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COLOMBIA: PUBLIC FINANCES – ANY CAUSE FOR CONCERN?

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Colombia's public finances have come under the spotlight in recent years amidst recurrent adverse external shocks, rising social spending pressures, ongoing challenges in raising revenues, persistent (optimistic) biases in fiscal planning and, as of late, the back loading of fiscal consolidation plans following the Covid-19 shock. The rapid progression of the public debt ratio and the capacity for future policy adjustment have, in particular, become points of concern and have, since the summer 2021, materialized in Colombia losing its investment grade status. However, overly focusing one's attention on debt levels, debt dynamics or the speed of fiscal adjustment to assess fiscal sustainability in Colombia can lead to overlook important risk-mitigating aspects of the sovereign's credit profile. Despite facing a challenging scenario of its underlying debt drivers, the sovereign maintains a solid capacity to support debt backstopped by a favorable interest-to-growth differential, low contingent liabilities, a manageable debt-servicing burden and a sound institutional framework. Looking forward, engaging the broadest swath of society in shaping fiscal policy represents a significant challenge that could – if done inclusively – pay important dividends in terms of both economic and fiscal outcomes.

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Colombia's public finances have come under the spotlight in recent years amidst recurrent adverse external shocks, rising social spending pressures, ongoing challenges in raising revenues, persistent (optimistic) biases in fiscal planning and, as of late, the back loading of fiscal consolidation plans following the Covid-19 shock. The rapid progression of the public debt ratio and the capacity for future policy adjustment have, in particular, become points of concern and have, since the summer 2021, materialized in Colombia losing its investment grade status. However, overly focusing one's attention on debt levels, debt dynamics or the speed of fiscal adjustment to assess fiscal sustainability in Colombia can lead to overlook important risk-mitigating aspects of the sovereign's credit profile. Despite facing a challenging scenario of its underlying debt drivers, the sovereign maintains a solid capacity to support debt backstopped by a favorable interest-to-growth differential, low contingent liabilities, a manageable debt-servicing burden and a sound institutional framework. Looking forward, engaging the broadest swath of society in shaping fiscal policy represents a significant challenge that could – if done inclusively – pay important dividends in terms of both economic and fiscal outcomes.

In the summer of 2021, Colombia *de facto* lost its "investment grade" status – which it acquired back in 2011[1]. Colombia had faced recurrent pressures on its sovereign rating (*chart 1*), in the wake of the reversal in the commodity super-cycle in 2014-15. The latter spurred a rapid decline in oil prices – a staple which accounts for close to 40% of exports, 1/3 of FDI and some 10% of total fiscal revenues. The shock led to a sizeable deceleration of real GDP growth (*chart 2*), a cumulative loss of 5.5% of GDP in oil revenues over the period 2015-18[2] and as a result heightened pressure to increase non-oil revenues through tax reform.

A combination of factors precipitated Colombia's fall out of investment grade, according to the rating agencies: a deterioration in key fiscal metrics aggravated by the oil and pandemic shocks, an unfavourable socio-political environment to pass fiscal reforms, limited visibility of the post-pandemic adjustment process, in particular concerns over ability to cut down deficits and stabilize debt (the general government debt ratio has close to double since 2012 reaching 65% of GDP in 2020 (*chart 3*). The depreciation trend of the peso since the oil price shock (*chart 4*) has also made debt stabilization hard to achieve as a little over 1/3 of public debt is denominated in foreign-currency, one of the highest levels amongst Latin America's largest economies (*chart 5*). The government's decision to maintain headline fiscal deficits in the range of [7-8.6%] over period 2020-2022 contributed to further put public finances in the spotlight as Colombia was only one of the few emerging markets that decided to backload its fiscal adjustment plans to 2023. Perhaps more importantly, the country faced a tipping point in May 2021 when a controversial fiscal reform proposal by the government led to a 62-day national strike marked by violent protests and road blockades. The social unrest which resulted in 84 casualties (civilians and police) and cost more than USD 3 bn according to the Finance Ministry, led to the withdrawal of the reform proposal, precipitated the departure of two ministers (Finance and Foreign Affairs) and led to a spike in Covid-19 cases exacerbating the country's 3rd epidemic wave.

There has been no shortage of debate related to how the pandemic shock should be treated in credit models or credit assessment frameworks. Just like the Global Financial Crisis previously, the Covid-19 epidemic raised important questions concerning the appropriate fiscal response, its size, composition and duration. In any case, it became apparent early on that most sovereigns would be dealing with sizeable debt increases and would have to engage (at some point) in some form of policy adjustment to consolidate fiscal accounts, while having to compose with a more pressing set of challenges (lower potential growth, accelerated digitalization of their economies, energy transition).

EVOLUTION OF COLOMBIA'S SOVEREIGN RATING (2004-2021)

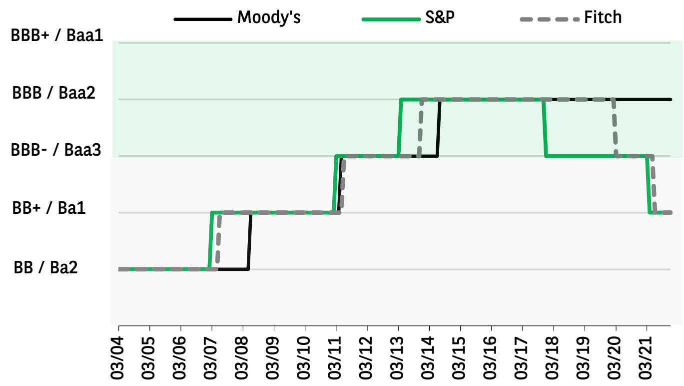

CHART 1 SOURCE: MOODY'S, S&P, FITCH

REAL GDP GROWTH VS OIL PRICES

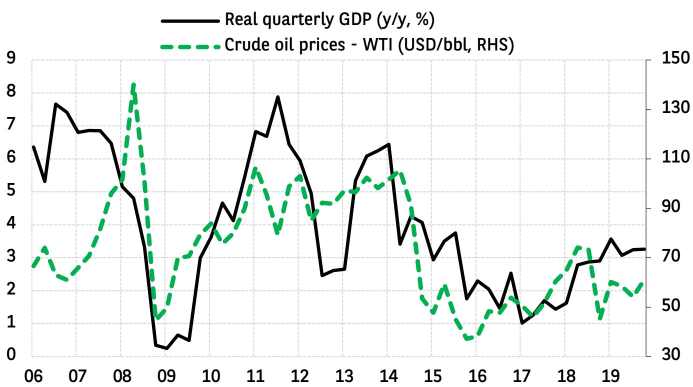

CHART 2 SOURCE: DANE, MACROBOND

1 S&P (May 2021) and Fitch (July 2021) downgraded Colombia from BBB- to BB+. Moody's kept its rating unchanged (at Baa2 since 2014) during its July review. However, two investment grade ratings from the three main rating agencies are required to maintain an overall investment grade status.
2 IMF (2021). Article IV: Colombia

Considering the warnings relayed by many international organizations[3] relative to the risks of adjusting too quickly, a case could be made to temporarily move away from strictly focusing on government debt burdens and benchmarking exercises[4] when evaluating the trajectory of sovereign ratings. However, just as in 2007-8 previously, attention in sovereign creditworthiness assessments has already turned to the speed of consolidation – the latter often being equated with fiscal tightening due to the implicit assumption "[...*] that fiscal tightening is the key test of a government's determination to honour its debts, and is therefore necessary for a quick return of investor confidence and a rapid pickup in growth*[5]". Is Colombia's ability and willingness to pay being adversely impacted by its decision to delay its fiscal adjustment? Is Colombia's intrinsic credit quality worse today or comparable to that of 2007-2011 – the last time the country durably found itself in the BB+ category? Is the downgrade into speculative grade harbinger of worse things to come or a temporary backslide? Does the accumulation of public debt incurred by the pandemic response and ensuing fiscal expansion pose a risk to debt sustainability?

In an effort to address these questions, **section "Pre-Covid-19 public finances snapshot: the pros and cons"** looks at the state of public finances prior to the Covid-19 health crisis – outlining the main elements, which back then, supported or constrained Colombia's public creditworthiness. **Section "Covid-19 shock: what is the damage to public finances?"** provides an overview of the fiscal response to the health crisis and its impact on fiscal metrics in an effort to assess the damage done to public finances by Covid-19. **Section "Post-covid shock recovery: possible trajectory of debt metrics"** projects the possible paths of the public debt ratio after estimating the trajectory of its underlying drivers. In light of the insights formulated, the conclusion attempts to answer the central question of this article, that is whether there are any cause for concern about the current trajectory of Colombia's public finances.

Pre-Covid-19 public finances snapshot: the pros and cons

A good starting point to evaluate Colombia public finances is to first look at some of the improvements in terms of public financial management as well as the enduring challenges encountered by successive governments ahead of the health crisis.

Sound institutional, regulatory and policy frameworks

Colombia has bolstered its fiscal policy frameworks and governance in significant ways over the past 25 years or so (box 1). In particular, the introduction of a fiscal rule with precise structural deficit[6] targets and

3 Many international institutions including the IMF, the World Bank, ECLAC have warned about how premature fiscal tightening in some cases could be self-defeating if it ends up weakening the recovery process, reducing growth and investment all of which ultimately can end up hurting the prospects of fiscal consolidation and reduce fiscal space.
4 Whereby the performance metrics of a sovereign (in particular GDP per capita, fiscal deficit, debt to GDP and economic growth volatility) are evaluated against that of a typical sovereign in a given rating category (captured by the median). These types of benchmarking exercises are often used to justify rating actions (a change in outlook or an outright rating change).
5 Unctad (2011). *Trade and development report*.
6 The structural fiscal balance = the headline fiscal deficit without business-cycle effects (cyclically adjusted) + adjusting for other temporary factors beyond the cycle (ie disaster-related relief, commodity shock that temporarily increases or reduces natural resources revenues). It allows to disentangle the permanent and temporary influence on the budget balance in order to gauge the medium-term orientation of fiscal policy (cf Hagemann, M. R. P. (1999). *The Structural Budget Balance*. The IMF's Methodology. International Monetary Fund.

DEBT DYNAMICS

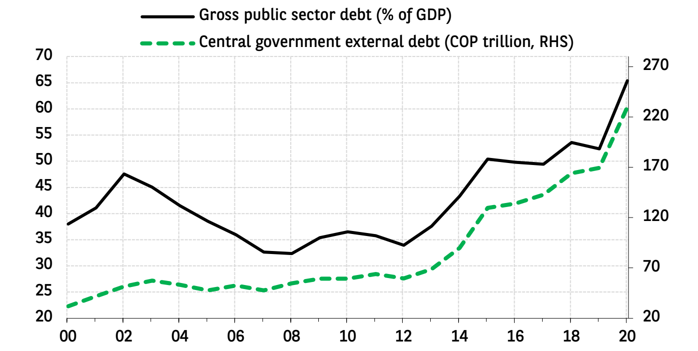

CHART 3
SOURCE: BANREP, IMF FISCAL MONITOR

COLOMBIAN PESO DEPRECIATION

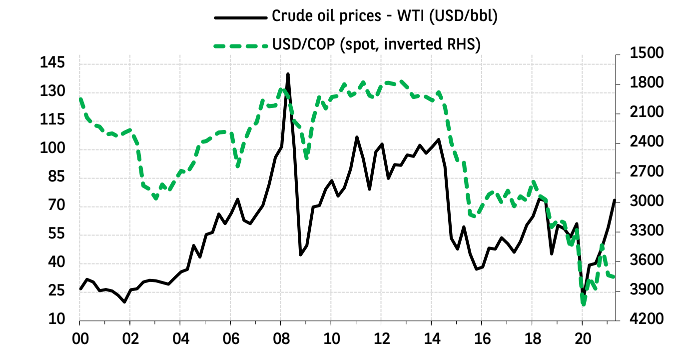

CHART 4
SOURCE: BANREP, MACROBOND

LATAM : SHARE OF PUBLIC DEBT SECURITIES DENOMINATED IN F.X.*

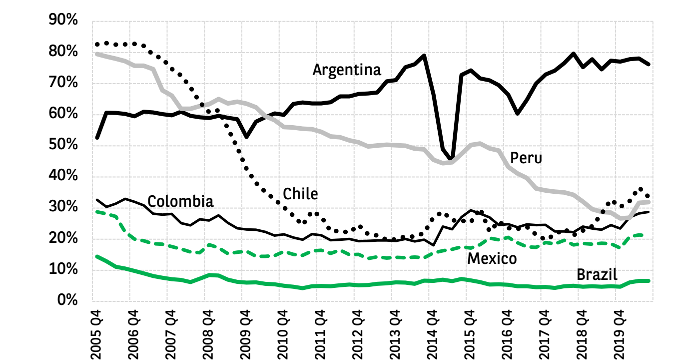

CHART 5
SOURCE:IMF SOVEREIGN DEBT INVESTOR DATABASE FOR EMERGING MARKETS
*SHARE OF CENTRAL GOVERNMENT DEBT SECURITIES DENOMINATED IN FOREIGN CURRENCY (AS PERCENT OF ALL CENTRAL GOVERNMENT DEBT SECURITIES)

mechanisms to control spending and revenues has been particularly foundational in instilling policy discipline and helping to improve coordination between monetary and fiscal policy. There have also been important qualitative improvements in the form of advancing gender parity in the public sector and strongly improving data availability and transparency[7]. Improved fiscal management helped save a large portion of the commodity windfall induced by large increases in terms of trade over period 2004-2012[8], as well as built up saving funds to cover against the materialization of contingent liabilities (estimated at some 2% of GDP).

Advances on the fiscal front have mirrored other policy improvements, regulatory and institutional developments:

- Democratic institutions have experienced an uninterrupted functioning over the past 50 years or so[9]. Unlike many peer countries in Latin America, there have not been repeated coup attempts in Colombia since 1958 – following the end of the military regime of General Rojas Pinilla (1953-1958). Continuity of democratic governance has been shown to be an important long-term determinant of prosperity[10].
- Colombia has a central institution in charge of long-term planning – the National Planning Department (NPD) created in 1958[11] – helping to link public policies with an overall development vision. The NPD helps formulate national development plans (NDP) whereby long-term targets and objectives are laid out while medium-term priorities and goals are identified in the realm of socio-economic and environmental policies. The NDP is used to monitor the government's performance against said targets and objectives.
- Several improvements in terms of policymaking are the product of structural reforms from the 1990's following the adoption of a new constitution in 1991: independence of the Central Bank (1991), creation of a string of development banks, export promotion and investment agencies (1989-1991), adoption of a flexible exchange rate (1999), waving of exchange controls[12], adoption of inflation targeting regime (1999), privatization of state enterprises, tariffs reduction, waving of import restrictions, relaxation of foreign direct investment (FDI) rules, strengthening of financial supervision and regulation following the banking crisis of 1998-1999[13]. As part of the reforms of the Central Bank (BanRep), it was determined that monetary authorities would not be permitted to monetize the

KEY MOMENTS IN IMPROVING THE FISCAL POLICY FRAMEWORK

1997 & 2000: Strengthening of public financial management at the subnational level. New constraints are imposed on sub-national fiscal balances including limits on subnational government borrowing. Improved budgeting and resource allocation across different levels of government. Local government cannot contract debt in foreign currency or local currency without the consent of the central government.

