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Department

Economic Observatory
Colombia

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Economic Analysis

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Public finances on path to orthodoxy
Reforms in fiscal policy aim to isolate it from economic cycle

- **New regulatory framework to make public spending more predictable**

With the constitutional reform on fiscal sustainability, the fiscal rule law, and the reform on royalties, it is hoped that the central government's fiscal balance will be strengthened. Reforms will check the excessive growth of public expenditure in boom periods and, in retrospect, would have avoided high fiscal uncertainty periods that made the country vulnerable to external shocks.

- **The new regulation will limit the structural deficit to 2.3% in 2014 and 1% on the long term.**

The fiscal rule establishes pluriannual restrictions on the size of the Central Government's fiscal deficit, with the objective of achieving a primary budget surplus from 2013. Likewise, qualitative and quantitative restrictions are established on the government's short and medium-term planning.

- **Rulemaking of the new framework should contribute to improving the transparency of public finances.**

Rulemaking of various matters already approved by Congress is still pending, including the definition of structural deficit, counter-cyclical expenditure, and exceptions to compliance to the fiscal rule when faced with external shocks. The specific legal measures will determine the effectiveness of the new regulation framework and should complete the advances made by Congress.

New regulatory framework

Colombia has recently modified its public finances regulatory framework. The Constitutional reform that establishes the principal of fiscal sustainability, the fiscal rule based on achieving a structural balance (i.e. adjusted for economic cycles), and the royalties reform, all seek to avoid pro-cyclical effects of public expenditure as well as to make the dynamics of the fiscal balance more predictable.

The fiscal sustainability reform raised to constitutional level the issue of correct Government's fiscal management. It also introduced the constitutional notion of Fiscal Impact Incident, through which, when faced with a legal sentence of significant fiscal impact, the attorney general or government ministers shall have the power to request a variation, modification, or deferral of the effects of the sentence to the highest courts, who will then hear the cases made and decide if the objections are valid.

The fiscal rule uses the structural balance as a reference and establishes pluriannual objectives to reduce the structural deficit of the nation. The law makes it mandatory to limit the structural deficit to 2.3% of GDP or less in 2014, 1.9% or less in 2018, and 1% or less in 2022 with the possibility, however, of a temporary suspension of the rule in case of extraordinary events jeopardizing the macro-economic stability of the country. The figure of counter-cyclical spending is also regulated, allowing it not be accounted for as part of the structural deficit of the nation, and authorized if the potential output is less than 2% of the long-term product but only if it is withdrawn within a maximum of two years.

The legislative act on royalties elevated to constitutional law the regulation and administration of such resources by territorial entities, making it possible to primarily focus them on science and technology, retirement savings, regional development projects, physical investments in education, public savings, and for the oversight of geological resources. Their administration will be also overseen by the Central Government.

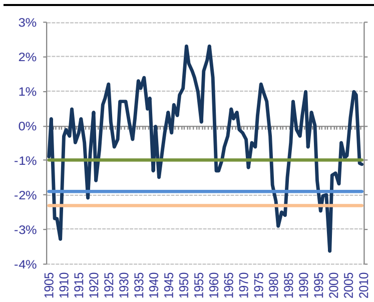
The new regulatory framework is joined by the advances of previous governments such as law 358 of 1997 and 617 of 2000 that limited operational expenditures and the indebtedness of regional entities to their repayment capacity, as well as law 819 of 2003 mandates the national government and regional entities to present a Medium-term Fiscal Framework to increase responsibility and transparency of the medium and long-term fiscal balance.

Fiscal regulation would have avoided high uncertainty fiscal episodes in the past

The principle of fiscal sustainability implies the elevation to a constitutional requirement the need for annual budget laws, appropriations, and the four-year development plan to be fiscally sustainable. Likewise, it introduces a new criterion that judges will be able to invoke in constitutional cases.

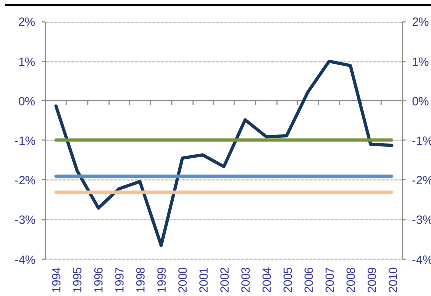
Although the definition of structural deficit within the fiscal rule has yet to be regulated, we hope that its definition will be a measure close to the primary budget balance. In this case, assuming that the 2.3% of GDP limit had been applied in the past on the primary budget deficit, it would have potentially restricted fiscal spending during the Turbay government in the early eighties (see Chart 1), as well as the excess in spending at the start of the 20th century following the accelerated infrastructure investment of President Reyes (1904-1909), or the nineties crisis with the accelerated increase in the size of the State under the Samper administration (1994-1998).

Chart 1
Primary Budget Balance of the central government and objectives of the fiscal rule: 1905-2010 (% GDP)



Source: Junguito and Rincón (2004), Ministry of Finance, and BBVA Research

Chart 2
Primary Budget Balance of the central government excluding mining and oil revenues, and objectives of the fiscal rule: 1994-2010 (% GDP)



Source: Ministry of Finance and BBVA Research

The limits of the fiscal rule now set for 2018 and 2022, would have limited vulnerability in some episodes in Colombian fiscal history. They would have limited the so-called "prosperity of debt" of 1921-1928 when conservative governments increased public expenditure, with most of the financing coming from external debt; they would have detained the fiscal consequences of law 81/60 of the

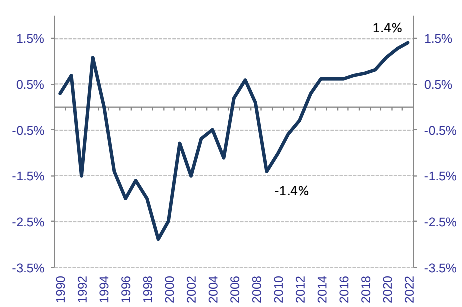
Lleras administration (1958-1962) which reduced income tax and provided incentives to "basic" industries; and it would have detained the deterioration of the tax burden in 1972. The law, with its clause on extraordinary events, could possibly have allowed fiscal deterioration after the Second World War or the deterioration seen in 2009 and 2010 in public finances after the world recession and the activation of counter-cyclical spending by the government.

