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1. Introduction

Someone once said that Canadians were experts at solving the problems of federalism largely because they were even more expert at creating those problems in the first place. Something similar might perhaps be said of Colombia's experiences with decentralization in recent years. Many of the problems that have been encountered appear to reflect certain characteristics of the specific policies that have been adopted. Problems that have been created by mistaken policies may presumably be corrected by better policies – policies forged, as it were, in the fires of experience. What seems simple in principle may prove difficult to accomplish in practice, however. Institutions, once created, are not easily altered, not least because the coalition of interests behind their creation often becomes stronger with time and increasingly resistant to change. Colombia's experience with decentralization provides an excellent illustration of the truth of this propostion.

The basic "dilemma of decentralization" in Colombia, we suggest, is not that decentralization is inherently undesirable, unstable, or impossible to fix. However, some important policies were initially implemented too hastily. When problems arose, essentially contradictory policies were sometimes put into place too quickly in an effort to offset the perceived difficulties with the first set of policies. The present situation reflects a succession of such inconsistent policy actions. As a result, Colombians have to date paid more for decentralization and reaped fewer of its potential benefits than they should. To a considerable extent, what is needed to fix matters is to go back to first principles and to redesign fiscal decentralization to recapture the process from vested interests and to create

[1] Fedesarrollo and Universidad de Rosario and University of Toronto, respectively. The authors are grateful to Eduardo Wiesner Durán and Henry Rodriguez Sosa for helpful comments on an earlier version prepared for the Mision de Ingresos Publicos, Bogota, Colombia..

appropriate incentives for governments at all levels to act responsibly in the interests of citizens.[2] It is, of course, much easier to sketch how this might be done than it will be to do it in the real world of Colombian politics, but unless measures are taken soon to link spending authority and taxing responsibility more sensibly at all levels of government, major fiscal improvements seem unlikely to be attainable. Both transfers and subnational tax and expenditure policies thus need to be rethought as an essential ingredient of fiscal reform in Colombia.

In section 2 we sketch the general course of Colombian decentralization over the last two decades, with particular emphasis on the last critical decade of the century. Although it is common in Colombia to treat the subnational sector as a whole, it is not very useful to do so: departments (the regional governments), small rural municipalities, small urban areas, and the big cities are all in very different situations. Each group needs to be considered separately. It is thus essential to decompose decentralization into several different strands in order to understand both the nature of the problems and the direction of possible solutions.[3]

In this chapter, especially section 3, we focus on the intermediate level of subnational government, the departments. We argue that the present situation is inherently untenable. Either departments must be cut back to tasks they can handle, or they must be strengthened to be able to handle the tasks they have. Unfortunately, both ways out of the departmental dilemma raise severe institutional obstacles. With the election of governors, powerful political forces have been created (particularly in some regions) that make it unlikely that the role of departments can be significantly reduced. On the other hand, the pressing national fiscal needs explored in other chapters of this book make it both undesirable and unlikely that significant additional "own-source" revenues will be given to departments. We therefore explore the extent to which the present problems can be

[2] We shall not here summarize the conventional wisdom on how to do decentralization "right": see Bird (2001) for a recent review of this literature.
[3] As we stress later, the lack of a coherent strategy and design for the intergovernmental transfers has also been a dominant feature of decentralization policy in Colombia. We do not, however, analyze the effects of transfers here, deferring this subject to the detailed analysis at the municipal level in the next chapter.

resolved by such incremental changes as better use of existing department revenue sources, more systematic "categorization" of departments with respect to expenditure responsibilities, and a revised transfer system.

In section 4, we consider briefly the even more diverse and complex problems at the municipal level, some of which are also discussed in more detail in the next chapter. As mentioned above, lumping together the very different situations faced by the largest cities (especially Bogotá, Medellín, and Cali), the small rural municipalities, and the important (and diverse) intermediate group between these extremes into an abstraction called "the municipal sector" hinders both meaningful analysis and sound policy. As shown in the next chapter, the great expansion of transfers to municipalities over the last decade had some adverse effects. But as that chapter also makes clear, and as more detailed examination of particular cases reinforces (DNP, 2002), the differences among municipalities are so great as to make simple generalizations of little use as a good to policy.

In particular, as the recent experience of Bogotá we discuss later in the chapter demonstrates, the larger, richer cities can, if their citizens wish, do much to help themselves fiscally. They should be encouraged to do so. Unfortunately, one cannot say the same with respect to many of the smaller municipalities in which many Colombians still live. As in the case of the departments, decentralization policy needs to recognize these diverse realities more explicitly -- on one hand giving more responsibility for both revenue and expenditure to those who can make good use of it and on the other refraining from bestowing excessive revenues and responsibility to those who cannot.

A short final Section 5 pulls together our principal policy conclusions. Central to any improvement in decentralization is a reform of intergovernmental fiscal transfers. Most recent discussion of transfers in Colombia has focused on the appropriate level of transfers. This concentration is quite understandable in view of the precarious situation of the national fisc discussed earlier in this book. But it is not so much the ***level*** as the ***structure*** of transfers -- whatever their level -- that lies at the heart of the dilemma of

decentralization in Colombia. Reform of transfer design, like bestowing more fiscal autonomy (but not more taxing power) on those who can tax themselves, is central to creating the incentive structure needed to resolve this dilemma. The key question, however, is whether the coalition of political interests that gave rise to the present system cannot only be brought to see the need for such changes but also to support them for a sufficiently long period to produce results.

2. Three Decades of Decentralization

In 1973, about 13 percent of central government current revenues were transferred to subnational governments. In 2001, the comparable figure was almost 50 percent. Colombia is not a federal country, but few countries in the world have changed from being essentially centralized to being largely decentralized in fiscal terms as rapidly as Colombia did in the latter third of the 20th century. Of course, this drastic change did not take place all at once, nor at an even pace, over this period. There were several key events in the process.

First, a 1968 constitutional reform provided for a share of the "ordinary income" of the central government to be distributed between the departments, the national territories, and the Special District of Bogota.[4] This provision, implemented by Law 46 of 1971, took effect for the first time in 1973. In that year, 13 percent of central revenue was to be shared as follows: 30 percent in equal parts to each of the entities mentioned, with the other 70 percent in proportion to population (as recorded in the 1964 census). The level of this transfer rose to 14 percent of central revenues in 1974 and 15 percent in 1975.

The 1968 constitutional provision was introduced at least in part as a result of substantial political unrest during the 1960s among teachers who were then largely departmental employees and who were not being paid very regularly in many departments.

[4] "Ordinary income" was defined as current income less three other transfers to subnational governments -- the *cesión de ventas* (see later discussion), the share of the sales tax on liquor transferred to the Sectional Health Services, and the small income tax shares received (for historic reasons) by a few departments.

Reflecting in part the growing strength of the national teacher's union, Law 46 directed 74 percent of the new transfer – called the *situado fiscal* (SF) – to the operating expenditures of primary education, with the balance (26 percent) going to health.[5] This early emphasis on education – and the critical role of the teacher's union – has continued to be a key feature of decentralization in Colombia.

Also in 1968, Law 33 established a quite different transfer to both the departments (including Bogotá) and to the municipalities. This transfer – called the *cesión de ventas* – consisted of a share of the collections of the new national sales tax. The level of this sales tax transfer was set at 10 percent of such collections in 1969, 20 percent in 1970, and 30 percent in 1971. It was distributed to the departments by the same formula – 30 percent in equal shares and 70 percent by population – as the SF, but the departments in turn were required to distribute half of this transfer to their municipal governments in proportion to population (again as established in the 1964 census).

By the end of the 1970s, in addition to constant complaints from subnational governments about the inadequacy of the amounts transferred, increasing concern was being expressed by others about the efficiency with which these transfers were being utilized. A commission – the *Misión de Finanzas Intergubernamentales* – was established to study this issue. Its 1981 report criticized the existing transfers for not taking adequate account of either fiscal needs or fiscal capacity and effort and proposed a new formula – very much like a standard "foundation" grant – to take these factors more adequately into account.[6] The report also suggested measures intended to make the largest cities essentially self-financing, to link the transfers received by other municipalities more closely to fiscal capacity and effort, and reforms in both departmental and municipal revenues intended to make them more elastic.

Althoug this report was written at a time when neither mayors nor governors were elected in Colombia, its aim was thus to strengthen the subnational revenue system, to

[5] The law required the departments to continue to spend at least at much on these activities our of their own resources as they had in 1972, although inflation soon rendered this stipulation meaningless.

redesign transfers into something closer to a conventional "equalization" system, and to establish subnational governments that had both the capability to act more independently and the incentive to do so in ways responsive both to the needs of their citizens and to certain important policy goals established by the national government (notably the provision of basic levels of health and education uniformly throughout the country).

While several important initiatives, such as Law 14 of 1983 on local revenues and Law 12 of 1986 on municipal transfers, followed the recommendations of this commission to a certain extent, the most significant subsequent changes in the subnational sector were not fiscal but political, reflecting the emergence of what has been called the "new federalism" on the Colombian political scene. In 1986, mayors were, for the first time, elected, and in 1991, governors too were elected. In additiona, a further important change in 1991 was made in the Constitution, following extended discussion by a National Constitutional Assembly. The new constitution both redefined the assignment of functions to different levels of government and established a completely new transfer system, which came into effect with Law 60 of 1993.

This law began by establishing the level of transfers as a proportion of national current revenues.[7] The revised SF was increased substantially from 15 to 23 percent of such revenues in 1994, rising to 23.5 percent in 1995 and 24.5 percent in 1996. In addition, a new "municipal participation" – replacing the former sales tax transfer (*cesión de ventas*) – was set initially at an additional15 percent of national current revenues in 1994, increasing by 1 percent annually to a level of 22 percent by 2001. As before, the SF went to the departmental level essentially for spending on education and health. The new municipal transfer, however, now went directly to the municipalities, although it too was dedicated largely to education and health. Indeed, in 1996 an additional "Educational Compensation Fund" was established to make up deficiencies in payments of teachers'

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[6] One of the present authors chaired this Misión, and Bird (1984) is essentially an English version of Misión (1981).