2003: Congress passes **a fiscal responsibility law**. The law requires authorities to set a target for the consolidated primary balance for the non-financial public sector. The law also imposes the yearly presentation to Congress of **a medium term fiscal framework (MTFF)** – a detailed breakdown of the government's fiscal consolidation strategy, which also includes the reporting of contingent liabilities.

2011: Adoption of fiscal reforms to (a) strengthen the **management and distribution of oil and mining royalties** (more equitable distribution of resources across regions and encourage their allocation to productivity enhancing initiatives).The authorities also (b) enshrined the **principle of fiscal sustainability** in the Constitution and (c) enacted a **fiscal rule** at the central government level (targeting to bring down the structural deficit of the central government to 2.3% of GDP by 2014, 1.9% by 2018 and projected to lower it to 1% from 2022 onwards). The structural deficit target was destined to limit use of revenues stemming from volatile sources such as commodities to reduce the historical pro-cyclical bias of fiscal policy. The rule also provided a framework to save exceptional revenues (ie. surplus revenues resulting from a higher levels of GDP growth and commodity prices compared to their long-term level) into a **Savings and Stabilization fund (FAE)**, managed by the Central Bank, that could be used to implement counter-cyclical policies. Every year, the government must present to Congress a report on its implementation of the rule.

2012: Authorities **bolster public debt management framework** with assistance from the World Bank. This led to the adoption of a formal debt management strategy. The debt strategy focused on minimizing risks and costs and reprofiling debt in favour of domestic debt. The authorities also took steps to **minimize fiscal risks stemming from public-private partnerships (PPP)** with technical assistance from the World Bank, IADB, IFC. Colombia is one of the countries in Latin America with the largest shares of projects financed through PPP. Contract standardization, contract monitoring with improved accounting and reporting practices, creation of a specialized agency - the *Agencia nacional de infraestructura* or ANI) to oversee public-private partnerships and concessions.

BOX 1 SOURCE: IMF, AFD, ECHEVERRY ET AL (2011)

DEVELOPMENT OF THE LOCAL DEBT MARKET

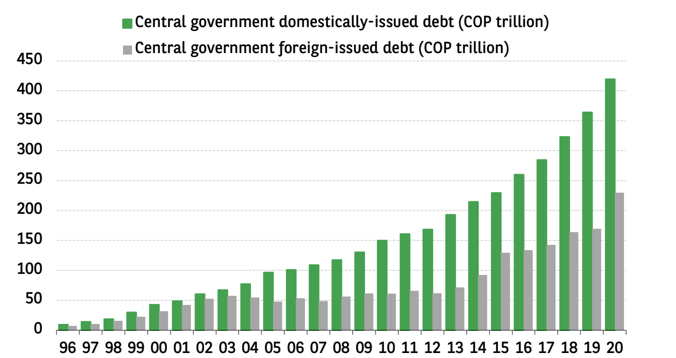

CHART 6 SOURCE: IIF

7 Colombia persistently registers the highest score in the region on the OECD's OURdata index – an index measuring government data availability, data usability, the extent to which data are available in open, free and accessible formats. OECD (2020). *Government at a Glance. Country report: Colombia.*
8 IMF (2014). Article IV : Colombia. Note that *"the economy saved about 90% of the commodity windfall, the highest share in the region."*
9 Vergne, C. (2015). *Colombie: l'enjeu des réformes structurelles et du processus de paix.* Agence française de développement.
10 European Parliament Research Service (2021). *Democratic institutions and prosperity: the benefits of open society*. Briefing, re-thinking democracy.
11 OECD, (2019). *Production Transformation Policy Review of Colombia: Unleashing productivity*. OECD Development Centre. The latest national development plan presented by President Duque in 2019 had an endowment of USD 325 bn with focuses on education, employment entrepreneurship and the environment.
12 Exchange controls had been in place since the 1930's. However, some restrictions were maintained. Colombia maintained an exchange restriction arising from the special regime for the hydrocarbon sector under which branches of foreign companies in the sector have to give up their exports proceeds or agree to government-imposed limits on their access to foreign exchange.
13 Colombia set up a Financial Stability Committee to coordinate the action of its three main supervisory bodies (Ministry of Finance, the Financial Superintendence of Colombia (FSC) which supervises financial institutions and the Central Bank). The FSC carries its supervisory functions with no political interference

public debt (ie BanRep cannot buy sovereign debt instruments in the primary market).

- Colombia's accession to the OECD (in 2018 but formalized in 2020) is a testimony to its efforts towards structural reforms and improved policy management. Adhesion to the organization implies in particular to take steps in improving governance (anti-corruption, better access to information strengthening the rule of law, and protection of human rights).

This prudent policy framework helped underpin financial and macroeconomic stability—both important stepping-stones in the development of the local sovereign debt market (*chart 6*). Indeed, compared to some peers in the region, Colombia has managed over the past two decades to post solid growth performances, control inflation (*chart 7*), avoid debt restructuring (unlike Argentina, Uruguay, Ecuador).

Structural public debt management reforms have also helped reduce the vulnerability of public accounts to financial shocks.

Active debt management initiatives have in particular helped to :

- **Progressively alter the composition of public debt**, reducing dependence on debt denominated in foreign currency to cover financing needs (*chart 8*). The greater reliance on local debt instrument has been fostered by the development of the local sovereign bond market (3rd largest in Latin America after Brazil and Mexico). The foreign-currency debt portfolio has hovered around 35% of the public debt stock.
- **Diversify the sovereign's investors' base**. There are no dominant holders of the public debt (*chart 9*). However, non-residents still account for some 35% of holders in the local public debt market (25% if one only counts bond debt).
- **Smooth out/lengthen debt maturities and reduce refinancing risks** (*chart 10*). The Treasury has improved the profile of public debt amortizations through active liability management operations (using swaps, buy back operations, exchanges) and the issuance of longer-term bonds. The lengthening of debt maturities has helped reduce the sensitivity of debt to interest rate risk as debt is refinanced less frequently. These operations have also helped avoid the bunching of maturities. Around 80% of the debt will mature by 2034 and, in any given year, the Treasury does not have amortizations that account for more than 10% of the public debt stock.
- **Reduce the average cost of debt** (*chart 11*). In the span of about 15 years from 2006 to 2021, the nominal cost of debt in the local market dropped from over 11% to 6.7% and from about 8% to 3.7% in the external market. As a result, the weighted average cost of public debt touched new lows in 2021 hovering at around 5.6%. This, in turn, has helped keep the burden of debt repayment at moderate and relatively stable levels over time (interest payments representing some 10% of revenues) despite a rising debt to GDP ratio.
- **Improve coordination with monetary authorities and lower levels of government.** Debt managers meet with the Central Bank to build projections on current and future liquidity needs and actively manage subnational debt (unlike in many other countries, national debt managers are actively involved in the management of debt issued at lower levels of government.)
- **Build up the risk management framework** in order to better account for the impact of contingent liabilities and to the risk associated with having a high foreign participation in local bond markets.
- **Reduce exposure to FX risks:** Since the Global Financial Crisis (2007-08), monetary authorities took a proactive approach to strengthen external buffers and establish a precautionary credit line with the IMF – helping to provide insurance against global

LATAM : INFLATION – CPI (Y/Y %, AVERAGE)

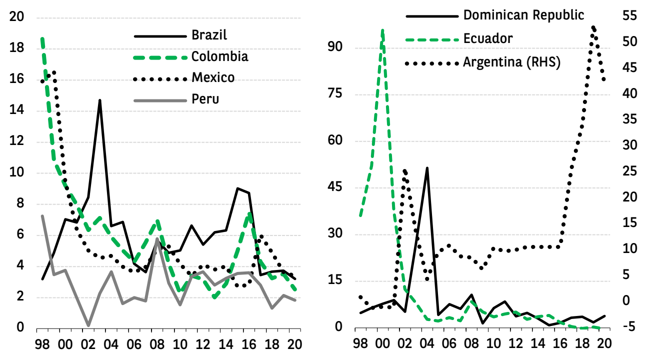

CHART 7 SOURCE: IMF (WEO)

COMPOSITION OF CENTRAL GOVERNMENT DEBT - BY CURRENCY

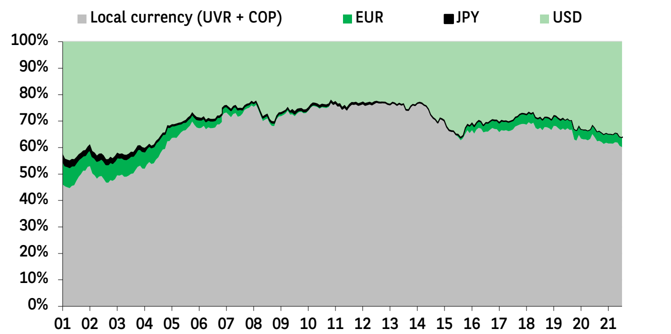

CHART 8 SOURCE: MINISTERIO DE HACIENDA Y CREDITO PUBLICO

COMPOSITION OF CENTRAL GOVERNMENT DEBT – BY HOLDERS

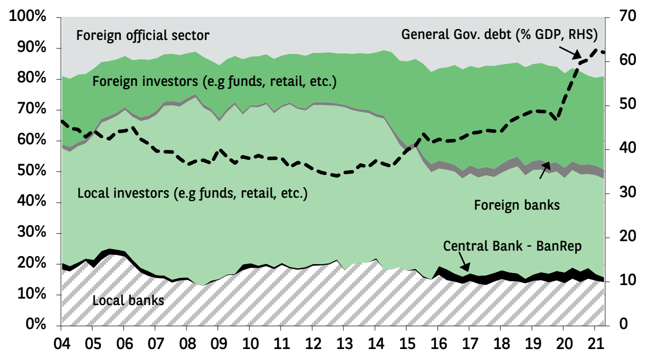

CHART 9 SOURCE: IMF (SOVEREIGN DEBT INVESTOR DATABASE FOR EMERGING MARKETS)

tail risks and provide a backstop for external payments in foreign currency of both public and private counterparties. FX reserves reached USD 58.9 bn, some 13.8 months of import cover versus 6 months in 2008 (*chart 12*). The accumulation of reserves has helped bring about a fall in the net external public debt to GDP ratio.

The more challenging part: upholding fiscal credibility

Even if authorities have continued to show a commitment to the fiscal rule, they have faced more challenges in recent years in upholding fiscal targets and credibly communicating a path on how to reach future fiscal targets. There are three main sets of factors either cyclical or structural, that help to explain these difficulties:

A series of external shocks in recent years have led to headline fiscal targets being revised every year since 2015: the oil price shock of 2014-5, severe droughts caused by El Niño as well as the truckers strike in 2016, the implosion of the Odebrecht corruption scandal and the resulting tightening of credit to infrastructure projects at the origin of delays in the country's biggest ever road building program (4G), the large influx of Venezuelan migrants in 2018-19[14], the Covid-19 pandemic in 2020. These have generated important pressures on public accounts leading expenditures to grow at times more rapidly than revenues (*chart 13*). The oil shock in particular has increased the urgency of increasing non-oil revenues through tax reform (the loss of revenues was estimated at some 5.5% of GDP over the period 2015-18, according to the IMF).

Authorities have continued to face difficulties in raising revenues: even if it has doubled since the early 1980s, the tax-to GDP ratio has been continuously lower than the average for the Latin American and Caribbean (LAC) region over the past 20 years (*chart 14*). Several structural factors have underpinned Colombia's chronic challenges in raising tax revenues:

- **Strong and long-standing opposition in Congress and the population to comprehensive tax reform**. Despite well-known shortcomings of the tax code (limited redistributive impact, special regimes, high marginal tax rates[15]), opposition to reforming the current tax system tends to be strong. This has forced successive governments to adopt a piecemeal approach to tax reform. As a result, Colombia has had close to 20 tax reforms since 1990 including some important ones over the past decade (*appendix 1*). Tax reform proposals have had a tendency to be watered down in Congress and rarely deliver larger gains than 1% of GDP. Historically, the avenue to increase tax revenues has primarily taken place through frequent changes to the VAT rate and coverage[16]. Increases in VAT rate (currently at 19%) however tend to be controversial because of their adverse impact on the poor – who spend the largest portion of their income on consumer goods and services. VAT has therefore been subject to many exemptions (see below). Another important imbalance stands from the disproportionate reliance on corporate income tax as a source of tax revenues. Corporates in Colombia face the highest effective tax rate in the OECD at some 60%. The corporate income taxes along with the VAT / goods and services tax have been the main contributors to total tax revenues contributing respectively 24% and 30% of total tax revenues in 2019 – relatively high shares in comparison with the OECD (10% and 20%). Meanwhile, personal income tax only represented 6% of total tax revenues in 2019 versus 24% on average for the OECD.

14 According to estimates by the IMF, fiscal costs associated with the migration flows amount to some 0.5% of GDP in 2019.
15 OECD (2013). *Economic survey : Colombia*.
16 Lozano, I. (2001). *Colombia's public finance in the 1990s: a decade of reforms, fiscal imbalance, and debt*. Subgerencia de Estudios Económicos, Banco de la República.

