1 Introduction and Summary

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1.1 Introduction

Colombia faces a critical juncture in its recent history. One road leads to civil war, chaos, and economic collapse. The other leads to peace, reforms, and economic progress.

The need for institutional reforms in Colombia is self-evident. Violence, crime, and terrorism are rampant; the judicial system is incapable of effectively prosecuting crime. The parliament is fragmented; its members code to myriad lobbying pressures, and the economic stability of Colombia is threatened by this institutional shortcoming. Further decentralization has led to large fiscal imbalances and inefficiencies in the central/local government relationship. The budget process is chaotic and nontransparent. Improvements in the development of social services and poverty reduction programs are still lacking because of an inefficient use of limited resources. Monetary and financial stability require a firmer commitment to inflation control.

Although these problems are common to many developing and industrial countries, the combination of them all has led Colombia to the brink of collapse. This is tragic for the people of Colombia. However, for the outside observer and the student of institutional reforms, Colombia offers a fascinating case study of what can go wrong and how to try to fix it. This book can therefore be read with two purposes in mind. One is to learn about Colombia, her problems, struggle, and road to recovery. The other is as a case study to see how political economics can be used in practical circumstances for policy analysis and policy advice.

1.1.1 The "New" Political Economics

The common intellectual ground that underlies these essays is the new political economics framework. This is an exciting new area of research that has literally exploded in the last fifteen years at the borderline of economics, political science, and recently sociology. Many economists have started to realize that studying economic policy in a vacuum, without accounting for political constraints and institutions, can produce excellent normative models but not useful "positive" models. They discovered that giving policy advice in an institutional vacuum was rather pointless. Even for international organizations like the IMF or the World Bank, words like "political constants," "governance and corruption," and "institutional failure" have now become part of the common parlance and interest.

Political scientists were for the most part ready to welcome the interaction with economists and provided expertise on institutional issues and details and learned how to think in a more sophisticated way about economic variables. The result of this interaction is an exciting new field that is now in the mainstream of economics and political science. For instance, recent volumes by Alesina, Roubini, and Cohen (1997), Drazen (1999), and Persson and Tabellini (2000) have summarized this field, especially in its relation to the macroeconomic policy sphere.

An important insight that emerges from this body of work is that policy advice based on institution-free models is often irrelevant. For example, how does one advise a country to keep inflation low if its central bank is an agency of the treasury? It is clearly more useful to give advice about central bank independence than specific advice on inflation. This example is simple, but the logic is the same for complex phenomena. The point is that it is not enough to identify policy failures in a country; it is critical to understand *why* these failures occur.

In this respect Colombia is a fascinating case. It shares many common Latin American problems, political instability, corruption, and rural poverty. But in many other ways it is different. Colombia has had relative macroeconomic stability and the least unequally distributed income in the region. Juan Echavarria, in chapter 2, gives a summary of long-run and more recent economic developments in Colombia that deal with these similarities and differences.

From this intellectual base, we can look into the institutional problems of Colombia and aim to find potential solutions. We do not want to produce new theories. We want to be clear about what one can accomplish with institutional reform: individuals, not institutions, make policy decisions. No one should expect that institutional engineering alone can enforce good policies and achieve peace and progress. However, one can ask institutions to avoid creating obstacles for well-intentioned policy makers to achieve the desired good outcomes, and conversely, to create obstacles to corrupt, self-serving, and short-sighted policies.

1.1.2 Endogenous Institutions

A goal of this project is to suggest ideas that are politically feasible and require few legislative transaction costs. The formidable obstacles to this goal are the 1991 Colombian Constitution, which is very detailed, and the Constitutional Court, which has been very active in enforcing various constitutional articles. The consequence is that more than in other countries, even relatively small changes of economic institutions, or of economic policy, require a constitutional change.

But why was the Constitution written this way? As becomes clear below, the current Constitution was the result of complex bargaining forces that led to a document containing something for everyone. Further, since some groups did not trust others, extremely detailed prescriptions were added to ensure that the application of the Constitution would be strict.

The case of the 1991 constitution leads to a general observation. Institutions are not randomly assigned to countries; they are chosen by their citizens. Clearly, history matters, and one cannot engineer institutional reform in a laboratory without accounting for why certain institutions that malfunction were chosen. Recent academic research has started to tackle this problem.[1] But it is not the purpose of this volume to describe a history of Colombia and examine why and how this country got to the point where it is now. Nevertheless, some understanding of its history is critical if we are to formulate appropriate solutions.

Some readers may wonder whether issues like decentralization, electoral reforms, and monetary policy even matter in a country on the brink of a civil war and rampant violence. One could argue that until a détente is reached, there can be no talking about anything else. I believe that this is view is incorrect, for two reasons. One is that to the extent that terrorism and narcotraffic are viewed as a special case of crime and violence, how to deal with them is part of an important institutional question. In fact we have devoted chapter 5 to this problem. The second reason is that to the extent that some of the roots of the violence have to do with discontent about governance in Colombia, the pacification process will need to be accompanied by a vision of what will come after.

1.2 Organization of This Book

As I noted earlier, chapter 2 sets the stage for what follows with an overview of the recent economic history of Colombia. Unfortunately, this history is very much linked to the evolution of terrorism and the civil war, so much space has to be devoted to these topics.

The next eight chapters are organized in two parts, around political and economic issues. Maurice Kugler and Howard Rosenthal begin, in chapter 3, with a discussion of the role of the judicial system and the separation of powers. Their contribution is followed by Gérard Roland and Juan Gonzalo Zapata's discussion, chapter 4, of the electoral law and structure of parliament. Next, in chapter 5, Steven Levitt and Mauricio Rubio discuss crime prevention and the criminal justice system. With my colleagues Alberto Carrasquilla and Juan José Echavarría, we move to introduce in chapter 6 the issues surrounding economic institutions. We focus on those institutions that have to do with the bureaucracy and provision of social services, and on monetary and fiscal institutions. Ulpiano Ayala and Roberto Perotti, in chapter 7, discuss namely the central bank and the budget process. In chapter 8, George J. Borjas and Olga Lucía Acosta look at the reforms in education, and in chapter 9, Roberto Perotti, at social safety programs in the local/central government relationships. In chapter 10, with my colleagues Alberto Carrasquilla and Roberto Steiner, we raise some pending issues on the functioning of the central bank.

1.2.1 Political Institutions

A student of the political institutions of Colombia is immediately struck by several anomalies. Colombia has two parties that are virtually indistinguishable and often share government responsibilities, an extremely fragmented parliament composed of innumerable "lists" of candidates, a conflictual relationship between the executive and the parliament, and constitutional courts that are very active in applying and interpreting a very long, verbose, and interventionist Constitution.

For the most part the current political institutions were born in the 1991 Constitution. This document is very detailed, but it does not preclude interpretation by the courts. A particularly clear example is the article that prescribes "equal treatment" for all. This principle could be seen as a generic statement, but it has often been interpreted by the Court in an interventionist and proactive way that has interfered in economic matters better left for discretionary policy-making. The electoral system has made it easy for "local" lobbies to find a voice in the Parliament, and by a very small number of strategically placed votes to "buy" a seat. Finally, the relatively small ruling class of policy makers and technocrats in administrative positions raises critical issues of separation of power and checks and balances as well as representation.