[7] Current revenues were defined as central government tax and non-tax revenues *less* revenues of the national royalties fund (distributed separately, as discussed in the next chapter) *and* also less three percentage points of VAT collections (the sales tax had been replaced by a VAT in 1986) that were assigned to the central government by Law 6 of 1992 to finance, in part, the increase in transfers.

salaries --which, it should be emphasized, are set by the central government-- at the rate of approximately 3.6 percent of national current revenues. This new transfer was distributed to departments and municipalities in proportion to the deficiency remaining in meeting teachers' salaries.

Figure 1 sets out the level of these three transfers as a share of national current revenues, the distribution formula for each transfer, and the way in which each transfer was to be spent. This chart makes three points clear.

- First, half of all national current revenues were now committed to these three intergovernmental transfers.[8]

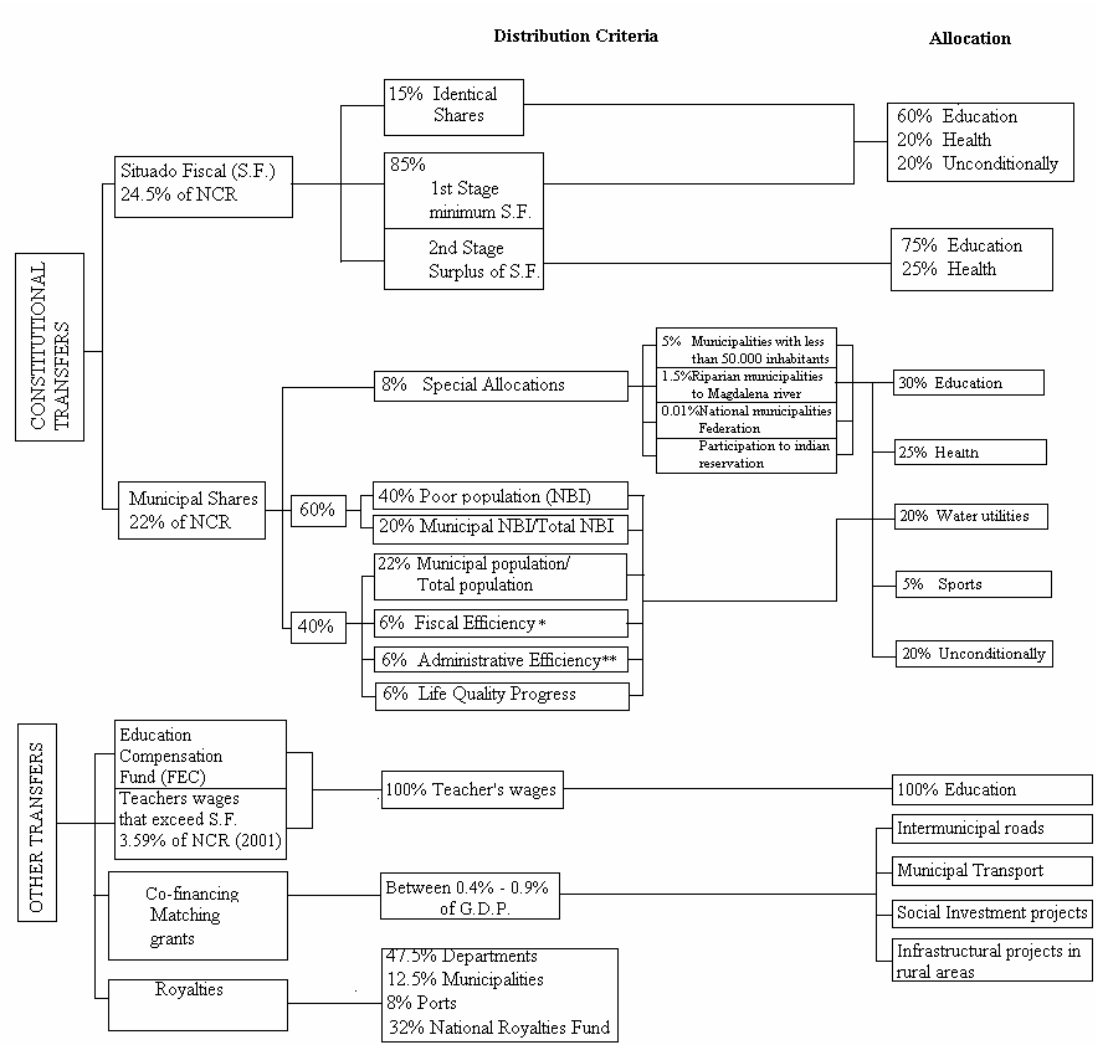
- Second, at the departmental level, the preference for smaller departments was reduced, since the share of the SF allocated in equal parts was reduced to 15 percent. The rest of the SF (85 percent) was allocated to the departments in two stages. The first stage was intended to guarantee sufficient resources (including those from the 15 percent share) to cover the cost of the services (education and health) delivered. This is the so-called "minimum" SF. In the second stage, provision was made to allocate any increment in the SF above the minimum (that is, as the result of higher-than-expected budgetary revenues) first according to potential "needs" (measured by the share of the children not enrolled in the schools and the share of population not covered in health system), and second by fiscal "effort" (defined as the proportion of per-capita expenditure in education and health financed with own resources weighted by the per capita revenues of the

[8] Actually, as shown in Figure 1 there are also other transfers, in part through the "coparticipation fund" (*sistema de cofinanciación nacional*, SCN) a sort of matching investment grant, broadly defined. The level and composition of these transfers are defined by the national budget, and the program coordinated by the National Planning Department. The SCN allowed the central government to pursue specific priorities to be executed at the territorial level. The various funds in the SCN (Fondo de inversión social, FIS, for social investments; Fondo para la inversión rural, DRI, for infrastructure projects in rural areas; Fondo de cofinanciación de vías, FCV, for intermunicipal roads; and Fondo para la infraestructura urbana, FIU, for municipal transport) did not function very transparently nor were they well coordinated with subnational or private investment. The allocation of resources to the SCN and its geographical distribution appears to have been arbitrary and subject to strong political pressures (Echavarría et al., 2000). There are also transfers to regional universities, transfers to regional "autonomous corporations" (established by the national government), and most importantly, transfers of shares of mineral royalties (see discussion in next chapter).

department). In addition, for the first time, departments were allowed to direct a share (20 percent) of the minimum SF to purposes other than education or health if they chose to do so.

Figure 1

Main Transfers in the 1990s



* Fiscal Efficiency is defined as the relationship between standardized tax revenue and transfers received by municipality i.

** Administrative Efficiency is defined as the standardized ratio of the number of people receiving basic services (water, sewage and elericity) and per capita expenditures in personal services for municipality i.

- Third, the new municipal transfer was in principle to be directed overwhelmingly to "poor" (and mainly small) municipalities, with some attempt being made to take

into account also both tax and expenditure efficiency. But how municipalities could spend these funds was largely mandated, with, as usual, education and health being the favored sectors.[9]

As shown in Table 1 the net effect of these important changes in intergovernmental finance was to more than double the share of transfers in GDP over the decade. In a country increasingly suffering from fiscal problems, this huge increase did not go unnoticed. In 1995, yet another commission – the *Commisión de Racionalización del Gasto y las Finanzas Publicas* – was appointed to study the growing deficit of the central government. In its 1997 report, this commission concluded that the principal cause of this increased deficit was the growth in transfers. Some (e.g. Bird and Fiszbein, 1998) disputed this conclusion, arguing instead that the cause was essentially the failure of the central government to reduce expenditures proportionally to the revenues (and expenditures) transferred to the subnational level.[10] But even the critics agreed with the report's argument that the distribution of transfers set out in Law 60 was unduly rigid and, as a later study argued, left far too little space for either efficient local provision of services or adequate exercise of local fiscal responsibility (Alesina et al., 2002).

To deal with both this problem and the perceived lack of effective conditionality in the existing system, the Commission (1997) recommended a change in the distribution formula. The proposed new formula would have, first, keyed the receipt of education and health financing to regional needs in these areas (measured by client population and average unit cost), and, second, removed the other conditions on municipal spending set out in Figure 1. The Commission wanted to break the linkage between transfers and national budgetary revenues for several reasons. It argued, for example, that the instability of revenues imparted an undesirable instability to transfers. It also felt that this linkage

[9] See the next chapter for an analysis of how effective this earmarking was.
[10] In part the failure of national expenditures to fall reflected the increased need for security expenditures in the face of growing guerilla and drug-related activities in some parts of the country as well as a sensible major reform of the national pension system that gradually brought some previously contingent liabilities to the budgetary surface. In part, however, it also reflected the persistent strength of the teacher's union in contesting the intention to "departmentalize" most educational spending.

Table 1
Evolution of transfers 1990-2001 (% GDP)

	Situado Fiscal	Education Compensation Fund (FEC)	Municipal Shares	Co-financing	Royalties	Total
1990	1.7		0.7	0.0	1.0	3.4
1991	1.7		0.9	0.4	0.9	3.9
1992	2.0		1.1	0.5	0.7	4.3
1993	2.0		1.3	0.5	0.6	4.4
1994	2.2		1.2	0.6	0.6	4.6
1995	2.2		1.3	0.7	0.6	4.8
1996	2.6	0.1	1.5	0.9	0.5	5.6
1997	2.4	0.3	1.6	0.6	0.5	5.4
1998	2.3	0.5	1.8		0.5	5.1
1999	3.0	0.3	2.2		0.8	6.3
2000	2.6	0.6	1.9		1.1	6.2
2001	2.8	0.4	2.5		1.1	6.8
INCR.1990-01	**1.1**	**0.4**	**1.8**		**0.1**	**3.4**

Source: Ministry of Finance - CONFIS

unduly constrained national macroeconomic policy. For instance, to raise net national revenues by 1 percent of GDP, taxes would have to be increased by 2 percent, since half of the increase would flow to the subnational governments. The commission therefore recommended that intergovernmental fiscal transfers be fixed at 5.5 percent of GDP (the approximate level of all transfers in 1997).

