

Decentralization and Fiscal Management in Colombia

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Institutional arrangements have helped Colombia manage the fiscal aspects of decentralization, despite the country's political problems.



Summary findings

Colombia's political geography contrasts sharply with its economy. Physical characteristics and guerilla war fragment the country geographically, yet it has a long tradition of political centrism and macroeconomic stability.

Recently, with political and economic decentralization, there has been some weakening of macroeconomic performance. Dillinger and Webb explore institutional arrangements that have helped Colombia manage the fiscal aspects of decentralization, despite the country's political problems.

Fiscal decentralization proceeded rapidly in Colombia. Education, health, and much infrastructure provision have been decentralized to the *departamentos* and *municipios*.

Decentralization has led to substantial but not overwhelming problems, both in maintaining fiscal balance nationally (as resources are transferred to

subnational levels) and in preventing unsustainable deficits by the subnational governments.

The problems have arisen because central government interference prevents departments from controlling their costs and because of expectations of debt bailouts. Both are legacies of the earlier pattern of management from the center, and some recent changes — especially about subnational debt — may improve matters.

Colombia's traditional political process has had difficulty dealing with problems of decentralization because traditional parties are weak in internal organization and have lost de facto rule over substantial territories.

The fiscal problems of subnational government have been contained, however, because subnational governments are relatively weak politically and the central government, for the time being, has been able to enforce restrictions on subnational borrowing.

This paper — a product of the Poverty Reduction and Economic Management Sector Unit, Latin America and Caribbean Region — is part of a larger effort in the region to examine the macroeconomic consequences of decentralization. Copies of the paper are available free from the World Bank, 1818 H Street NW, Washington, DC 20433. Please contact Steven Webb, room I8-137, telephone 202-473-8680, fax 202-522-2119, or William Dillinger, room MC2-323, telephone 202-473-3940. Policy Research Working Papers are also posted on the Web at <http://www.worldbank.org/html/dec/Publications/Workpapers/home.html>. The authors may be contacted at wdillinger@worldbank.org or swebb@worldbank.org. May 1999. (45 pages)

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EXECUTIVE SUMMARY

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Colombia is a nation of sharp contrasts. The country is geographically fragmented by physical characteristics and guerrilla war, yet it has a long tradition of political centralism and macroeconomic stability. Recently it has experienced political and economic decentralization and also some weakening of macroeconomic performance. This paper explores the institutional arrangements that have helped Colombia to manage the fiscal aspects of decentralization, despite its political problems.

Fiscal decentralization has proceeded rapidly in Colombia because political democratization of municipalities and then departments began at a time when substantial expenditures already had been delegated to the previously appointed mayors and governors. The decentralization has led to substantial but not overwhelming problems, both in maintaining fiscal balance at the national level, as resources are transferred to subnational levels, and in preventing unsustainable deficits by the subnational governments. The problems have arisen because national government interference prevents departments from controlling their costs and because subnational governments have come to expect debt bailouts. Both of these are legacies of the earlier pattern of management from the center, and some recent changes, particularly in the area of subnational debt, may improve matters. The regular political process has not been dealing with the problems of decentralization, because traditional parties have weak internal organizations and illegal parties exercise de facto rule over substantial territories. The fiscal problems of subnational governments have been contained, however, because these governments are relatively weak politically, and some key control functions are regulated by law or are delegated to national agencies. Fiscal problems of the national government are mostly its own doing.

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Since 1986, Colombia has been decentralizing its democracy and public finances, joining Argentina and Brazil in the ranks of Latin American countries with highly decentralized public sectors. In Colombia, political decentralization, in the sense of elected mayors in 1986 and then governors in 1991, came after spending had been substantially delegated to the local levels, starting in 1968. In contrast to Argentina and Brazil, Colombia implemented decentralization long after the transition from military to civilian rule and without the complication of hyperinflation. Indeed, on the one hand, Colombia has enjoyed a tradition and reputation for sound macroeconomic management, which was associated in some minds with central fiscal control or with centrally controlled fiscal deconcentration in the early 1980s. In the 1990s, on the other hand, the expansion of political and fiscal decentralization coincided with the expansion of fiscal deficits and a failure to share in the general increase in macroeconomic stability in most other parts of Latin America.

This paper analyzes the institutional features of fiscal decentralization in Colombia and its effects on macroeconomic stability. The paper identifies a number of weaknesses in Colombia's decentralization but finds that decentralization has not been the main cause of the nation's macroeconomic problems. The institutions for decentralization and overall macroeconomic management have prevented Colombia's serious political problems—guerrilla war and corruption from drug money—from causing even greater problems for economic policy and have mitigated the fiscal problems that have arisen in other countries from the decentralization process. Of course, fiscal stability is not the only measure of success for decentralization, and the extent or form of decentralization to date has not been adequate to solve Colombia's political problems.

Colombia is a unitary state, so the departments and municipalities have less autonomous status than Brazilian states or Argentine provinces, but the constitution and the electoral process confer substantial political legitimacy on them. Another distinguishing feature are the two or three decades of guerrilla war that have conferred de facto, but not constitutional, autonomous status on large areas of the country. This partially motivated the decentralization process in the 1980s, as the national government sought to strengthen the legitimacy of formal government. The fragile legitimacy of the subnational governments (SNGs) facing guerrilla threats also limits their scope for politically feasible fiscal adjustment.¹

Despite several differences, Colombia has faced the same basic challenges with fiscal management as Argentina and Brazil. One of the main dangers in this area is that national government will incur excess fiscal deficits as it transfers its revenue base to subnational governments but has difficulty reducing expenditure in equal measure. The other main risk is that the combination of democratic rule and the expectation of bailouts from the center could lead subnational governments to run excessive deficits, upsetting the overall balance of the public sector and eventually the fiscal balance of the national government itself. Argentina and Brazil have faced these dangers over the past 15 years and often succumbed to them. In the 1990s both countries struggled against these tendencies, Argentina with considerable success (Dillinger and Webb 1998). Because of differences in their institutions and history, Colombia's outcomes have differed thus far from those of its larger neighbors, but some of the problems and the options in Colombia today are like those in Brazil and five to fifteen years ago in Argentina, when subnational fiscal imbalances caused problems at the national level.

The central and subnational government deficits are the key manifestations of macroeconomic problems. The outcomes depend on the combination of fiscal and political rules for

¹ This is not to say that local governments in guerrilla-controlled areas have not been fiscally prudent, for

intergovernmental relations. As background to the discussion of these rules and their fiscal outcomes in the 1990s, we start with a chronological overview.

I. Historical Overview

Colombia embarked on political decentralization more recently than Brazil and Argentina. Although the country has a long history of civilian rule and regional diversity, the government became increasingly centralized beginning with the 1886 constitution and up until the late 1970s. By then, the national government raised more than 80 percent of the revenue, as opposed to about 60 percent in the first half of the century (Bird 1984; Sánchez and Gutiérrez 1995). The first indications of national interest in decentralization appeared in the 1968 constitution, which established a regional fund for education and health to be financed from a fixed percentage of national revenues. Because the national government appointed governors, who appointed mayors, this represented less a decentralization than a deconcentration of the budget to subnational administrative units—32 departments, 4 districts (municipalities with the status of departments), and 1,070 municipalities. In addition, municipalities were assigned 10 percent of the then-new value added tax (IVA). Further steps toward fiscal decentralization were made in 1983 with laws that strengthened the tax authority of departments and municipalities. The design of this decentralization drew heavily on a report by a panel of international experts (reprinted as Bird 1984). Although Colombia remained politically centralized in the sense that elections were held only for the president and Congress, the politicians for a locality—senators and deputies—had a lot of say in the selection of governors and mayors.

Political decentralization in the law began in 1986, with Law 78/86 removing the power of departmental governors to appoint mayors. The first mayoral elections took place in 1988. Over the

indeed they have typically shown fiscal restraint, perhaps in part because they do not have much access to credit.

next three years, the government enacted sweeping legislation aimed at transferring many public service responsibilities to the newly elected mayors and providing them with additional fiscal resources (Laws 12/86, 24/88, and 29/89; Decree 24/88). This legislation largely bypassed departments, leaving them mainly supervisory or coordinating roles. Some municipalities developed the capacity to manage the new responsibilities, demonstrating that it could be done (Fiszbein 1997; World Bank 1995). But many did not develop the capacity, at least not quickly, which motivated government to shift to a more deliberate, step-by-step process.