Some of these institutional features are "old" and explain some "historical" features of Colombia, such as the difficulty in governability.

Others are new, like the 1991 Constitution, and are more directly responsible for the emergence of more recent problems, such as fiscal imbalances.

1.2.2 Checks and Balances

As Kugler and Rosenthal show in chapter 3, the 1991 Constitution has vastly changed the Colombian institutional structure. One of the goals of a constitution should be to create a system of institutional checks and balances that allows the executive to govern, while at the same time guaranteeing the rights of the minority and the rule of law. The 1991 Constitution indeed makes progress in this direction, but not enough. Colombia is still governed in a manner that is both unchecked and unbalanced.

The 1991 Constitution grew out of a negotiation to resolve internal conflict. It is a document of rigid micromanagement (e.g., it mandates indexation of pensions and sets specific targets for inflation and the allocation of regional public expenditures) rather than one that establishes basic institutions for democratic decision-making in a dynamic world. In addition the Constitution promises too much to too many citizens, as if Colombia could create the welfare state of an advanced industrial country. For instance, Chapter 2, Article 1, on economic, social and cultural rights creates high expectations for groups in society such as the handicapped, children, and senior citizens. But Colombia, with a per-capita income of less than 3,000 US dollars, cannot possibly emulate Sweden or Canada or even the United States. In contrast, the US Constitution asserts only that it seeks to "promote the general welfare," rather than making specific "promises" to various groups. Likewise an overemphasis on egalitarianism can be counterproductive. For example, Article 58, which permits uncompensated expropriation for reasons of "equity," can be a substantial deterrent to foreign investment.

These declarations about the rights to welfare and equality are not only words on paper. The Constitutional Court has often intervened in these matters with ruling about issues that, in other counties, are left to normal legislation. Furthermore the Constitution gives private individuals standing to contest legislation directly with the highest courts in the land. As a result almost all legislation potentially can be challenged in court. The Constitutional Court is free to pick and choose among the complaints, and often some laws are overturned on procedural grounds.

A second issue concerns the executive–legislative interaction. Often there has been tension between these two institutions. Because of its fragmentation, lack of party structure and clientelism, the legislature has often failed to be a channel of grassroots representation and a "check" on executive power. As discussed by Echavarría in chapter 2, the electoral system has contributed to this situation.

Partly as a result of the poor functioning of the legislature, the executive has enjoyed a large amount of discretion and often bypasses the legislature. This has been achieved by repeated declarations of a "state of emergency," a situation in which policy-making can be very centralized. In other words, the system of checks and balances between the legislature and the government does not work well. A combination of legislative action and court rulings often makes executive action ineffective. On the other hand, sometimes the executive reaction is to infringe on legislative responsibilities, at least temporarily.

Finally, it is worth noting that the institutional structure in Colombia has not been very stable. Since independence in 1810, there have been drastic constitutional changes in 1821, 1848, 1863, 1886, 1910, and 1991. There have been periods of two-party consensus, as in the National Front, as well as winner-take-all arrangements, with widespread redistribution of political control from the losing party to the winning party. Moreover there have been periods of military rule and also one-party dominance.

Proposals

Successful democracies have adopted very different institutional settings, and the same is true for less successful ones: the "ideal" institutional arrangement does not exist. There is trade-off between alternative goals that can be achieved by different institutions. In addition, it is often hard to predict precisely how these trade-offs may play out in practice in a specific case. Having said that, it is pretty clear that democratic institutions in Colombia do not work well enough and do not provide an appropriate system of checks and balances. The underlying motivation of the following proposals is to suggest improvement in the current system without revolutionizing it.

Proposals Concerning the Courts

- Make the hierarchy of decision-making across the three systems of courts (Constitutional Court, Supreme Court, and Council of State) extremely clear, such that decisions can be appealed upward in the hierarchy and that decisions of a higher court in the hierarchy are binding on courts lower in the hierarchy.
- A supermajority vote of seven of its nine members should be required for the Constitutional Court to overturn a law passed with the agreement of the president and Congress.

• Modify Article 253 of the Constitution to make members of the Constitutional Court, the Supreme Court, and the Council of State life appointees.
• Modify Articles 231 and 239 to have judges in the high courts nominated by the executive and confirmed by the Senate.

The motivation for these proposals is to make the constitutional courts more politically independent. At the same time, the second point makes it more difficult for the courts to be excessively proactive in economic matters.

Proposals Concerning the Executive–Legislative Interaction
• Modify Articles 154 and 163 to give the president "fast-track" powers to submit unamendable propositions for urgent matters of economic policy to the Congress.
• Eliminate nominal voting in Congress and make compulsory the publication of voting decisions by lawmakers and court magistrates, except on matters relating to organized crime.
• Revise Article 171 such that the size of the Senate is reduced from 102 to 51 members.
• Revise Article 176 such that the size of the Chamber of Representatives does not increase from its present size of 165.

These proposals, coupled with those discussed below on the electoral law, are intended in change the system in two ways. First, they empower the executive with a constitutional guarantee of having a "fast track." This can avoid the unchecked declarations of a "state of emergency." Second, the reduction in size and elimination of secret ballot in the legislature could help reduce the clientelism and fragmentation that is rampant in this institution. Reinforcing the party structure can also help reduce these problems. This is a main objective of the proposals for reforms of the electoral law discussed in the next section.

Referendum Process
• Private citizens collecting signatures of 5 percent of the electorate can initiate national referenda on legislation and constitutional changes. (At present, Article 375 allows citizens only to propose changes to Congress.)

1.2.3 Electoral Law and the Parliament

As Roland and Zapata show in chapter 4, Colombia's bicameral legislature is characterized by an extreme degree of fragmentation. Although only two parties exist, different lobby groups compete within each party, and as a result it is often difficult for the legislature to produce laws that pursue the general interest instead of a compromise between competing lobbies. To be fair, many legislatures have this problem, but the Colombian case has some peculiarities. In Colombia, parties do not have control over their party labels, and different lists can compete within the same party. However, the party organization can be made to control and find ways to discipline or control the activities and behavior of party members beholden to lobbists in the legislature.

The proliferation of lists both in the Chamber of Representatives (the House) and in the Senate and the ability of quite small groups to elect a representative follow from the electoral system. Colombia has an LR-(largest remainder) Hare system that works as follows. In each district, seat quotas are calculated by dividing the number of votes by the number of seats. Seats are first allocated to parties according to integer multiples of quotas. The remaining seats are then allocated in order of the largest remainders. In practice, this system has worked in such a way that most seats are allocated by largest remainders, instead of the quota, because of the fragmentation of lists. In fact the larger the number of lists, the lower is the number of votes necessary to win a seat.

The 1991 constitutional reform attempted to threat this problem by instituting a single national electoral district for the Senate. The purpose was (correctly) to encourage candidates to broaden their electoral platform and to rally voters in a nationwide fashion, based on national issues, and to "include" minorities scattered around the country. However, that reform was prone to fail from the start. In the 1991 election in the Senate, the first to be held nationwide, the number of lists decreased only slightly; then over 1994 and 1998 the number of lists steadily increased.