The deluge of studies, official and otherwise, continued throughout the decade.[11] So did the pressure, both internal and external, to do something about the fiscal deficit. The result was a flurry of new laws attempting to varying degrees to patch up, and to some extent reshape, the intergovernmental finance system, culminating in a constitutional amendment in 2001 and in Law 715 of 2001, which reformed the system of transfers established only a few years before. In brief:

[11] See for examples, Wiesner (1992), Fainboim, Acosta and Cadena (1994), Zapata (1999), Acosta et al., (1999), Wiesner (1995).

- Law 549 of 1999 set up a new fund (FONPET, the National Territorial Pension Fund) to cover the pension obligations of subnational governments (mainly for teachers).

- Law 617 of 2000 established "categories" of departments and municipalities, based on the proportion of their current income they could spend freely, and then set limits on the amounts that each category could pay to elected and some appointed officials.

- Legislative Act No. 1 of 2001 temporarily modified the constitutional system of the three transfers. It established a new General System of Participations (SGP, in Spanish), setting the level of this transfer equal to the three main transfers in 2000 (as a percent of GDP), to be increased by 2 percent in real terms annually until 2005 and then by 2.5 percent annually until 2008. Thereafter, the system is supposed to revert to that described earlier.

- In contrast to the preceding measures, which were aimed mainly at the level of transfers, Law 715 of 2001 reformed the distribution formula, as set out in Table 2. In addition to adjusting some of the details of conditionality, this new formulation is interesting for several reasons. First, for the first time it lumps together distributions to departments and municipalities in the same transfer. Second, also for the first time in transfer legislation, it distinguishes between different types of municipal governments. Finally, it makes it even clearer how limited the freedom of recipient governments is to allocate even the "general" portion of the transfers they receive.

Several conclusions emerge from this highly condensed presentation of several decades of study, discussion, and legislation affecting decentralization in Colombia.

First, the debate about fiscal decentralization in Colombia in recent years has largely been driven by perceived macroeconomic concerns. Viewed from this perspective, starting in the early 1970s, and driven initially in part by the central government's desire to reduce disputes with the powerful teachers' union, an increasing share of national revenues was directed to the subnational level. As discussed further in Section 3 below, at first not much

Table 2

Law 715 of 2001. Distribution according to General System of Participations (SGP) Components

Concept	%	Criteria
1. Special Allocations	**4**	
Native reservations	0.52	Proportional to population
Municipalities on the Magdalena River shore	0.08	Proportional to the river frontier (Km.)
Scholar Food Programs	0.50	Ministry of Finance Regulations.
National Territorial Pension Fund (FONPET)	2.90	Principles established in the General Purpose Participation
2. Allocation by sectors	**96**	
Education	56.18	Educational Service Cost: • Departments • Certified Municipalities (all mun. > than 100.000 inhabitants) • Non-certified municipalities Allocation per student: • Districts.
Health	23.52	Subsidized Regime, Public Health, Services and surplus SGP.
General Purposes	16.32	Allocation to districts and municipalities: • 40% to current revenue participation. • 40% relative poverty. • 40% urban and rural population. • 10% fiscal efficiency. • 10% administrative efficiency

changed as a result other than the accounting unit in which revenues and expenditures were recorded. As time went on, however, and particularly after the introduction of popular elections strengthened local political forces, demands from below for more funds -- though not necessarily more responsibility -- prevailed. The high point in this respect was reached in the 1991 constitutional reform and the subsequent Law 60 of 1993. Since then, in many ways the central government has been struggling largely to regain control over revenues rather than to ensure that decentralization "worked."

As noted earlier, the extent to which the obvious macroeconomic problems of the 1990s were in fact attributable to the accompanying increase in transfers remains somewhat arguable, but that increase undoubtedly made it more difficult to deal with those problems. The emphasis on the level of transfers was thus understandable and an acceptable solution -- though allegedly only "transitory"-- may now have been reached on this point. In particular, Legislative Act No. 1 succeeded in breaking the rigid link between national revenues and the amount of subnational transfers – although, ironically, the weak growth of revenues in the last few years means that it may have resulted in transfers being higher than they otherwise would have been.

Since our principal concern in this chapter is not macroeconomic, however, the second conclusion suggested by the story told in this section is more interesting. That conclusion is simply that, despite the huge increase in transfers over this period, there has been surprisingly little "real" decentralization in Colombia as yet. Moreover, despite the large literature on transfers in Colombia, the reasons for, and the nature of, this rather surprising failure have seldom been discussed in depth. We argue in the next sections that this outcome results from an unfortunate combination of an inadequate, unclear and overly rigid assignment of functions, an inadequate and unduly rigid local revenue structure, and a transfer system that did not -- and still does not -- either distribute funds sensibly or confront subnational governments with incentives to behave sensibly. Indeed, on the contrary, the results of the present system have arguably been to strengthen supply monopolies (notably in education) and to inhibit more demand-driven public service supply, with consequent inimical results for efficiency and growth.

Finally, although Colombia has certainly done much to decentralize, and much of what it has done appears -- despite the criticism it has received from many (including us) -- to be sensible, there is still much more that can and should be done if the country wants to increase the benefits and reduce the costs of its considerable decentralization efforts to date. In part, the problem is clearly a matter of redesigning some key fiscal institutions and in particular to focus not on the level of transfers but on their purposes and effects. More fundamentally, however, we suggest that the problem is one of perception. What should subnational governments do? How should their actions be judged? And who should do the judging? Colombia has decentralized a lot in some ways. But it is not yet clear that many Colombians have a deep understanding of what decentralization means, or at least can mean, and indeed probably must mean, if the game is to be worth the candle.

3. The Uneasy Role of the Departments

By definition, a federal country is one in which regional governments have clear boundaries and a clear and constitutionally-assigned role. Discussion of federal fiscal matters must start with this reality. There may often be arguments about possible conflicts between regional functions and national functions or about the adequacy of state revenues in federal countries, but there is seldom serious discussion about the need for state governments or their basic role. They exist, for better or worse, and they have the functions and revenues that they have. Determining the appropriate role, functions, and revenues of regional governments is not within the powers of the central government. Regional governments are what they are, and central policy-makers must, for the most part, work within the established constitutional framework.[12]

In sharp contrast, much about the role of intermediate level governments remains controversial in decentralizing unitary countries like Colombia. Controversy arises for several reasons. In some countries, essentially no such governments existed under the

previous regime, and it is far from clear whether they are needed or desired (by either, or both, of the central government or the population at large), what their boundaries should be, and what, if any, role they should play under the new, more decentralized structure. In other countries, although regional administrations exist, they have traditionally been controlled almost completely by the center. In some countries, at some point in history such regions may have had some real independence that was subsequently lost as the fisc became more centralized. Often, in Latin America as elsewhere, such centralization was preceded by a political struggle in which, essentially, the center won out over the regions. Finally, in some cases -- not least when decentralization is associated with democratization as in much of Latin America today (IDB, 1997) -- most emphasis is put on "local" (municipal) governments as being "closer to the people," and the role of intermediate governments is downplayed.

Traces of all these factors may be discerned in Colombia. Geography and history made Colombia a decentralized country in reality until the late 19th century. War and growing central fiscal capacity made it increasingly centralized throughout the 20th century. As discussed above, developments over the last few decades, and especially the last decade, have been such that Colombia enters the 21st century as, in many ways, one of the most decentralized countries in the world – indeed, considerably more decentralized in fiscal terms than such nominally federal countries as Mexico and Venezuela. Unlike its only continental rivals in decentralization, however – Argentina and Brazil – Colombia is *not* a federal country. Instead, it is a unitary country that has decentralized, and like most such countries it has found it difficult to determine the appropriate role of its intermediate level of government – the departments.

Until the election of governors in 1991 departmental governments were essentially regional administrations under the control of the central government. Although departmental assemblies were elected, governors were appointed by the President. Departments had few (and inelastic) revenues of their own. Their lack of revenue independence did not matter much, however, because they had equally few responsibilities.

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[12] Note that this is not true even in most federal countries with respect to local governments, which as a rule

Even the 1991 Constitution, which provided for the election of governors, did not change the basic fiscal situation. Departments still had few functions, and few independent revenue sources. The main constitutional responsibility of departments is planning and promoting regional development. Departments are also responsible for control and supervision of municipalities, although this role has diminished since the 2001 SGP direct transfer to municipalities. The main real function of departments is to administer national programs, especially in education and health. Since 1994 transfers for education and health, which formerly went to two national decentralized regional administrative agencies – the education fund (*Fondo Educativo Regional*, FER) and the health service (*Servicio Seccional de Salud*, SSS)—have been recorded as departmental revenue, and the expenditure on education and health paid for by these transfers recorded as departmental expenditure. For the most part, however, departments have little autonomy with respect to these expenditures and act as heavily constrained central agents – although, as noted below, there are considerable regional variations in the degree of central control.

To a considerable extent the "decentralization crisis" some perceive at the departmental level is thus an accounting myth. Deploring the decreasing share of "departmental" expenditures that are financed from own revenues or the increasing departmental dependence on transfers to finance expenditures makes little sense when the expenditures financed are, to a large extent, driven by the transfers rather than vice versa. Of course, to the extent that departmental own revenues have not kept up to increases in departmental "own" (that is, other than education and health) expenditures, there may indeed be a sustainability problem at this level of government. Given the miniscule size of such expenditures, however, any such problem is unlikely to be serious. On the whole, the reality of departmental finance in Colombia is that any serious problems that manifest themselves in departmental budgetary accounts are more likely to have their causes, and solutions, at the central than at the departmental level.

