



“Better Policies” Series

COLOMBIA

POLICY PRIORITIES FOR
INCLUSIVE DEVELOPMENT

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On 29 May 2013, the OECD decided to open accession discussions with Colombia and on 19 September 2013, an Accession Roadmap was adopted setting out the terms, conditions and process for accession [C(2013)110/FINAL] which includes in-depth reviews by 23 OECD Committees.

This publication has been prepared by the OECD Secretariat on the basis of currently available information and does not prejudge in any way the results of the ongoing reviews of Colombia by OECD committees as part of the process of accession to the OECD.

FOREWORD

Under the leadership of President Juan Manuel Santos, Colombia's economy has performed strongly in recent years. Robust growth has been accompanied by low inflation, declining public debt and better management of public resources. Poverty has declined substantially and the share of middle-income households in the population has expanded dramatically over the last decade. The government's major reform efforts – including a new fiscal framework, and important tax and labour market reforms, among others – have contributed to the improving economic and social situation. A successful conclusion to the ongoing peace process holds the promise of a substantial social and economic 'peace dividend', if coupled with ambitious reform efforts.

With a view to building on this significant progress, the Colombian government is preparing a National Development Plan 2014-2018 resting on three core pillars: Peace, Equity and Education. In this context, the OECD has been asked to provide substantive inputs to the Plan. Following the recently released Economic Survey of Colombia, this report identifies a set of policy priorities to support more balanced, sustainable and inclusive growth to improve the well-being of the population, in line with the key goals of the National Development Plan.

Colombia's road ahead to high-income status will be challenging. Productivity growth has been slow and remains well below levels of OECD countries. The country also remains beset by high levels of informality, unemployment and income inequality. Over the course of its renewed four-year term, the government needs to address Colombia's equity and productivity challenges through a comprehensive policy reform package. Further reforms are needed to tackle deficiencies in the country's territorial development, education and innovation systems, competition framework, land rights, and infrastructure. Colombia should also consider a reform of its social protection and tax systems to make them fairer and more growth-friendly.

Tax reform should become the government's immediate priority. Tax revenues are insufficient to meet the public spending and investment needed to close the productivity gap. The design of the tax system could be improved to make it more progressive, reduce the negative impact on employment and promote green growth. Determined and strong government action is also necessary to tackle pervasive tax evasion.

To deliver this ambitious reform agenda, Colombia needs to continue to modernise its public institutions. In recent years, the government has made significant progress in implementing a good-governance agenda. But major improvements can still be made to strengthen contract enforcement, address regional disparities in public services, raise the quality of the judicial process, and fight corruption.

The implementation of these policy recommendations would complement the legislative and regulatory reforms that Colombia is carrying out in various policy areas as it moves ahead on the OECD accession process launched in 2013. We look forward to continuing to support Colombia in its reform agenda and on the road to membership to the OECD.



Angel Gurría
Secretary-General, OECD

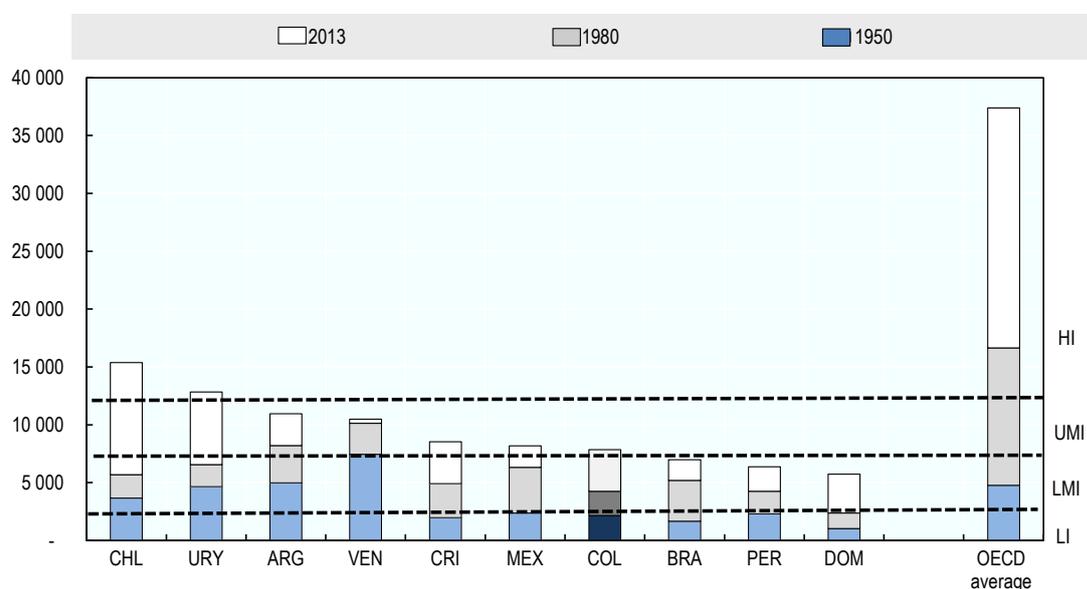
1. INTRODUCTION

In recent years, Colombia has made major economic and social advances. Despite this recent progress, Colombia faces significant structural challenges associated with the concentration of economic activity – particularly exports - in a few sectors, low levels of productivity, and high inequality. Embarking on a path towards inclusive growth is vital in the context of successfully eradicating poverty, providing opportunities for its growing middle class and solidifying progress towards lasting peace. The road ahead to high-income status will be demanding and calls for major policy initiatives in areas such as education, innovation, infrastructure and rural development, as embodied in the *New Development Plan 2014-2018: Everyone for a new country*. Furthermore, the country needs to work towards bolstering government capacities, building strong institutions, and effectively mobilising domestic revenues to facilitate effective implementation of its public policy priorities.

