Direction of Subnational Governments Fiscal Support (DAF) in the Ministry of finance is dedicated to monitoring and supporting the fiscal management of SNGs.
23 Initially, a green light indicated that the subnational government had autonomy to borrow, a yellow one that its level of indebtedness was at a medium level and a red that it was critically indebted. In 2003 the yellow category was removed by including it within the red one (Law 795 of 2003).
24 This requirement is in force only for the biggest departments and municipalities.
15. First, concerning SNG, the borrowing control rules at local level were complemented by the introduction of a quantitative fiscal rule in 2000. This rule stipulates that for any local government current expenditures can’t exceed its freely disposable current revenues, giving a transition period to adjust the expenditures. A local entity not adhering to these indicators would have to accord a fiscal adjustment plan, to be monitored by the central Ministry of Finance.

16. Later, in 2003, the Fiscal Transparency and Responsibility Law (Law 819) improved fiscal transparency and responsibility at all levels of government and introduced elements of fiscal coordination among them. This law required CG and subnational governments to present each year the Medium Term Fiscal Framework (MTFF) that is condensed in a document and constitutes the main fiscal programming tool. Concerning the macro-fiscal programming the MTFF has to present a consistent 10-year macroeconomic framework comprising multi-annual fiscal primary balance targets that guarantee fiscal sustainability in the medium term. It further stipulates that fiscal management at all levels of government, including all annual budget decisions, expenditure authorizations and revenue measures, has to be consistent with the medium-term fiscal framework.

17. Even though the MTFF has been a valuable tool for fiscal programming, from a macroeconomic perspective it evidenced some limitations. First, the imposed primary balance targets do not constitute strong fiscal policy commitments as such as those under a quantitative fiscal rule due to the fact that targets can be modified without requiring subsequent measures to compensate temporary deviations. Second, fiscal programming does not explicitly address the effect of the economic cycle on revenues and expenditures, increasing the risks of fiscal policy pro-cyclicality (Vargas et al., 2012).

18. In order to strengthen the fiscal responsibility legislation and facilitate the operation of a countercyclical and sustainable fiscal policy, a quantitative fiscal rule initiative for the Central government passed into law in June 2012. This rule establishes a structural deficit target of 1% of GDP from 2022 onwards with a transition period between 2012 and 2021. The rule allows for some fiscal response to cyclical fluctuations in output and oil revenue. Savings generated with the operation of the fiscal rule are saved in a sovereign wealth fund. At the subnational level, the recent royalties reform also introduced a counter cyclical element to local fiscal management as it creates a subnational saving and stabilization fund to save windfall royalties revenues.

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26 The CG must present its MTFF to the Congress and SNGs to assemblies and councils.
27 Law 1473 of 2011.
28 The law establishes intermediate targets for CG structural deficit in 2014 and 2018 (2.3% of GDP or less and 1.9 % of GDP or less, respectively).
29 The government is the owner of 80% of Ecopetrol (major Colombian oil enterprise) shares.
30 The fiscal rule is incorporated in the MTFF
31 Constitutional Amendment 05 of 2011.
32 In addition, this reform sought to improve the regional distribution of royalties and incentivize a more efficient investment of resources.
Finally, to limit the fiscal cost of both fiscal constitutional rulings and laws presented by Congress’ initiative, the notion of “fiscal sustainability” was added as a criterion (principle) in the Colombian Constitution, through the Constitutional amendment 03 of 2011. In 2012, the Constitutional Court in its constitutional review upheld the legality of the sustainability principle.

Strong policy frameworks and the resilience during the global crisis

The Colombian policy framework faced its first acid test during the global financial crisis. Despite a slowdown in 2009, the economy grew by 1.7% in real terms, a remarkable growth rate in an international comparison. Colombia’s strong policy framework (inflation-targeting regime, medium-term fiscal framework, financial sector soundness and flexible exchange rate regime) provided the authorities with policy space to undertake timely and effective countercyclical measures in response to the crisis (IMF, 2011). Fiscal indicators deteriorated as consequence of counter cyclical measures, but without putting at risk the overall fiscal sustainability. Solid macroeconomic indicators allowed for uninterrupted access to global financial markets. In 2011, economic resilience, institutional developments and improvements in the security situation, allowed the Colombian sovereign debt rating to recover its investment grade status.

III. Disclosing fiscal risks

In an effort to promote fiscal transparency and risk management, Law 819 of 2003 stipulated that MTFF must contain, in addition to the 10-year fiscal programming framework mentioned before, an assessment and valuation of the main fiscal risks and a quantification of the fiscal impact of economic decisions adopted in the previous year. All this information is consolidated yearly in a single public document that must be submitted to Congress before the budget bill discussion. According to Everaert et al. (2009), only seven countries, among them Colombia, systematically produce a public “fiscal risk statement”.