Senators learned quickly that the old clientelistic equilibrium could be replicated in the national district. No representation thresholds were put in place to discourage small lists and the LR-Hare system remains in place, encouraging fragmentation and election by largest remainders. The number of seats allocated by quota has steadily decreased, and in 1998 only 5 out of 100 senators were elected by quota. All the others were elected by remainder. The marginal price of a seat, calculated as the minimum remainder for which a seat was allocated, represents roughly only 40 percent of the number of votes specified by the quota and was lower in 1998 compared to 1991 and 1994. Instead of trying to gather votes across districts as initially intended by the reform, seats are gained mostly by getting regionally concentrated votes.

This fragmentation and the low "price" (in terms of votes) for a candidate to win have had two negative consequences. The first is a loss of legitimacy of many members of the House and of the Senate. The second is the emergence of a strained executive–legislative relationship. Due to the fragmentation in the legislature, the perception is that the only way to govern effectively is to "bypass" the legislature. While a strong executive is essential in a well-functioning democracy, and executive–legislature conflicts are common (even in the United States), the situation in Colombia has vastly deteriorated.

Proposals

The following proposals aim to reduce fragmentation in the legislature, increase party cohesion, and increase legitimacy. However, when thinking about electoral reforms, it is important to keep in mind "feasibility"—in two senses. One is in terms of transaction costs and history. For example, it would be some task to transform the US system into a parliamentary democracy given its tradition, history, and institutional forms. The second is that existing legislature would have to vote on a reform. Any electoral reform that would make current legislators unlikely to be reelected is likely to be defeated. The following proposals are relatively simple to implement but do have their important consequences.

Create a Two-Tiered District System

The idea is to keep the current electoral formula (LR-Hare) for the election of the lower chamber (House) but to shift the above-quota residual votes of local district lists to the national arena. Those residual votes would be pooled together by the national party with which the list is associated. National parties would have control over the order of candidates in the upper-tier district. In other words, seats not attributed by local quota would be allocated proportionally to the national district lists. A threshold rule—a percentage of the residuals—would determine what those national parties are.

The threshold limit is important. It is a way to avoid the failure of the 1991 Senate reform. Even relatively low quotas can create a strong incentive for local politicians to "group" and substantially reduce the number of parties represented in the House.

Besides the reform to the electoral system, some other reforms may improve the functioning of Congress and make parties more cohesive.

Move the Presidential Election before the Legislative Election, but in the Same Month
This reform should make the newly elected president less dependent on local barons, and allow the newly elected president to create a national "focal point" in the ensuing legislative elections.

Reduce a Host of Special Privileges to Congress
This is one of those changes that many legislatures can be expected to oppose, but it should increase legitimacy and voters' participation.

Introduce Automatic Registration of Voters
Any measure that increases voters' participation has the potential of reducing the extent of clientelism.

Better Define the Relationship between the House and the Senate
Currently the impression is that the two legislative bodies duplicate their functions. An extreme solution to this problem is to move to a unicameral system. This would be complicated, costly, and not likely to pass. An alternative is to define precisely legislative functions and divide the responsibilities.

1.2.4 The Judicial System and Crime Prevention

As Levitt and Rubio write in chapter 5, crime is a big problem and likely the major cause of all problems in Colombia. However, contrary to common belief, not every type of crime is uniformly high. Although the number of Colombians victimized by crime is high by international standards, the rate is not out of line compared with other Latin American countries. The important difference is the type of crime. The homicide rates in Colombia are about the highest in the world. It peaked in 1991, when almost one in a thousand Colombians was murdered that year. The homicide rate in Colombia is three times higher than in Brazil or Mexico, and ten times higher than in Argentina, Uruguay, or the United States. Since 1991 the homicide rate has substantially declined. Today the number of people killed every year is about 60 in a 100,000 compared to the 1991 rate. While the homicide rate is high by international standards, property crime rates are not.

What explanation can be found for the exceptionally high homicide rate? The first and obvious is the drug trade. There is overwhelming evidence that the drug trade encourages violence. Participants in the drug market, unable to legally enforce contracts and property rights, turn to violence and intimidation to accomplish these tasks. The illegality of drugs makes traditional forms of industrial competition like advertising and price cutting difficult. In addition the lawlessness of this sector erodes the recourse to law among those marginalized by the drug trade.

The period of sharply increasing homicides in the 1990s matches the time period in which the export market for cocaine rapidly expanded and drug cartels fought for control of markets. The two departments of the country with the highest rates are Valle and Antioquia, in which Cali and Medellin, respectively, are located. The homicide rates in these departments were four times higher than the rate in the median department over the 1990s. Another indication of the link between the drug market and homicides is that much of the drop in homicides since 1991 is due to reductions in Cali and Medellin, as a result of the dismantling of the traditional drug cartels.[2]

The second explanation is the lack of punishment of criminals. Although Colombia has one of the highest homicide rates in the world, it has the lowest punishment rates. In the United States, an arrest is made and the defendant is brought to trial in 65 percent of discovered murders, and a conviction occurs in more than half of these instances. In Colombia, investigations are made in only 38 percent of the homicides, and only 11 percent of these homicides leads to trials. Convictions occur in less than 7 percent of the homicides in Colombia, which is about one-seventh of the rate in the United States. Average sentence length for those convicted of murder in the United States is about twenty years, of which about one-third of the time is usually served. In Colombia, the average sentence length is fourteen years. There is no good information on the fraction of the sentence actually served. If one assumes that the fraction served is about one-third (which may be an overestimate), then combining the information on probability of conviction with average time served yields a calculation of the expected time served behind bars per murder. In the United States, this number is 3.8 years, compared to 0.32 years—less than four months—in Colombia. Thus effective punishment in Colombia seems to be less than one-tenth that of the United States.

The best empirical estimate of the responsiveness of crime to punishment is that a 10 percent increase in punishment lowers crime by 2 percent. If this estimate is correct, then raising Colombian punishment to US levels, which are similar to most European countries, would reduce Colombian crime rates by more than 50 percent. That would mean eliminating over 10,000 murders annually in Colombia.

A third factor often mentioned to explain homicides is the guerrilla activity. Actually the link between guerrilla activities and the homicide rate is weak. Looking across municipalities, areas with a guerrilla presence are no worse than the others, in terms of homicides. Those areas that did not have guerrillas in the early 1990s, but had guerrillas in 1997, have even seen great declines in homicides over the 1990s. Municipalities that never had guerrillas, or those that had guerillas both in early 1990s and in 1997, show smaller declines in homicides. On the contrary, there is, almost by definition, a very strong connection between guerrilla presence and kidnappings, the latter used to finance the former.

An additional explanation often given is that poverty and income inequality foster crime. This is not convincing. Concerning poverty, international evidence suggests that crime is actually higher in richer countries, even though this effect is due to higher reporting rates. As for income inequality, there is indeed a strong relationship between inequality and crime. However, income distribution is not especially unequal in Colombia relative to other Latin American countries. So the exceptionally high homicidal rate in Colombia cannot be explained by income inequality or poverty.

As the previous discussion suggests, the malfunctioning of the criminal justice system has a critical influence on the crime rate in Colombia. There is a large and growing discrepancy between crimes that citizens say they reported and those crimes officially recorded by the police. The number of crimes that citizens say they reported to the police rose substantially between 1985 and 1995, from 941 to 1,296 per 100,000. Official police records, however, show fewer crimes (661 per 100,000 in 1985) than citizens say they report. Moreover the official data actually show a 10 percent decline in crime between 1985 and 1994. There appears to be little relationship between official police records and victimization or citizen claims of reported crime. Police records include fewer than half of the crimes that citizens claim to have reported.