This conclusion is of course too sweeping in a number of respects. Colombia is a country with widely different regions, and one respect in which they differ is the degree of

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are largely at the mercy of either or both of the regional or central government.

autonomy with which they exercise their functions in practice, regardless of the apparent legal uniformity. The Department of Antioquia, for example, has long walked its own path in many respects, not least in the active role it has taken in such areas as education. Every department in Colombia – indeed, every government at every level -- virtually replicates the administrative structure of the national government. The country is full of "Secretaries" (department heads) of Education and Health. In Antioquia, however, the Secretary of Education appointed by the governor was the effective head of the supposedly centrally-controlled education establishment well before education was formally delegated to the departments in the early 1990s. Similarly, other departments such as Valle in health and at times the coffee departments of "Viejo Caldas" with respect to certain infrastructure investments – these departments had some independence owing to the funds they received from the taxes earmarked for the Coffee-growers' Federation (Bird, 1984) -- often acted surprisingly independently even in the pre-democratic era of departmental government. More recently, some of the new "oil" departments have received (much greater) revenue from royalties, as discussed in the next chapter, and thus similarly had some scope for independent action (Gaviria, Zapata and Gonzalez, 2002). Regardless of constitutional niceties, money brings a certain degree of empowerment. On the other hand, most of the present 33 regional governments remain, as they always been, essentially dependent on national largesse.

Indeed, their dependent situation has been exacerbated in recent years by political and fiscal factors that have encouraged the creation of new, and in most cases inherently non-viable, departments. Both the "equal shares" element of the transfer system and the new regional political power attainable with the election of governors made the creation of new departments attractive. A person who has just been elected the governor of Department X is, as a rule, going to want to do something with his or her newly-acquired power, limited though it may be. Given the very restricted range of departmental functions and the even more restricted range of departmental revenue that is really within the governor's control -- not to mention the novelty of political independence at the regional level -- it is perhaps not surprising that in some instances the most immediate manifestation of independent power appears to have taken the form of appointing as many supporters and relatives to

official posts as possible. Such at least seems to be the common perception of the results of decentralization to departments in Colombia, certainly at the level of the central government. Unfortunately, the immediate reaction to this situation has not been to consider the fundamental imbalance of responsibility and authority that lies at its root but rather to attempt to control the symptoms by restricting the salaries that can be paid by different "categories" of departments (as is done in Law 617).

In principle, a more fundamental solution to the problems of the departments might take one of three paths. First, the reality that for the most part all departments do is to administer national policies in health and education could be explicitly recognized, the revenues and expenditures related to these activities reincorporated into the national budget, and the whole question as to whether Colombia needs or wants the skeletal regional governments that would be left then considered. Given that departments essentially have no other significant functions, the logical conclusion of this approach might well be that there is really no need for the departmental level of government as such. Regional agencies of the central government on one hand and associations of municipal governments on the other hand could likely do whatever departments do as well as they do, or do not do, it now.[13] Such a coldly rational approach to this issue seems most improbable, however, given the historic diversity of Colombian regions and the now democratically-elected regional governments.

In contrast, a quite different approach is to recognize that, whether or not departments as they now are *should* exist, they *do* exist. This particular genie is most unlikely to be put back into the bottle. While this position understandably underlies most Colombian discussion of this matter, it too seems unlikely to be sustainable in the long run. Two decades ago, the intergovernmental mission noted that the inelastic departmental revenue system could not adequately support growing expenditure on education and health (Bird, 1984). That same system is in place today, so it is not surprising that substantial (and growing) central support has been needed in recent years. Given the precarious fiscal

[13] An important issue that cannot be discussed here concerns how best to deal with major metropolitan regions (Bird and Slack, 2003). As World Bank (2002) has argued with respect to Cali, for example, the economic reality of such regions is not adequately reflected in their government structure.

position of the center, such support will doubtless continue to bring with it the heavy hand of central control. Such control may be warranted for such reasons as to ensure more equitable provision of services throughout the national territory or to prevent regional waste of central resources. Nonetheless, it is fundamentally inconsistent with either departmental autonomy or genuine departmental responsibility for these important public services. Continuing further down this path thus seems less likely to solve the present problems at the departmental level than to exacerbate them.

If the first path mentioned is unattainable for political reasons and the second path is unsustainable for economic reasons, only the third path is left. This alternative approach would recognize both that one has to start where one is and that more of the same is unsustainable. What can and should be done to improve matters, we suggest, is essentially to recognize more explicitly the great differences in capacities and interests in different regions. Such asymmetrical treatment of different departments goes against the Colombian legal grain to some extent an dmay hence prove to be unattainable, at least as a matter of legal form. As mentioned earlier with respect to the differing degrees of regional autonomy observed in practice, however, Colombia has long been a considerably more pragmatic country than its legal system recognizes. In the end, therefore, a certain degree of pragmatism in the treatment of the very different entities called "departments" is probably possible. Such at least is the strategy suggested here.

There are two prongs to this strategy. The first prong, which applies to all departments, is – as has often been proposed before -- to improve the departmental revenue structure and to make it work as well as possible. The second prong, however, is more novel: it is to recognize that some departments have a considerably bigger revenue potential than others and that some (not necessarily the same ones) are willing to exploit that potential more heavily than others, and then -- through the design of transfers and the use of conditional options -- to, so to speak, cut the departmental expenditure cloth to fit departmental revenue reality. In the remainder of this section we sketch how such a system might work.

Fixing Departmental Revenues

The taxes assigned to departments are inadequate and inflexible. Unusually, Colombia's regional governments are financed largely by excise taxes, as shown in Table 3. These taxes usually have high rates and relatively small bases and suffer from serious administrative problems (especially smuggling). Taxes on liquor, beer and tobacco accounted for 70 percent of total departmental tax revenues. Other minor departmental taxes include taxes on motor vehicles, gambling, and animal slaughter: such levies generally overlap similar municipal taxes. The yield of departmental taxes has decreased over the last decade and is now to less than 1 percent of GDP.

Table 3

Departmental Taxation (1999)

	Percent of the total
Liquor	29.8
Tobacco	14.7
Beer	25.5
Surcharge on gasoline	11.7
Other	18.3
Total	100.0

The *liquor tax* is the single most important departmental levy. Unfortunately, as detailed in a recent study, there are many defects in this tax (Oxford, 2001). It is excessively complicated. The high tax rates on spirits encourage both smuggling and counterfeiting (of tax stamps). Corruption seems widespread. Although the market is dominated by departmental production monopolies (*licoreras*), collection costs are high. Indeed, incredible as it seems, some *licoreras* have even managed to go bankrupt. More generally, contributions from *licoreras* to departmental finances have decreased, and there is considerable evidence that these agencies commonly evade their obligations or, when

they do transfer funds to the departments, do so much more slowly than they are supposed to do.

Law 223 of 1995 gave the departments the task of administering the tax on tobacco, which had previously been administered in practice by the tobacco manufacturers (Bird, 1984). In addition to the basic consumption tax (55 percent of retail price), additional levies are imposed on tobacco by the national VAT (16 percent), a special tax to finance sports (10 percent of price excluding VAT and consumption tax), and a small levy (2 percent of the price of a kilo of tobacco) to finance the National Tobacco Fund. Although some effort was made in Law 223 to simplify administration by imposing tax on the basis of origin rather than destination, as had earlier been the case (thus eliminating the need for "internal customs" control), the yield of tobacco taxes remains low and decreasing, owing largely to the lack of control over smuggling.

The story is much the same with other departmental taxes: high rates, complex structures, poor administration, and low and inelastic collections. Lotteries, for example, which in many countries have become increasingly important at the subnational level, are poorly administered and not very productive revenue sources. Earlier studies found that in Colombia taxes on lotteries amounted to only 13 percent of gross revenues, compared to the 30 percent or so found in many other countries. Even after a recent reform (Law 646), an analysis by the Contraloría General de la República (CGR, 2001) found many financial and administrative problems in lotteries. In some areas most revenues from regional lotteries go to administrative and operative costs rather than (as legally directed) to finance health expenditures. In practice, many departmental lotteries, like departmental *licoreras*, seem to function more as employment agencies than as revenue agencies.

Nonetheless, despite the poor record of departmental excises to date, these levies are likely to continue to be the main "own" revenue source of this level of government in the future. What can be done to improve outcomes?

First, as numerous reports have argued, the departments should get out of the business of directly producing alcohol.[14] Departmental liquor monopolies should be abolished. Indeed, ideally all restrictions on distribution and sales between departments should be abolished to create a true competitive national market. If existing departmental enterprises can survive in a market in which they compete on an equal basis with private firms and foreign goods, all being subject to the same tax regime, they will. In addition, to improve administrative efficiency, taxes on domestic liquors should be imposed uniformly nation-wide (as is now done with imported liquors), with the revenues distributed in accordance with consumption patterns. Such a levy could be administered by the national tax agency (DIAN) or perhaps by a special joint departmental agency. In either case, such a system would obviously reduce departmental fiscal autonomy because rates would have to be uniform. In reality, however, departments have little autonomy anyway and the present liquor taxes are so badly administered that this price seems worth paying.

Secondly, as mentioned above, the tobacco tax is already uniform across the country in terms of rate. Nonetheless, there appear to be problems in establishing the tax base, which is specified in Law 223 as the sales price (less consumption tax) in the capital city of the department in which the factory is located. Again, some further administrative centralization seems necessary both to calculate comparable tax bases and to deal with the pervasive problems of smuggling and tax collection. Much the same can be said with respect to the important beer tax.

Thirdly, the remaining, less important, sources of departmental revenue also need to be carefully re-examined and in most instances changed in various respects. Departmental net revenues from lotteries, for example, are, as noted earlier, unbelievably low and indicative of either extremely low efficiency, corruption, or both. Departmental stamp taxes (in effect "fees" of various sorts for the most part) similarly need to be revised, tightened, and made more effective and efficient.

[14] This recommendation dates back at least to Lauchlin Currie's early reports in the middle of the last century. The principal reason it has never been implemented appears to be the role played by *licoreras* as part of the system of political patronage.