A restructuring of decentralization arrangements in 1991 granted more political autonomy and service responsibilities to the departments and made the fiscal authority of both departments and municipalities conditional on a certification process (Ahmad and Baer 1997; Ferreira and Valenzuela 1993; Sánchez and Gutiérrez 1995; Wiesner Duran 1992). The new 1991 constitution established the direct election of governors. Subsequent implementing legislation (Law 60) partially reversed the functional decentralization of social services to municipalities. For municipalities, the revisions during the early 1990s represented a loss of management autonomy but a gain in transfer revenues. The 1991–94 reforms also reduced the national government’s discretion in the distribution of transfers. The increased transfers and the assignment of oil royalties gave subnational entities about half of public sector current revenues. The degree of true fiscal decentralization was less than it appears in the accounts, however, because the national government decided how the departments and to some extent the municipalities would have to use their main transfers.

The national executive and congressmen each had different motives for decentralization but eventually reached a pragmatic agreement on action. Presidents from both parties, starting in the early 1980s, saw decentralization as a way to help rebuild the shattered legitimacy of the formal state. In 1991 a constitutional convention, mandated by a referendum called by the president using emergency powers, wrote a new constitution establishing decentralization. The nontraditional parties, representing interests long excluded from national power, had the majority of delegates and

used the opportunity to pass power and resources to the subnational levels where they held some of the executive offices. Also, the Liberal Party, which had favored decentralization since the nineteenth century, had a plurality of delegates—about one-third—many more than the traditionally centrist Conservative party (Buenahora 1997). Congress decided to live with decentralization because it gave local administrations the power to execute spending, and these local entities were usually allied with their congressmen, acting as their machines in many cases (Archer and Shugart 1997; Willis, Garman, and Haggard 1997).

Table 1. Growth, Inflation, and Fiscal Balances in Colombia, 1987–97

<i>Indicator</i>	(percent)		
	<i>1987–90</i>	<i>1991–94</i>	<i>1995–97^a</i>
Real growth (annual average)	4.5	4.3	3.5
Inflation (annual average)	15	9	7
Overall fiscal balance as a percentage of GDP			
Central	-1.0	-1.1	-4.2
Department	-0.2	-0.3	-0.2
Municipal	-0.1	-0.3	-0.1
Primary balance as a percentage of GDP			
Central	0.1	0.3	-2.2
Department	-0.1	-0.1	0.1
Municipal	0.0	0.0	0.2

a. 1995 only for department and municipal balances.

Sources: World Bank database; Central Bank of Colombia, table 4.

As the system operated in the late 1990s, strengths emerged, such as increased political participation, and so did weaknesses, such as mismatched spending authority and excessive borrowing by some subnational units. Overall, however, the fiscal deterioration occurred mostly at the national level. See table 1.

II. Explanatory Variables

Because the Colombian experience with political and fiscal decentralization is relatively short and an economic crisis has not yet tested the system, we evaluate the system on dimensions that have proven critical in Argentina and Brazil for determining whether subnational governments contribute to unsustainable overall public sector deficits. The explanatory variables fall into two

main groups: fiscal institutions and intergovernmental political relations. In each area we identify as hypotheses the *conditions* we would expect to lessen the likelihood that fiscal decentralization will lead to excessive deficits. It is rare for a country to meet all of the conditions, but severe problems arise if too few of the conditions are met. The challenge of this research is to discover which combinations are adequate to prevent fiscal decentralization from leading to unsustainable fiscal deficits and which are not.

Fiscal institutions

For fiscal institutions, the key questions concern the division of authority in three areas: revenues, spending, and borrowing. What authority do SNGs have to raise revenue and control their spending? What authority does the national government have to shift spending responsibilities to the subnational governments and to reduce the transfer of resources in order to balance the national government budget? What budget constraints do SNGs face, and how are they set? Under what conditions can SNGs issue debt?

Revenue autonomy. With fiscal decentralization, the SNGs usually receive certain tax bases, but for various reasons—politics, equity, and efficiency—these tax bases rarely cover all of their expenses. Thus SNGs also receive some federal transfers. One view is that subnational governments have smaller deficits if they rely more on their own tax bases (and have the power to change tax rates on the margin) because they can adjust to shocks by increasing revenue. Also, relying on one's own resources may strengthen the incentives to control spending, and of course it reduces the burden on national government. Thus unsustainable overall public sector deficits are less likely under *condition 1, subnational governments raise much of their own revenue*. Furthermore, given that there are transfers from the center to the subnational governments, unsustainable deficits would be less likely to be problematic under *condition 2, transfers are specified by legal formula, not ad hoc*.

In Colombia, decentralization grew out of the deconcentration of national revenues to subnational administrative units. As in Argentina and Brazil, revenue sharing set by formula accounts for most of the transfers. The critical question was flexibility at the margin. Starting in 1968 a departmental fund for education and health was financed from a fixed percentage of national revenues, and municipalities were assigned 10 percent of the then-new IVA, which was not earmarked. This was designed to solve the problem of ad hoc transfers to supplement inadequate sources of local revenue. Even after 1968 ad hoc transfers remained a problem, as mayors continued to ask the president for help to meet the cost of their new responsibilities. A major review of the system of intergovernmental transfers hardened the SNGs' budget constraint vis-à-vis the national government and strengthened their own revenue sources (Bird 1984). A 1983 law standardized the departmental taxes on liquor and cigarettes and ceded the national tax on vehicles to territorial governments. It also authorized a revaluation of the municipal property tax and permitted some local discretion over tax rates. Although it may seem unimportant that earmarked revenues were deconcentrated to subnational authorities appointed by the national government, congressmen at the head of local political machines actually controlled these funds and appointments.

The 1991 constitution (which also made the office of governor an elected post) and Law 60 of 1993 moderately expanded the amount of revenues assigned to departments by broadening the base of the existing revenue-sharing system (the *situado fiscal*) to include all recurrent revenues of the government: the value added tax, customs, income tax, and special funds.² They mandated a steady increase in the share of these revenues to be transferred to the departments. The share of the *situado* increased from 22.1 percent in 1993—net of one-time adjustments—to 23 percent in 1994, 23.5 percent in 1995, and 24.5 percent in 1996. Thereafter, the constitution committed the government to increasing the share sufficiently “to permit adequate provision of the services for

² Revenues from special funds were excluded.

which it is intended.” The sharing formula was to be revised by Congress every five years. For municipalities, the 1991 constitution broadened the base of the existing revenue-sharing system from the IVA to all government current revenues and committed the national government to increase the municipal share from 14 percent in 1993 to a minimum of 22 percent by 2002. Thus the 1991 constitution and Law 60 committed the national government to sharing nearly half of all its current revenues with territorial governments and entities by 2002. (The proportion in 1998 was already 42.5 percent.)

The 1991–94 reforms also reduced the national government’s discretion in the distribution of transfers. Prior to Law 60, the *situado* was paid directly to teachers and health workers under the ministries of education and health. Law 60 changed this system to one in which the *situado* was transferred directly to each departmental government on the basis of a formula.³

The distribution of revenue sharing among municipalities—the *participaciones municipales* and the share of the value added tax—was also formula driven: 60 percent was to be distributed in proportion to the number of habitants with unsatisfied basic needs and relative level of poverty (as determined by the Central Statistical Agency), with the remaining 40 percent distributed according to population, administrative efficiency, and improvements in quality of life (all quantitatively defined in legislation). As a transition measure in 1994–98, each municipality received, as a minimum, the amount of IVA transferred in 1992, in constant prices. Also Law 60 specified that part of the transfer would be distributed equally to all municipalities, which meant that small municipalities got much more per capita and that there was a lot of incentive to form new (small) municipalities. The latter happened a lot at first, as in Brazil and Mexico, but then the problem was brought under some control by the rules for certification of municipalities. Even though this sort of

³ According to Law 60, 15 percent of the *situado* is to be uniformly distributed to each department and district. The distribution of the remaining 85 percent is to be based on a formula taking into account the current number of students enrolled, the number of school-age children not attending school, the number of patients seen by health units, and the number of potential patients based on population.

arrangement is not an immediate danger to overall fiscal balance, since the amount of money distributed stays fixed, it contributed to inefficient expansion of the total public sector.

Cofinancing funds, derived from a national government program for rural development in the 1970s, have evolved into a program of transfers to municipalities for capital investment needs—intermunicipal roads, municipal roads, social investment (mainly education), and rural infrastructure. The investment funding is important because it provides flexibility in usage, whereas most of the other transfers are earmarked for specific and relatively inflexible current expenses, mainly wages. In principle, they are distributed by a formula similar to that for other transfers—per capita plus the number of persons with unsatisfied basic needs and the local fiscal effort. In practice, at least until 1997, there was no coordination among the four main funds (one for each of the areas listed), and there was considerable political discretion in the allocation of projects, which became important channels for patronage. The total amounts were not fixed as a percentage of total tax revenues, like the other transfers, but rather were a budget item. Up to the mid-1990s they grew in importance, reaching 40 percent of total transfers to municipalities. Since then, they have declined somewhat, due to fiscal pressure on the national budget. In 1997 a reform unified the funds, and converted most of them into soft loans managed by FINDETER, a government financial intermediary (Ahmad and Baer 1997; Rojas 1997). The reform improved the coordination and transparency of the investment funds, but along with discretionary transfers for universities, they remain important loopholes in the hard budget constraint for states.