LENGTHENING OF THE AVERAGE MATURITY OF CENTRAL GOVERNMENT DEBT

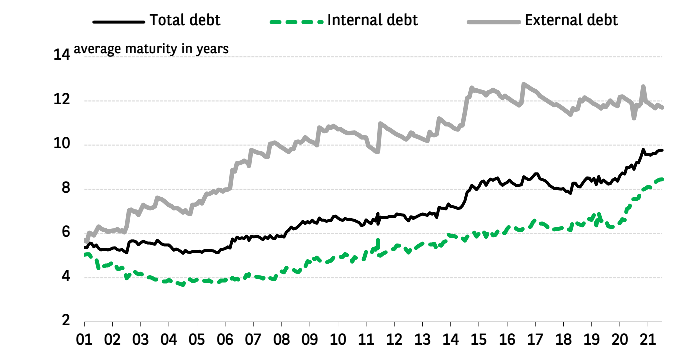

CHART 10 SOURCE: MINISTERIO DE HACIENDA Y CREDITO PUBLICO

DROP IN THE AVERAGE COST OF PUBLIC DEBT (AVERAGE COUPON)

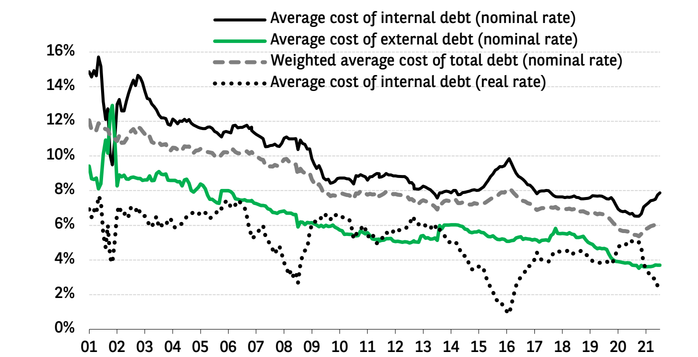

CHART 11 SOURCE: MINISTERIO DE HACIENDA Y CREDITO PUBLICO, DANE, BNP PARIBAS

IMPROVED CAPACITY TO WITHSTAND EXTERNAL SHOCKS

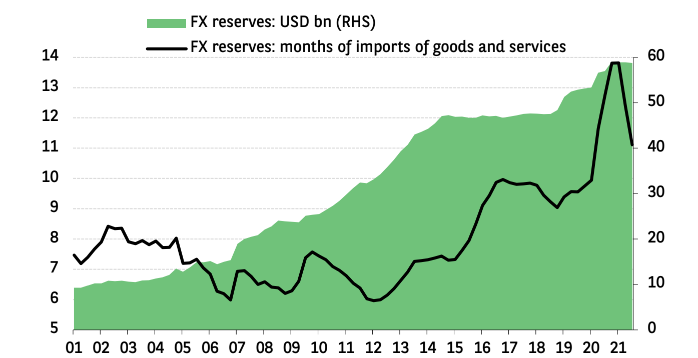

CHART 12 SOURCE: BANREP, BNP PARIBAS

- **High levels of informality in the labour market and high thresholds for paying income tax have impeded an expansion of the tax base** (*chart 15*). A significant portion of the labour market operates outside formal channels (62% of the labour force is estimated to work in the informal sector)[17]. The high level of informality is in large part explained by elevated start-up costs for formal businesses and high labour costs driven by a comparatively high minimum wage[18]. The persistently high level of informality generates an estimated 1.4% of GDP in foregone government revenue every year. Another reason for the low tax base stems from the high threshold to pay income tax such that less than 10% of workers pay personal income tax (*chart 16*). Over time, there has been little political consensus on raising the taxable base on individual income.
- **On top of tax evasion and loopholes, distortions in the tax system have reduced potential revenues by at least one third** according to Colombia's revenue services DIAN. *i/* Many items are exempt from VAT with exemptions accounting for an estimated 7% of GDP[19]) *ii/* Tax benefits to encourage investment in priority industries *iii/* Imbalances in tax collection between sectors and company size (preferential special regimes for businesses). The ad-hoc expansion of tax exemptions (including VAT free days) are often deployed to help ease popular tensions and cope with political constraints following increases in nominal tax rates[20]. According to the Finance Ministry some 40% of potential VAT tax collection and 30% of income tax collection is subject to evasion.
- **Loss of short term revenues from reforms**: for instance, *i/* the 2012 tax reform led to an estimated loss of 1.2 percentage points of GDP in revenues by suppressing a financial transaction and capital gains tax (0.8% of GDP) and wealth tax (0.4% of GDP). *ii/* The 2018 fiscal reform has also been highly criticized for having led to permanent revenue losses of 0.8% of GDP as a result of corporate tax cuts[21]. The original 2018 Financing Law was however meant to be revenue-neutral in the medium term with a widening of the VAT tax base. However, that aspect of the reform never made it through Congress.

Optimistic biases in fiscal planning have contributed to dilute policy credibility about future consolidation paths[22] :

- **Assumptions about oil-related revenues**[23]. As public accounts still exhibit a significant dependence on the oil and mining sectors (*chart 17*), assumptions made about the course of commodity prices tend to have important consequences for revenue forecasting and the government's capacity to achieve fiscal targets.

CENTRAL GOVERNMENT REVENUES AND EXPENDITURES GROWTH

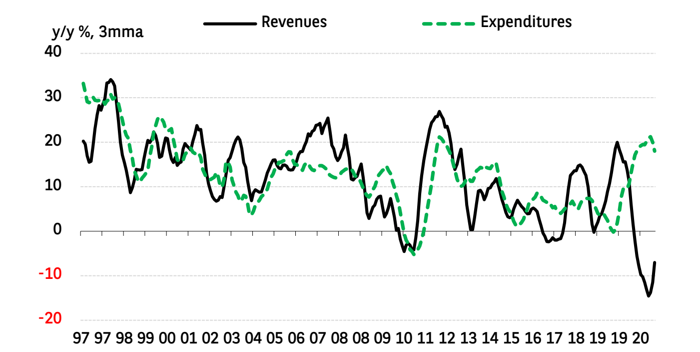

CHART 13 SOURCE: BANREP, BNP PARIBAS

LATAM: TAX REVENUES TO GDP RATIO (%) 2019

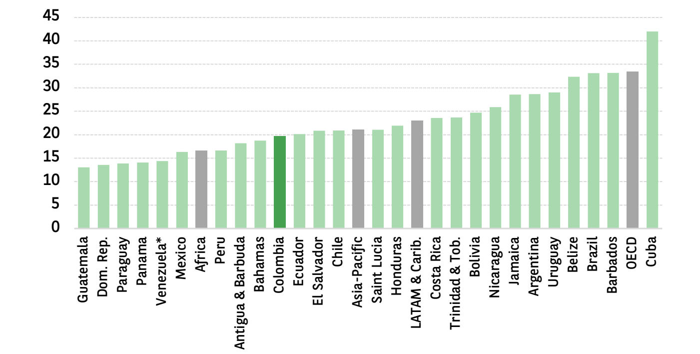

CHART 14 SOURCE: OECD

SHARE OF INFORMAL EMPLOYMENT IN TOTAL EMPLOYMENT (%)

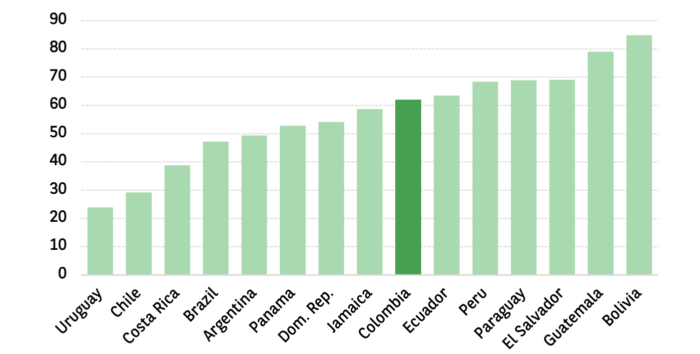

CHART 15 SOURCE: ILOSTAT

17 Informality defined as workers who do not contribute to social security. It is however down from 70% in 2007.
18 The high minimum wage and high non-wage labour costs are important cost factors found to reduce formal employment. OECD (2019) notes: *"At 87% of the median wage of full-time formal employees, the minimum wage is higher in relative terms than in any other OECD country"*. For a review of drivers of informality and barriers to formalization, cf. OECD (2019), *Economic survey: Colombia*.
19 Klein Felipe (2021). *Colombia: a cloudy fiscal horizon*. BNP- Paribas, Global Markets.
20 Salazar, N. (2013). *Political economy of tax reforms: The case of Colombia*. Woodrow Wilson Center Update on the Americas. Washington, DC, United States: Wilson Center, Latin America Program
21 Note that in 2021, many of the corporate tax cuts initially voted in 2018 were overturned at least temporarily (cf appendix 1)
22 According to Hudson, B., Hunter, D., & Peckham, S. (2019). *Policy failure and the policy-implementation gap: can policy support programs help? Policy design and practice*, 2(1), 1-14. Overly optimistic expectations represent one of the vagaries explaining the gap between policy formation and implementation.
23 The central government primarily depends on two sources of oil-related revenues: dividends paid by Ecopetrol and taxes paid by oil companies. Royalties on the other hand benefit regional governments. Export tax receipts are also an indirect form of revenue since more than 40% of exports are oil-based. See EIFI reports for breakdown for source revenues emanating from the extractive industry.

According to the IMF, more conservative estimates of oil revenues would have been the most effective way to contain the rise in public debt[24].

- **Projections regarding the capacity to improve tax administration (efficiency gains)**. In its latest two proposals for fiscal reforms, the administration projected revenues resulting from improved efficiency in tax collection of close to 0.3% of GDP. These gains are premised on making improvements to the tax administration (DIAN)'s IT system and governance[25], increasing sanctions to staunch tax evasion. However, Colombia does not have a strong track record in implementing stronger sanctions.
- **Assumptions about economic growth.** With some rare exceptions, economic growth has been systematically projected to grow above potential growth since 2012 in the government's medium-term fiscal framework[26]. According to government estimates a 1-percentage point drop in real GDP growth costs the government around 0.4% of GDP in revenues.

Given the limited compressibility of current spending, the additional spending needs generated by external shocks and the underperformance of revenues (due to lower oil related revenues, underperforming GDP growth or unrealized efficiency gains), the authorities have been at times forced to cut subsidies, infrastructure spending but most importantly rely on extraordinary (one-off) sources of revenues to meet revised fiscal targets[27]. This has included *i/* sale of assets *ii/* divestment from assets (selling some of its stakes in utility company ISA and Ecopetrol). But, because these types of non-recurrent revenues do not offer a structural solution to achieving fiscal consolidation, they have tended to be perceived negatively in rating agencies' credit assessments.

Covid-19 shock: what is the damage to public finances?

The Covid-19 pandemic hit Latin America especially hard. While it experienced few infections in the early days of the crisis, Colombia severely caught up having registered more than 135 000 deaths by mid-February 2021 (*chart 18*). In an effort to evaluate the magnitude of the pandemic shock on public finances, next we will review i/ the state of fiscal accounts prior to entering the crisis, ii/ the contours of the policy response and iii/ the impact of the crisis on fiscal metrics.

Initial fiscal conditions

Colombia entered the Covid-19 crisis with a weaker fiscal position, less policy scope and a weaker growth track record compared to the 2007-8 Global Financial Crisis (GFC).

When the pandemic hit, the economy was starting to gain pace (3.3% growth in 2019) after years of sluggish growth following the 2014-15 oil shock (the 5-year average growth rate stood at 2.4% in 2019 vs. 5.5% on average in the years preceding 2007). The economy faced a less supportive external environment (crude oil prices stood above USD 100/barrel in Sept 2007 vs. approximately USD 48 USD in February 2020). The average size of the fiscal deficit was comparable over the 5 years preceding the shocks: 3.6% of GDP (2003-2007) vs. 3.1% (2015-2019). On the flipside, however, the public debt ratio decreased by some 12 points of GDP in the 5 years preceding the GFC reaching 32% of GDP in 2007. By contrast, public debt continued to rise steadily

PERSONAL INCOME TAX MAKE UP A SMALL SHARE OF TAX REVENUES

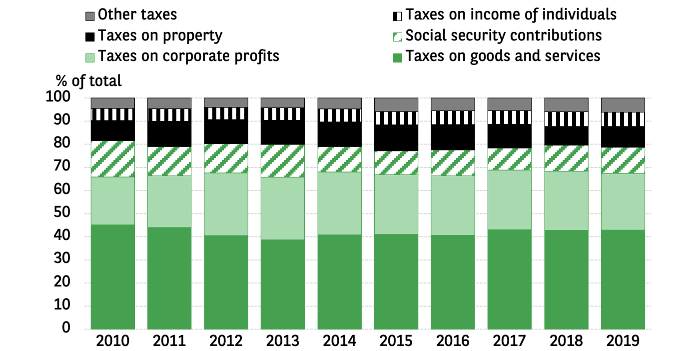

CHART 16 SOURCE: DANE, OECD

GENERAL GOVERNMENT OIL & MINING FISCAL REVENUES (% OF GDP)

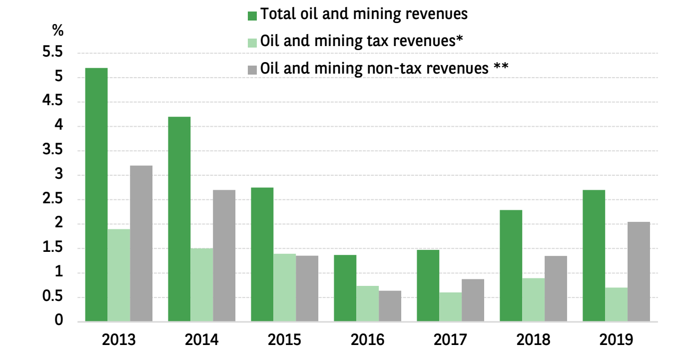

CHART 17 SOURCE: ECLAC, OECD, BNP PARIBAS
* TAX ON INCOME, PROFITS AND CAPITAL GAINS AND OTHER TAXES
** ROYALTIES AND OTHER PARTICIPATIONS, DIVIDENDS, PRODUCTION LEVIES, OTHER NON-TAX REVENUES

COVID-19 : CASES AND DEATHS IN COLOMBIA (7-DAY MOVING AVERAGE)

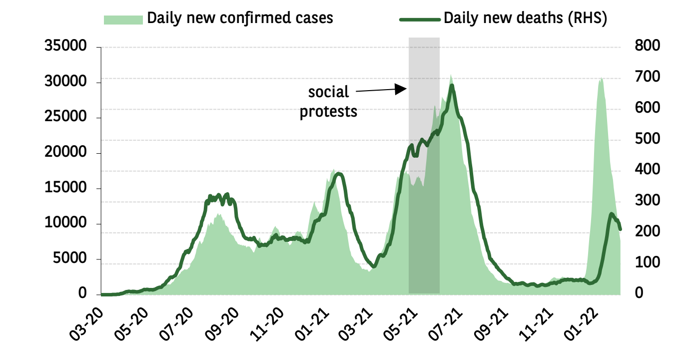

CHART 18 SOURCE: OUR WORLD IN DATA, BNP PARIBAS

24 More conservative approaches to determine structural oil prices (for example, by subtracting one standard deviation of oil estimates from the estimates of long-term prices) would have led to 3.5 percent of GDP less debt accumulation. Different estimates of the output gap would also have had an impact on debt accumulation but less so. (IMF 2021)
25 IMF (2021). Article IV. For instance by making greater use of electronic invoicing.
26 Felipe Klein and Luca Maia (2021). *The looming downgrade*. BNP Paribas Global Markets- *According to a report from the IDB, except for 2013, growth turned to be well below potential growth projections in all MTFF between 2012 and 2018.*
27 According to Fitch, extraordinary revenues were used to meet revised central government deficit targets in 2017 (-3.6% of GDP), 2018 (-3.1% of GDP) and 2019 (-2.5% of GDP)

between 2012-2019 gaining some 14 percentage points of GDP over the period, despite budget deficit plans being formulated in accordance with the fiscal rule[28]. This can be largely explained by *"automatic debt dynamics"* (*appendix 4*). Indeed, according to calculations by the IMF, "*6.5 points of the increase was driven by cyclical components (oil and output) while another 6.5 percent of GDP was driven by a sharp depreciation of the exchange rate in response to the drop in oil prices*"[29]. The public debt trajectory however masks the fact that in the interim period, the fiscal institutional framework strengthened, debt became more affordable, the country improved its capacity to withstand external shocks and more importantly, a peace agreement with the FARC was signed.