The investigation of crime is also very poor. A striking figure is that the percentage of reported crime investigated is about 40 percent for each type of crime. In most countries this percentage is much higher for more serious crime, like homicide or kidnapping. Colombian authorities shy away from investigating the most serious crimes. Crimes that are easy to solve are investigated; the others are not.

Proposals

Information Gathering

• Take away reporting/statistical duties from the agencies involved in the criminal procedures. This should include the police, the Fiscalia, the Juzgados, and the prisons.

• Maintain regular (every three years) victimization surveys for the whole country, and not just certain urban areas.
• Maintain a log of prison population. It should be possible to accurately determine the composition of prison population by type of crime committed or the actual time served by inmates.

Fight against Corruption
• Supervise externally corruption/infiltration investigation in the Fiscalia. Since the Fiscalia are the critical link in bringing criminals to justice, progress in fighting crime cannot be made until improvements are seen here. This is a basic preliminary step toward reducing what, to some people, looks like a Fiscalia-military confrontation.
• Investigate reports of corruption and purge the military of corrupted officials the same as was done with the police a few years ago, with some external supervision.

Investigation and Persecution
• Establish a separate task force to thwart kidnapping, made up of an elite group of fiscales who have proved themselves not corruptible. This group would devote 100 percent of their attention to investigating kidnapping incidents.
• Establish an elite task force to investigate every homicide that occurs. For a task force of 1,000 fiscales, there would be roughly 20 cases annually for each fiscal to investigate.
• Establish mandatory sentences for corrupted judges in order to deter judges from collusion with narcos or guerrillas.
• Guarantee the safety of judges and prosecutors. The government should provide twenty-four-hour protection to judges and prosecutors working on cases dealing with narcos or guerrillas. Extremely harsh mandatory sentences should be introduced for intimidation and retaliatory crimes against judges.
• Increase the share of the police, Fiscalia, and prison resources dedicated to violent crime, especially murder and kidnapping, even if this means withdrawing resources from property crime.
• Increase substantially Colombia's prison capacity. It would not be unreasonable to build enough prison cells to hold 100,000 prisoners (compared to the current prison capacity of 28,000 and actual prison population of 40,000). Even with a prison population of 100,000, the number of prisoners per crime committed will still be very low by international and even South American standards.

• Remove control of the prisons from prisoners. Steps must be taken to put the government and not the prisoners in charge.
• Separate prisoners according to the seriousness of their crimes. Guerrilla and paramilitary should be separated from the rest of the prisoners to avoid the rise of conflagration within prisons.

1.3 Economic Institutions

By Latin American standards, Colombia has traditionally enjoyed macroeconomic stability, avoiding hyperinflation and the very large deficits common to the region. With long periods of moderate inflation and a relative fiscal balance, Colombia is (or was) considered a model of macroeconomic management for Latin America. Recently, with the much improved macroeconomic situation in the region, Colombia is becoming a "problem case." The appearance of budget deficits and of financial fragility has led to IMF intervention and international concerns.

Macroeconomic stability is only one pillar for economic development. The others are good infrastructures, well-functioning markets, and efficient bureaucracies. In addition economic growth has to benefit the entire population, and not a minority. Poverty reduction and, as much as possible, equal opportunity for all have to be primary policy objectives. In fact income inequality is very high in many Latin American countries, so Colombia is not the worst case in this respect. However, in Colombia poverty reduction and better provision of social services remain a priority. There can be no trade-off between growth, poverty reduction, and macroeconomic stability. They are all part of the same virtuous circle. Growth and poverty reduction are also the critical ingredients to forging a peaceful society. In the next five chapters, we examine the institutional aspects of economic policy-making.

1.3.2 Decentralization and Fiscal Federalism

As Alesina, Carrasquilla, and Echavarria show in chapter 6, the interrelationships among the divisions of governments are a hotly debated issue in many countries and international organizations. Colombia has become by some measures the most decentralized Latin American country among the nonfederal types such as Argentina and Brazil. While the process of decentralization had started earlier, the 1991 Constitution has vastly accelerated the process. Tax collection remains centralized but spending is decentralized. This arrangement creates risks of fiscal imbalance, since the level of government that spends does not fully internalize the costs of its spending. However, in a country at the level of development of Colombia, many localities, especially in rural areas, lack the ability to efficiently collect revenues. Thus centralizing tax collection is a necessity. On the other hand, concentration of spending is rejected because localities should be able to allocate spending in ways closer to the population's needs and preferences. But given how little discretion localities have to allocate spending, it is not clear that this goal of the decentralization process has been reached. For example, about 80 percent of the fiscal allocation to departments and municipalities has to be spent on health and education. In addition teacher's salaries (which are 80 percent of total spending in education) are decided nationally, and localities have very little discretion. A good argument thus in favor of centralization of revenues is that it allows for the redistribution of the tax burden across localities.

The separation of taxation and spending between different levels of government has fueled serious fiscal imbalances. A large fraction of departments and municipalities has accumulated large debts and operating deficits, and as a result the central government has already intervened to bail out localities, with more bailouts to come. Certainly Colombia is not the only country with this problem. The fiscal deficits originating in the localities are an important issue for many industrial and developing countries in general and Latin America in particular. An additional problem stems from the fact that localities can borrow from banks, thus creating dangerous links between fiscal imbalances and the financial stability of the banking system.

Since the bulk of tax revenues is collected by the central government, an important and politically charged issue is the rules for allocation of tax revenues to departments and municipalities. The current rules are relatively complex (especially those for the municipalities). They take into account several parameters and indicators of relative income, the number of users of certain services, the composition of the population, and so on. These allocations leave no room for incentive schemes that can increase the fiscal responsibility of localities and their efficiency in the delivery of public services. In addition it is not clear how equitable these rules are.

Finally, the short horizons of mayors that cannot be reappointed for two consecutive terms make it difficult to implement long-term policies. Mayors have the incentive to spend, knowing that the tax burden is spread over the entire country and will be felt after they leave the office.

Proposals

The academic literature on fiscal federalism often suggests two general principles for enforcing fiscal responsibility and efficient use of resources by localities. One is to increase the ratio of local spending financed by taxes collected locally. The coincidence of taxation and spending for the same level of government obviously creates the "correct" incentives. The second is to link transfers from a higher level of government to the achievement of certain objectives, in terms of delivery of social services. In theory, these are two impeccable principles. In practice, their implementation in a middle-income country is highly problematic. For a start, many municipalities and departments (especially the poorest ones) lack the technical competence to raise revenues effectively. Second, problems with the measurement of efficiency in the "delivery" of social services are quite difficult, and are likely to foster corruption and arbitrariness.

For these reasons we shy away from making these two rather "radical" proposals, because of difficulties of implementation. Nevertheless, we do think that several significant changes are necessary and feasible.