In addition, some taxes are under the control of subnational governments. A few SNGs receive royalties from mineral production, which go mostly to the producer departments (47.5 percent), producer municipalities (12.5 percent), and port municipalities (8 percent). These units receive a large amount of resources. Less than one-third—32 percent—of the royalties go into a fund that is redistributed across the country; no royalties go to the federal government (Sánchez and Gutiérrez 1995). This innovation in the 1990s may have been aimed at strengthening the hand of

local governments facing guerrilla threats, which often targeted oil production, but this rationale does not seem to have been explicit.⁴ Most departments have only the tax on alcohol, cigarettes, and lotteries. Municipal governments have a broader range of small excise taxes and property tax. The most important revenue sources for subnational governments are the tax on alcoholic beverages by the departments and the tax on gross turnover of business and on property by the municipalities (Ahmad and Baer 1997; Bird and Fiszbein 1998).

In summary then, Colombia does not meet condition 1, since subnational governments do not raise most of their own revenue. Most transfers are through revenue sharing by formula, in line with condition 2, but there are important exceptions.

Expenditure autonomy. Without SNGs having autonomy over their expenditure, there is really no fiscal decentralization and no macro-fiscal problem likely to come of it. Subnational spending autonomy is, of course, the way in which decentralization would have the expected benefits of increased efficiency in matching the needs and desires of a diverse population. In terms of the effects on macro-fiscal management, two aspects are usually important. One is whether the central government can dictate which functions the subnational governments must take on, at least in exchange for receiving transfers from the center. Where the central government can do this, it helps contain central spending and deficits. Where it cannot, as in Brazil, the central government may find itself with a constitutional obligation and political expectation that it will continue to provide some service even after it begins turning over revenues or tax bases to subnational governments with the understanding that they will do the task. The other issue is whether SNGs have authority to cut costs, particularly to cut personnel, salaries, and pension benefits, which are

⁴ Perry and Rodríguez (1991, p. 77) note that this allocation goes against standard practice in the literature and that the reasons were “mas bien de índole pragmática y, si se quiere, política.” (“largely pragmatic and perhaps political”).

typically the largest single item of subnational expenditure. Where central rules constrain this ability, it is more difficult to reduce deficits and expectations of a central government bailout are higher. Thus unsustainable deficits should be less likely under *condition 3, the central government can effectively delegate functions to subnational governments to go along with the delegation of revenue sources, and condition 4, subnational governments have authority to cut their costs.*

In Colombia in 1986, municipalities were assigned responsibility for constructing and maintaining schools and for administering the teaching staff assigned (and paid) by the national government. In the health sector, municipalities were made responsible for constructing and maintaining health care facilities. Municipalities were assigned responsibility for providing water and sewerage services and for constructing and maintaining local roads and urban transport facilities. To finance these expanded responsibilities, Law 12/86 committed the government to increasing municipality's share of the IVA from 50 percent (by 1992). Corresponding national agencies were to be abolished. These included the Colombian Institute for School Construction, the National Institute for Municipal Development, INSFOPAL (which was responsible for water and sewerage), and urban development companies, which were responsible for the construction and maintenance of urban roads, management of urban transport, and provision of low-income housing.

The *situado fiscal* always provided most of the departments' revenue, as the law gave them little scope to raise their own revenues: 60 percent of the *situado* was to be spent on education, 20 percent on health, and the remaining 20 percent on either sector. With the *situado*, departments must pay teachers and health workers, whose salaries are set in negotiations between the national government and the unions and whom the departments are effectively prohibited from dismissing. In theory since 1995 the departments have had discretion within the sector as to how to use the *situado fiscal* once the salaries have been paid, but such surpluses have been rare thus far. The national government's authority to negotiate teachers' salaries directly with the national teachers union has already provoked a funding crisis in the sector. In 1996 the government conceded an 8

percent real increase in salaries over three years. As the resulting wages exceeded the amount of the *situado* assigned for education in many departments, the government was forced to establish the Special Compensation Fund to finance the gap between the *situado* and the actual costs of teachers' salaries.

For the municipalities, revenue sharing was also earmarked, but less strictly: 30 percent was to be spent on basic education (infrastructure, equipment, or personnel), 25 percent on health, 20 percent on water supply (except in municipalities that had already achieved 70 percent coverage), 5 percent on physical education, and the remaining 20 percent on housing, welfare, debt service, and other functions. Given the latitude for interpreting these terms, the earmarking of MUNICIPAL TRANSFERS has not been restrictive in practice.

Some of the assignment of functions depends on the establishment of adequate management capacity. Legislation in 1993 (Law 60) reversed the earlier decentralization of social services to municipalities.⁵ In education, it reassigned responsibility for managing secondary and primary schools to the departments, except for (larger) municipalities that met established criteria for financial and managerial competency. In health, decentralization was included with ongoing reforms in the structure of public sector health provision. These measures aimed to shift public health spending from the so-called supply side—direct funding of public health care facilities—to the demand side, in the form of subsidies for national insurance. Some uncertainty remained in the allocation of responsibilities between the state health schemes and the national social security system (Bird and Fiszbein 1996). In implementing this program, territorial governments were to transform their existing facilities into public corporations, which would finance themselves by

⁵ Due to its political composition, the constituent assembly that wrote the 1991 constitution could not provide for differential treatment of municipalities or departments according to their size and capacity, even though the differences are great. This had to be done later by law (Perry and Rodríguez 1991).

charging the insured a fee for service. During the transition, each level of government was to continue subsidizing its own facilities.

To assume the administration of education and health under the terms provided by Law 60, each department and district was required to receive accreditation by the respective ministry of education or health. In principle, accreditation required (1) a functional information system, (2) the adoption of a development plan for each sector, (3) the approval by the departmental assembly of the rules and procedures for the distribution of funding, (4) the adoption of a plan for coverage, and (5) agreement with the respective ministry on institutional arrangements. These institutional arrangements delineated which dependency of the department would take responsibility for the service, how the assets would be transferred, and how personnel would be structured and administered. Once accredited, departments were to receive, within four years, the assets and personnel that would “permit them to comply with the functions and obligations they have assumed.” In the absence of accreditation, these services were to continue being provided directly by the national government. (The law also established that departments could, after they were accredited and at the discretion of their legislative assemblies, further decentralize education to the municipal level, subject to an accreditation process.) Initially only the departments of Valle del Cauca (Cali) and Antioquia (Medellín) were fully certified, and a few others were certified for health services only. In the mid-1990s, the number expanded to include most of the departments and all the large cities.

Once accredited, departments still remained subject to national-government control over key management issues. The law prohibited any territorial government from hiring teachers without meeting the requirements of the *estatuto docente*. Departments were required to incorporate the terms of employment of all existing government or nationalized staff.⁶ Existing departmental or

⁶ Departmental or municipal teachers who were transferred to the national government prior to Law 60.

municipal staff had to be brought into the national payment structure for teachers. Most important, all future remuneration and salary scales had to conform to national legislation, set in negotiations between the national government and the national union.

After several adjustments to the rules, which themselves create some uncertainty, the spending assignment in Colombia largely meets condition 3, in that revenue decentralization is accompanied by clear assignment of responsibilities, especially to departments, and the national government is not left with any major unfunded responsibilities for service delivery. For municipalities the assignment of functions is less clear, but the requirement of demonstrating administrative capacity also serves as a check. From a deeper perspective, the prevalence of earmarking and sometimes mandating expenditure even without a corresponding transfer reduces the political value of good fiscal management by subnational government (because the unfunded mandates already claim their marginal resources some times.) Condition 4, freedom to cut costs, has not been met, at least for departments. Furthermore, the Special Compensation Fund to offset this problem overrides the automatic formula for transfers and thus partially violates condition 2.

Borrowing constraints. Although tax and spending policies create fiscal pressures, whether they cause problems for macro-fiscal management depends on whether the SNGs face hard budget constraints, limiting their borrowing. A hard budget constraint is universally recommended as essential for getting proper fiscal behavior (Tanzi 1995; Ter-Minassian 1997; IDB 1997; Weingast 1995; Wildasin 1997). Some borrowing may be sustainable and good for development, and many national governments, such as that of Brazil, try to control SNG borrowing (Ter-Minassian and Craig 1997). Unsustainable deficits would be less likely under *condition 5, central government strictly controls subnational borrowing ex ante*. But how to achieve this in practice is not always clear when the subnational governments have considerable political autonomy. Pseudo-strict controls could make matters worse, if central government approval creates the impression and

perhaps a self-fulfilling expectation that the central government has also made a guarantee (Bird and Fiszbein 1996).