Finally, once departmental taxes are improved, and their administration strengthened, some rates may perhaps be raised. A recent survey, for example, found that a majority of those polled in most cities favored increasing taxes on liquor and tobacco.[15] Such support for higher taxes is hard to come by for any tax in any country. Colombian departments should seize this apparent opportunity to strengthen their fiscal base in a politically acceptable fashion. First, however, they need to clean up their tax act.

All this, and more, has been said before (e.g. Bird, 1984). In principle, as McLure (2000) notes, a limited conceptual case can be made for using excise taxes as a source of own-revenue for regional governments. In practice, however, Colombia's departmental excises have been poorly designed and poorly administered for decades. The current fiscal and political situation may perhaps be favorable to making changes in excise tax design and tax administration that may turn at least some of the potential of this system into reality.[16] Since part of the price of doing so, however, will almost certainly be to reduce even further the very limited degree of fiscal autonomy that departments have, revenue reform alone will not do the job, and it thus critical to consider also just what the appropriate role of departmental governments should be.

Who Should Do What?

It seems reasonable to assume in Colombia that, despite the extensive expenditure decentralization of recent years, a key national policy objective isl to provide some nationally-mandated (minimal) level of service to everyone, regardless of where they live, particularly with respect to education and health. Obviously, however, some departments have more capacity to provide such services (e.g. a higher GDP per capita) and some -- and not necessarily the richer ones -- make more effort to do so than others. The variation that exists and the changes that have taken place over time are illustrated in the next two tables. Table 4 shows (for the larger departments) changes in the rate of growth of

[15] See note 19 below.
[16] Space precludes us from discussing excise tax design in detail here: for a recent review of some aspects of this question in the African context, see Bird and Wallace (2003). Cnossen (forthcoming) contains a more extensive discussion of excises in general -- including the potentially important regional taxes on motor vehicles (Bird, 2000) that have also not been discussed here.

population, departmental GDP, and tax revenue per capita over the last two decades. Table 5 provides a crude estimate of fiscal effort.

Table 4

REGIONAL GDP, POPULATION AND TAXATION

	AVERAGE ANNUAL RATES OF GROWTH								
DEPARTMENTS	GDP PER CAPITA			POPULATION			TAXATION PER CAPITA		
	1980-1990	1990-1999	1980-1999	1980-1990	1990-1999	1980-1999	1984-1990	1990-1999	1984-
Antioquia	2,96	2,05	2,53	2,18	1,86	2,03	-0,44	-2,26	-1,3
Atlántico	1,97	2,87	2,40	3,13	2,67	2,91	1,46	5,32	3,2
Bolívar	1,99	2,42	2,19	1,85	2,33	2,08	1,41	2,25	1,8
Boyacá	1,90	-0,43	0,79	1,22	1,16	1,19	1,13	1,31	1,2
Caldas	3,29	1,04	2,22	1,63	1,57	1,60	2,32	-5,30	-1,3
Caquetá	3,58	0,61	2,16	2,83	2,78	2,81			
Cauca	3,57	1,72	2,69	1,75	2,02	1,88	2,05	-2,87	-0,3
Cesar	2,25	2,62	2,43	2,56	2,31	2,44	-0,25	4,97	2,1
Chocó	6,17	-2,06	2,19	2,45	1,87	2,17	6,88	-6,40	0,3
Córdoba	3,85	4,00	3,92	2,22	1,67	1,96	-0,09	2,55	1,1
Cundinamarca	4,83	3,82	4,35	2,56	2,65	2,61	3,38	3,65	3,5
Guajira	14,58	0,40	7,63	2,06	2,47	2,25	7,23	2,82	5,1
Huila	4,04	1,29	2,73	2,38	1,78	2,10	2,47	1,83	2,1
Magdalena	2,66	3,75	3,18	1,35	2,08	1,70	1,05	5,21	3,0
Meta	5,08	2,89	4,04	4,14	2,80	3,51	-3,01	6,20	1,2
Nariño	2,65	1,72	2,21	1,82	2,11	1,95	3,10	2,95	3,0
Norte de Santander	2,35	1,54	1,96	2,25	2,62	2,43	1,99	3,60	2,7
Quindío	-0,51	0,76	0,09	0,91	1,77	1,32	3,46	-2,85	0,4
Risaralda	4,92	0,53	2,82	2,12	1,98	2,05	2,76	4,12	3,4
Santafé de Bogotá D.C.	3,55	2,58	3,09	4,35	3,71	4,04			
Santander	3,99	3,02	3,53	1,54	1,50	1,52	0,62	8,06	4,0
Sucre	2,03	2,00	2,02	1,75	1,77	1,76	0,02	4,33	2,0
Tolima	2,43	2,49	2,46	1,11	0,68	0,91	0,15	-1,26	-0,5
Valle de Cauca	2,67	3,81	3,21	1,99	2,05	2,02	5,23	-2,21	1,6
TOTAL MAIN DEPTOS	3,21	2,44	2,85	2,03	1,98	2,01	2,05	1,52	1,8

TABLE 5

DEPARTMENTAL TAXATION AND *"FISCAL EFFORT"*

DEPARTMENTS	REAL TAX REVENUES [B]			PER CAPITA TAXATION [c]			TAXATION IN % OF GDP PIB PER CAPITA[d]		
	millions of 1994 pesos			1994 pesos					
	1985	1990	1999	1985	1990	1999	1985	1990	1999
Antioquia	15.431	60.482	198.836	30.337	26.128	18.025	1,70	1,30	0,88
Atlántico	2.370	10.730	67.483	11.767	11.537	14.514	0,83	0,79	0,98
Bolívar	1.848	9.263	58.110	14.069	17.023	16.900	1,05	1,12	1,10
Boyacá	2.446	11.317	60.040	18.584	21.598	21.887	1,40	1,37	1,60
Caldas	3.017	11.537	28.090	25.228	22.689	12.085	2,04	1,62	0,90
Cauca	1.253	4.696	20.475	12.789	14.089	9.049	1,59	1,36	0,90
Cesar	950	3.654	23.405	9.820	10.850	13.677	0,89	0,78	0,95
Chocó	232	1.693	4.212	6.235	11.963	5.584	0,85	1,06	0,70
Córdoba	1.376	6.238	31.526	12.972	12.016	12.980	1,45	1,07	0,94
Cundinamarca [a]	8.851	46.065	249.952	40.847	50.610	55.209	3,14	3,36	3,31
Guajira	256	1.586	8.035	5.559	10.318	10.637	0,30	0,37	0,46
Huila	1.243	6.338	30.338	13.925	16.895	16.971	1,04	1,08	1,14
Magdalena	925	4.930	26.666	7.312	9.411	12.347	0,93	0,92	1,04
Meta	1.778	5.058	38.645	33.880	21.634	28.999	2,15	1,00	1,32
Nariño	1.105	5.588	31.401	8.263	10.028	10.802	0,97	1,07	1,19
Norte de Santander	1.313	4.801	31.395	11.406	10.668	11.617	0,94	0,92	1,10
Quindío	708	3.737	14.535	15.885	22.445	14.785	1,01	1,29	0,93
Risaralda	1.058	5.063	36.884	13.941	17.187	20.721	1,03	1,02	1,40
Santander	2.734	12.093	106.535	14.264	16.029	28.171	0,85	0,78	1,20
Sucre	687	2.570	15.555	9.792	8.964	11.207	1,16	0,95	1,16
Tolima	2.780	8.911	33.790	19.917	16.101	13.516	1,74	1,12	0,80
Valle de Cauca	8.559	54.051	170.201	20.848	30.589	20.853	1,22	1,61	0,94
DEPTOS CON INFORMA	60.920	280.402	1.286.107	18.104	20.185	19.375	1,02	0,97	0,89

a Without Bogota D.C.
b Tex revenues. Contraloria General de la Republica Statistiques. Deflated by the implicit GDP regional deflator
c Real taxation divides by the population. Source: DANE
d Real Taxation divided by the Regional GDP per capita. Source: Dane Regional Accounts and Demographic Statistics
e Per Capita Real Taxation Index divided by the Regional GDP per capita (National Average = 100)l

As Table 4 shows, some large departments have clearly grown much faster than others in terms of per capita GDP – for example, Córdoba, Cundinamarca, and Santander – and others, such as Bogotá, more slowly. Other departments have had much higher than average rates of population growth, such as Atlántico, Meta, and especially Bogotá. Interestingly, per capita taxes have not always increased most rapidly in departments with the fastest growth.

Table 5 presents a simple view of departmental fiscal effort (excluding the capital district), taking into account changes in both GDP and population. Real per capita taxes (as a ratio of the national average) have actually *decreased* over time in a number of departments. This decline was especially striking in the 1990s in the important department of Antioquia, which accounts for over 15 percent of national GDP. At the end of the period, another economically strong department, Valle, also declined in terms of"effort," as measured (crudely) here. Although these relatively poor performances in two traditionally strong departments were undoubtedly heavily influenced by the severe national recession at the end of the decade, some other departments such as Atlántico and Santander nonetheless managed to increase tax effort in 1999 compared to 1990. Even Guajira did better over time, although its performance remained at the bottom of the national barrel. Of the 8 departments (excluding Bogota) that grew relatively faster in terms of GDP over the 1980-99 period, however, only 4 had a higher "effort" index in 1999 than in 1985 -- although only one (Guajira) had an index lower than 100 (the national average).