Policy response

Colombia's 2020 fiscal support package was larger than during the 2007-8 Global Financial Crisis but it was smaller compared to other large economies in the region (*chart 19*). According to the IMF Fiscal Monitor, discretionary above-the-line (excluding credit guarantees) measures amounted to some 4% of GDP, in line with the Latin American average (~4.5% of GDP)[30] . To deploy emergency spending, the government activated an escape clause to suspend its fiscal rules through the end of 2022[31].

Many of the measures focused on supporting the most vulnerable, providing tax / financial relief as well as initiatives to combat the pandemic (*appendix 2*)[32]. In order to manage emergency spending, the authorities created a National Emergency Mitigation Fund (FOME), which brought together the national pension fund for local/state government (FONCET), savings and stabilization fund from oil royalties (FAE), and the central government budget.

While initial fiscal support was considered average relative to some regional peers, the authorities opted to prolong support, taking advantage of higher commodity prices[33]. Unlike many other emerging markets which withdrew emergency support, Colombia decided to further pursue its policy support through the end of 2022 *"to protect the most vulnerable and support the recovery"*. Overall, when accounting for additional spending, financing instruments and guarantees (off budget measures) amongst others, the fiscal response amounted to some 10% of GDP (*chart 20*).

Impact on fiscal metrics

The health crisis affected fiscal balances and public debt through multiple channels :

- Reduced revenues (*via* collapse of economic activity, tax relief measures, drop in earnings from commodity exports),
- Automatic stabilizers (unemployment allowances),
- Social spending,
- Currency depreciation (given that about a third of the debt is denominated in foreign currency),
- Steep fall in nominal GDP (the collapse of demand was particularly steep in Colombia compared to other regional peers[34]),
- Lag in vaccination campaign (need to extend support to the economy over longer periods of time compared to developed markets).

In 2020, the central government fiscal deficit reached 8.1% of GDP (vs. 2.2% projected before the crisis) with the interest burden absorbing some 2.5% of GDP (*chart 21*). In the 2021 fiscal plan, the headline deficit was projected to widen further in 2021 (8.6% of GDP) and remain quite substantial in 2022 (7%). Better than expected real GDP growth performance in 2021 (10.6% y/y) and a large statistical carry-over effect into 2022 (5.3 pp) however point to projected fiscal deficits that are likely to come in below 7% of GDP over the period.

LATAM: SIZE OF FISCAL PACKAGES (OCTOBER 2020)

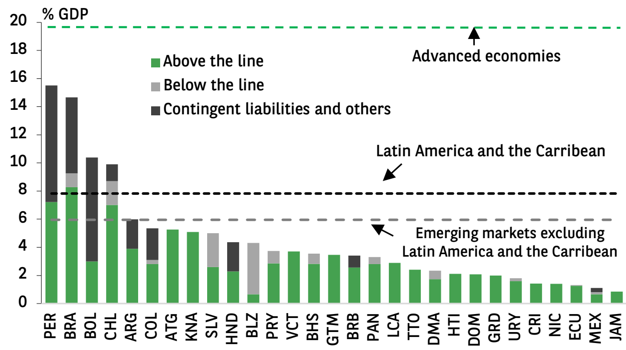

CHART 19

SOURCE: IMF (WESTERN HEMISPHERE REGIONAL OUTLOOK OCTOBER 2020)

EMERGING MARKETS: FISCAL RESPONSE TO COVID-19 (OCTOBER 2021)

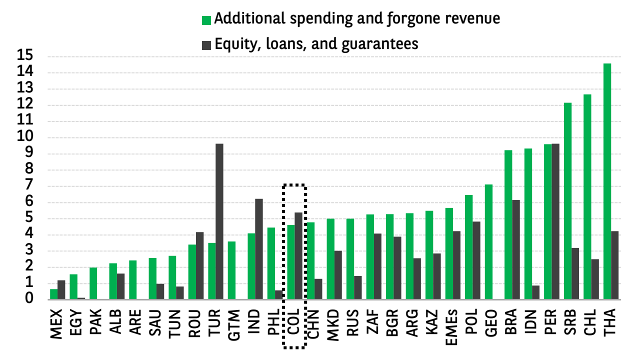

CHART 20

SOURCE: IMF (FISCAL MONITOR DATABASE FISCAL POLICY RESPONSE TO COVID-19 - OCT 2021)

28 IMF (2021).
29 IMF (2021).
30 Mauricio Cardenas, Luca Antonio Rocco, Jorge Roldos, and Alejandro Werner (2021). *Fiscal Policy Challenges for Latin America During the Next Stages of the Pandemic: The Need for a Fiscal Pact by*. IMF Working Paper WP/21//77, March 2021.
31 According to the safeguard clause, when the output gap is negative and the expected real growth rate of production is at least 2 pp lower than the long-term rate (estimated between 4.3% and 4.8% by the government), a countercyclical spending program can be initiated. These countercyclical spending measures should be gradually dismantled once the economic growth rate has returned to its long-term level or above for 2 years.
32 For an empirical discussion of the impact of fiscal and monetary measures (cf. IMF 2021).
33 According to calculations by the IIF, a 10% increase in commodity prices adds ~0.25% of GDP in fiscal revenues. IIF(2021), *The Fiscal Challenge*, Latam view (August 2021)
34 World Bank (2021). *Recovering growth: Rebuilding Dynamic Post-COVID-19 Economies Amidst Fiscal Constraints*. Semi-annual report on Latin America and the Caribbean region – October 2021.

In order to meet higher than usual financing needs (~10% of GDP) over the period 2020-22, the authorities are relying on 5 main sources of financing:

- The saving and stabilization fund (FAE, 1.2% of GDP),
- The national pension fund for local governments (FONCET),
- Issuance in the local bond market in the range of USD 13 bn to USD 16 bn on average per year (it asked banks to buy USD 2.5 bn worth of solidarity bonds in 2020),
- External financing (in the range of USD 10-11 bn per year – typically from CAF, IBRD, IBD, including some emergency financing from the IMF),
- The government also resorted to privatizations (USD 3.5 bn in 2021 and an expected USD 1.7bn in 2022) and introduced a temporary "solidarity tax"[35].

In 2020, the central government debt ratio increased by 13 percentage points to 59% of GDP (+13pp also for the general government debt and +15 pp for the non-financial public sector debt to 71% of GDP). As such, the debt burden increased almost by the same amount in 2020 then over the preceding 8 years with the debt to GDP ratio close to doubling since the instauration of the fiscal rule in 2011. The increase in the debt burden was larger than the Latin American average (+10pp), in line with the global average (+13pp) but smaller than the increase in advanced economies (+16 pp)[36]. The extension of guarantees, like in many other countries also increased contingent liabilities to the tune of 2.6% of GDP[37].

Post-covid shock recovery: possible trajectory of debt metrics

The growth rate of a country's debt to GDP ratio depends essentially on the future paths of the primary balance, interest rates, the exchange rate and growth prospects (*appendix 4*). But in large part the debt to GDP ratio responds to the interaction of interest rates and output growth:

- If the economy's growth rate is higher than the average interest rate on public debt, authorities may stabilize or even reduce their public debt to GDP ratio even if they run a primary deficit. Thereby *"low rates of interest can allow for a fiscal expansion on a sustainable basis"*[38].
- If the average interest rate on public debt is higher than the rate of growth of the economy then the authorities will have to run a primary surplus (which size can be determined arithmetically) to stabilize the public debt ratio otherwise debt will automatically grow over time.

In the first subsection, we start by evaluating the drivers of the public debt ratio in light of the social context in the country, political developments in recent years, and the effects of Covid-19. This will help us get a sense of their likely future direction. In the second subsection, we use the insights from the previous subsection to come up with macro-assumptions that will serve as inputs to generate a baseline scenario for the public debt path. The baseline scenario and shocks to the baseline scenario can serve as a basis of comparison against official projections (embodied in the government's medium-term fiscal framework).

35 For 4 months from mid-April 2020 public sector workers with salaries between COP 10 million and COP 15 million per month (ie between USD 2,500 and USD 3700) contributed 10% of their salary to finance COVID-19 related measures, while salaries above 15 million pesos contributed 15 percent. People who made less than COP10 million per month could make voluntary contributions.
36 Kose, M. A., Ohnsorge, F., & Sugawara, N. (2021). *A mountain of debt: Navigating the legacy of the pandemic*. Policy Research working paper, no. WPS 9800, COVID-19 (Coronavirus) Washington, D.C.: World Bank Group
37 According to July 2021 figures of the Fiscal Monitor Database: Country Fiscal Measures in Response to the COVID-19 Pandemic.
38 Unctad (2011)

CENTRAL GOVERNEMNT FISCAL METRICS (% OF GDP)

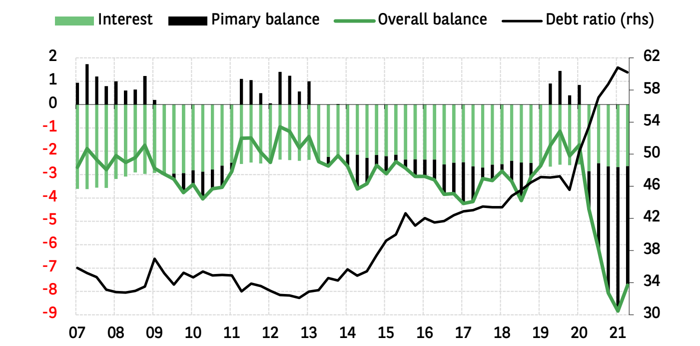

CHART 21 SOURCE: BANREP, BNP PARIBAS

COLOMBIA: POVERTY AND EXTREME POVERTY VS. LATAM

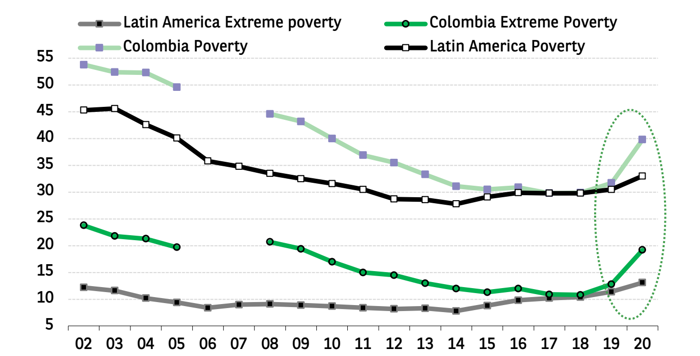

CHART 22 SOURCE: ECLAC

*PERCENTAGE OF THE POPULATION WHOSE AVERAGE PER CAPITA INCOME IS BELOW THE EXTREME POVERTY AND POVERTY LINE. DATA IN 2007-2008 FOR COLOMBIA NOT AVAILABLE

Evaluating the drivers of the public debt ratio in a post-Covid-19 era:

Driver n°1 – Primary balance: in deficit for at least 5 years.

In the same way that the 1991 constitution led to a sharp rise in spending[39], the government will have to compose with important fiscal pressures in coming years which will likely keep the primary balance in deficit through the medium-term.

39 Salazar, N. (2013). "*The 1991 constitution granted not only fundamental human rights but also economic and social guarantees within its social rule of law framework, as well as creating mechanisms to ensure and protect those rights. These guarantees have resulted in an expanded public sector and a significant growth in public spending [...] Increased spending linked to the new constitution was coupled with other expenditure pressures, particularly those related to the financial imbalance in the pension system and increased resource demands from the defence sector.*"

- The government opted to continue supporting the economy and vulnerable population through the end of 2022 in the forms of health spending, household transfers, support to firms and investment (*table 1*).
- Pressures to increase social spending will persist:
  - The Peace agreement signed in 2016 with the FARC has partly displaced concerns from the security sphere to the social sphere. This has helped long-standing social issues come more forcefully to the fore of the political debate and progressively alter the structure of the political landscape (*appendix 3*).
  - Colombia has witnessed a slower progression of social indicators in recent years Even if social outcomes have progressed overall in the past 15 years, Colombia, like many countries in the region, has witnessed a slower progression of social indicators since the end of the commodity super cycle[40].

    Poverty is considered high compared to the typical upper-middle income country. In recent years close to 1/3 of the population lived with less than USD 5.50 per day (poverty line) and close to 2 million Colombians lived in extreme poverty and the phenomenon has been further accentuated by Covid-19 (*chart 22*) due in part to its disruptive effects on the labour market[41].

    Income inequality remains one of the highest in the world (with the top 1% accounting for approximately 20% of total income) and 4th highest in the region and the Covid-19 pandemic has contributed to further deepen existing inequalities[42] (*chart 23*). Many factors perpetuate the reproduction of inequalities across the country: high concentrated ownership of lands, structurally high levels of unemployment (with rates close to 10% over the past decade), high labour market informality (whereby workers benefit from limited social protection, low pension coverage and are more likely to fall into poverty when facing job loss), (d) the dominance of private universities in the higher educational system (more than 70% are private with costs considered prohibitive for a large part of the population) and a highly capital-intensive extractive industry (while an important growth driver and source of income for the economy, the sector is not a strong generator of jobs and/or a vector of social mobility)[43].