To run deficits, a subnational government must find a source of financing, which potentially includes contractual borrowing from private domestic or foreign banks, issuance of domestic or foreign bonds, and running up of arrears to suppliers and personnel.⁷ A creditor and the subnational government would only agree to finance unsustainable deficits if both sides expected to gain, most likely through some sort of federal bailout. The bailout could take many forms, including allowing the financial system (implicitly insured by the government) to count as an asset debt that is not being serviced. So unsustainable deficits would also be less likely under *condition 6, central government credibly commits not to have bailouts, prohibiting explicit bailouts and forcing subnational governments to service their debts*, and under *condition 7, regulators force creditors to accept the losses implied by any failure to service debt*. There is understandable ambivalence about the incentive effects of deductions from transfers to force subnational governments to pay debt service. In Argentina they have worked to enforce a hard budget constraint because the national government has not filled the gap with extra transfers when provinces found themselves unable to meet expenses after the deduction of debt service (Dillinger and Webb 1998). In Mexico, on the other hand, the federal government has repeatedly given extraordinary transfers to over-indebted states when debt service became burdensome and the automatic transfers has been a route through which the responsibility has been traced back to the federal level. In one case they reduced the moral hazard, in the other they increased it. The policy on transfers made the difference.

It is also still an open question whether ex ante regulation or ex post enforcement of debt service is more effective in preventing excessive SNG borrowing. The comparison of Argentina's experience with ex post enforcement and Brazil's experience with ex ante regulation suggests that

the former approach works better, but of course the two are not mutually exclusive and can reinforce each other (Dillinger and Webb 1998). The administrative details may matter as much as the legal principles, because the former determine who starts bearing the cost immediately when there is some problem with payments. The effectiveness of the ultimate legal remedies depends in part on whether they are anticipated by, or are contradictory to, the initial allocation of burdens.

In Colombia the controls on subnational borrowing have varied over time. In the 1980s and before, all subnational borrowing had to be approved by the Ministry of Finance, and such approval was the exception. This was natural, since the subnational entities were appointed representatives by the national government and had no political or fiscal autonomy. The ad hoc approval process gradually allowed more freedom for domestic borrowing in the late 1980s and 1990s, as the political and fiscal autonomy of subnational governments increased. (For external borrowing the control was strict.) There was no effective ex ante control of cash advances from banks. In 1997 the so-called Ley de Semáforos (the traffic-light law) brought into effect a rating system for territorial governments, based on the ratio of interest to operational savings and debt to current revenues (Perry and Huertas. 1997).⁸ The effectiveness of this law was questionable at first. As shown in table 2, the rating system allowed a fairly high degree of leveraging of revenues. Territorial governments could receive a “green” rating even with 40 percent of so-called operational savings allocated to interest payments. Moreover, because some recurrent costs for human capital development are counted as investment and saving, operational saving can be considerably larger than the current account surplus, which is a more conventional measure of public sector saving and creditworthiness.

⁷ Borrowing from state-owned banks was a problem in Argentina and Brazil, but the subnational governments in Colombia do not own banks.

⁸ Operational savings are defined as current income (including local taxes, charges, receipts from intergovernmental transfers, and budget surpluses from the previous year) less current spending on personnel (but excluding other recurrent operating costs and interest). Interest includes interest on existing debt and the proposed loan.

Table 2. Traffic-Light Rating System

<i>Criteria</i>	<i>Rating</i>	<i>Consequence</i>
Interest as a percentage of operational savings less than 40 percent	Green	No restrictions on lending
Interest as a percentage of operational savings greater than or equal to 40 percent but less than 60 percent	Yellow	Lending only with approval of Ministry of Finance, after review of debt service projections
Interest as a percentage of operational savings greater than 60 percent or debt stock as a percentage of current revenues greater than 80 percent	Red	No lending, unless the territorial government agrees to adjustment plan

In addition to controls of credit from the demand side, there have recently been controls of credit by suppliers. In Colombia, subnational debt started as debt to private commercial banks, multilateral development banks, or domestic and foreign bond holders. Private commercial banks are the most important creditors, and their regulation and supervision have become key channels for restraining subnational borrowing. When the subnational entities were more or less outposts of the national government, their debt was treated as fully secure by regulators, who did not require banks to provision for nonperforming territorial debt, on the grounds that national government guarantees ensured eventual compliance. The growing independence of the subnational governments, especially after 1991, converted this assumption into an important loophole in the budget constraint. The Superintendency of Banks has varied its requirement that banks provision against nonperforming territorial loans, even when they are backed by guarantees. Borrowing blossomed in 1993-94, prompting the Superintendency to classify any subnational loan with over a year maturity as risky and to require some provisioning. This reduced credit supply sharply. Regulations relaxed again in 1996, leading to two years of high borrowing, and back to tighter controls. Starting in 1999, the debt of any territory with a red rating in the traffic-light system must be fully provisioned, making such loans costly for the banks. This combination may make the traffic-light law more effective.

Unlike in Argentina, the national government in Colombia does not automatically deduct debt service from the transfers to subnational governments. This may weaken the incentive of subnational governments to avoid excessive borrowing, but it should make lenders more cautious. Either way, it should discourage excess borrowing.

Territorial governments also borrow, indirectly, from multilateral development banks through FINDETER, a rediscounting facility that obtains its resources largely from the Inter-American Development Bank and World Bank. FINDETER uses these funds to rediscount loans made by private banks to territorial governments, rediscounting from 50 to 100 percent of the original loan amount. Since the originating banks take 100 percent of the risk of default, FINDETER's only direct risk is that the private banks will default. In 1997 FINDETER also became the conduit for some of the funds lent under the national government's cofinancing program, which gave it a more discretionary and political role.

The national government has bailed out over-indebted departments. There were big, ad hoc bailouts for Bogotá in 1991 and for Medellín in the late 1990s for debt incurred to build the metro. There has also been regular rescheduling of debt that financed electrification in the early 1980s. Departments, then under the direct political control of the center, found that they could not service the debt when a devaluation pushed up their fuel costs and the national government would not allow corresponding increases in the electricity tariff. In the electrification cases, the bailout seems justified, for the federal government was not giving departments the authority to make necessary adjustments to spending or taxes. There has been some conditionality, with serious fiscal adjustment requirements imposed for the rescheduling of department debt, so the incentives have been better than they would have been without conditions. There have been no federal bailouts for municipalities.

Often financing from the central bank is what loosens the budget constraint for the subnational governments, either directly by discounting subnational debt or indirectly by easing the

national government's budget constraint or allowing commercial banks to roll over bad subnational debts. In Argentina after 1991, making the central bank a currency board hardened the budget constraint for the national government and encouraged it to harden the constraint vis-à-vis the subnational levels (Dillinger and Webb 1998). Supervision of commercial banks also tightened, and the central bank was no longer a lender of last resort. Unsustainable deficits would be less likely under *condition 8, the central bank (and bank regulators) is more autonomous and has a strong anti-inflation mandate.*

Both of the traditional Colombian parties value macroeconomic stability and decentralization, so the Congress and presidents have readily delegated substantial authority to technocrats, which seems a common pattern where frequent but moderate political change is the norm and expectation (Keefer and Staasavage 1998; Cukierman and Webb 1995). The Central Bank and the Superintendency of Banks have strong capacity and de facto as well as legal independence. The central bank has always been prohibited from lending to subnational governments, unlike Brazil or, in the 1980s, Argentina.⁹ In the 1972–89 period, Colombia had three changes of the central bank president, two of which followed within six months of a change of government. This indicates more independence than most Latin American countries in the same period, although less than the industrial countries or even most countries outside of Latin America (Cukierman and Webb 1995). The Colombian Constitution of 1991 increased the bank's autonomy vis-à-vis the government, as in several other Latin American countries, especially Argentina and Chile.

In sum, Colombia presents a mixed picture of borrowing constraints. The traffic-light law potentially meets condition 5, but its terms are somewhat lax. There is no deduction from transfers to force debt service, and there have been frequent bailouts in the past, violating condition 6. There

⁹ The 1991 constitution forbids the central bank from lending to the national government except in a deep crisis and with the unanimous approval the bank's board, which has never happened. Thus the national government faces a hard-budget constraint its own borrowing.

is potentially a good mechanism for forcing creditors to take losses, meeting condition 7, but we will see only in 1999 how well it is enforced. Independence of the central bank and of regulators meets condition 8.