Table 6

Department classification by fiscal stance

Best performance in fiscal situation [1]	Good fiscal performance, but risks in short and medium term [2]	Bad fiscal results, but running adjustment programs [3]	Bad fiscal results, without any program to adjust their fiscal accounts [4]
Norte de Santander	Cundinamarca	Antioquia	Valle del Cauca
Caquetá	Guajira	Santander	Caldas
Risaralda	Arauca	Atlántico	Boyacá
Guaviare	Meta	Nariño	Chocó
Casanare	Huila	San Andrés	Córdoba
	Quindio	Magdalena	Sucre
		Cauca	Vaupés
		Bolivar	Vichada
		Tolima	Guainía
		Cesar	Amazonas
			Putumayo

1/ Positive current balance, primary balance, indebtedness capacity and meets requirements of Laws 549 and 617

2/ Positive current balance, primary balance, indebtedness capacity, but does not meet all the requirements of Laws 549 and 617

3/ Low or negative current balance, overindebted, but with adjustments program to meet the requieremtes of Laws 549 and 617

4/ Low or negative current balance, overindebted, and no adjustment program or an unsuccessful program.

Another approach is taken in Table 6, which categorizes departments in terms of fiscal "outcomes" in recent years (Ministerio de Hacienda, 2002).[17] While Table 6 includes a number of smaller departments not covered in the earlier tables, it is nonetheless

[17] A somewhat more detailed picture is presented in Appendix Table 1. Some questions may perhaps be raised about the credibility of classifying outcomes as "successful" in some departments which apparently benefited from subsidized financial restructuring in 1999, but this issue cannot be pursued here.

interesting to note that all of the major departments with "good" performance according to Table 6 (except Meta) improved their relative effort over the period (as shown in Table 5). Finally, Table 7 presents a more subjective picture as to how departments might perhaps be categorized in terms of fiscal and institutional capacity, drawing on both the preceding data and on our knowledge of the institutional reality of departmental governments in different departments. Of course, this picture is by no means the last word. For example, Table 7 shows two important departments, Antioquia and Valle del Cauca, as having relatively little fiscal capacity, when most (including us) would generally consider them to have considerable capacity. Similarly, the table also shows all "new" departments as having little fiscal capacity, when in fact some of them (e.g. Casanare) are relatively "royalty-rich" (Gaviria, 2002).

Table 7

Departmental fiscal and institutional capacity

	High fiscal capacity	**Little fiscal capacity**
High institutional capacity	Atlántico Cundinamarca Meta Quindio Risaralda Santander	Antioquia Caldas Valle del Cauca
Low institutional capacity	Boyacá Cesar Huila Guajira Magdalena Nariño Norte de Santander Sucre	Bolivar Cauca Córdoba Chocó Tolima New Departaments 1/

1/ Amazonas, Arauca, Casanare, Guainía, Guaviare, Putumayo, San Andrés, Vaupes, Vichada.

Despite such possible flaws, for illustrative purposes we can combine the "capacity" categorization of Table 7 with a "needs" categorization (based on the information on various "welfare indexes" by department shown in Appendix Table 2) to suggest that Colombia in effect has four distinct types of government at the regional level:

1. Those with high capacity and high needs.
2. Those with high capacity and low needs.
3. Those with low capacity and low needs.
4. Those with low capacity and high needs.

Given the inadequacy of the data at hand and the conflicts between our two (highly imperfect)"capacity" indicators (fiscal, institutional) and our three "needs" measures (see Appendix Table 2), it is definitely rather rash to categorize departments in accordance with this schema based on present information. Nonetheless, as an example consider the five regions shown in the upper left quadrant of Table 7 (which appear to have high capacity in both fiscal and institutional terms). All five also turn out to be close to or above the national average in terms of the welfare indexes in Appendix Table 2. On the other hand, of the five "old" departments shown in the lower right quadrant of Table 7 (low capacity in both respect), all but Tolima are also well below the national average in "welfare" terms.

Clearly, much more work is needed to develop a soundly-based system of categorizing departments. Even the crude system sketched above, however, seems superior to that set out in Law 617 of 2000, which classifies departments into six categories depending upon the proportion of their current income that can be spent for non-mandated purposes. That classification, for example, puts Antioquia and Valle in the same category as Cundinamarca and Atlántico, quite contrary to what the preceding discussion suggests

Suppose a more rational departmental "categorization" system than than in Law 617 can be developed. What should be done with it? We suggest that two lines of approach to departmental finance need to be explored in more depth. First, those departments with higher "capacity" (fiscal and institutional) should be encouraged to take on broader responsibilities. Secondly, transfers should be more effectively directed to those with higher "needs" after adjusting for their "own" fiscal capacity. To achieve the first of these

aims, minimal conditions in terms of institutional capacity and own fiscal capacity should be met before decentralizing the provision of health and education to the departments. To achieve the second, transfers should take into account both fiscal capacity and need.

To illustrate how such a system might work, a department might, for instance, be guaranteed a minimum per student amount for education. This amount would consist of two distinct elements – its own revenues (estimated, for example, as potential collections on its tax base if departmental taxes are levied at average rates with average efficiency) and a transfer to cover the difference between this amount and the targeted support amount. If a department failed to collect taxes, it would not be rewarded by a higher grant. It would just have less to spend on education. To ensure the adequate provision of nationally important services, however, it might also be desirable to have some rule to the effect that failure to spend at least the mandated minimum amount on education for, say, two years a row would lead to a department losing control over education, since it would have demonstrated its incapacity to run the system properly.

Many variations of such systems are possible – e.g. the "fail-safe" level could be set at 80 percent of estimated potential, "potential" itself could be estimated in various ways, the "target" amount might be the national average or some other figure, and so on. The key point, however is to balance "autonomy" and "accountability" in as clear and transparent (rule-based) a manner as possible in order to produce as uniform a system of national education and health services as the the differing capacities of different regions permits. In this framework, differential preferences can be expressed in the sense that those regions that wish to provide more than the national standard can do so by taxing themselves more. On the other hand, the freedom of regions that prefer to tax themselves less than average at the price of providing less service is obviously restricted because they can exercise this freedom only for a year or two before losing it – although of course this provision too is adjustable as desired.

4. The Diverse World of Municipalities

As discussed in Section 2, municipalities, not departments, have been the main actors in Colombia's recent decentralization. Unlike departments, municipalities have more precisely defined functions and, at least in the case of the larger cities, more independent revenue sources. As discussed in more detail in the next chapter, however, there have also been many problems at the municipal level. We shall discuss only one such problem here. What are the realistic possibilities for the muncipal sector in general to raise more taxes?

Although municipalities in Colombia – *all* municipalities – have 15 taxes at their disposal by law, in reality only three taxes account for most local revenue, and only two of these are really "local" taxes, as shown in Table 8. While, as in the case of the departments, tax collections clearly vary with size, level of economic activity, most local governments could likely do more to raise revenues, as is discussed further in the next chapter.

Table 8
Municipal Taxation (1999)

	Percent of the total
Property taxes	35.0
Industry and Commerce	38.0
Surcharge on gasoline	13.0
Other	14.0
Total	100.0

With respect to the property tax – the only significant tax in the many small municipalities that have no real industry and commerce tax base -- municipalities in aggregate have clearly done quite a lot already, though still more could be done. Colombia already collected 0.65 percent of GDP in property tax in 1999 – a substantial increase from

0.24 percent in 1985 -- compared to 0.61 percent in Chile (usually considered to have the best tax administration in Latin America) and only 0.31 percent in Mexico (Bird and Slack, 2002). As Liebovich and Nuñez (2002) show, to a considerable extent this achievement reflects the fact that cadastral valuations have increased substantially (at an annual rate in real terms of 7.3 percent), thus increasing the ratio of assessed values to GDP from only 1.02 in the 1960s (Bird, 1970) to 1.28 at the end of the 1990s. Nonetheless, the system of cadastral valuation remains very incomplete, and many municipalities have not been revalued for years. More could clearly be done to improve the central valuation agency (the National Geographic Institute 'Agustin Codazzi') – not so much technically as in terms of coverage and the rapidity of valuations – and especially to improve valuations in the three major cities (Bogotá, Cali, and Medellín) and the Department of Antioquia, all of which have their own valuation systems. In addition, the effective rate of tax appears to be low,[18] and there may well be room in many situations for some increases in tax rates.

The second major municipal revenue source, *industria y comercio* (the industry and commerce tax, ICT), is essentially a tax on gross receipts. Like many such taxes found around the world (Bird, 2002), the ICT is both good and bad. It is a bad tax by most criteria – it is distorting in its effects on both factor and product choice and it encourages tax exporting, for example. On the other hand, the ICT is a good tax in the sense that it produces a lot of revenue, it is elastic, and it meets little political resistance. Despite the productivity of the ICT -- particularly in larger cities such as Bogotá (where it accounts for 43 percent of local revenue), its structure is defective in several important respects. There is, for example, no clear "territorial" rule so that double taxation on the same transaction (both in place of origin and place of consumption) is possible, and many exemptions erode the tax base (Ospina, 2002). In some instances, special tax bases have been defined to deal with some of the problems, for example, with respect to the financial sector, electric energy companies ,and fuel sales. Such measures may remove certain inequities, but as a whole

[18] Leibovich and Nuñez (2002) estimate that the effective rate for a sample of municipalities was only 0.005 percent in 1999. Statutory rates varied from 0.001 percent to 0.016 percent (limits set by national law). Interestingly, effective rates tended to be higher in the very smallest municipalities (less than 10,000 people) than in those between 10,000 and 20,000. Both the level of rural violence (which lowered taxes) and the degree of political support and legitimacy of local government (which raised them) were found to be econometrically significant.

they probably accentuate the general arbitrariness of this levy as it operates in practice. Since there is little effective control over evasion of this tax, particularly when more than one muncipality is involved, it is understandable that proposals have been made to turn its administration over to a national agency. Although we suggested something similar above with respect to departmental excises, it seems more arguable whether any gain thus realized in the administrative efficiency of the ICT would be worth the substantial loss in local fiscal autonomy.