  The combined effects of increased social awareness and concurrent slower progression of social indicators has translated into a multiplication of social movements in recent years (*box 2*) destined to enhance protection, reduce

40 ECLAC (2021). *Panorama Social da América Latina 2020*.
41 An estimated 5 million jobs were temporarily affected by the shock with most jobs being lost in the informal sector and unemployment hitting close to 20% at the height of the pandemic. As in many other LA5 countries (Brazil, Mexico, Peru, Argentina) females, the youth and low-educated workers endured the brunt of the adjustment in the labour market but Colombia, compared to the other LA5 had the specificity of enduring a larger rise in unemployment relative to the drop in economic activity. See Silva, Joana, Liliana D. Sousa, Truman G. Packard, and Raymond Robertson (2021). *Employment in Crisis*. World Bank Group, Book - Open Knowledge Repository. The OECD anticipates that pre-pandemic employment levels will only be regained by mid-2022. OECD (2021). *Colombia Economic Outlook*. December 2021.
42 There has been greater income and job losses amongst poorer households, with lower levels of education that are self-employed or in informal jobs – thereby further worsening inequality. Cf IMF (2021). *Colombia: selected issues*. Also the expansion of transfer programs helped but did not fully offset income losses, as a majority of those who reported losing jobs due to COVID-19 were not enrolled in any government transfer program.
43 Vergne (2015).

PROJECTED FISCAL BALANCE (% OF GDP)

	2021	2022
Total Revenues	16.2	16.2
Tax revenue	13.6	14.2
Others	2.5	2
Total Expenditures	24.8	23.2
Interests	3.3	3.5
Current expenditure + investment	21.5	19.7
Current expenditures	17.8	17.1
Investment	2.7	2.1
Social investment	1	0.5
Primary balance	-5.3	-3.5
Total Balance	-8.6	-7

TABLE 1 SOURCE: MINISTRY OF FINANCE - MEDIUM TERM FISCAL FRAMEWORK (2021)

INCOME INEQUALITY (GINI INDEX) - SELECTED ECONOMIES*

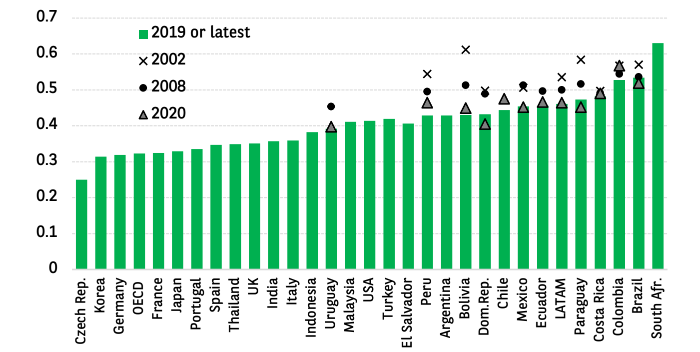

CHART 23 SOURCE: ECLAC, OECD
*HISTORICAL DATA ADDED FOR LATIN AMERICAN ECONOMIES.
SOME HISTORICAL DATA MISSING FOR ARGENTINA, CHILE, ECUADOR, URUGUAY

COLOMBIA: EDUCATION SPENDING (% OF GDP AND % OF EXPENDITURES)

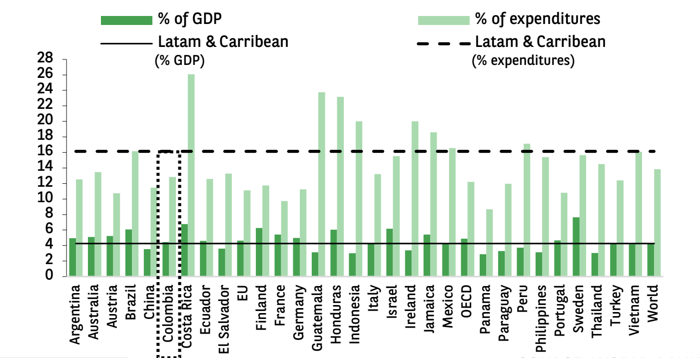

CHART 24 SOURCE: WORLD BANK
(WORLD DEVELOPMENT INDICATORS, DATA FOR 2018)

inequalities and improve employability. For some observers, the absence of policy measures destined to counter the distributional impact of the pandemic on the most vulnerable is likely to further feed social unrest ultimately fueling a vicious cycle (lower output, increases inequality which triggers social unrest which leads to lower output etc.)[44]. Avoiding this trap should provide enough incentive for policymakers to keep support schemes in place for longer, and spend more on healthcare and education (currently in lower tier of countries in the region (*chart 25)*).

- Other types of increasing spending pressures are likely to emanate from : *i/* costs of integrating migrants (as migration pressures are likely to subsist given the deepening of the socio-economic crisis in Venezuela and the effects of climate change), *ii/* implementation costs of 2016 peace accords (there will be continued pressure both by local stakeholders as well as the international community for a better implementation of the negotiated agreement.), *iii/* control of narco-trafficking and combating organized crime (one of the many consequences of Covid-19 has been the increase in drug use, and organized crime, higher levels of poverty and disparities has also favoured recruitment into crime cells[45]), *iv/* energy transition costs (as part of the COP26, Colombia has committed to reducing emissions by 50% by 2030), *v/* age-related spending pressures (the country's demographic profile will require important changes to the pension and healthcare systems in the coming years).

Driver n°2 - Interest rates: the way is up

There are multiple arguments militating in favour of public finances being affected by rising interest rates going forward:

- **Rising inflation is driving up the short end of the yield curve.** During the pandemic, the Central Bank of Colombia (BanRep) cut rates to unprecedented levels. However, inflation has been creeping back up (*chart 26*) in many emerging markets on the back of high commodity prices, supply chain disruptions, lagged effects of FX depreciation, consumption bounce back[46]. In Colombia in addition to these factors, a nationwide protest in May-June 2021 led to an increase in food prices as the unrest affected the provision of basic goods. Indexations practices and a sizable real increase in the minimal wage also contributed to increased inflation. So far, the BanRep has been one of the last large Central Banks in Latin America to start normalizing its policy stance (*chart 27*) but all points to faster tightening in the coming year both for domestic and external reasons (i.e. monetary policy normalization in advanced economies may affect yields, capital flows and debt pricing for EM).
- **Policy uncertainty is affecting the long end of the local yield curve:** sociopolitical stress (social unrest) and higher concern by market players of fiscal risks and other political risks have led to rising inflation expectations, wider risk premia and thus higher borrowing costs. As such, 10-year sovereign bond yields are already 300 bps higher than at the end of 2020. Policy action to

44 Sedik, T. S., Xu, R., & Stuart, A. (2020). *A Vicious Cycle: How Pandemics Lead to Economic Despair and Social Unrest*. IMF Working Papers, 2020(216).
45 UNODC (2021). *The impact of COVID-19 on organized crime*. Research brief - UNODC Research.
46 IIF (2021), *The inflation challenge*, Latam views (July 2021)

COLOMBIA: HEALTH SPENDING (% OF GDP)

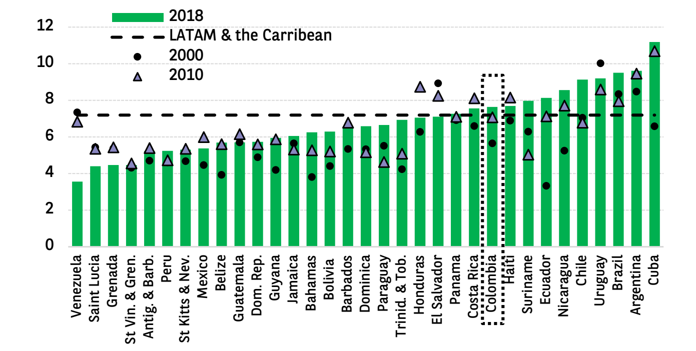

CHART 25

SOURCE: ECLAC, WHO

SOCIAL MOVEMENTS HAVE INTENSIFIED IN RECENT YEARS

2018 (October – December): Student protests to denounce the underfunding of public universities and denounce the government repression of student movements.
2019 (November – January): National strike (November 21st) and anti-government protests organized by labor unions, student associations, as well as other groups (farmers, indigenous groups, afro-descendants, government opposition, anti-corruption activists). Demands were wide-encompassing: calls for police reform, faster implementation of the 2016 Peace process, demands for greater protection of indigenous groups from para-military groups, improvements to education and the judicial system (in particular to reduce impunity), better access to jobs, demands for greater social justice, including access to better social safety nets, improvements in the provision and access to good quality public services (in particular healthcare). Protesters also decried the current tax code for being highly inequitable and the pension system for being highly regressive and providing limited coverage (only 25% of the adult population benefits from retirement pension coverage). The authorities have come under increased criticisms for failing to protect human rights activists and populations affected by escalating violence in the border region of Venezuela. A National Dialogue was promised to protesters but the Covid-19 crisis put a lid on addressing social demands. The protests resulted in hundreds of injured and 17 deaths.
2020 (September): A wave of widespread demonstrations against police brutality resulted in the death of 13 protesters. Calls for better access to food were also formulated as the pandemic generated widespread instances of food shortages in some areas.
2021 (end of April - June): (a) Protests against the government's fiscal reform proposal considered to put the brunt of the fiscal adjustment on the middle class and lower income groups (b) Protests against the hard stance taken against protesters despite the adoption of a new protocol, ordered by the Supreme court in January 2021, regarding the use of police force in protests. Some 84 people are estimated to have died (with more than half in the city of Cali) and hundreds had disappeared according to NGOs at the end of May. Protesters also decried the slow vaccination rollout to combat Covid-19.
2021 (July): anti-government protests to denounce the introduction in Parliament of a new tax reform bill. Demonstrators also demanded (a) additional support to cushion the effects of the pandemic (b) an end to police repression and (c) a formal separation of the Police from under the military (the Police is under the control of the Ministry of National Defence).

BOX 2

SOURCE: AL JAZEERA, REUTERS, ATLANTIC COUNCIL, COURRIER INTERNATIONAL control the long end of the curve to keep interest rates low by buying government bonds in the secondary market are considered highly unlikely going forward. Even if the Central Bank was given the prerogative to undertake quantitative easing during the pandemic, it used it parsimoniously and in emergency situations. Going forward, the BanRep is likely to continue to be strictly focused on inflation expectations and the output gap to guide monetary policy.

- **Following the Covid-19 shock, the economy will need to adjust to a new macroeconomic equilibrium which will drive up the real policy interest rates.** One consequence of the Covid-19 shock has been the temporary expansion of the twin deficit (especially in 2021 with a current account deficit at -5.7% of GDP). Adjusting to the accumulation of these macroeconomic imbalances will either require fiscal policy to be less expansionary (i.e. faster fiscal consolidation) or require a faster adjustment of monetary policy. The latter's stance is still expansionary (real policy rates stood at approximately -3% in February much below the neutral (equilibrium) real interest rates estimated at 1.5%[47]). Given the current fiscal stance and outlook as well as the likely convergence of private savings to their pre-pandemic historical average (17% of GDP vs. current 20% of GDP), the BanRep may need to raise policy rate closer to equilibrium faster if it wants to close external imbalances[48].

Driver n°3 – Nominal exchange rate: some room for appreciation in the medium-term

The exchange rate (USDCOP) has typically shown a close relationship with the price of oil (*chart 4*) as well as the US dollar Trade Weighted Dollar Index (USTWI)[49]. In fact, when the commodity super-cycle turned, the currency lost close to 40% of its value (between July 2014 and March 2015). Since, it has followed a depreciating trend and the signing of the Peace Accords in 2016 only marginally helped the currency make up some of its previous losses (*chart 28*). Following, the Covid-19 crisis however both the nominal and real effective exchange rates have shown greater levels of decoupling with oil prices. Domestic political risks (social protests, changes in the political landscape), higher market perception of sovereign risk (widening CDS spreads), deterioration of external imbalances and slower tightening of monetary policy relative to regional peers are explanations put forward to account for the greater divergence.

Fundamental changes to the BanRep's current exchange rate policy are not anticipated in the context of our simulations. Historically, since Colombia shifted from a crawling band (from 1960's on) to a flexible exchange rate regime in 1999, the BanRep's interventions in the FX market (discretionary or scheduled) have been motivated by three

INFLATION AND TARGETS (%)

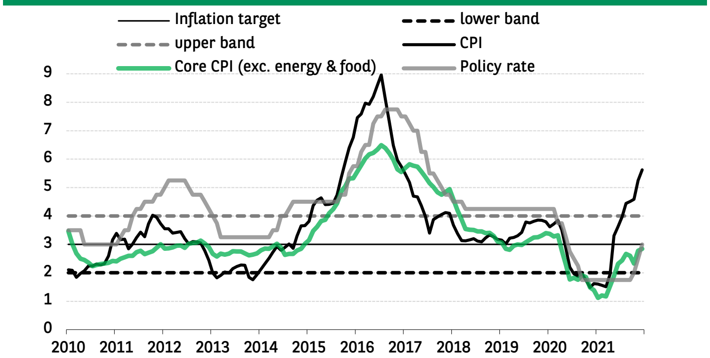

CHART 26 SOURCE: BANREP, BNP PARIBAS

MONETARY POLICY RATES (%)

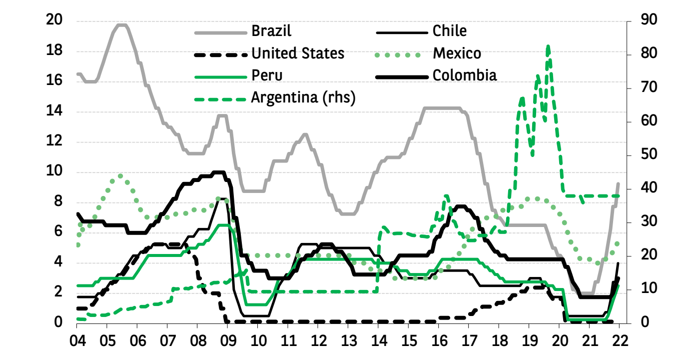

CHART 27 SOURCE: BIS

USD/COP NOMINAL EXCHANGE RATE (INVERTED SCALE)

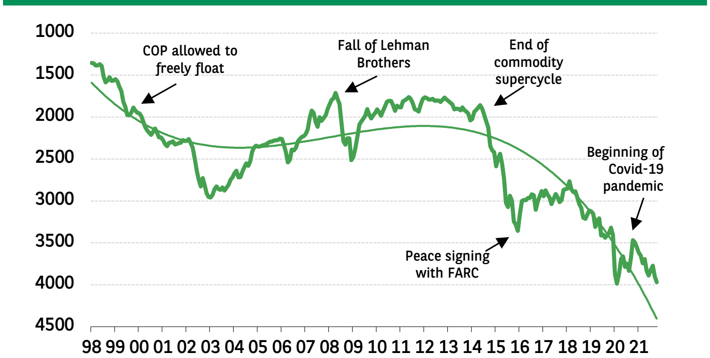

CHART 28 SOURCE: SOURCE: BANREP, CEIC

main objectives: 1/ build up FX reserves 2/ curb excessive volatility (dampen illiquidity in the market) and 3/ correct misalignment of the exchange rate[50]. The exchange rate regime is, as such, better classified as a managed float rather than a pure float. The BanRep has at times countered excess appreciation or depreciation as long as its

47 The neutral real interest rate (or natural rate) is the rate expected to prevail when an economy is at full employment and inflation is stable (ie the economy operates at potential). At the natural rate, monetary policy is neither expansionary nor contractionary. The natural rate cannot be observed, its level and trend can only be estimated. (cf Brookings). Note that the BanRep has used various methodologies to estimate the natural rate with estimates ranging from 1.1% to 2% with an average at 1.5% (cf inflation report, September 2018). The IMF also estimates the neutral real rate between 1% and 2% (cf article IV, 2021).