Intergovernmental political relations

The rules for intergovernmental fiscal relations and the way in which they are implemented result from the political relations between the levels. Why does the central government say *yes* or *no* to an SNG's request for more resources? Why do the SNGs take on additional tasks or accept reduced transfers in order to help the central government balance its budget? In a situation with substantial transfers from the national government to politically autonomous subnational governments, the ability of the national government to take a firm stance toward the SNGs depends most on the power of the president vis-à-vis the governors and mayors themselves and their representation in Congress.¹⁰ We would expect systems with strong presidencies to be better able to fend off pressures to cover the states' deficits. The presidency is basically the only elected office with a national constituency and as such would be more likely to take into account the interests of the overall economy, while the members of Congress represent regional constituencies as well as their parties.

We can analyze the power relationships between the national and subnational levels in four steps, corresponding to four conditions. Unsustainable deficits arising from fiscal decentralization would be less likely under *condition 9, the president is constitutionally strong at the national level*, and under *condition 10, governors have little constitutional autonomy*. These conditions may not be beneficial for all aspects of governance, and of course fiscal decentralization presumes that the governors have enough political autonomy to be considered a politically separate level of

government, not just a field representative of central government. Governors and the president also contend for resources indirectly, especially via Congress and the parties. So we must also consider their effects on the intergovernmental balance of power. We would expect the central government to be able to maintain a harder budget constraint under *condition 11, electoral rules orient Congress toward national issues, not local ones*, and under *condition 12, party discipline is strong*. The balance between these forces depends on the interaction of the constitution, electoral procedures, and party discipline. The constitution is a given at most times, as are electoral procedures. Therefore, party discipline is the dependent outcome. But constitutions and electoral procedures change with some frequency in Colombia and the rest of Latin America, and they reflect the political balances and party characteristics at the time of each change.

President's constitutional authority. Colombia's president is directly elected by majority, which, with a number of new parties in addition to the two traditional ones, generally requires a runoff election. At the second stage of the election, the president allies himself with other parties to get a majority, as in Brazil, and thus must bargain away some of his power and party cohesion even before entering office. The president has a four-year term and cannot be re-elected, which reduces his power even in his own party near the end of his term.¹¹ Presidents can propose legislation and often do, but they have little power to sustain a veto of what Congress passes. If the president objects to all or part of a proposed law that has been approved by both houses of Congress, the proposed law returns to Congress for a second debate. Then if both (*una y otra*) chambers approve it again by a simple majority, it becomes law, unless the objection is that the law is unconstitutional,

¹⁰ In the classic decentralized fiscal system, local voters are the taxpayers who pay the bill and therefore exercise restraint on spending (Tiebout 1956; Weingast 1995).

¹¹ The most recent Argentine and Brazilian constitutions also forbade reelection originally, but the presidents who stopped hyperinflation (Menem and Cardoso) used their resultant popularity to push through amendments permitting re-election. In Colombia, the tradition of alternating between Liberal and Conservative presidencies makes such an amendment less likely. Also, there is no hyperinflation to conquer; stopping the civil war might be the Colombian equivalent.

in which case the constitutional court decides (Article 167). Thus under normal circumstances the president faces some limits to his power (Archer and Shugart 1997).

Although the constitution and the party structure limit the president's power to push legislation through Congress, the president has considerable power to do things without them. The president can declare a 90-day state of internal upheaval (*conmoción interior*) with the approval of all of his cabinet, although to extend the declaration up to 270 days, he needs the approval of the Senate (Article 213). When there are (even) more serious disturbances or threats of disturbance to the economic, social, and ecological order of the country, the president can declare a 30-day state of emergency, with the approval of all the ministers, but not necessarily that of the Senate. There can be no more than 90 days of state of emergency in one calendar year (Article 215). The two provisions, if used to their maximum, would allow up to 360 days of executive rule by decree in a given year, although the Senate would need to approve half of that. Emergency powers were frequently used (and abused) before the 1991 constitution, especially the economic emergency clause. The new constitution strengthened the requirements for congressional approval, and since then use has been rare.

In the economic sphere and elsewhere, Congress delegates wide discretion in implementation and regulation to the executive branch or special agencies, like the Superintendency of Banks. Thus, although the president's power to change policy in lasting a way still depends on his ability to get Congress to enact legislation at least ex post to ratify his actions, condition 9 is met, especially through emergency powers and delegation to agencies.

Gubernatorial and mayoral power. If subnational governments can run unsustainable deficits or can refuse to cooperate in the national government's effort to control its deficits, then governors and mayors have the power to oppose the national executive. Colombian governors and mayors often have relatively strong democratic legitimacy, with a higher voter turnout rate than for congressional elections and sometimes even higher than for presidential elections, although voter

turnout is generally low at all levels of government (Colombia, Departamento de Planificación 1997). The elections for mayors and governors are held at different times and usually different years than the national elections, a pattern that typically leads to more autonomy from national politics.

The law does not give mayors and governors much power, however. The 1991 constitution says that “Colombia is a state *social de derecho* organized in the form of a unitary decentralized republic, with autonomy of its territorial entities” (Article 1), but the states do not have their own constitutions. The governors and mayors are constitutionally part of the executive branch of the nation’s government (Article 115). They have a duty to enforce national laws, as in Argentina. They are elected for terms of only three years and cannot succeed themselves, unlike in Argentina and Brazil, so they are lame ducks for even a greater fraction of their tenure than is the president.¹² Although the 1991 constitution is too young for all of its implications to be evident, the terms seem too short to encourage subnational governments to follow fiscal prudence or other policies with long-term payoff. The posts of mayor and governor are not enduring positions of power in themselves, in contrast to the Congress, where deputies and senators can be re-elected. Clientelism without major patrons (barons) has replaced the domination of the big electoral patrons in the pre-1991 system (Buenahora 1997).

The starkest form of federal executive control over the states is the power to intervene, in extreme cases to depose an elected governor and legislature and replace them with federal appointments. In Colombia, although the governors and mayors are no longer appointed from the center, the national government has at least as much constitutional authority to intervene as in Argentina, and much more than in Brazil.

¹² A 1994 law (Article 131/1994) made mayors and governors subject to recall by plebiscite if they fail to follow the platform on which they campaigned. It remains to be seen whether this law will play an active role in local politics, but it would seem to be at least one more obstacle to the buildup of personal power.

So, condition 10 is fulfilled in that the state executives are relatively weak, certainly weaker than in Brazil and also weaker than in Argentina. The incentives in a potential center-subnational confrontation differ greatly between Colombia and Argentina, however. Whereas many of the provincial governments in Argentina are well-established rivals to the center and command strong local loyalty, Colombian subnational governments are former outposts of the center. Their nascent independence is part of the national government executive's strategy to enhance the legitimacy of formal government in the face of challenges from guerrilla, para-military, and *narco-traficante* groups. Although the center might have the power to overwhelm its creations, exercising that power would undermine its own strategy. Intervention would also contravene the value of decentralization from a congressman's viewpoint, providing a way to move some power to execute spending programs out of the hands of the national executive and into the hands of locally elected offices that would be part of a congressman's patronage machine.

Congressional power as state representative. Congressional representation can also give state governments the power to challenge the national executive. Rules governing the election of congressional representatives in Colombia tend to undermine party discipline and reduce the likelihood that they will support national, as opposed to regional, interests. Under the 1991 constitution, representation in the Senate and House of Deputies is not organized according to departments or municipalities, although informally they usually seek votes in limited geographic areas that correspond to the subnational entities.

Congress is bicameral. The Senate has 100 members elected at-large with the country as a single district plus two elected by indigenous communities. Members of the House of Deputies are elected by department (or district in the case of the four municipalities with this status). Each department has a minimum of one deputy, plus one additional deputy for each 250,000 population. Senators and representatives serve four-year terms. Both are elected by proportional representation,

according to the formula of the highest residual, which encourages small parties and even candidates from the same party to campaign on separate lists. At the extreme, the Liberal party has put forth 134 lists (often with only one name) for 100 seats (Buenahora 1997).

In contrast to Argentina and Brazil, these terms give low-population areas little extra representation per capita in the House of Deputies and effectively under-represent them in the Senate. Because it is difficult for senatorial candidates to be known nationally (they only run once if successful), they target voters in a limited geographic area or sometimes a particular interest group. Efficient targeting focuses on high-density areas. In 1994, 12 of the 34 departments had no affiliated senator. Bogotá was the main source of votes for 25 senators, and another 22 came from Valle de Cauca (Cali), Antioquia (Medellín), Atlántico, and Santander (Buenahora 1997, pp. 334–37). An example of special-interest senators are those who were elected by focusing on teachers as a constituency. They were important protectors of the arrangement by which the national government negotiated wages and guaranteed the job security of teachers, even after department and municipal governments started paying the teachers. This electoral targeting was less successful in the 1998 election, however, opening some political scope for decentralization of personnel decisions regarding teachers.