Do Not Allow Local Borrowing

Departments and municipalities should not be allowed to borrow, either from the public by issuing bonds or from private or public financial institutions, domestic or foreign. The only way in which a department or municipality should be able to spend, in one year, more than its revenues (local taxes plus transfers from the central government) is to borrow from the following year's transfers from the central government. The government should set a limit (e.g., 5 percent of yearly transfers) for any borrowing against the following year's allocation and should have the right to refuse "lending" even within this limit.

The motivation of this proposal is self-evident. The inevitability of central government bailouts creates incorrect incentives if localities can borrow from the market. An important caveat concerns public investment. Large investment projects may require multi-year financing. If the preceding budget-balance rule left out investment, the main result would be a reclassification of many noninvestment spending items into investment. The discussion (see below) on the budget process makes it clear how that has happened at the central government level, and it is a common phenomenon internationally. Large investment projects, particularly those involving several departments and municipalities, should be financed and controlled by the central government.

Simplify of Allocation Rules

Since it is not feasible that localities raise their own revenues, a large fraction of fiscal transfers from the central government to the localities will continue to exist. The allocation rule for these flows must include some system of "weights" for different objectives. We do not want to choose these weights, for that is a political decision to be taken by the government and the legislature. However, we stress that the allocation rule has to be simple and transparent. These two features (clarity and transparency) will make it clear which weights are given to different objectives and will make it more difficult to achieve "political deals" behind the scene.

An ideal rule should achieve three goals: return to the localities a certain fraction of the tax revenues generated by the region (the remaining fraction is kept by the central government), generate some redistributive flow from richer to poorer regions, and allow for some reward for tax collection effort. We propose an allocation rule based on these three principles.

Allow More Flexibility in Spending Decisions

If one of the goals of the decentralization process is to make public spending better match the public's needs, increasing the freedom of choice of localities seem reasonable. A cynical observer might argue that the current arrangement allows localities to write "checks" but does not allow them to make any relevant policy decisions.

The increase in flexibility coupled with the balanced budget rule described above should not make the budget of localities less sound. In practice, this proposal implies reducing the shares of the budget allocated by law to certain uses, and increases the "discretionary" share. Even with more discretion, the bulk of local government spending will still be for health and education. See, however, the discussion of social services below (section 1.3.5), which suggests that these two sectors are overextended relative to other social services.

Clarify Spending Responsibilities

Spending responsibilities of different government levels of need to be better specified to avoid duplication, waste, mismanagement, and confusion. Lack of clarity often breeds corruption and rewards for individuals with better connections who can "navigate" the system. As we learn in chapter 6, the education sector is a prime example of this confusion. Currently the same school may be financed partly by the central government, partly by a department, and partly by a municipality. This creates confusion, duplications, and unfair allocation. It is imperative that spending responsibilities be redesigned in a coherent way. More discussion of this issue appears in chapter 8.

Allow Reelection of Mayors for Two Consecutive Terms of Four Years Each

The current combination of a very short electoral cycle (three years) and the "one-term" rule gives mayors an exceptionally short horizon. The proposed change is more in line with international standards. It creates a sufficiently long political horizon for mayors and, at the same time, it avoids the excessively long tenures in office that can foster entrenched interests and "local connections."

1.3.3 Budget Institutions

Ayala and Perotti deal with the budget process in chapter 7. Budget institutions are all the laws and regulations under which budgets are drafted by the government, approved by the legislature, and then implemented by the bureaucracy. Before proceeding, let us state clearly that there is little defense, procedural or otherwise, against a government that is determined to run a "bad" fiscal policy without opposition from Congress. Nevertheless, a well-structured budget process can fulfill an important role in fiscal policy.

The rules governing the formation and dissemination of information on fiscal policy should achieve as least three goals:

- "Good" fiscal policy run in a transparent manner.
- Fiscal policy that does not get out of control in the presence of shocks of moderate to large dimensions.
- Fiscal policy projections that can be understood by persons with moderate knowledge of economics and accounting and are compared with performance in previous years.

The last condition is the most important. Since there is no enforcement mechanism that can prevent a government from running a "bad" fiscal policy, only the market and public opinion can exert pressure on the government. Thus the public should have a clear and transparent view of the fiscal policy run by the government. In Colombia, however, the preparation, discussion, and implementation of the budget are not transparent. As a result the average citizen, journalist, or trained economist has a hard time understanding the budgetary documents. In recent years, international organizations have put a lot of emphasis on improving transparency, but Colombia has a long way to go.

Several factors contribute to the lack of transparency. The first is the multiplicity of budget documents. Several budget documents could be useful if they had clearly differentiated functions, allowing one to go from one document to the other. Technically, by Article 13 of EOP, the budget must be consistent with the Plan Nacional de Desarrollo, the Plan Nacional de Inversiones, the Plan Financiero, and the Plan Operativo Annual de Inversiones. A careful examination of these documents reveals, however, that the requirement of consistency is often circumvented de facto, and in some places even de iure. The proliferation of documents, which includes multi-year horizons with a very loose enforcement of consistency, makes it fairly easy to find something for everyone in the budget. Therefore, although the Colombian Constitution provides the finance minister with a strong role in the preparation of the budget, the agencies of these documents tend to obfuscate and reduce his role.

The second is the definition and classification of investment spending. Investment is a magic word in the Colombian budget plan (and it becomes even more magical when combined with "social"). This is largely a reflection of the emphasis on planning, of which investment is the key instrument, and of the populist bent of the 1991 Constitution. The assumption underlying all the budget documents is that only investment has any social value—all other expenditures are necessary evils. This, together with the prohibition on cutting the share of social investment spending in the budget, is an open invitation to a very liberal view of investment, one that is at odds with any conventional usage of the term in the macroeconomic and accounting professions. The Manual de Programacion de la Inversion Publica of DNP gives such a loose definition of investment that very little exists that cannot fit into it. Thus the most important process in the budget becomes extremely difficult to interpret.

The third source of lack of transparency is the frequent use of nonstandard accounting practices. Particularly troublesome is the inclusion of gross debt issues (both amortization and new) and of proceeds from asset sales and amortization as a *recurso de captial* (Article 31 of EOP), and hence above the line. That is, the structure of the budget presentation is:

$$\begin{aligned}\text{Revenue} = {} & \text{Current revenues} + \text{New emission of debt}\\ & + \text{Proceeds for asset sales and privatization}\\ & + \text{Other capital spending} + \text{Other revenues}\end{aligned}$$

$$\text{Spending} = \text{Current spending} + \text{Capital spending} \\ + \text{Interest} + \text{Amortization of debt}$$

This classification hides the deficit. The more proper, common definition of the deficit is (see IMF 1999): New emission of debt – Amortization of existing debt + Proceeds from asset sales and privatization (+ Some quasi-fiscal operations of limited size). Without a long and detailed analysis of both the revenue and spending sides of the budget, it is impossible to form an idea of the deficit. Thus it is difficult to assess the budget.

A fourth source of lack of transparency is the incomplete coverage of the budget. Ideally the budget should cover the entire public sector, as prescribed by international standards (e.g., those enforced, by the OECD). This is far from what happens in Colombia. Particularly troublesome is that not even the entire amounts of public pensions are covered in the budget.

A final two sources of confusion have to do with imperfect macroeconomic forecasts and with the intertemporal links between budgets (i.e., arrears). Most governments have a tendency to manipulate forecasts to "predict" the best fiscal outcome with the minimum effort. For instance, GNP growth has been systematically overpredicted in the nineties. The treatment of the "quite large" areas needs to be improved.