48 Felipe Klein (2021). *Colombia: External deficits strike again.* Global Markets – EM Economics, Focus Latin America. Indeed from a saving-investment perspective, the current account deficit is equal to the fiscal balance plus a private saving-investment gap. To avoid large misalignments of the current account deficit relative to equilibrium (consistent with fundamentals), policy decisions have to affect the supply and demand for savings which ultimately are a function of the real interest rate.

49 Moreno J.F. and Rojas J.S (2015). *Recent performance of the exchange rate in Colombia.* Monetary policy report, BanRep.

50 Vargas, H. (2011). *Monetary policy and the exchange rate in Colombia.* Borradores de Economía, 655. FX interventions are made with a view to controlling inflation (the main mandate of the Central Bank) and preserving financial stability.

interventions were compatible with its mandate (control inflation and preserve financial stability.) However, it has not done so with an explicit target for the nominal or real exchange rate and we do not expect that this policy will change over the forecast period in the medium-term fiscal framework (approximately 10 years). For the simulations, we assume an appreciating trend for the nominal exchange rate as most fair-value models mobilized to estimate the long-run equilibrium exchange rate – whether they are based on prices (purchasing power parity or PPP) or fundamentals (behavioural equilibrium exchange rate or BEER) – show evidence that the Colombian peso has been persistently undervalued in recent years.

Driver n°4 - Potential growth: weakened by the Covid-19 shock

Colombia has traditionally relied on the accumulation of its factors of production rather than on productivity gains to grow. Over period 2003-2012 – factor accumulation has accounted for 4pp of GDP growth versus 0.5 percentage points for total factor productivity (TFP)[51]. But in recent years, the contribution of TFP to GDP growth has turned negative (*chart 29*). Looking forward, demographic factors imply that the contribution of labour accumulation to growth will diminish over time.

Structural impediments have limited productivity gains explaining the weak contribution of TFP over time. These include high levels of labour market informality, barriers to international trade (in particular high non-tariff barriers and slow customs processing), a sizeable infrastructure gap (*chart 30*), skills mismatches in the labour market, burdensome regulations, lack of innovation (weak research and development effort) etc. These structural factors have acted as drags on potential growth.

In recent years, potential growth has suffered from the effects of specific shocks for which it is hard to say if they are transitory or not:

- Terms of trade shock of 2014-15. Lower oil revenues have impacted potential growth through a weakening of capital stock accumulation.
- The Covid-19 pandemic: some permanent loss in potential output results from i/ the adverse impact of extended school closure on human capital, ii/ the slow return of women to the labour force due to the gender imbalance in household and childcare[52]. The IMF has shaved off some 0.25pp of GDP when comparing its long-term forecasts pre and post-pandemic (2019 vs. 2021). Its estimates of potential growth at 3.5% are more or less in line with government projections (3.3%). These estimates account for the positive labour supply shock resulting from the influx of Venezuelan migrants since 2018-19 which is expected to help partially offset the weakening contribution of labour accumulation on growth as well as the impact of the pandemic on investment. Venezuelan migrants tend to be young and well-educated – supporting labour force participation rates and productivity[53]. For the most part current estimates of potential growth fluctuate in the range of 2.5% to 3.5%[54] (*chart 31*).

CONTRIBUTION TO GDP GROWTH (2010-2019)

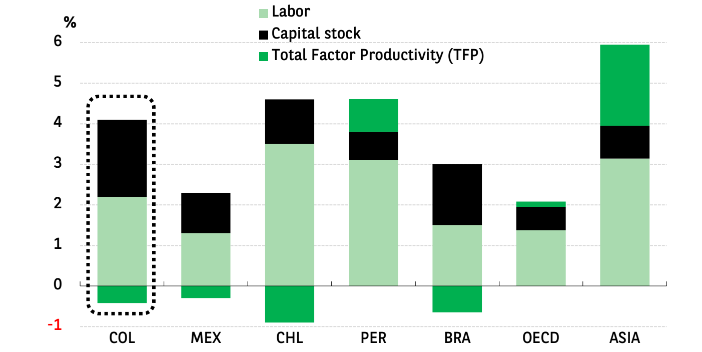

CHART 29

SOURCE: OECD

WEF: QUALITY OF INFRASTRUCTURE

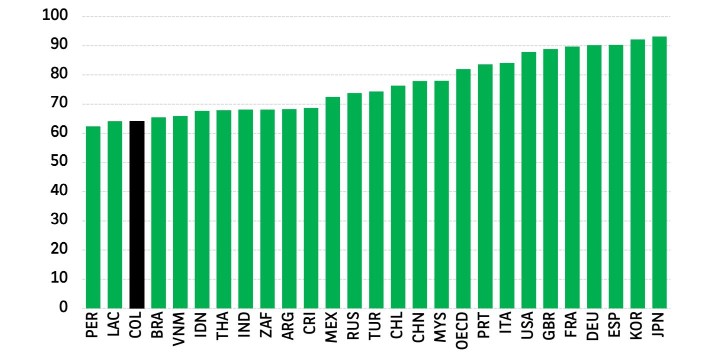

CHART 30

SOURCE: OECD , WEF (2019, DATA)
* QUALITY OF INFRASTRUCTURE : 1-100 (BEST)

ESTIMATES OF POTENTIAL GROWTH* (%)

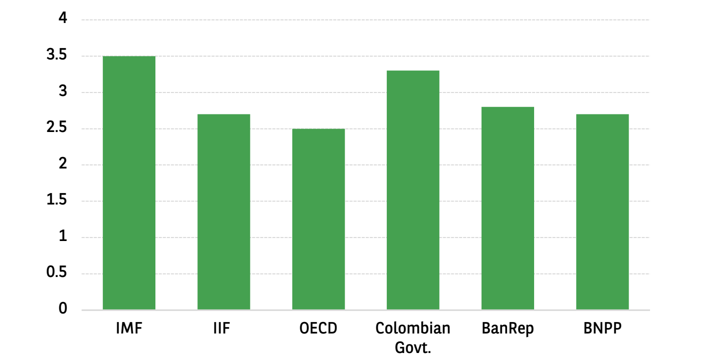

CHART 31

SOURCE: OECD, IMF, IIF, NATIONAL SOURCES, BNP PARIBAS
*USING EXPLICIT ESTIMATES OR MEDIUM-TERM FORECASTS AS PROXY

51 Vergne (2015)
52 *World Bank Global Economic Prospect* (June 2020) for a review of channels through which Covid-19 affected potential growth worldwide.
53 IMF, *Colombia : selected issues*, 2020. OECD (2019). *Venezuelan migration shock in Colombia and its fiscal implications*. OECD Policy Note.
54 There are multiples ways of estimating potential (trend) output. For a review of methodologies on the issue see i/ Leonardo Bonilla Mejía, José David Pulido (2020). *New Estimates for Colombia's Potential (Trend) GDP and Output Gap.* Box 1 In BanRep Monetary Policy Report (January 2020) and ii/ IMF, *Colombia selected issues*, 2021.

Simulations: Upside risks on the debt ratio

In this subsection, we evaluate alternative assumptions to those envisaged in the medium-term fiscal framework. We translate information from the previous section into numerical form to gauge the possible evolution of public debt dynamics.

The benchmark: the MTFF scenario

The government has made some important revisions to its medium-term fiscal framework (MTFF) in June 2021 with fiscal deficits for the general government projected to be significantly larger going forward than in previous MTFFs. Part of the increases stem from the fact that deficit targets appeared unattainable in light of the pandemic[55] but the plan goes much further. Important takeaways are summarized in box 3, table 2, charts 32 & 33.

According to the MTFF, public debt ratio would peak at close to 70% of GDP in 2022-23 and bring the debt burden to about 60% of GDP by 2032. However in order to fully comply with the fiscal rule, the government projects that in addition to fiscal revenues of 1.2% of GDP internalized in the 2021 tax reform (which would only kick in 2023), it

55 The fiscal deficit for 2022 was originally at 2.5% of GDP. It is now projected at 7% of GDP. According to calculations by the IIF, assuming that a tax reform yielded 1% of fiscal savings in 2022, in order to achieve a fiscal deficit of 2.5% of GDP (the original target of the medium-term fiscal plan for 2022), primary spending would have to be cut by almost 6%, a difficult result to achieve given the pressures to prop up social spending. IIF (2021). *Fiscal risk in Colombia*. Economic views.

CHANGES TO THE MEDIUM-TERM FISCAL FRAMEWORK (2021)

Spending side:

• Social spending increased by 0.4% of GDP and 0.5% of GDP in 2021-2. In 2022, a gradual adjustment would take place but maintain the expansionary fiscal policy.

• The government projects to cut social spending starting in 2023 by some 0.3pp of GDP (to 0.1% of GDP). The additional social spending would disappear thereafter.(cf chart 32).

• The projected primary spending in 2024 will be close to 2pp of GDP higher than in 2019.

• Projected cuts of 0.2% of GDP per year through 2032.

Revenue side:

• Fiscal consolidation will be back loaded with increased revenues coming in only as of 2023 with ambitious revenue raising plan based on tax hikes (0.9% of GDP – focused on corporate taxes) and tax efficiency gains (0.3% of GDP) which will help generate 1.2% of GDP yearly.

• A non-negligible part of the fiscal adjustment relies on oil-related revenues. Oil revenues are expected to go down gradually through 2032. They are expected to contribute 0.3% of GDP in revenues in 2032 versus 0.6% of GDP in 2024. Projections are premised on a Brent at USD 66.

Balance:

• The government will not be in a position to extract a primary surplus (0.3% of GDP) before 2025 (3 years later compared to pre-Covid-19 projections). It projects an average primary surplus of 0.75% of GDP over the period 2026-32.

BOX 3

REVENUES PROJECTIONS - MTFF

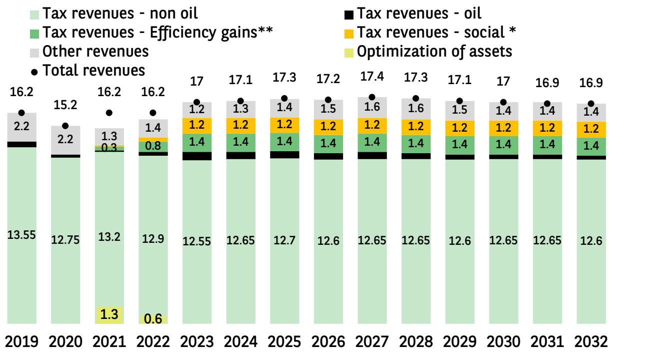

CHART 32

SOURCE: MINISTRY OF FINANCE, MEDIUM-TERM FISCAL FRAMEWORK (2021)
* TAX LEVIED TO FINANCE SOCIAL SPENDING (PROYECTO DE LEY DE INVERSION SOCIAL)
** RESULTING FROM MODERNIZATION OF TAX AND CUSTOMS DIRECTORATE, DIAN

SPENDING PROJECTIONS - MTFF

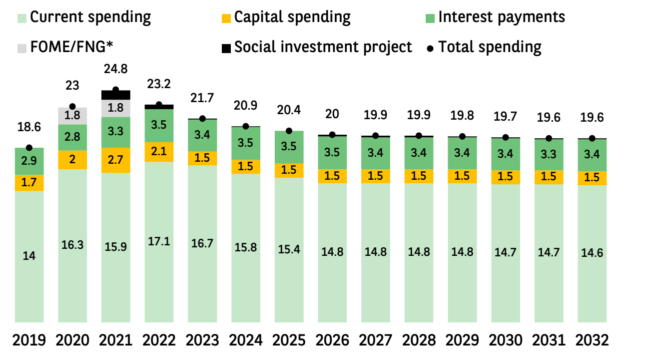

CHART 33

SOURCE: MINISTRY OF FINANCE, MEDIUM-TERM FISCAL FRAMEWORK (2021)
*FONDO DE MITIGACION DE EMERGENCIAS / FONDO NATIONAL DE GARANTIAS

OFFICIAL PROJECTIONS (MTFF)

	Actual		Projections										
	2020	2021	2022	2023	2024	2025	2026	2027	2028	2029	2030	2031	2032
Nominal GDP growth (%)	-5.5	10.6	7.9	7.0	6.7	6.6	6.6	6.4	6.4	6.4	6.4	6.3	6.3
Real GDP growth (%)	-6.8	6.0	4.3	3.8	3.6	3.5	3.5	3.3	3.3	3.3	3.3	3.2	3.2
Effective nominal domestic interest rate (%, average)	5.0	5.1	5.1	5.1	5.1	5.1	5.1	5.1	5.1	5.1	5.1	5.1	5.1
Inflation (%) (GDP deflator) -calc	1.3	4.6	3.6	3.2	3.1	3.1	3.1	3.1	3.1	3.1	3.1	3.1	3.1
Effective nominal foreign interest rate (%)	4.3	4.0	4.1	4.4	4.5	4.5	4.5	4.4	4.4	4.3	4.1	4.0	3.9
Exchange rate (period average)	3694	3667	3744	3822	3903	3985	4068	4154	4241	4330	4421	4514	4609
Exchange rate depreciation (%)	12.6	-0.7	2.1	2.1	2.1	2.1	2.1	2.1	2.1	2.1	2.1	2.1	2.1
Share of foreign currency debt (% of total)*	36.2	39.2	36	36	36	36	36	36	36	36	36	36	36
Effective real domestic interest rate (%) - calc.	3.3	0.5	1.4	1.8	1.9	1.9	1.9	1.9	1.9	1.9	1.9	1.9	1.9
Effective real foreign interest rate (%) - calc.	15.6	0.2	3.4	3.5	3.6	3.6	3.6	3.5	3.5	3.4	3.2	3.1	3.0
Weighted average interest rate (%) - calc.	8.4	0.4	2.2	2.4	2.5	2.5	2.5	2.5	2.5	2.5	2.4	2.4	2.3
General government primary balance (% of GDP)	-4.9	-5.3	-3.5	-1.3	-0.3	0.3	0.8	0.9	0.8	0.7	0.7	0.7	0.7
General Governement debt (% of GDP) - calc.	64.7	66.6	68.7	69.1	68.7	67.8	66.3	64.9	63.6	62.4	61.2	60.0	58.7

** Projected share of foreign currency debt not communicated. It is assumed fixed at its level of 2020. This impacts our calculations but only leads to slight differences with official general government debt to GDP projections.* *Source : Ministry of Finance, BNP Paribas*

TABLE 2

would need an additional fiscal adjustment amounting to some 0.6% of GDP per year over the period 2023-26 – with a smaller adjustment thereafter. This implies that a new package of reform will be needed in the short term.