The electoral rules are set partly in the constitution but also in ordinary law and in the rules of individual parties. The lack of party lists (versus local individual candidates) and the election of subnational candidates at separate times (often different years) than the national executive tend to weaken the influence of the national executive. Thus, condition 11 is not met in Colombia, because most features of congressional elections orient attention to local interests, rather than national ones.

Party discipline. The Colombian party system, closely linked to the electoral rules for the various levels and branches of government, weakens the power of the president and the political attention paid to national issues. In general, a president as party leader has more power when parties are disciplined, enabling him to compel support from the members of his party despite costs to

individual local constituencies. The contrast of Argentina and Brazil shows this (Dillinger and Webb 1998). Party concentration may also increase the power of the presidency by reducing the need to build coalitions. Although a unified opposition weakens the power of an individual president, having two coherent parties, each with a chance to occupy the presidency next time, can facilitate agreements on matters of national interest that transcend party lines.

Two parties, the Liberals and the Conservatives, have dominated Colombian politics for more than a century. Affiliation with one or the other is virtually hereditary, at least for those who associate with either (Buenahora 1997). The parties broke into open, armed conflict in the late nineteenth century and again in the 1950s. In 1958 they agreed to form an interim National Front, rotating the presidency every four years. This agreement lapsed in 1968 with the promulgation of a new constitution. In the competitive presidential elections since then, the party of the president has switched in about half of the elections.

The venue for armed political conflict, and serious policy differences, shifted to leftist guerrilla groups in the 1960s and 1970s and became increasingly complicated with the entry of *narco-traficantes* and right-wing paramilitary groups in subsequent decades. Nongovernmental military organizations continue to be a de facto part of the political system in the 1990s. They have considerable influence even in departments like Valle and Antioquia, where the traditional parties rule.

Although party affiliation is even more rigid in Colombia than in Argentina, this does not lead to strong internal party discipline. The automaticity of the revenue-sharing systems with subnational governments reduces the incentive for subnational politicians to assure that the president is a member of their party. Under the 1991 constitution, the open-list system of electing senators and congressmen, similar to the system in Brazil, gives no one leverage to exert party discipline from the electoral side, but the lack of discretionary budget in the hands of governors, unlike in Brazil or Argentina, also denies that avenue of party control.

Now that neither of the two major parties has national majority, the two-stage election procedure means that the president is effectively elected by a coalition, to whom he must promise policies or favors. This seems to encourage the growth of special-interest parties that can then gain concessions in exchange for support in the second round. The impossibility of re-election and the inability of a president to name his successor, as he can in Mexico, weakens the president's ability to discipline his own party. Successors are always openly organizing.

So condition 12 (party discipline) is not met at all in Colombia. Yet the absence of two political conditions does not make discipline in intergovernmental fiscal relations impossible. It does imply that such discipline would have to rely on the conditions that are present, namely the power of the national executive to act through delegation of power and the constitutional weakness of the subnational executives. As we saw earlier, this is indeed the case, so the political analysis offers an explanation of the current emphasis on technocratic solutions and indicates the potential danger if fiscal decentralization problems were to escalate to the political level.

Table 3 summarizes the conditions laid out above. The absence of conditions 1, 4, 6, 11, and 12 are drawbacks, especially 4 and 6. Condition 2 is problematic, as the narratives in the next section show, because of the asymmetry in the transfer rules as well as the exceptional transfers. The asymmetry is that national government shares almost all of its revenue sources, so it has difficulty raising revenue to maintain fiscal balance, but the departments get ad hoc transfers from the Special Compensation Fund and from debt bailouts. Many conditions for fiscal prudence are strongly present in Colombia, however, especially constraints on borrowing, and we shall see how well they operate to sustain fiscal balance.

**Table 3. Summary of Conditions for Reduced Danger
of Excess Fiscal Deficits and Their Status in Colombia after 1991**

<i>Condition</i>	<i>Status in Colombia</i>
1. Subnational governments raise much of their own revenue	No
2. Transfers are specified by legal formula, not ad hoc	Yes, with important exceptions
3. National government can effectively delegate functions to subnational governments to go along with the delegation of revenue sources	Yes
4. Subnational governments have authority to cut their costs	No
5. National government strictly controls subnational borrowing ex ante	Yes
6. National government credibly commits not to have bailouts, prohibiting explicit bailouts and forcing subnational governments to service their debt	No
7. Regulators force creditors to accept the losses implied by any failure to service debt	Yes
8. The central bank and bank regulators are more autonomous and has a strong anti-inflation mandate	Yes
9. The president is constitutionally strong at the national level	Yes
10. Governors have little constitutional autonomy	Yes
11. Electoral rules orient Congress toward national, not local, interests	No
12. Party discipline is strong	No

III. Fiscal Difficulties from Decentralization

To understand the effects of the features of the political system and of the system of fiscal decentralization, we need to look at the recent history. With decentralized government in the 1990s, Colombia has had to contend with the twin problems of national government deficits and subnational deficits that threaten to become debt problems of the national government. The problems and the efforts to solve them are still evolving, so the story has not reached a conclusion, but certain trends and the efficacy of some solutions are already evident. This section reviews the history of the two main problem areas and evaluates the effects of the presence or absence of the various conditions outlined above.

Imbalances at the center

Since the late 1980s, fiscal decentralization has proceeded alongside the growth of total government spending and of deficits. There is some relationship between the three phenomena, but most of the changes in the fiscal aggregates are independent of decentralization.¹³ See table 4. Total government spending grew at the same pace as gross domestic product (GDP) in the late 1980s and then grew more rapidly during the 1990s, increasing from around 12 percent of GDP in 1987/90 to almost 19 percent in 1997. Revenues, in contrast, only increased from 11 percent of GDP in 1987–90 to almost 14 percent in 1997. The national government's primary spending (net of interest and of transfers to the territorial governments and entities) has roughly doubled its share of GDP since the late 1980s, from 5 to 10 percent. The national government increased its own expenditures for the military, judges, and social security (to cover accrued liabilities not paid before). There was no reduction of national government outlays for administration, which should have occurred with the transfer of functions to the subnational levels, and the deficit of the national government grew from 1 percent of GDP to almost 5 percent. National government interest expenses grew from 1 to 2 percent of GDP. Transfers to territorial governments and enterprises expanded by less than 2 percent of GDP, and this accounts for only a third of the growth in national government outlays.

At the subnational levels, spending and deficits of departmental governments increased only 0.1 or 0.2 percent of GDP in the 1990s; municipal spending increased 2.3 percent of GDP. The municipal deficit rose by only 0.1 percent of GDP, but this would have been greater if the transfers from the national level and tax revenues (mostly shared taxes) had not also risen by about 1 percent of GDP each. Mostly the increase in transfers to subnational governments can be attributed to national government's objective of increasing the coverage of social services, especially rural health and education, and to salary increases negotiated by the national government. Although scheduled

increases in the municipal transfers will require further national government outlays, it is clear that the growth in the national government deficit in the 1990s was mainly due to its own spending, not to higher transfers to territorial governments (see also Bird and Fiszbein 1998).

Table 4. Government Fiscal Accounts at Three Levels, 1987–97

(percentage of GDP)								
<i>Level of government</i>	1987–90	1991	1992	1993	1994	1995	1996	1997
<i>National central government</i>								
Total revenue	10.9	12.1	12.7	13.5	15.2	13.2	13.5	13.9
Total spending	11.7	11.5	15.4	14.5	16.3	16.6	18.5	18.8
Primary spending ^a	5.1	4.8	6.4	7.0	8.3	8.5	10.1	10.5
Transfers to subnational governments and enterprises	5.5	5.4	7.7	5.9	6.8	6.5	6.3	6.0
Of which, current to subnational central Administrations	0.7	1.2	1.1	1.4	1.9	2.0		
Interest	1.0	1.2	1.3	1.5	1.2	1.6	2.1	2.3
Total surplus (deficit) ^b	-1.0	-0.7	-2.8	-1.3	0.6	-2.8	-4.9	-4.9
Primary balance	0.1	0.5	-1.5	0.3	1.7	-1.2	-2.8	-2.6
Domestic financing	1.4	0.8	3.6	0.5	-0.5	3.1		
External financing	-0.4	-0.1	-0.8	0.7	0.0	-0.3		
<i>Departmental central administration</i>								
Total revenue	1.8	1.8	1.8	1.9	1.8	2.0		
Total transfers to central administration	0.4	0.4	0.4	0.5	0.5	0.6		
Own revenue	1.4	1.4	1.4	1.4	1.4	1.4		
Total spending	1.9	2.0	1.9	2.2	2.1	2.1		
Primary spending ^a	1.8	1.8	1.8	2.1	1.9	1.9		
Interest	0.1	0.1	0.1	0.1	0.2	0.2		
Total surplus (deficit) ^b	-0.2	-0.2	-0.1	-0.4	-0.3	-0.1		
Primary balance	-0.1	-0.1	0.0	-0.3	-0.1	0.1		
Domestic financing	0.2	0.2	0.1	0.4	0.3	0.1		
<i>Municipal central administration</i>								
Total revenue	2.2	2.6	3.0	3.4	3.9	4.4		
Transfers (from national and departments)	0.9	1.2	1.5	1.8	1.8	2.1		
Own revenue	1.3	1.4	1.5	1.6	2.1	2.3		
Total spending	2.3	2.9	3.0	3.7	4.4	4.6		
Primary spending ^a	2.2	2.7	2.8	3.5	4.1	4.2		
Interest	0.1	0.2	0.2	0.2	0.3	0.4		
Total surplus (deficit) ^b	-0.1	-0.2	-0.1	-0.3	-0.5	-0.2		
Primary balance	0.0	0.0	0.1	0.0	-0.2	0.2		
Domestic financing	0.2	0.3	0.1	0.2	0.5	0.2		

a. Primary spending is net of interest and transfers to territories.

b. Balance after adjustment of transfers and inclusion of net lending.