Specifically, the law requires the CG to carry out particular analyses about each of the following fiscal policy issues:

33 The consolidated public sector balance deteriorated from -0.1% of GDP in 2008 to -2.7% of GDP in 2009 and to -3.3% of GDP in 2010. In 2011 this balance improved to -2% of GDP in 2011 and it is expected to close at -1.2% of GDP in 2012.
34 In this section, we refer particularly to the content of MTFF of the CG.
35 The MTFF must be submitted to the Congress before June 15 and the budget bill before July 29.
36 Australia, Brazil, Chile, Colombia, Indonesia, New Zealand and Pakistan.
38 In practice, each of the topics is presented as a chapter in the MTFF document.
Macro-fiscal program and stress-testing and scenario analysis to external and internal shocks

23. These analyses must contain: i) A report on macroeconomic and fiscal performance over the previous year. In the event of non-compliance with targets set in the previous MTFF, the CG should explain such deviation and present corrective measures, ii) A 10-year horizon macroeconomic framework, iii) Numerical targets for the primary balance of the non-financial public sector (NFPS) for the following year and indicative targets for the subsequent nine, consistent with the macroeconomic scenario and medium-term sustainability, iv) Impact of internal and external shocks on the debt/GDP trend relative to the baseline scenario, and v) Next-year’s financial plan for the NFPS.

Fiscal impact of economic decisions

24. This analysis must include: i) estimates of fiscal cost of enacted laws in the previous year, ii) estimates of sacrificed revenue associated with tax credits and deductions or fiscal expenses in the tax code and in force during the previous year and iii) Assessment of fiscal impact of quasi-fiscal operations of the Central Bank and Fogafin (deposit insurance agency).

Valuation of non-explicit debt and contingent liabilities

25. Given its significant impact on public finances, since the late 90s, the government had been making internal efforts to evaluate non-explicit and contingent debts. It would be with the creation of the MTFF that these exercises became public. The Law 448 of 1998 issued the first regulations for the budgetary management of contingencies and created, as a hedging mechanism, the Contingency Fund of State Entities. State entities must follow the Ministry of Finance’s methodologies for contingencies valuation and for calculation of the respective contribution to the fund. This law established that the Ministry of Finance has the responsibility of approving and monitoring the assessment of fiscal contingencies. Later, in 1999, the National Planning Department, based on the development of a model that simulates the behavior of the Colombian pension system in a time horizon of 100 years, estimated for the first time the present value of pension liabilities. In addition, that same year, a research report of the National Planning Department built an “extended balance sheet” for the Colombian public sector, which included a valuation of items not covered, underestimated or overestimated in official figures and an assessment of the most important non-explicit debts and contingent liabilities.

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39 This exercise is prepared in coordination with the National Planning Department and the Central Bank.
40 This chapter has to be presented and approved by the Consejo Económico de Política Económica (CONPES) conformed by the President, his cabinet and the Head of the National Planning Department.
41 These tasks would be developed by the Risk Area created within the Directorate of Public Credit of the Ministry of Finance.
42 For more detail, see Ministry of Finance (2011).
26. **The Law 819 of 2003 required the MTFF to contain an assessment and valuation of the main contingent liabilities and non-explicit debts that could affect the public sector financial position. In compliance with this law, the MTFF includes annually an assessment of non-explicit public debts associated with pension and severance liabilities and a valuation of contingent liabilities related with state guarantees in PPP projects.**

   44 **credit operation guarantees and lawsuits against the state.**

27. **Non-explicit debts:** an estimation of the net present value of pension liabilities is based on the model developed by the National Planning Department. With a 4% real discount rate, the net present value of pension liabilities was equivalent to 114% of GDP in 2012 (MTFF, 2012). It is important to note that the MTFF 2012 includes the fiscal impact that judicial decisions have had concerning changes to the pension transition regime for some public sector employees may have. According to official estimates, these decisions amount to an increase of liabilities between 2.2% to 3.8% of GDP. If these decisions were extended to all public employees, the effect would be close to 7% of GDP.