Besides the lack of transparency, a second big problem in the Colombian budget process has been the excessive emphasis on planning. The fact that a market economy chooses to name an important and powerful agency the "Planning Department" is quite telling. There are several reasons why the emphasis on planning is counterproductive. First, the Planning Department (DNP) itself is a hodgepodge of good intentions, to which virtually all institutions and interest groups in the country contribute with their own preferred investment projects. According to the Constitution, the DNP is elaborated by the government with the "active participation of the planning authorities, the territorial entities, and the government with the Consejo Superior de la Judicatura." The draft plan must be submitted to the Consejo Nacional de Planeacion, which is formed by "representatives of the territorial entities, and the economic, social, ecological, community, and cultural sectors" (Article 320 of Constitution). In addition one must add the Departmental Consejos de Planeacion, each of which elaborates its own Plan de Desarrollo. The separation of investment from the budget, controlled by the DNP, and the rest of the budget contributes to the budget's decentralization.

Proposals

Reduce the Number and Consolidate Budget Documents
The entire budgetary process could consist of just one document. At the moment among the documents there are large differences between the semi-accrual figures of the budget and the cash figures imposed by reality (it would not be realistic to impose a move to an exclusively accrual or cash basis). Hence two documents are required: the budget and a finance plan. The two documents should have exactly the same structure and should provide a table of reconciliation. The development plan should be eliminated.

Adopt Accounting Standards in Line with International Practice, as Prescribed by IMF
The accounting standards of the budget should be subjected to an "auditing," especially in the transitional period, by internationally respected private firms.

Broaden the Budget's Coverage as Much as Possible
The Colombian budget does not provide a complete picture of the central government. It covers only a fraction of public pensions; it should cover them all. Further all the territorial entities should be included as well as the rest of the nonfinancial public sector. There are obvious legal obstacles to overcome.

Outsource the Government Forecasting Operation to Internationally Reputable Private Companies

Extend Budget to Deal with Appropriations That Must Straddle Fiscal Years
In recent years information on arrears has created considerable problems for the management of fiscal policy. Improvements in accounting may help. The IMF Code of Good Practice on Fiscal Transparency provides accounting procedures that improve transparency and control arrears. Such data do not result from simple cash accounting and must be supplemented with modified accrual statements, such as developed by the International Federation of Accountants, IFAC.

1.3.4 Bureaucracy, Civil Servants, and Teachers
As Acosta and Borjas write in chapter 8, public spending in Colombia places a great emphasis on education. Teachers are the largest group

of public employees; currently in Colombia there are about 310,000 teachers, equal to 26 percent of the total number of public employees. The public sector spends about 4.5 percent of GDP on education and about 70 percent of all teachers are in the public sector.

Despite the emphasis of public spending on teachers, several problems negatively influence the outcome of the education sector. The first is the confusion and overlap that exist between different government levels. The reorganization of the education system was developed in the context of a general decentralization of public administration. However, there has been confusion about which level of government is best suited to administer the public education system. Law 29 of 1989 favored the municipalization of public education, but the 1991 Constitution emphasized the role of the departmental level. Similarly Law 60 of 1993, which regulates the system of transfers of central funds to departments and municipalities, enhances the role of municipalities in the administration of public funds for education. In contrast, Law 115 of 1994, the General Education Law, responded to pressure from the teachers' union and assigned a greater role to the departments. As a result there are three types of public school teachers in Colombia: those funded by the central government, those funded by departmental governments, and those funded by municipalities.

The second problem is that teachers, thanks to their powerful union, are an overly protected category that, by and large, receives a very favorable treatment both in terms of salaries and, especially, in terms of pensions. Note that the favorable position of teachers within the public sector is in addition to the favorable treatment (by international standards) of public sector employees. Colombia has the highest public sector wage premium among Latin American countries.

The current regulations of the teaching profession in Colombia originated in an education statute (Estatuto Docente) promulgated in 1979. The statute specifies the norms that regulate the recruitment, labor stability, promotion, and retirement of teachers. The statute, and particularly the way it has been administered, has introduced several inefficiencies into public education:

- *Too much centralization.* Teacher salaries are set by the central government, with little input from the regional government agencies that end up paying the bill.
- *Inefficient appointment process.* The departments and the municipalities can create temporary teaching positions. The provisions of the Estatuto Docente imply that these short-term positions eventually become

permanent positions, putting additional pressure on the central government to increase its monetary transfers.

• *Ineffective disciplinary regime.* The directives (rectors) do not exercise any disciplinary control over the teachers. The Estatuto Docente orders that promotions be determined internally within the magistery, using a set of rules that are not always related to teaching activities.

The pension system of teachers is very generous in comparison with other categories. First, public teachers do not have to contribute to the funding of the system in order to receive a pension. Most nonteachers contribute 25 percent (13.5 percent is obligatory). Second, teachers qualify to receive the special pension (pension de gracia) at 50 years of age. Under the pay-as-you-go system set up by Law 100 of 1993 for nonteachers, the retirement age is 55 for women and 60 for men. Third, a different base salary is used to calculate the pension for teachers and nonteachers. The special pension is based on the basic monthly salary that the teacher had at the time of retirement, including bonuses and other benefits. In addition the teacher's retirement pension is based on the average salary of the last year employed. In contrast, the pension benefits for nonteachers are based on the average salary in the last 10 years of the entire career if more than 1,250 weeks have been contributed. Finally, the pension regime grants teachers the right to receive several of these pensions simultaneously.

A third problem concerns the geographical distribution and allocation of teachers. The centralized setting of wages makes it difficult to let wages adjust to needs. In addition teachers have a very low degree of mobility compared to other workers, in part because they are, on average, an older work force to retrain.

During the 1990s Colombia implemented major reforms in the education sector and substantially increased the amount of resources invested (from 3.1 percent of GDP in 1991 to 4.5 percent in 1997). What has been the outcome in terms of quantity and quality of education? It is still too early for a clear answer: the returns on human capital investment take decades to fully materialize in terms of more productivity and growth. Thus it may be premature to judge this effort, but the initial results are mixed. Enrollment ratios in primary school have increased substantially in the nineties, even though they were increasing before. Enrollment ratios in secondary schools have increased much less.

Measuring the quality of education is very difficult. The available international evidence suggests that Colombia ranks relatively poorly, but not extremely poorly, in terms of test scores, if compared with other countries with a similar level of development. There is some evidence that

Colombia's results on these standardized tests have slightly improved in the 1990s. Whether or not the large investment in education in the nineties has paid off remains to be seen. However, too much of this effort has been devoted to increasing the salaries and pensions for teachers, a group that was already relatively privileged.[3]

Some specific reform initiatives seem to have had much success. One is the Escuela Nueva Program, adopted in the rural sector. Under this program teachers have much greater flexibility in making their decisions regarding the curriculum. Classroom instruction is also more targeted to the needs of different students and practical problem solving, so that the interests of students are more engaged. Parents are encouraged to become involved through participation in after school activities. It may be useful to discover if this type of program can be expanded to Colombia's urban public schools.