Baseline and alternative scenarios

In light of the elements discussed previously, we present in the notes of table 3 our baseline macro assumptions for each drivers of the public debt ratio. Note that we internalized the release of new data since the publication of the MTFF in June 2021. Real and nominal GDP in 2021 were for instance much stronger than anticipated in the MTFF while the exchange rate depreciation was relatively contained. We also evaluate alternative paths for the debt ratio considering adverse shocks to the baseline scenario:

- **Primary balance shock:** under this scenario, consistently larger primary deficits are projected assuming less supportive oil prices, higher social spending needs, sustained growth underperformance or a watering down of future tax reforms. The baseline primary balance scenario is shocked by an additional 0.8% of GDP over the forecast period (representing about half a standard deviation of the primary balance over the period 2010-20).
- **Interest rate shock:** we also consider higher inflation dynamics and tighter external financial conditions over the forecast period. As such we internalize a 100 basis points (bps) shock to the baseline local interest rate scenario. Baseline foreign borrowing costs are also shocked by a 50 bps reflecting tighter external financial conditions (equivalent in each case to approximately one standard deviation considering 10-year historical rates both local and foreign).
- **Growth shock:** the economy is assumed to grow below potential (estimated at 2.7%) for 2 years starting in 2024-2025 with baseline growth rates lowered by one standard deviation (3.5 percentage points over period 2010-2020). This implies a mild recession in both years.
- **Exchange rate shock:** we introduce two depreciative episodes to our otherwise optimistic assumptions for the USDCOP path (relative to official projections). A severe nominal depreciation of the exchange rate analogous in size to the one experienced in 2015 (36%) is introduced in 2025. A milder episode is introduced in 2028 corresponding to one standard deviation over the period 2010-2020.

BASELINE SCENARIO (BNP PARIBAS)

	Actual		Projections										
	2020	2021	2022	2023	2024	2025	2026	2027	2028	2029	2030	2031	2032
Nominal GDP growth (%)	-5.5	17.8	11	7	6.6	6.6	6.6	5.6	5.5	5.4	5.3	5.2	5.1
Real GDP growth (%)	-6.8	10.6	6.1	3.0	2.7	2.7	2.7	2.7	2.7	2.7	2.7	2.7	2.7
Effective nominal domestic interest rate (%, average)	6.3	6.7	6.9	6.7	6.3	6.1	5.8	5.6	5.5	5.3	5.1	5.0	4.8
Inflation (%) (GDP deflator) -calc.	1.4	7.3	4.9	4.0	3.9	3.9	3.9	2.9	2.8	2.7	2.6	2.5	2.4
Effective nominal foreign interest rate (%)	4.0	4.5	4.6	4.9	5.0	5.0	5.0	4.9	4.9	4.8	4.6	4.5	4.4
Exchange rate (period average)	3694	3744	3861	3731	3623	3534	3448	3390	3333	3279	3226	3195	3155
Exchange rate depreciation (%) *(COP per USD : negative = COP appreciation)*	12.7	1.4	3.1	-3.4	-2.9	-2.5	-2.4	-1.7	-1.7	-1.6	-1.6	-1.0	-1.3
Share of foreign currency debt (% of total debt)	36.2	39.8	36	36	36	36	36	36	36	36	36	36	36
Effective real domestic interest rate (%) - calc.	4.9	-0.5	1.9	2.6	2.4	2.1	1.9	2.6	2.6	2.5	2.4	2.4	2.4
Effective real foreign interest rate (%) - calc.	15.5	-1.3	2.8	-2.5	-1.8	-1.4	-1.4	0.2	0.3	0.4	0.3	1.0	0.7
Weighted average interest rate (%) - calc.	8.4	-0.8	2.3	0.7	0.9	0.8	0.7	1.7	1.7	1.7	1.7	1.9	1.8
General government Primary balance (% of GDP)	-4.3	-6.1	-4.3	-2.1	-1.1	-0.5	0.0	0.1	0.0	-0.1	-0.1	-0.1	-0.1
General Governement debt (% of GDP) - calc.	64.7	64.2	66.2	66.8	66.7	66.0	64.7	64.0	63.4	62.9	62.3	61.9	61.5

-Real GDP expected to converge to our estimates of potential growth of 2.7%
-Nominal GDP is projected using as a benchmark OECD long-term projections (Economic outlook)
-Exchange rate trajectory : uses the OECD long-term projections (Economic outlook) ; given undervaluation of the COP relative to the USD, it assumes a strengthening trend for the COP over the forecast period
-Share of foreign currency debt held constant at the level of 2020 -a level that is consistent with official medium-term debt strategy of holding a portfolio of FX debt in the range of about 35%.

(contd.):
-Effective nominal domestic interest rate use as proxy OECD projections on 10y government bonds
-Effective nominal foreign interest rates assumes 50 bps higher average external cost of borrowing compared to official projections.
-Primary balance projections internalizes increased spending pressures coupled with difficulties raising revenues thereby lowering official projections by 0.8% of GDP over the forecast horizon.

TABLE 3

PUBLIC DEBT DYNAMICS: SHOCKING THE BASELINE SCENARIO (BNP PARIBAS)

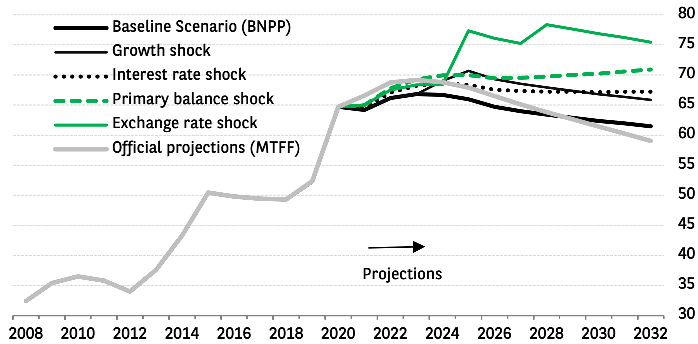

CHART 34 SOURCE: MINISTRY OF FINANCE (MTFF), BNP PARIBAS

PRIMARY BALANCE (% OF GDP) REQUIRED TO STABILISE PUBLIC DEBT FOR DIFFERENT COMBINATIONS OF INTEREST RATES AND GROWTH RATES

Debt/GDP (%) = 65

Trend / Potential growth (%) - G	Weighted average real interest rate (%) - I						
	2.0	2.5	3.0	3.5	4.0	4.5	5.0
1.5	0.3	0.6	1.0	1.3	1.6	1.9	2.2
2.0	0.0	0.3	0.6	1.0	1.3	1.6	1.9
2.5	-0.3	0.0	0.3	0.6	1.0	1.3	1.6
3.0	-0.6	-0.3	0.0	0.3	0.6	0.9	1.3
3.5	-0.9	-0.6	-0.3	0.0	0.3	0.6	0.9
4.0	-1.3	-0.9	-0.6	-0.3	0.0	0.3	0.6
4.5	-1.6	-1.2	-0.9	-0.6	-0.3	0.0	0.3
5.0	-1.9	-1.5	-1.2	-0.9	-0.6	-0.3	0.0

Unfavorable interest rate - growth differential When I>G (positive differential) : need to extract a primary surplus to stabilize public debt ratio

Favorable interest rate - growth differential (negative differential) When I<G : can run a primary deficit and still stabilize public debt ratio

Most likely scenario

TABLE 4 SOURCE: BNP PARIBAS

Despite using more conservative assumptions (to tame the optimistic bias alluded to earlier in the text) on real GDP growth and the primary balance (internalizing higher spending pressures), we see in table 3 that under the baseline scenario the debt to GDP ratio would peak at close to 67% of GDP in 2023-2024 – below official projections. This more favourable path is in large part due to the internalization of the strong economic rebound witnessed in 2021, which helped stabilize the debt trajectory much earlier than anticipated, improving the fiscal outlook. In the latter part of the projection horizon, the baseline assumptions weigh more heavily on the debt dynamics with the debt trajectory dropping less quickly than official projections. However the deterioration appears overall relatively modest despite generally more pessimistic assumptions. This can be explained by the fact that automatic debt dynamic components tend to play in Colombia's favour over the forecast horizon (projected appreciating trend for the nominal exchange rate and favourable interest-growth differentials). In fact, we see in table 4, that the conditions for debt stabilization appear within the scope of policy adjustments, reducing concerns over the sustainability of the public debt. In terms of the shocks (*chart 34*), we see that the public debt trajectory is most vulnerable to a weakening of the exchange rate given the comparatively large share of debt denominated in foreign currency. With the exception of the exchange rate shocks, the debt tends to stabilize at higher levels, on average about 5 to 10 percentage points higher than official projections. All in all, while long-term projections exercise are subject to important uncertainties, we see that the possible trends in the debt path under several adverse scenarios remains overall manageable. Ultimately risks to the debt in Colombia may come less from its overall level but rather from aspects of its profile (share of foreign currency debt, non-resident holdings of the debt, in the context of typically large external financing requirements).

Conclusion: any cause for concern then?

Our analysis[56] showed that achieving official medium-term fiscal consolidation goals and meeting fiscal targets could be challenging as Colombia will have a narrower space for fiscal consolidation in the next 5 years.

Given that diagnostic, how concerned should we then be about the trajectory of public finances in Colombia?

The situation is far from being critical and Colombia has a good ability to support its debt. Colombia faces a stable interest payments burden, highly manageable debt servicing costs and a relatively favourable interest-growth differential. In addition, Colombia may offer greater upside risks compared to some of its regional peers in keeping rates low and keeping higher growth potential. Admittedly, there has been a big increase in the public debt ratio and it will take a long time return to pre-pandemic levels but active debt management and the build-up of the country's external asset position have helped reduce interest rate, currency and rollover risks. The medium-term outlook is also supported by low contingent liabilities (which are well identified and provisioned for) as well as a solid institutional framework (*section "Pre-Covid-19 public finances snapshot: the pros and cons"*) and safeguards (no monetization of the public debt) should help to keep spending and the debt at sustainable levels. The effect of volatile commodity prices on public accounts is also partially alleviated through the fiscal rule which is likely to be further enhanced going forward[57].

However, there are three main vectors of risk, which if left unattended, could heighten concerns over the trajectory of public finances in the medium to longer term:

- If no efforts are made **to rebuild policy credibility** by revising future fiscal targets on the basis of more conservative macroeconomic assumptions.
- If future administrations are unable to **generate new permanent sources of revenues**. A risk of fiscal slippage could materialize if revenues and growth disappoint or if future governments do not adhere to the current administration's fiscal plans – a possible scenario in light of emerging shifts in the political landscape.
- If little effort is made to **mend the social expectation gap**.

Without addressing these challenges, Colombia may find it difficult to appease credit rating agencies and bolster investors' confidence. This would likely compromise Colombia's ability to maintain market access at favourable terms.

In order to enhance its chances of fulfilling the MTFF aspirations of *fostering a virtuous cycle between the social, the economic and the fiscal*, Colombia's first order of business should be to enhance social dialogue to improve the existing social pact. Economists at the IMF remarked that amidst increasing poverty and defiance towards governing institutions, the countries that are likely to do better post-pandemic (in terms of both growth outcomes and passing reforms) are the ones most capable of building *"broad social consensus and political cohesion around several crucial dimensions of public finances [through] a fiscal pact"*[58].

This proposed roadmap would, in the case of Colombia, help address all three aforementioned vectors of risk. It stresses the need to engage in a social dialogue on how to broaden the social safety net (i.e. mending the social expectation gap) and how to finance it (generate new permanent sources of revenues), "*to assess society's preferences regarding the tax and expenditure implications behind these very consequential tradeoffs. This public dialogue should serve as a basis into the legislative process that should take place in the next couple of years to revise pensions, health, and educational systems as well as reforming tax frameworks to support it*". The authors also stress the importance of improving the effectiveness and flexibility of fiscal responsibility frameworks (to increase credibility and reduce fiscal risk): *"the formal adoption of fiscal anchors, introduction or strengthening of fiscal councils, and enhancement of communication strategies will improve efficiency and reduce fiscal risk, thus increasing credibility, lowering interest rates, and widening much needed fiscal space"*. In that regard, changes to the fiscal rule in the most recent tax reform is one step in the right direction. A more conservative calibration of the medium-term plan and the creation of an independent fiscal council (as recommended by the OECD) tasked with costing and forecasting the impact of fiscal policy measures over medium to longer time horizons could also help bolster fiscal policy credibility.

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56 Considering i/ the government' decision to backload its fiscal adjustment, ii/ the prolonged impact of Covid-19 variants on public accounts, iii/ the historical challenges in raising tax revenues, iv/ the downside risks to projected oil related revenues, v/ the optimistic bias of government assumptions regarding GDP growth and efficiency gains, vi/ increased spending pressures in a post-Covid era (healthcare, social spending) as well as other fiscal pressures (migration, Peace, etc..).

57 In its 2021 article IV, the IMF provides a number of recommendations based on international experience to further strengthen the fiscal rule and the latest 2021 tax reform introduced a reform of the existing fiscal rule (cf. appendix 1).

58 Mauricio Cardenas, Luca Antonio Rocco, Jorge Roldos, and Alejandro Werner (2021). *Fiscal Policy Challenges for Latin America During the Next Stages of the Pandemic: The Need for a Fiscal Pact by*. IMF Working Paper WP/21//77, March 2021.