Source: Central bank; Clavijo (1998); World Bank and International Monetary Fund staff estimates.

¹³ Fiscal data from various sources all show the same broad trends described here, although they differ in detail. The central bank's assemblage of data for 1987–95 is the best long-term series.

The larger of the transfer programs—the *situado fiscal*, which goes to departments—represents expenditures that the national government would have made anyway for education and health care. If the *situado* did not exist, the government would have made the expenditures directly.

Transfers to municipalities grew from less than 1 percent to more than 2 percent of GDP and are slated to keep growing until 2002. For the most part, they represent additional outlays, not merely a rerouting of what the national government would be spending anyway. As subnational expenses rose, those at the national level did not decline, even within the area of health and education, which was the main area of increase at the subnational levels. These additional expenses are being met by additional revenues or by cuts elsewhere.

The 1991 constitution (Articles 360–361) gave all mineral royalties (mostly oil) to subnational governments, and these revenues have grown to almost 1 percent of GDP (Colombia, Departamento Nacional de Planeación 1998). Most of the royalties go to the departments where the mineral originates and through which it is exported; the remainder go into a fund that is distributed among all the territorial governments. Although it is not usually counted as a transfer in the statistics, the assignment of mineral revenues to territorial governments amounted to an important step toward decentralization, but not a rational one in the opinion of most economists. They usually recommend assigning such revenues to the national level (McLure 1994; McLure and Mieszkowski 1983). In Colombia, the transfer of this revenue source was not accompanied by any corresponding transfer of spending responsibility, although the funds are loosely earmarked for investment. For the few territories that get most of the money, it is a great bonus; but most of the territories get so little from the Natural Resource Fund that it does not reduce their need for transfers from the center.

The transfers also complicated macro-fiscal management in more subtle ways. The (lower bounds on the) monthly transfers to the territorial governments are based on the budgeted figures, so within a given year they are a fixed charge, forcing all negative revenue shocks to be absorbed by borrowing or spending cuts at the national level.

Excessive subnational borrowing

The second macroeconomic concern in countries implementing decentralization is that elected mayors and governors will use their independence to borrow beyond their jurisdictions' capacity to repay. This raises the specter of defaults, followed by failures in the banking system and pressures for national government bailouts.

In Colombia the total debt stock of departments and municipalities actually declined as a share of GDP from 1991 to 1998, but several departments and municipalities nonetheless had debt crises. The decrease in total debt was all due to the amortization of external debt, much of which was due to multinationals for electrification projects in the 1980s, before the subnational governments had political or fiscal autonomy. Domestic debt of the subnational governments grew in the 1990s, especially to the banking sector (Perry and Huertas. 1997). Although the data are not complete, the debt to the domestic banking system increased from 2.6 percent of GDP in 1991 to 4.6 percent in 1997, according to estimates of the Superintendency of Banks.¹⁴ See table 5. Of this was debt, 30 percent was owed by territorial power companies to the National Electricity Fund (FEN) and was backed by electricity tariffs. Excluding this power-sector debt, in 1991 territorial bank debt totaled 1.8 percent of GDP; by 1997 it had increased to 3.2 percent. In addition to bank debt, several of the larger municipalities have outstanding bonds. Total bond debt (as of August 1997) was estimated at \$500 billion.

¹⁴ National government data imply somewhat lower debt levels, but following the same pattern. Subnational debt levels in Colombia compare favorably with provincial and state debt in 1997 of 6 and 12 percent of GDP in Argentina and Brazil, respectively.

Table 5. Stock of Territorial Governments' Debt to Banks, 1991-97

(billions of current pesos)

<i>Level of government</i>	1991	1992	1993	1994	1995	1996	1997
Departments							
Direct administration	56	73	154	330	422	665	966
Electricity sector	15	25	193	177	480	513	864
Other enterprises	124	135	160	201	170	134	106
Municipalities							
Direct administration	137	159	305	594	802	1,050	1574
Electricity sector	224	323	385	499	753	840	653
Other enterprises	142	183	187	257	336	556	757
Total	698	897	1,383	2,057	2,962	3,757	4,920
As a percentage of GDP	2.6	2.7	3.2	3.6	4.0	4.2	4.6
As a percentage of GDP, excluding the electricity sector	1.8	1.6	1.8	2.4	2.4	2.7	3.2

Source: Superintendencia Bancaria.

The imbalances were not distributed equally, and some municipalities and departments were in much worse shape than average. The subnational debt in Colombia has been problematic mainly because the departments have little discretion over their receipts or spending, most of which has to go for salaries. Neither the departments, the creditors, nor the Ministry of Finance took sufficient account of this inflexibility in their ex ante evaluations of ability to pay.

Most territorial borrowing in Colombia is from private banks. See table 6. They typically lend for short to medium terms, at variable rates of interest (pegged to the domestic cost of funds). Banks normally require territorial governments to pledge specific revenue sources as collateral. Some territorial governments have pledged *situado* or municipal transfers for this purpose, although of questionable legality, because these resources are earmarked. The increasing discretion (theoretically but not actually) in the use of *situado* resources and the increase in municipal transfers are said to be partly responsible for the increase in territorial borrowing during the mid-1990s. The surges of borrowing in 1993-94 and in 1996-98 correspond to periods of more lax banking supervision with respect to subnational debt.

There are no departmental or municipal banks in Colombia, unlike in Brazil and Argentina. Moreover, direct national government lending to subnational governments is small (except for the

quasi-public National Electric Fund). Government-owned banks accounted for about one-quarter of lending to territorial governments in 1997. Of the government banks, the largest lender to subnational was the Banco Popular, which was being privatized in the late 1990s. This situation has important advantages. The absence of territorial banks helps to prevent territorial governments from de-capitalizing the banking system, and the small extent of national government exposure to territorial debt reduces the pressure for politically motivated debt forgiveness.

Table 6. Major Lenders to Territorial Governments, 1997

(as of December 31 in billions of pesos)

<i>Lender</i>	<i>Loans to public sector^a</i>	<i>Percentage of total (excluding FEN)</i>
Public sector banks	2,697	25
Banco Cafetero	346	
Banco Popular ^b	482	
Banco del Estado	162	
Private sector banks	1,381	35
Banco Ganadero	539	
Banco de Colombia	420	
Banco de Bogotá	281	
Comercio Antioqueño	141	
Other intermediaries	1,582	40
Total	3,953	

a. In process of privatization.

b. Includes \$604 billion in national government debt to financial intermediaries, which could not be separated due to data constraints.

The predominance of private banks in lending to territorial governments meant that the national government was not heavily exposed to the threat of territorial default, in contrast to Brazil. Also, territorial borrowing has not been large enough to cause a general banking crisis that would require national government intervention. In 1997 the largest lender

to territorial governments, the Banco Ganadero, had only about 20 percent of its portfolio in the form of territorial debt, and this was broadly dispersed among many jurisdictions.

The government nevertheless has been concerned about territorial government debt and attempted to exert some control over it, as mentioned earlier. On the credit-supply side, the Superintendency of Banks imposed tight regulations in 1995, which slowed the growth of subnational debt in real terms (except to the electricity sector). This helped pressure subnational governments to accept the traffic-light law, which would require banks to provision against nonperforming territorial loans, even when they were backed by guarantees. In 1997, the first year

of transition to the new regime, subnational deficits increased somewhat, and in 1998 local debt crises began to test the new system.