The next chapter shows that the results on muncipal revenue efforts of the huge increase in transfers to municipalities in the 1990s (see Section 2 above) seem to have been negative on balance. On the other hand, it is equally clear that there have been some very positive examples of local initiative and success over this same period. In addition to Bogotá (see below), some smaller localities – for example, Giradota and San Vicente in Antioquia and Calima and Versalles in Valle (DNP, 2002) – have achieved marked increases in local tax effort. As these examples suggest, the existing municipal tax base can be exploited effectively under enlightened and persistent leadership and with community support. is usually thought. One way to encourage more such outcomes may be to offset the tide of bad news reported from many municipalities by publicizing and rewarding those who do well.[19] A complementary approach may be (as stressed in Section 3 above with respect to departments) to recognize that both willingness and ability vary from place to place and to repackage local functions and responsibilities to better match financial realities. In addition, again as in the departmental case, the transfer system to municipalities needs to be redesigned to ensure that those who can collect, do, while at the same time avoiding penalizing those who are doing the best they can with what they have but who have very little.

The greatest potential for local revenue-raising is clearly in the largest cities. Indeed, it has sometimes been argued (Bird, 1984) that, if they properly utilized their existing resources, such cities could be essentially "self-financing", that is, need no national

[19] For example, in 2002 Bogota received a prize from the United Nations for showing the greatest improvement in governance.

transfers to carry out their designated "local" functions. An interesting recent illustration of how local taxation may be improved has been provided by Bogotá, where local revenues were doubled during the 1990s, under three different administrations. Of course, Bogotá is a special case in several respects. It is by far the largest city in Colombia, accounting for almost 25 percent of GDP. Moreove, it is subject to a special regime that in effect gives it the expenditure role and revenue powers of both a department and a municipality.

Despite these advantages, until the 1990s Bogotá's fiscal structure was weak, owing largely to its relatively low tax revenue. Over the last decade, matters changed drastically. Bogotá increased its operational spending by 70 percent (notably increasing coverage in education in health) and its investment expenditure by 500 percent (especially on mass transit and roads).[20] Public investment rose from only 1.3 percent of regional GDP in 1990 to 7.4 percent in 1999 (Zapata and Chaparro, 2002). This expansion was based on the establishment of a sound revenue system. Among the actions critical to this result were the following:

1. Property tax collections were increased substantially. Initially, a "self-valuation" system was employed that led to an increase of over 50 percent in the number of property tax payers and an increase of about 30 percent in the base of the tax (Vasquez et al., 2002).[21]
2. The assessment and collection of the industry and commerce tax was strengthened considerably (Ospina, 2002).
3. In addition to the increased transfers Bogotá received in the 1990s, the city also privatized a number of municipal public enterprises, thus freeing the capital tied up in them for other uses.
4. Finally, it issued new debt – and, based on its newly strengthened fiscal structure, - received high ratings from international credit agencies.

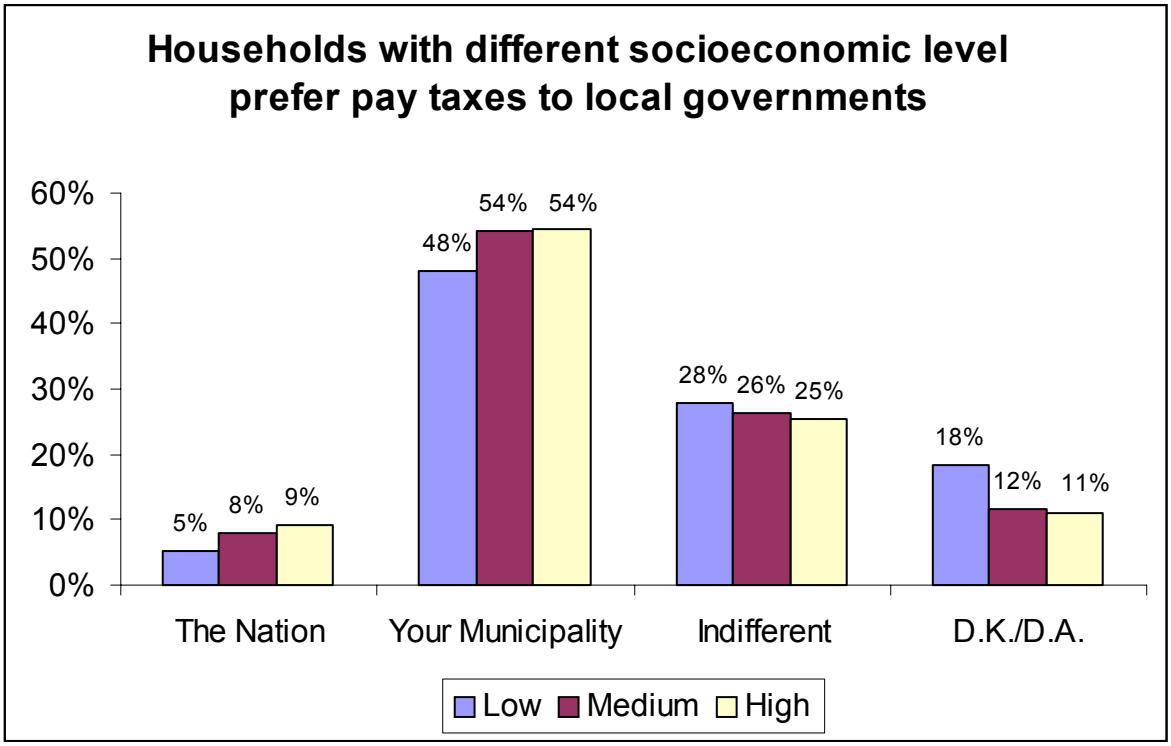
Equally or more importantly, Bogotá not only had three mayors in a row who, although strong political opponents, agreed on the basic long-term strategy of not only delivering

[20] Some of the increase in investment appears to have been financed by proceeds from privatization.
[21] Bird and Slack (2002), however, express considerable skepticism about the long-term effects of this approach to valuation, and indeed it appears that Bogotá , like other jurisdictions, is going to have to depend more on updated official valuations in the future. Still, Bogotá's self-valuation system clearly provided a vital "jump-start" to revenue reform at a critical time.

obvious benefits to many groups (for example, by improving urban transport) but also encouraging "civic education," including the need to pay taxes. It is easy to be cynical about such matters, but the fact that when, in 2002, citizens were asked to pay an additional voluntary tax of 10 percent (on the property tax) in order to help the city's budgetary situation, some 10 percent (50,000 out of 500, 000) did so, surely suggests that the city was doing something right. Citizens, it seems, can not only tell good government from bad but are, in the right circumstances, surprisingly willing to support the former.

Even a very large city can thus do better within the existing structure. Similar good things have, as mentioned earlier, occurred in a few smaller muncipalities in recent years. Perhaps because of the growing awareness of such successes, citizens in all economic groups in Colombia seem persuaded that they get more out of paying taxes to local than to national governments, as Figure 2 suggests. More generally, however, it seems that the lack of a well-articulated functional linkage between departments and municipalities – recall that Bogotá is a "department-municipality" – as well as the imbalance between the resources flowing to municipalities and the confused objectives with which they are charged has led to less favorable outcomes in terms of education and health in the municipal sector as a whole (DNP, 2002). As Alesina et al. (2002) note, the limited autonomy arising from the rigid assignment of transfers by the central government precludes local definition of priorities and acts counter to the emergence of accountable and responsible local govenrment. Powers and resources thus need to be better balanced at the municipal as at the departmental level if decentralization is to produce more beneficial results in Colombia.

Figure 2[22]



5. The Way Forward

The rules for good decentralization set out in this chapter are simple. First, decide who does what. Second, allocate revenue sources so that at least the richest subnational governments can finance the services allocated to them at satisfactory levels. Third, design the transfer system so that the poorer subnational governments can do the same.

Practice is always more complicated than principle in any real-world setting – and decentralization in Colombia is very much in the real world. Few governmental functions are unequivocally allocated to one level or the other. Setting up clear rules on how functions such as education are shared between levels is more complex task than simply

[22] Based on a September 2002 household survey carried out by Fedesarrollo of 3,328 households in five cities (Bogota, Medellin, Barranquilla, Bucaramanga, and Cali).

assigning all power to decide on such matters to one level or the other. Central governments are themselves often fiscally hard-pressed and reluctant to turn over lucrative revenue sources to others. Most local governments would rather have more money without pain in the form of transfers rather than face the painful necessity of taxing their own people. Transfer design tends to get lost in a morass of conflicting objectives – send money here, encourage this, discourage that – with the result that its key stated purpose of ensuring that all citizens have access at least potentially to some minimum bundle of public services, while at the same time making all players in the intergovernmental game face a hard budget constraint, is often not achieved.

Many specific decisions need to be made in setting up a decentralized fiscal system. To what extent, and in what way, should the level of transfers be tied to national budgetary needs? Should the amount of transfers received by any particular government be conditioned on its fiscal effort – the extent to which it utilizes its capacity? How should effort and capacity be measured? Should transfers be conditioned on how, and how well, the funds are spent? If so, how should performance be monitored? Or should subnational governments be able to spend transfers as they wish? Can subnational governments be trusted to tax responsibly or does tight control have to be kept over the taxes and charges they impose? Who is ultimately responsible if subnational governments fail to deliver services or to collect taxes, and what does such responsibility imply? To what extent can different rules be applied to different subnational governments with different capacities and preferences?

It is not surprising that the political process that has driven decentralization in Colombia did not always produce clear or consistent answers to many of these difficult questions. Indeed, as we have suggested earlier, it seems clear that, in some important respects, Colombia got it wrong. In principle, it may not seem that difficult to fix matters up: decentralization, unlike federalization, is reversible in the sense that what the central government gives, it can equally take away.[23] As usual, however, life is not so simple. The

[23] On the important distinction between decentralization and federalization in this respect, see Breton (2001).

decentralization process has created and strengthened a variety of interest groups that are unlikely to give up what they have attained without a fight.