TAX REFORMS IN COLOMBIA OVER THE PAST DECADE (2011-2021)

2011: Law 1473 establishes the fiscal rule (effective as of June 2012 however) and passing of a royalty law. Regarding the fiscal rule, two technical committees of independent experts are charged with providing inputs to estimate long-term growth, output gaps and assumptions on the structural price of oil (10-year projections). Another independent Consultative Committee on the Fiscal rule (CCFR) assesses the parameters built into the fiscal rule and evaluate any changes to the rule proposed by the government. The CCFR also assesses ex-post compliance with the fiscal rule and proposes a headline fiscal deficit consistent with the rule ex-ante. The CCFR also presents an independent report to Congress on the implementation of the rule.

The royalty law required regional governments to save 30% of future royalty revenues. From those, 10 percentage points (pp) would go to pension savings, and 20 pp will go to the Savings and Stabilization Fund (with the fund expected to act as a buffer in the event of sizable drops in oil prices).

2012/2013: Reduction of payroll taxes from 29.5% to 16% of gross wage earnings for workers earning less than 10 minimum wages. Replacement of part of foregone revenues from payroll taxes via the introduction of a new tax on corporate profits. Simplification of personal income taxes. Simplification of the VAT structure with a reduction in the number of VAT rates. Reduction in the capital gains tax.

Comment: the reform was primarily destined to change the structure of the tax system to improve its redistributive impact (reduce informality, unemployment and enhance tax progressivity) rather than improve the revenue intake per se. It focused on improving the income distribution, reduce incentives to remain in the informal sector (by promoting labour formalization by reducing non-wage labour costs with most evaluation studies indicating it worked), improve tax administration and compliance (reduce fraud and tax evasion). The reform was considered revenue-neutral in both the short and medium terms.

2016/2017: Increase in the general VAT rate by 3 pp to 19% from 16%. Limit exemptions on personal income tax. Reduction of the corporate tax rates to 33% by 2019 from 35% and simplification of tax procedures for small businesses (simplification of the tax code). Extension of financial transaction taxes beyond 2019 (was originally scheduled to be phased out in 2019). Strengthening of the tax administration and increased penalties to counter tax evasion.

Comment: hike in VAT was to affect consumption but lower corporate tax rates was to support investment and thereby medium-term growth. The structural tax reform was destined to increase tax revenues (to replace lost oil revenues), while improving the efficiency, progressivity and competitiveness of the tax system.

2018: The reform bill originally sought to reduce corporate tax rates, increase personal income tax and broaden the VAT base. The projected revenue from the approved reform amounted to some 0.7% of GDP (1/2 of the original proposal). Reduction of corporate taxes by 3 percentage points to 30% until 2022 and creation of exemptions on the VAT charges on capital goods imports; increase in the wealth tax (higher income tax for higher bracket individuals + 1% tax on assets above COP 5bn) ; tax cuts on fixed-income operations by non-residents to 5% from 14%. Strengthening of the capabilities of the tax-collection agency (DIAN) and implementation of electronic invoicing to reduce tax evasion.

Comment: the reform provided some incentives to boost real investment growth. The lost revenues from tax cuts were supposed to be compensated by a broadening of the tax base (in particular for VAT). However, the reform came short of expectations, as it was unable to widen the tax base, reduce tax loopholes and expand VAT to most goods and services.

2021 (April, proposal - withdrawn): To meet the target of the existing fiscal rule, the government announced in Q1 2021, it needed a tax reform that increased revenues by some 2% of GDP. The proposal projected 1.4% of GDP in fiscal savings per year from 2022 onwards (2.4 % of GDP in new revenues : via reduction of VAT exemptions (0.7% of GDP), expansion of personal income tax base (1.4% of GDP), changes to corporate taxes (0.3% of GDP) ; the proposal also projected 1% of GDP in new expenditures via expansion of social spending (0.4% of GDP), VAT refunds to lower income people (0.2%), transfers to regions (0.4% of GDP).

Comment: the reform sent to Congress appeared highly ambitious but consistent with the Duque's administration fiscally responsible stance. The proposed reform was perceived as an attempt to send a signal to rating agencies about the government's commitment to fiscal consolidation — at a time when the threat of a rating downgrade below investment grade seemed imminent. The reform proposal produced a backlash in society ultimately materializing into in a national strike. The removal of VAT exemptions and rise in the personal income tax was thought to place a disproportionate burden of the adjustment on the middle class. The proposal was eventually withdrawn by President Duque.

2021 (July, proposal – approved in September): The reform which is much broader than a tax reform was labelled "social investment law". On the revenue side, projected increase in fiscal receipts by 1.2% of GDP starting in 2023 with 70% coming from corporate income tax measures including a rise in the corporate tax rate from 30% to 35% from 2023 through 2025 and permanence of the Industry and Commerce tax (ICA) ; the remaining 30% would come from improving tax administration (ie reduce tax evasion). Increase in social spending (in 2021-2022) with the extension of the Payroll Support Program (PAEF) and Solidarity Income Programs in addition to support for employment and higher education. The reform also broadens the Simple Taxation Regime, a regime specially created to support smaller businesses. Austerity measures of 0.2% of GDP per year through 2032 are also internalized in the reform. Reform of the fiscal rule: (a) law limits public debt to 71% of GDP with a target to reduce it to 55% of GDP in the medium-term (b) the medium-term target for the structural fiscal deficit will be closer to 2.5% of GDP rather than the previous 1% of GDP. A transition period between 2022-2025 is introduced proscribing interim primary balance targets.

Comment: the reform is less structural in nature (but turned out to be the most politically viable) and includes primarily social measures but these have a temporary character destined to accommodate the residual effects of the Covid-19 crisis on the most vulnerable. Planned reductions of corporate taxes from previous reforms were suspended. While the reform raises revenues, when discounting the temporary social spending component the net impact of the reform is estimated to be closer to 0.9% of GDP. The introduction of a new anchor (debt target) to complement the structural fiscal deficit goal has been particularly welcomed.

APPENDIX 1

SOURCE: AUXADI, LOZANO (2001), BNP PARIBAS GM, BBVA, FITCH RATINGS, IMF, THOMSON REUTERS, OECD, AFD.

PROGRAMS DEPLOYED AND INSTITUTIONS MOBILIZED IN RESPONSE TO COVID-19

Fiscal policy:

- **Measures aimed at supporting vulnerable populations including elderly and poor people, informal / independent workers, migrants:**

  - Support for households: i/ Solidarity Income Program (ingreso solidario) - program targeted to support vulnerable populations through unconditional direct transfers to households not covered by other programs (an estimated 3 million households). Other pre-pandemic programs that were expanded to offer increased social protection included ii/ Familias en accion iii/ Jovenes en accion iv/ Colombia Mayor. Other forms of support: energy subsidies, food delivery, suspension of evictions, rent freeze, reconnecting low-income families without access to electricity grid, VAT refunds to poorest families, VAT deductions

  - Support for migrants: Temporary Protection Status (TPS) Program + acceleration of accreditation of Venezuelan degrees : Deepening of efforts to integrate some 2 million Venezuelan migrants. TPS will be valid for 10 years with right to apply for permanent residence visas after 5 years.

- **Measures to provide tax and financial relief, financing/refinancing for companies and households, protect jobs, avoid business failures and aid with the recovery:**

  - Job support: i/ Payroll Support Program (programa de apoyo al empleo - PAEF) ; ii/ income support schemes (programa de apoyo a la prima - PAP).

  - Support for companies: Subsidized Loan Program / financial guarantees primarily through FNG (National Guarantee Fund, which typically offers financial guarantees to micro, small and medium sized enterprises, put in place lines of credit to help companies cash flow). Measures to provide relief included payments deferrals on mortgage, guarantees, different types of insurance schemes, credit lines/loans to cover working capital and payroll costs, payment deferrals on taxes, etc.). Public institutions that were leaned on for support:

    ≥ BANCOLDEX (industrial development bank and export-import bank),

    ≥ FINAGRO (development bank specialized in agriculture and rural development),

    ≥ FDN (development bank specialized in infrastructure),

    ≥ FINDETER (national development which operates to support subnational entities),

    ≥ PRO-COLOMBIA (export and investment promotion)

  - Support the economy at large: 5G infrastructure program (5% of GDP): Public investment program that rests largely on public-private partnerships (PPP); the acceleration of large infrastructure projects (toll road concession, airports etc.) aims to generate 1 million new jobs (Compromiso por Colombia strategy)

- **Measures to combat the pandemic / support the healthcare sector:**

  - Reduction of tariffs for essential/strategic imports, loosening of rules for procurement of equipment (ie medical devices, personal protective equipment), reallocation of expenditure in support of increased capacity in the health sector, bonuses to health workers etc..).

  - Vaccination program: the vaccination campaign, which started in 2021 at first faced issues in terms of provision and distribution. It has progressed but it still lags behind peers in the region.

Monetary policy:

- **Measures to provide liquidity to the market in COP and USD and eventually support the economic recovery:**
  - It cut rates by a cumulative 250 bps over the period from March 2020 to October 2021). It had previously been 2 years since the BanRep had cut rates.
  - Extended access to repos auctions and discount window to more market players to have access to liquidity overnight,
  - Extended the type of collateral the BanRep accepts in liquidity operations,
  - Rolled out a new mechanism for FX hedging using non-deliverable forward,
  - Cut banks' reserve requirements to allow banks to ease payments terms for both households and corporates,
  - Rolled out an asset purchase programme (quantitative easing-type measures). BanRep takes on credit risk from private counterparties which it is not exposed to in repo operations). BanRep will purchase corporate bonds in the amount of COP 10 trillion maturing within three years as well as sovereign bonds in the amount of COP 2 trillion.

APPENDIX 2

SOURCE: MINISTRY OF FINANCE, BANREP, OECD, IMF

CHANGING POLITICAL DYNAMICS: SIGNS OF STRUCTURAL SHIFTS IN THE POLITICAL LANDSCAPE WITH INCREASED SUPPORT FOR SOCIAL POLICIES

Compared to other Latin American countries, leftist political currents have been relatively marginal in Colombia's political landscape. Since the 1960's, a closed two party system prevailed between the Liberal Party and the Conservative Party (both parties signed a political pact whereby they would split seats in Congress and the public administration and commonly decide on presidential candidates). The adoption of a new Constitution in 1991, helped introduce greater levels of political pluralism in the Senate and the Chamber of representatives. However, both institutions have continued to be dominated by parties from the right or the center right (Liberal, Conservative and the Social Party of National Unity created by ex-President Alvaro Uribe in 2005). As such, there has been very limited ideological opposition. That said, in recent years, there have been incipient signs that the political landscape could be witnessing some shifts with greater support for leftist type policies:

- Green and leftist parties have gained some traction in local elections in recent years. Also seven left-wing political parties in Congress have already signed a pact to build a coalition in order to avoid a repeat of 2018 when divisions between the left and the center-left opened the door to a victory of the right.
- The multiplication of social protests and the lack of good faith in negotiations between government delegates and labour unions as well as other social organizations regarding advancement of the National Dialogue has fueled greater levels of discontent against the sitting administration to the benefit of left wing rivals (approval ratings for a sitting President have never been this low). In mid-June, the national strike committee – which represents some 40 labour unions, farmer organisations and student organisations – suspended talks with the government and expressed its intention to pursue its demands through other means, including by proposing bills to Congress. Since then, the strike committee has proposed ten draft bills to Congress on various social and economic policies, but they have received little support from lawmakers, according to media reports.
- Current polls regarding the 2022 presidential election show that Gustavo Petro, a left-leaning candidate, ex-mayor of Bogota and runner-up at the 2018 presidential election, could make a serious push for the presidency.
- The prosecution by the Supreme Court of Colombia's most influential right-wing politician and ex-President (2002-10) – Alvaro Uribe – has shaken the political establishment. Uribe – a political mentor and ally of sitting President Duque – was placed under house arrest for two months in 2020 for witness tampering and fraud. So far, his camp has failed to see the alleged criminal charges against him dropped (by the Constitutional, Supreme or Lower Courts).
- The Covid-19 crisis has brought about a return of the State and reinvigorated industrial policy all at the expense of globalization. However, there has not been a concomitant sense of improvement in political legitimacy. In fact, in Colombia, survey data show an increased defiance against the current functioning of democracy and a still high perception that corruption constitutes an important problem in society. This combined with slower growth and the exacerbation of already high levels of inequalities because of Covid-19 ultimately has the potential to fuel anti-establishment sentiment and rising discontent benefitting candidates on the extremes and / or running against the incumbent President (the incumbent has lost in all of the elections held in Latin America in 2021.)

APPENDIX 3

SOURCE: SECURITY COUNCIL.ORG, LATIN NEWS, LATIN BAROMETER

BREAKING DOWN THE CONTRIBUTIONS TO PUBLIC DEBT DYNAMICS

$$\underbrace{\Delta d_t}_{(1)+(2)+(3)} = \frac{r_w-\pi(1+g)d_{t-1}}{(1+g+\pi+g\pi)} + \frac{[-g d_{t-1}]}{(1+g+\pi+g\pi)} + \frac{\alpha e(1+r_f)}{(1+g+\pi+g\pi)} + p^b + SF^{adj}$$

Change in public debt $[d_t - d_{t-1}]$ (percentage points of GDP)

Average weighed nominal interest rate on local and foreign currency public debt (%)

Inflation (deflator) (%)

Real GDP growth rate (%)

Gross public debt denominated in foreign currency (% of GDP)

Nominal exchange rate depreciation (%)

Effective interest rate on public debt denominated in foreign currency (%)

Primary revenues - Primary expenditures (% of GDP)

Transactions on the assets and liabilities of the general government that are not accounted for in the primary balance - eg :
-privatization receipts
-recognition of implicit or contingent liabilities
-asset changes and interest revenues etc. (% of GDP)

(1) + (2) + (3)

Contribution from real interest rate + **Contribution from real GDP growth**

Contribution from exchange rate depreciation

(2) Contribution from primary deficit (non-interest)

(3) Stock-flow adjustment

Contrbution from interest (r) - growth (g) differential (ie."Snow-ball effect")
if r<g (negative differential) : for a given primary balance, public debt tends to increase mechanically
if r>g (positive differential): for a given primary balance, public debt tends to decrease mechanically

(1) "Automatic debt dynamics"

note: contribution can be further broken down into

Contribution from cyclical primary balance

Contribution from structural primary balance (adjusted for output gap)

APPENDIX 4

SOURCE: OFCE, IMF, BNP PARIBAS

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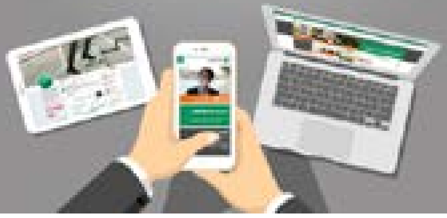

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