The economic slowdown in the late 1990s slowed or reversed the real growth of tax revenues and transfers, and tight credit conditions pushed up interest costs, with the result that several large and medium-size departments found themselves unable to pay their debt obligations. In mid-1998 the departments of Valle de Cauca (around Cali) and Santander Norte were not servicing their debt and needed to reschedule with their banks and to agree to a fiscal adjustment program that would assure servicing of the rescheduled debt. Antioquia (Medellín) and Atlántico (Baranquilla) were expected to need rescheduling in 1999 and were waiting to see the outcome in Valle. In the late 1990s, Cuindamarca and the federal district of Bogotá are the only major entities with clear creditworthiness, since the federal bailout for Bogotá in 1991 for the purchase of buses. Most of the smaller municipalities and even small-population departments have not had the autonomy to get themselves into much debt trouble.

The resolution in Valle may set precedents, so the example has general interest. If such an agreement were not reached, the banking regulations would require 100 percent provisioning, which provided the banks with strong incentives to reach a deal. For at least two of the largest bank groups with loans to the subnational governments—Santander Bank (Spanish) and Sarmiento Group (Colombian)—this would have severely hurt their annual profit positions but would not have bankrupted them. For the departments, the incentive to settle was to assure continued access to short-term credit and eventually restore access to net new medium-term lending. Santander Bank led the negotiations with the department of Valle, and the agreement emerging in late 1998 received little financial help from the national government, or direct involvement by the Ministry of Finance, and reflected mainly commercial banking interests. The banks would offer concessions by rescheduling and forgiving some of the debt, in exchange for prepayment of some debt with the proceeds from privatization. The department had to increase its tax effort somewhat but did not

have to reduce expenditures significantly, because that would require laying off workers.¹⁵ The department would get a nominal green light in its debt rating, allowing the banks to avoid provisioning, but any future borrowing would be subject to approval by the consortium of banks. In effect it was the first syndicated loan in Colombia's domestic market.¹⁶ It represented a market solution to the subnational debt problem, which was clearly motivated by national government regulation but was not dictated in detail.

Did decentralization produce an unsustainable level of territorial debt? Not in the aggregate. But the new rules that make private banks bear much of the risk of lending to territorial governments are not a cause for complaisance. With elections to win, governors and mayors have a strong incentive to run up large personnel bills along with big debts. Although recent banking regulations make lending to territorial governments less attractive to banks, evidence from Brazil and Argentina suggests that banks will continue to lend to questionable borrowers if they believe that the national government can be persuaded to bail them out eventually. This has happened before, in Bogotá in the early 1990s and more recently in Medellín with the debt for the metro, and some governors might count on a repeat scenario. Whether territorial debt can be contained will therefore depend on the national government's resistance to such pressures.

IV. Conclusions

The processes of political and fiscal decentralization have proceeded quickly in Colombia. Consequently, large amounts of money and other important decisions are being handled with institutional arrangements that are relatively untested and lack strong reputations. Of course, there are some strong institutions at the national level, such as the Superintendency of Banks, the Central

¹⁵ The legally required exit packages for workers would have been expensive, averaging more than a year of salary, and the payoff to this investment was too long to be financially attractive at prevailing interest rates.

Bank, and the Ministry of Finance—meeting condition 8—and the extent to which they have been brought into the process is significant.

The fiscal problems of the national government in the 1990s mostly originated on the spending side for items not related to decentralization. The requirement to share virtually all revenues with the subnational governments meant that the national government could not balance the budget just by raising taxes, as Brazil and Argentina did. The continued increase in transfers to the municipalities, mandated by the 1991 constitution, exacerbated the problems of the center. This is the manifestation of the asymmetry of condition 2 in Colombia, in which formulas for transfers commit the national government more than they restrain the demands of subnational governments.

The national government responded in different ways to the two waves of subnational debt crises, showing a positive learning process. Both times the departments and cities had to take fiscal adjustment measures, but first time the national government financed most of the relief. The second time, the initial settlement (in Valle) suggests a pattern where the department and its creditors bear the cost of settlement – the political cost of adjustment for the governor and the financial cost of debt relief for the banker. Fiscal problems of the subnational territorial governments have arisen because most of them have such meager discretionary revenue that they could divert to debt service. The departments, although they appear to have a lot of resources with the *situación fiscal*, actually have few discretionary resources with which to service debt, because so much of their spending is tied to educational personnel whose number and salaries are not under their control—the absence of condition 4. Resources they borrow offer some discretion, but of course only temporarily, at the cost of less discretion later.

The lack of fiscal autonomy commensurate with their democratic mandate puts the departments in an awkward political position and reduces their incentive to raise revenue or control

¹⁶ Conversations with Pedro Nel Ospina, July and November 1998.

costs in the few areas where they have some autonomy. Although municipalities have more spending authority than departments, they too are bound by number of mandates and matching fund arrangements with the national government.

In order to control subnational indebtedness, the national government is now working through both the borrowing-demand and the credit-supply channels—meeting conditions 5 and 7. Although the traffic-light system of regulating subnational borrowing has technical flaws, regarding the definition of saving, it has the potential to work better than the more complex system in Brazil, because Colombia's national government has more control over local governments, at least the ones with large economies and populations, which could threaten the economic system if there were a collapse. But this alone probably would not be enough, for the incentives would still exist for territories and creditors to collude in over-lending, with expectations of a national government bailout.¹⁷

To address the incentives, the creditors need to face potential loss, even before a general fiscal collapse, and the threat of having to provision against loans to territories with a red or yellow rating meets condition 7. Also, the relation of fiscal adjustment and access to credit seems to be made appropriately explicit by the new requirement that banks negotiate the terms of the workout with the territorial governments. It remains to be seen how well this actually works, as it is scheduled to be enforced in 1999.

Having the subnational governments face the risk of being forced into harsh fiscal adjustment if they over-spend would seem to instill the right incentives for prudent borrowing, but the political weakness of local governments in the face of guerrilla and paramilitary groups limits the credibility of such threats by the national government. The impossibility for governors and

¹⁷ The governor or mayor with only the chance of one term might want to over-borrow even without the expectation of a bailout, but the creditor would not agree unless he thought he would get the money back from someone.

mayors to have second terms also reduces their incentive for fiscal prudence. So this constraint would not have as much effect as in Argentina. Thus, neither the supply-side nor the demand-side constraints on subnational borrowing appear adequate by themselves, and so the national government is using both.

The problems in managing fiscal decentralization in Colombia arose out of certain political decisions, and their resolution would require others. The constitutional convention of 1991, which made some key decisions for decentralization, was dominated by nontraditional parties that did not have access to power at the national level; even under the new constitution, they still have much less influence at the national than at the local level. It is not surprising, therefore, that they would write a constitution mandating automatic transfer of substantial resources to local levels. Congress has substantial leeway to amend the constitution, so the preservation of fiscal decentralization has required at least the tacit support of most Liberals and Conservatives in the Congress. For those incumbents, decentralization is also beneficial, as it gives more resources to the local governments and thus to patronage machines that are also linked to the congressmen.

Before the Constitution of 1991, the Congress had delegated a lot of power and authority to the executive, because of its own inability to act decisively (Archer and Shugart 1997). The 1991 constitution effectively transfers some of that delegation to the municipalities. It leaves the executive with extensive power to construct policy, with only the ex post approval of Congress, but the decentralization took control of the execution of a lot of spending away from the national executive and gave it to territorial governments. It is not clear whether this division of power, with the potential for a system of checks and balances, has put accountability and authority together in the right places.

Since most transfers go to the subnational entities automatically and the discretionary funding is distributed case-by-case, not on purely party lines, congressmen in Colombia have a weaker

incentive than in Argentina to put someone from their own party in the presidency. The president does not have much extra to offer loyal party members. Consequently, Colombia's president, unlike Argentina's, does not command much intrinsic party loyalty; he has to buy it each time, like in Brazil. Indeed there seems to be a vicious circle, with lack of party discipline leading to more personal patronage, which then makes it less advantageous and perhaps even disadvantageous for a legislator to vote the party line without question or compensation (Buenahora 1997; Archer and Shugart 1997). This suggests that in order to bolster the national executive, internal party discipline—strong in Argentina, but weak in Brazil and Colombia—is more important than stable party affiliation, which is as strong in Colombia as in Argentina. Those elected with the current system will have incentives to preserve it, of course, at least as long as a challenge from forces outside the system—an economic or political crisis—is not perceived to threaten their survival.

Some groups are still under-represented or left out of the official system at the national level, such as the nontraditional parties, or at all levels, such as the guerrilla groups. They might have an interest in bargaining their participation in exchange for structural reforms of the political system.

Despite weak party discipline and the orientation of congressional politics to local patronage, the national government traditionally has maintained macroeconomic stability by delegating policy decisions to competent ministries and agencies. But this strategy has run into difficulties as more fiscal policy is delegated to the territorial governments. For decentralization to be real, central agencies have to relinquish control in at least some substantive areas. The challenge is to choose the areas in which to maintain control without stifling the nascent subnational democracies.

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