With respect to Fiscal Impact Incidents, the current situation is that the postponing of the entry into vigor of a sentence is discretionary depending on the judge. For instance, the case of Sentence T-760 in 2008 with a statement by judge MJ Cepeda, who ordered the unification of the contributive and subsidized healthcare systems, but with a flexibility defined in consultation with the government with regard to establishing its entry into vigor. The new figure, on the other hand, would have allowed the government to vary or modify controversial sentences from the fiscal point of view, such as Sentences C-815 of 1999 and C-1433 of 2000 on the indexation of public sector salaries; or Sentence C-383 of 1999 on the re-liquidation of mortgage debts during the economic crisis of 1999; and other controversial sentences that have significantly affected public finances.

The new fiscal regulation aims to achieve a primary budget surplus in 2013, in turn saving the gains emanating from the mining and energy boom.

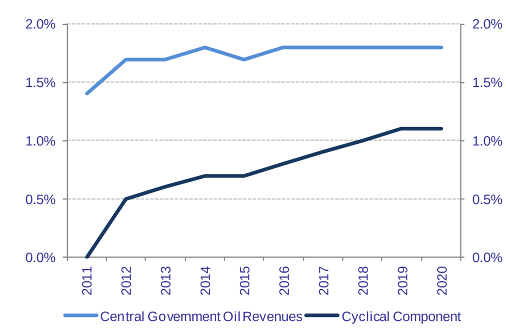
The Government estimates that the new institutional arrangement will make it possible to achieve a primary budget surplus of 1.4% as a proportion of GDP. This fiscal improvement is accompanied by the saving of the resources resulting from mining and energy, which are expected to be close to 1.7% of GDP, and which will be accounted for as counter-cyclical savings, and would be re-allocated when there is a reversal in the sector's boom.

Chart 3
Central government primary budget balance sheet: 1990-2022* (% GDP)



Source: Ministry of Finance and BBVA Research; *projections

Chart 4
Central government revenues from the mining and energy sector and their estimated cyclical component (% GDP)



Source: Ministry of Finance and BBVA Research

However, the Law on Royalties and the Fiscal Rule have yet to be followed by a rulemaking process, which leaves a residual uncertainty. Fiscal results over the coming years depend in great part in the way in which the distribution of royalties across regions and by investment type. Likewise, the fiscal rule requires a clearer definition of "counter-cyclical spending", as well as the accounts that would make up the "structural balance sheet", the way in which the output gap or the long-term growth will be estimated, and the compliance and transparency of the consulting committee that will supervise the application and development of the fiscal rule.

Rulemaking of the new law must improve transparency

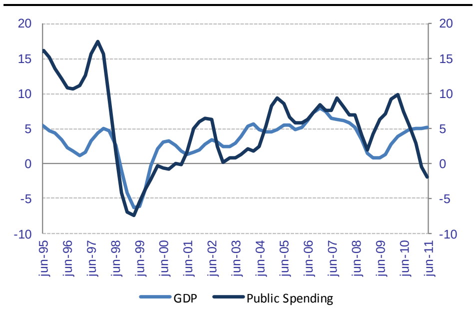
Rulemaking of the fiscal rule will be released by the Government over the coming months. We expect that it will require the Central Government to make public in a transparent manner the nation's detailed fiscal accounts, under a pre-established timetable. This information should be made available not only to the Fiscal Rule Consultation Committee but also to the public in general, which would permit permanent overseeing of its application.

The rulemaking must also clearly define accounting procedures for items under counter-cyclical spending and for the structural balance so as to avoid "creative accounting" on the part of governments in order to avoid compliance to the rule.

It is possible that the regulation of counter-cyclical spending will incentivize its more frequent use. In practice, spending in Colombia has been typically pro-cyclical, as happens in other economies of the region (Talvi and Végh, 2004); for instance, the correlation between quarterly GDP growth and public expenditure is 0.52 while the correlation between GDP and government consumption is 0.21, and that of GDP-public investment is 0.46 (see charts 5 and 6).

Chart 5

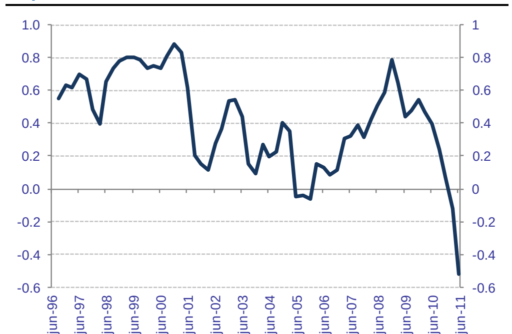
Quarterly growth of GDP and government expenditure (seasonally adjusted, % year-on-year variation)



Source: Ministry of Finance and BBVA Research

Chart 6

20-period moving average of the correlation between GDP growth and government expenditure 1996-2011



Source: Ministry of Finance and BBVA Research

Counter-cyclical spending, as it is not accounted for within the structural balance (which will be restricted by the fiscal rule), could incentivize governments to use it more frequently, in turn palliating the effects of economic cycles. Likewise, savings from royalties will make it possible to disburse them over time, avoiding the generation of undesirable episodes of Dutch disease or excessive domestic demand growth.

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