Proposals

Hiring and Salary Decisions Should Be Made by the Same Government Jurisdiction

This simple adjustment would compel those who hire the teacher to pay attention to the cost of the decision. Also those who set teacher salaries would have to pay more attention to the factors that determine the number and qualifications of teachers employed.

Cost of Living Should Figure in Pay Differences across Regions

In general, the policy of a uniform wage should be abandoned to give localities flexibility in teacher salaries.

Generous Teachers' Pensions Should Be Brought in Line with Other Categories of Workers

In the context of a broader pension reform, reforming the pension treatment of teachers should receive the highest priority.

Experiments Like the Escuela Nueva Should Be Supported by Grants

Teacher Salaries Should Reflect the Results of Performance Evaluations

A system of teachers' performance evaluation should be introduced.

1.3.5 Provision of Social Services

As Perotti shows in chapter 9, social spending and the delivery of social services should have priority over any other spending. But what is "social" expenditure? By Article 41 of the Estatuto Organico de Presupuesto, public social spending is "any expenditure whose objective is the satisfaction of unsatisfied basic needs in health, education, environment, drinkable water, housing, and those aiming at the general well-being and the improvement of the quality of life of the population." Thus Colombia combines a very loose definition of social expenditure with a very strong constitutional mandate to protect it. The result inevitably is confusion.

A standard classification of social security services distinguishes among social services (e.g., education and health), social insurance (e.g., old age and invalid pensions and unemployment insurance), and social assistance (e.g., cash transfers to the poor, family assistance benefits, maternity benefits, in kind transfers, and employment generating programs). Most industrialized countries have built their social protection systems around social insurance, leaving social assistance to pick up the uninsured individuals who fall through the cracks and to subsidize large families and maternal leaves.

There are three reasons why Latin American countries cannot aspire to the same structure of social protection. First, they can rely only on much smaller revenues. Second, because of the widespread rates of informal work and other technical problems, it is difficult to keep track of the work and contributory history of individuals; in any case, few workers would have unbroken records of contributions. Third, for many poor individuals, it makes sense to stay out of an insurance system, even if subsidized: poor individuals have much shorter life expectancies, and they put a high premium on liquidity. On the other hand, the experience of industrialized and developing countries alike has shown that universal, untargeted social assistance programs can quickly become very costly, and thus they are too costly for Colombia.

This leaves two more options: targeted social assistance, or social service spending. So far Colombia has clearly chosen the latter, devoting a large fraction of its efforts to health and education.[4]

One of the main arguments of chapter 9 is that given Colombia's limited fiscal resources, the emphasis on health and education has left out large pockets of extreme rural poverty. Since it is hard to think of social objectives that do not include the welfare of the extremely poor, this calls for a restructuring of social spending. More effort should be devoted to targeted social assistance programs.

As for the question of how to target, several considerations are important. The same objectives in terms of poverty reduction are achieved more cheaply: (1) by targeting the very poor, (2) by reducing overlaps between programs, (3) by achieving organizational simplicity, and (4) by a proper account of long-run sustainability (the long-run costs of a program may be much higher than the initial costs, as membership increases toward a steady state).

Finally, a word on "community involvement" as a targeting device. This approach has been very influential in Colombia and in other Latin American countries. It has taken various forms, wherein local residents initiate and even control the implementation of certain local services (e.g., child care centers in Colombia), they present the menu of projects for employment and housing programs, and they help locate the beneficiaries of targeted programs. Unfortunately, programs relying heavily on community involvement rarely reach the very poor. The very poor are exactly those that, for a variety of reasons, do not have the ability or the incentives to participate in the community initiatives. For instance, they do not have the financial means and the technical skills required to develop projects for local public employment programs, nor do they have the human capital to participate effectively in local debates and assemblies.

How effective has social spending been in Colombia? Most statistical sources about poverty agree that poverty has been declining in the 1990s, after a peak in 1991 to 1992. Some sources (probably the most reliable) indicate that poverty reduction is only an urban phenomenon, and that rural poverty is increasing. According to these sources, Colombia has one of the most skewed urban–rural poverty distributions of Latin America. Other sources indicate a more uniform distribution of poverty. However, even with these imperfect data, it is almost certain that better results in poverty reduction can be achieved by more targeting of the rural areas.

Proposals

The task of examining shortcomings and making proposals for the entire social service sector is enormous. Nevertheless, in chapter 9 Perotti manages to touch a remarkable number of issues with great care. This summary only touches briefly on some of the issues he addresses.

Policies for the Elderly and the Disabled

The distributional flows implied by the current system are very generous but have a very low coverage rate. Only about 2 percent of the population receives a pension, or 30 percent of the population over 60. The average pensions are very high, about twice the GDP per capita. The pension system is based on three pillars: The first is the state-run defined benefit pension scheme (or Prima Media). The second is the private sector, defined contribution system of AFP's, Chilean-style. In contrast to other countries, like Argentina, these two pillars are mutually exclusive for an individual. Together they make up the "social insurance" component of the policies for the elderly. The third pillar is a purely redistributive scheme for the elderly poor that are not entitled to a social insurance pension. At present, this pillar is represented by a small program, Revivir, and by many small programs run by municipalities. This is the "social assistance" component of the policies for the elderly.

The Prima Media has implied redistributive flows toward the relatively well-off workers in the formal sector. Also many benefits are redistributed to civil servants (especially to teachers, as discussed above). The system includes very little targeting of the very poor. Within the pension system, two programs target the very poor: the minimum pension guarantee and the Fondo de Solidaridad Pensional. Both are quite small and suffer from problems of low membership, especially in rural areas. Administrative problems also have vastly undermined the efficacy of the system and even the collection of information about the system. Outside of the main pension system, the Revivir program established in 1993 is directed toward the indigent elderly, as identified by municipalities. Once again, very low membership and administrative shortcomings are serious problems.

In summary, the key problem of the current pension system is clear: it spends too much on too few people. Resources should be moved away from relatively privileged groups (civil servants, relatively well off elderly members of the formal labor market) to the very poor, including those teachers in rural areas.

Policies for Families and Children

At present, policies for families and children are run mostly by ICBF, a central government agency with a total 1998 budget equal to about 0.5 percent of GDP (0.6 percent with municipal participation) and funded with the proceeds of a 3 percent payroll tax. A few programs are run by the RED de Solidaridad Social, often in coordination with ICBF. The present system contains elements of several different programs:

- Day care
- Food distribution and nutrition help
- Feeding children at school
- Help for mothers who are heads of families
- Preventive and health care

- In-kind support for children of school age
- Various programs for adolescents and minors

As for child care, there are three programs: CAIP, the older one; HCB; and Jardines Comunitarios de Bienestar. In 1997 CAIP represented 12.5 percent of all spending by ICBF, HCB 41 percent, and Jardines Comunitarios a small 0.1 percent.

One distinctive feature of the HCBs is the community involvement. A "community mother" (a person with no special qualification) is chosen by the community to be a child care provider. Because existing data are poor, it is very difficult to evaluate the cost effectiveness of the two HCB programs. The available, imperfect, information shows that HCBs are heavily used in rural areas where there are also indications of high unmet demand. The educational functions of HCB are extremely limited, and the quality of care provided is inferior to that of CAIP. There are concerns about the effectiveness of ICBF programs for children aged 0 to 2. It seems that the HCBs are more costly and, therefore, the policy of promoting HCDs over CAIP may be misguided.