28. **Contingent liabilities arising from guarantees on public-private partnership in infrastructure.** To estimate exposure level, the value of potential contingent liabilities as well as contributions to the Contingency Fund, the Ministry of Finance follows a methodology based on the identification, assessment, management and monitoring of risks that may affect expected financial results of projects. To estimate the probability of risk occurrence and its financial impact, the exercises use parametric and simulation models, depending on information availability. In the case of road concessions, the main risks assumed by the nation have been those associated with traffic guarantees, geological risks, environmental risk and property risk (ministry of Finance, 2011). The 2012 MTFF estimated contingent liabilities associated to PPPs contracts in 0.27% of GDP. It is important to note that there has been a process of risk reallocation with the purpose of having the state entities bearing only those risks that are endogenous to the State. Other recent actions, such as the creation of the National Infrastructure Agency and a new PPP law, have been taken in order to improve the technical and financial project structuring of investment projects and to reduce the incentives to contract renegotiation, a frequent practice that has generated additional fiscal costs.45

29. **Contingent liabilities related to lawsuits against the State.** The lawsuits against the Colombian State are numerous and have had a significant and growing fiscal impact. Therefore, since the late 1990s different actions have been undertaken, on one hand to assess the potential fiscal cost of existing filed lawsuit in the case of adverse decisions,

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44 The other non-explicit debt considered in the MTFF is the value of the severance liabilities with public workers that are covered by the old severance payment regime. In Colombia there are two severance payment regimes. Law 50 of 1990 created a new regime in which the employer pays annually the amount of severance accrued during the previous year. The employer deposits this amount in an individual worker’s account in a pension fund manager. However, the old severance regime, in which the employer pays the accumulated severance liabilities at the end of the job contract, remained in force for a group of public sector employees. In 2012, the value of severance liabilities was around 0.5% of GDP (MTFF, 2012).

45 The detailed legal base for contingent liabilities assessment is presented in Ministry of Finance (2011).
and on the other, to overcome several problems of the judicial defense of the State. The methodology for assessing these contingent liabilities is based on a probability tree that represents the dynamics along all stages of litigation process. The determination of this probability is based on historical information of similar actions in similar jurisdictions and also on qualitative analysis (Ministry of Finance, 2011). According to the 2012 MTFF, for the period 2011-2021, the fiscal contingencies associated with lawsuits against the State are equivalent to 71.1% of GDP. Despite the efforts made by the Ministry of Finance, it is important to note that one of the main limitations to obtain better estimates is the absence of comprehensive information. A more complete and consolidated database of lawsuits against the State is needed. On other hand, concerning the management of these risks, there is room to produce improvements in the judicial defense of the State. As stated by the Ministry of Finance (2011), the fiscal impact of these contingencies may be explained in part by low quality of the public defense. These inefficiencies are related to shortcomings in organization and coordination among the different areas in charge of the defense, the absence of unified criteria to face lawsuits and the low use of alternative resolution mechanisms. The recent creation of the National Agency for the Legal Defense of the State, in charge of representing the Nation’s interests, centralizing and coordinating the defense of state, is a positive measure in the right direction.

30. **Contingent liabilities related to guarantees in public credit operations:** Different state entities undertake credit transactions in which the State acts as guarantor. These guarantees may have a fiscal impact when the debtor entity is not able to comply with its obligations. It is important to highlight that there are legal restrictions for the extension of these guarantees. In addition, there is a hedge mechanism that consists of a counter-guarantee system and the obligation of the debtor entity to contribute to the Contingency Fund. The assessment of these contingencies is based on the estimation of a solvency probability curve (CPS). According to the 2012 MTFF, the contingencies associated to guarantees on public credit operations have an expected value of 0.22% of GDP for the period 2011-2021.

31. **Contingent liabilities related to natural disasters:** The country has been affected by the occurrence of natural disasters with significant human and social consequences and high fiscal impacts. For example, the earthquake in the coffee region in 1999 produced damages estimated in US$1.558 billion. Another example is the occurrence of widespread floods in the last three years that had affected significantly the transport infrastructure and the agricultural sector. The associated costs have been estimated around US$4.500 millions (World Bank, 2012).

32. According to estimates of exposure levels and potential loss values, the government would not have the financial capacity to cover extreme disasters (Ministry of Finance, 2011). Nevertheless, in the last decade, the Colombian government has made efforts to strengthen its institutional and financial capacity to react more adequately to the occurrence of natural disasters. Within these actions it is important to highlight the

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46 However, this value should be lower since a single lawsuit for the amount of 58.8% of GDP was ruled in favor of the Nation.
following: i) the creation of the Prevention and Attention of Disasters System in 1985 as a national coordinating instance, ii) the completion of several studies with the support of multilateral entities, directed to evaluate the potential costs and the institutional and to assess the financial capacity of the State to overcome natural disasters impacts, iii) the creation of the Adaptation Fund with important financial resources to recover and adapt the infrastructure affected by floods in recent years. Currently, the Ministry of Finance is working in the design of a financial strategy that would involve development of different instruments for withholding and transfer risk such as insurance and reinsurance instruments, bonds and climate derivative instruments (Ministry of Finance, 2011). According to the Ministry, the main challenge is the availability of a comprehensive information database in order to have better estimates of maximum potential losses associated the occurrence of natural disasters.
References