In addition, however, Colombia has so far tried to cope with the perceived flaws in decentralization largely through a series of patchwork measures that have exacerbated matters by obscuring still further the core question of who is responsible for what and in what sense. The perceived stress on the national budget resulting from transfers, for example, has been dealt with by capping transfers. The perceived poor use of funds by recipients has been dealt with by imposing expenditure controls and mandates. The perceived poor fiscal effort seems likely to be dealt with by imposing still more conditionality on transfers. Such measures do not get to the roots of the problem. The best answer to bad decentralization policies is not to replace them by more centralized policies such as increased conditionality but rather to introduce good decentralization policies.

Such policies essentially boil down to four. First, allow subnational governments sufficient autonomy with respect to both revenues and expenditures to make decentralization a reality. The bigger cities and the richer departments should be expected to look after themselves for the most part – that is, to finance those local activities (excluding the nationally-mandated minimal level of health and education) for which they are responsible primarily from resources that they are responsible for raising, subject only to normal auditing and political checks. Since the current national fiscal crisis probably precludes devolving significant additional taxing power to subnational governments, we have emphasized the critical importance of encouraging and assisting both departments and municipalities to do more with the powers they already have.

Secondly, in doing this, it is, as we argue in Section 3, critical to recognize the diverse reality of the country, formally if possible, but in any case in practice. Achieving some desired degree of unity in the face of diversity – *e pluribus unum*, as it says on the U.S. dollar -- is what decentralization is all about. Those subnational governments that can, and that want to, should be enabled to take on new responsibilities. Those that cannot, or will not, should not be expected to do so.

Thirdly, let subnational governments make mistakes – raise taxes too high, levy too little in taxes, spend money on things the central government considers to be mistaken, and so on. So long as those who make such decisions, and the residents they represent, pay for mistakes, this is precisely how decentralization will in the end produce the desired results. Of course, this requires both a clear and credible guarantee that the central government will not bail them out -- and, for a few extreme cases, perhaps some system for (unsubsidized) central takeover of failed governments.[24] More immediately, it also requires a transfer design that clearly puts the marginal cost (and benefit) of subnational decisions clearly, and publicly, on the governments that take them.

Finally, to avoid decentralization-induced crises at either level of government, set up the transfer system properly, so that it does not reward those who do not do their share but does provide both sufficient budgetary flexibility for national macroeconomic purposes and sufficient stability for sound subnational budgeting. Law 715 provides a good start with respect to the level of transfers, but , as argued earlier (and discussed further in the next chapter), no decentralization will work properly unless the transfer system is designed properly to ensure that decision-makers at all levels face the correct incentives.[25]

Throughout Latin America, the last decade has seen decentralization and democratization marching forward together. Colombia has gone a long way down the path to sound decentralization. It has, unsurprisingly, encountered some rough patches on the way. Rather than turn back the clock on the progress so far painfully made by adding to the current patchwork of contradictory rules, it seems more sensible to change a few key policy instruments to ensure that the mix is right, stir well, and then let matters work themselves out over time. That's what democracy is about.

[24] For a recent study of how different countries have "hardened" the budget constraint facing subnational governments, see Rodden, Eskeland, and Litvack (2003).
[25] For extensive discussions of this point, see Bird (2000, 2001).

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Appendix 1 FISCAL CAPACITY INDICATORS [1/]

	FISCAL CAPACITY INDICATORS					
	CURRENT SAVING	INTERES/ CURRENT SAVING	TAX REVENUES (GROWTH)	ACCOMPLISHMENT LAW 617	TAXATION PER CAPITA (increase)	HAVE DEPARTMENTS FISCAL CAPACITY
Antioquia	NON	NON	NON	NON	NON	NON
Atlántico	YES	YES	YES	YES	YES	YES
Bolívar	NON	NON	YES	NON	YES	NON
Boyacá	YES	YES	YES	NON	YES	YES
Caldas	YES	NON	NON	NON	NON	NON
Cauca	YES	YES	NON	NON	NON	NON
Cesar	YES	NON	YES	NON	YES	YES
Córdoba	YES	YES	YES	NON	YES	NON
Cundinamarca	YES	YES	YES	NON	YES	YES
Chocó	NON	NON	YES	NON	NON	NON
Huila	YES	YES	YES	NON	YES	YES
La Guajira	YES	YES	YES	NON	YES	YES
Magdalena	NON	NON	YES	YES	YES	YES
Meta	YES	YES	YES	NON	NON	YES
Nariño	NON	YES	YES	YES	YES	YES
Norte de Santander	YES	YES	YES	YES	YES	YES
Quindío	NON	NON	YES	YES	YES	YES
Risaralda	NON	NON	YES	YES	YES	YES
Santander	YES	YES	YES	NON	YES	YES
Sucre	YES	YES	YES	NON	YES	YES
Tolima	YES	NON	NON	NON	NON	NON
Valle del Cauca	NON	NON	YES	NON	YES	NON
Nuevos Departamentos c/	YES	YES	NON	NON	NON	NON

1/ Each variable have to be reach in the whole period (16 years between 1985 and 2000). A department have fiscal capacity if at least three of the variables reported in this table are observed.

Appendix 2 DEPARTMENTS SOCIOECONOMIC INDICATORS (INSTITUTIONAL CAPACITY)

DEPARTAMENTS SOCIOECONOMIC INDICATORS (INSTITUCIONAL CAPACITY)											
DEPARTMENTS	**NBI INDEX**				**QUALITY OF LIFE INDEX**				**HUMAN DEVELOPMENT INDEX**		
	1985	**1993**	**1997**	**1999**	**1985**	**1993**	**1997**	**1999**	**1985**	**1997**	**1999**
ANTIOQUIA	40,30	31,00	23,52	22,39	63,00	73,30	75,30	77,18	0,76	0,85	0,84
ATLÁNTICO	41,50	31,50	20,78	19,53	70,50	77,00	80,50	80,74	0,81	0,87	0,87
BOLÍVAR	64,60	54,20	43,09	37,53	50,90	62,70	65,00	68,17	0,71	0,83	0,82
BOYACÁ	60,60	39,30	34,60	28,02	44,50	60,00	61,60	62,17	0,73	0,81	0,79
CALDAS	34,30	28,90	21,60	20,39	60,60	71,80	71,00	72,67	0,76	0,82	0,82
CAQUETÁ	61,20	58,20	42,03	27,46	49,80	55,60	62,90	73,31	0,70	0,80	0,84
CAUCA	57,80	56,40	32,23	40,25	45,00	58,30	63,00	63,35	0,70	0,84	0,81
CESAR	61,90	56,10	35,51	32,09	51,30	60,00	62,10	68,59	0,71	0,81	0,80
CÓRDOBA	73,60	65,90	53,54	48,95	39,90	52,70	56,90	60,93	0,67	0,77	0,77
CUNDINAMARCA	48,90	34,00	21,82	23,00	51,00	67,50	71,00	75,24	0,76	0,85	0,86
CHOCÓ	82,00	80,40	49,06	64,86	35,20	47,90	58,80	55,22	0,62	0,80	0,80
HUILA	48,70	40,50	24,08	26,55	51,40	64,50	68,40	71,14	0,73	0,84	0,83
LA GUAJIRA	57,30	64,10	34,23	37,66	55,80	66,10	62,80	68,99	0,67	0,81	0,82
MAGDALENA	62,70	55,20	40,94	40,60	47,20	61,30	62,70	66,61	0,70	0,81	0,81
META	47,60	41,30	29,50	25,74	58,00	66,80	68,80	75,49	0,75	0,85	0,84
NARIÑO	59,20	56,30	39,45	34,02	45,80	55,00	61,00	64,46	0,68	0,80	0,82
NORTE SANTANDER	52,10	41,80	27,07	22,02	56,00	66,30	73,50	75,07	0,73	0,79	0,82
QUINDÍO	30,70	24,00	19,99	21,08	67,20	76,20	76,30	77,86	0,78	0,83	0,84
RISARALDA	33,50	26,70	14,93	15,14	63,20	74,30	79,40	78,80	0,76	0,87	0,84
SANTANDER	43,60	31,70	18,41	20,30	58,00	69,40	73,60	74,63	0,75	0,83	0,83
SUCRE	73,40	65,20	48,84	44,19	41,70	54,70	59,80	64,15	0,65	0,80	0,78
TOLIMA	48,50	39,20	29,90	28,93	54,10	66,90	69,30	71,22	0,74	0,83	0,85
VALLE	32,70	24,70	15,69	17,11	67,70	77,80	80,40	81,24	0,79	0,88	0,87
ARAUCA	61,30	53,80	n.d	n.d	45,10	59,80	n.d	n.d	n.d	n.d	n.d
CASANARE	69,80	52,10	n.d	n.d	41,50	58,10	n.d	n.d	n.d	n.d	n.d
PUTUMAYO	62,80	78,80	n.d	n.d	43,70	68,90	n.d	n.d	n.d	n.d	n.d
SAN ANDRÉS	44,20	33,30	n.d	n.d	62,20	76,60	n.d	n.d	n.d	n.d	n.d
AMAZONAS	35,40	69,40	n.d	n.d	65,30	71,70	n.d	n.d	n.d	n.d	n.d
GUAINÍA	56,80	100,00	n.d	n.d	55,50	n.d	n.d	n.d	n.d	n.d	n.d
GUAVIARE	70,60	79,80	n.d	n.d	36,20	64,10	n.d	n.d	n.d	n.d	n.d
VAUPÉS	60,30	100,00	n.d	n.d	54,80	n.d	n.d	n.d	n.d	n.d	n.d
VICHADA	53,60	88,90	n.d	n.d	40,90	65,50	n.d	n.d	n.d	n.d	n.d
SANTAFÉ DE BOGOTÁ*	23,50	17,30	12,96	12,44	78,80	84,40	86,50	86,57	0,86	0,91	0,91
NACIONAL	**45,00**	**37,20**	**25,89**	**24,85**	**60,17**	**70,80**	**73,30**	**75,22**	**0,80**	**0,85**	**0,84**

Fuente: Sistema de Indicadores Sociodemográficos de Colombia SISD, DNP, UDS-DIOGS. *Distrito Capital (municipio).