Employment and Unemployment Policies

Colombia does not have formal unemployment insurance. Because of the high rate of informal employment and the difficulties in keeping individual work-history records, a formal, well working unemployment insurance system is virtually impossible in a country like Colombia. In fact few Latin American countries have unemployment insurance, and where one exists it is almost invariably limited to very few individuals (e.g., to little more than 100,000 in Argentina).

Unemployment in Colombia is highly concentrated among youth: the unemployment rate among individuals in the 18 to 24 age group is 25.7 percent, compared to 6 percent in the 50 to 59 group. Training programs tend to be most effective in situations where there is a high rate of youth unemployment. The training of displaced adult workers rarely provides them with the skills necessary to return to the labor market, while short training programs might be adequate to provide young adults entering the labor force with job search skills.

Training in Colombia is the realm of SENA, the state training agencies patterned after Brazil's SENAI. SENA is a large organization, with a 1998 budget equal to about 0.3 percent of GDP. It provides training both for youths entering the labor force and for displaced workers. The available evidence on this program raises serious questions. The SENA training is highly geared toward the upper quintiles. This is not just a reflection of the fact that it is mostly an urban program: even among urban individuals, the poor enroll in SENA less frequently than the nonpoor. There is also a growing consensus that SENA, like most training agencies in Latin America, is a highly rigid institution, very reluctant to change and to adapt to the changing labor market.

Colombia has had a limited experience with employment generation programs in the recent past, in the form of two programs administered by the RED: one for urban areas and one for rural areas. The urban employment program (*Empleo Urbano*)[5] is one of the few RED programs that has been the object of some quantitative evaluation. A striking characteristic of this program is the extremely high wages it paid: in infrastructure projects, on average in 1997 it paid about 170 percent of the wage offered in the private construction sector; in services, it was about 150 percent of the wage offered in the "communal service" sector.

1.3.6 The Central Bank

As Alesina, Carrasquilla, and Steiner show in chapter 10, a widely accepted view in both the OECD and developing countries is that an independent central bank is conducive to a stable monetary policy. If a government (and in particular, a treasury) has day-to-day influence over monetary policy, the temptation will be strong to use monetary instruments to finance government deficits and overstimulate the economy for short-term benefits (or to be "weak" in inflation fighting) at the cost of long-term stability and growth. Central bank independence is insured by an arm's-length relationship between government officers and central bankers, appropriate appointment procedures for officers of the central bank, and a clear mandate for the central bank.

The Constitution of 1991 included sweeping reform of Colombia's central bank law. However, while the degree of Central Bank independence was increased relative to the previous arrangement, it was a compromise between two views: one that favored unconditionally the idea of central bank independence, and one that supported government intervention and control, especially in exchange rate policy. While some of the wording of the law indicates a strong stance for independence, certain aspects of the central bank law are at odds with the same idea of independence. For example, the fact that the treasury minister is not only a voting member of the central bank board but also is its president is extremely unusual by international standards. Also, as testified to by various Constitutional Court rulings, a fair amount of institutional confusion remains regarding the objectives of monetary policy and of the central bank. In fact the 1991 Constitution attempted to delegate to the central bank the goal of inflation control. But various Constitutional Court rulings do not make it clear who has precedence if the Plan de Desarrollo and the Central Bank have different inflation targets.

The 1991 Constitution was especially concerned about keeping the government involved in the choice of exchange rate policies and exchange rate regimes. However, for a small open economy like Colombia's the exchange rate is a tool that cannot be detached from an inflation control policy package. If the government is part of the exchange rate management "team," it means that the government is involved in monetary policy. The unclear position of the central bank, originating in the 1991 Constitution, has shown its consequences on a couple of occasions. In 1997 an overexpansion of monetary policy in response to a downturn in 1996 contributed to monetary and financial turbulence in the ensuing year. In early 1997 the Samper government had the opportunity to appoint three new members of the board—all of them recruited within the ranks of government. Recent interventions in the banking sector have led to a coordinated government–central bank effort to bail out banks that have gone beyond a temporary provision of liquidity.

In summary, the gist of our proposals is to eliminate the "confusion" surrounding the institutional position of the central bank and its mandate. The purpose is to reform the central bank law in order to make the central bank an institution to which the government delegates the goal of keeping inflation under control and supervising the financial stability of the country. It is important to stress that a truly independent central bank does not contradict the principles of democracy. Delegation and democracy are not incompatible. The "people" may democratically decide that a certain function (e.g., monetary policy) should be delegated to an institution appointed by the people but retaining independence in the administration of its duty—in the interest of the people itself.

Proposals

Composition of the Board

- Remove any member of the executive branch from the board of the central bank
- Reduce the board from the current five members to three, plus a chairman, who must cast the tie-breaking vote

The aim is to make the board small but strong without government participation.

Appointment Procedures
- Lengthen the term of office of all members of the board to seven years
- Introduce a staggered system of appointments so that no single administration has the prerogative of appointing a large fraction of the board
- Restrict who can be appointed in the board—current members of the administration or those who have served in the previous two years should not be allowed to be appointed chairman or members of the board

The aim is to maintain a stable central bank board that cannot be frequently changed or influenced by a single government. Restrictions on who can be appointed should also reduce direct government intervention.

Goals of Monetary Policy
- The central bank should set the inflation target; if in the central bank's judgment a particular Plan de Desarrollo threatens the medium-run goal of inflation control, the central bank's goal of inflation control should have precedence.

This legislation should clarify the confusion that exists in the Constitution about who really should set the inflation target.

Supervision of the Financial System
- The central bank should take this control from the treasury. The current situation ignores the conflict of interest between the goal of financial solidity and the goal of financing government spending.

Disclosure and Secrecy
- The central bank should adopt clear and binding procedures about the source and timing of official statements of the bank. Specific rules about disclosures of board minutes and announcements to the markets should be adopted and closely followed.

The aim is of course to give some transparency to the markets and to remove uncertainty and speculation.

1.4 Conclusions

With this book we aim to provide the reader with a good understanding of the economic and institutional problems facing Colombia today as well as a possible road to reform. We offer an example of how the tools developed in the new political economics framework can be used for policy analysis and policy advice.

Many of the institutional problems of Colombia—misguided social spending programs, ineffectual decentralization, disagreements between executive and legislative, branches, just to name a few—are quite common in developing countries. The experience of Colombia can help shed light on these problems in other countries.

Notes

1. See, for example, Aghion, Alesina, and Trebbi (2002).

2. The evolution of violence in Bogotá is harder to explain. Even though public officials optimistically claim the various policies since 1994 to be successful, a careful analysis of weekly data shows this not to be the case. See Paz Publica, "Homicidios en al Ciudad de Bogotá," forthcoming.

3. See the appendix to the chapter 6, for the different measures undertaken to improve the quality of education in the 1990s.

4. See also the discussion of this issue in chapter 6.

5. *Empleo Urbano* has three components: employment generation proper, training, and support for micro enterprises. The last was extremely small—less than 1 percent of the budget, covering only 56 projects in 26 municipalities—so it will be ignored. Training received about 13 percent of the budget in 1996 as was discussed in section 1.4.3. The remaining 86 percent of the budget was spent on employment creation programs.

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