Escaping the middle income trap

Colombia’s recent economic performance has been one of the most dynamic in Latin America, but higher value-added and more inclusive growth is needed. The country has remained within the middle-income range for over 60 years, attaining limited convergence relative to high-income countries as well as many other countries in the region (Figure 1.1). Thus, Colombia needs to build on the progress made in recent decades to overcome its obstacles to sustained economic growth. Effective income convergence requires boosting labour productivity and creating quality employment opportunities by moving towards higher-value added economic activities.

Figure 1.1. Colombia remains in the Middle Income Trap (GDP per capita, 1990 USD)



Note: The horizontal lines mark the boundaries between the low-income (LI), lower-middle income (LMI), upper middle (UMI) and high income (HI). The OECD average includes the 34 member countries.

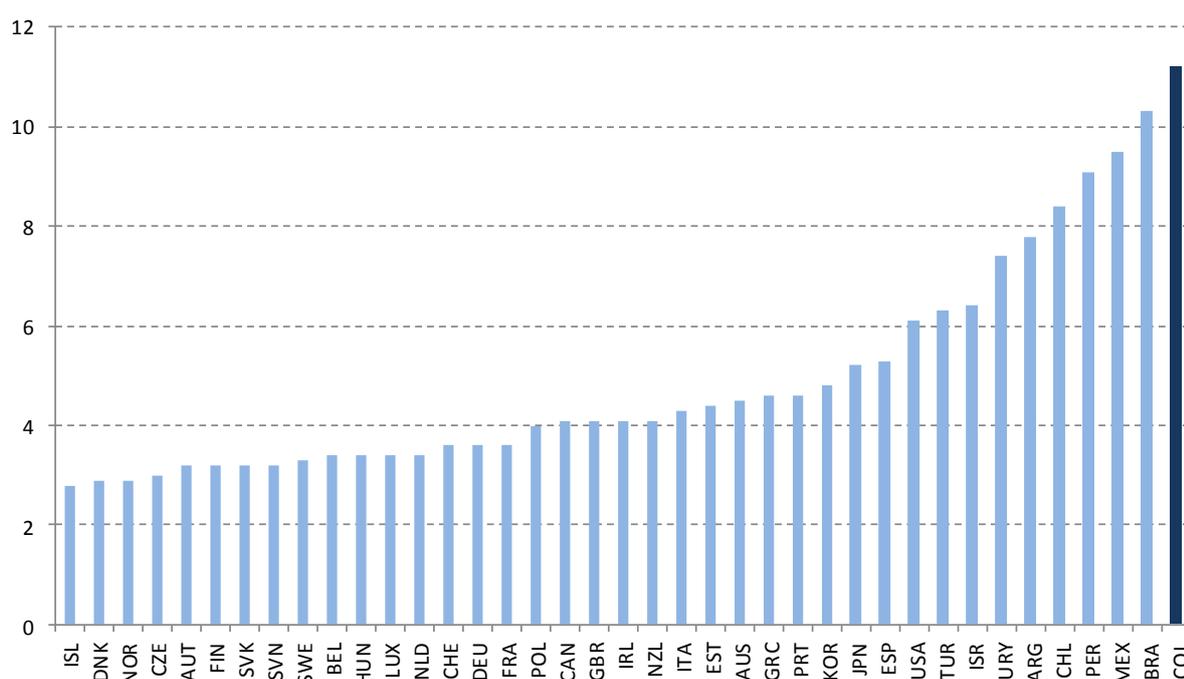
Source: OECD Latin American Economic Outlook 2015 based on The Conference Board-Total Economy Database and World Bank World Development Indicators.

Giving all Colombians a stake in progress

Despite recent improvements, income inequality is still among the highest in the world. In 2012, the ratio of the average incomes of the top 10% to the bottom 10% of the population was 37:1, compared to an OECD average of 9:1 in 2011 (over 25:1 in Chile and Mexico). Furthermore, Colombia's measure of interdecile inequality, at over 11:1, also stands out internationally (Figure 1.2). The long-term challenge of more sustainable and inclusive growth persists, and lies in ensuring equality of opportunity.

Figure 1.2. Income inequality is too high in Colombia

(P90/P10 ratios in 2012)



Note: The P90/P10 ratio shows the upper bound income of the ninth decile in the income distribution to the upper bound income of the first decile. 2011 data for OECD economies.

Source: OECD income distribution database and SEDLAC (CEDLAS and The World Bank).

Colombia also needs to tackle significant spatial inequalities to ensure lasting peace and the effective integration its wealth of natural and human resources (**Chapter 2**). Compared to OECD economies, Colombia displays one of the highest levels of regional inequality in terms of GDP per capita. The legacy of armed conflict, disjointed urban and rural contexts, and limitations in subnational administrative capacity, have generated vast diversity and stark inequality among regions.

Territorial policies will play a key role in addressing these challenges. In particular, there is a need to maximise the impact of the redistributive power of royalty payments through effectively coordinated regional investments with current expenditures (General System of Transfers). Another key goal is to build capacities and cooperation between national and sub-national entities through arrangements such as the *Contratos Plan*. Regional resources should also be devoted towards initiatives aimed at greening growth and harnessing Colombia's ecological abundance in a sustainable way to create new economic opportunities outside of the extractive sectors.

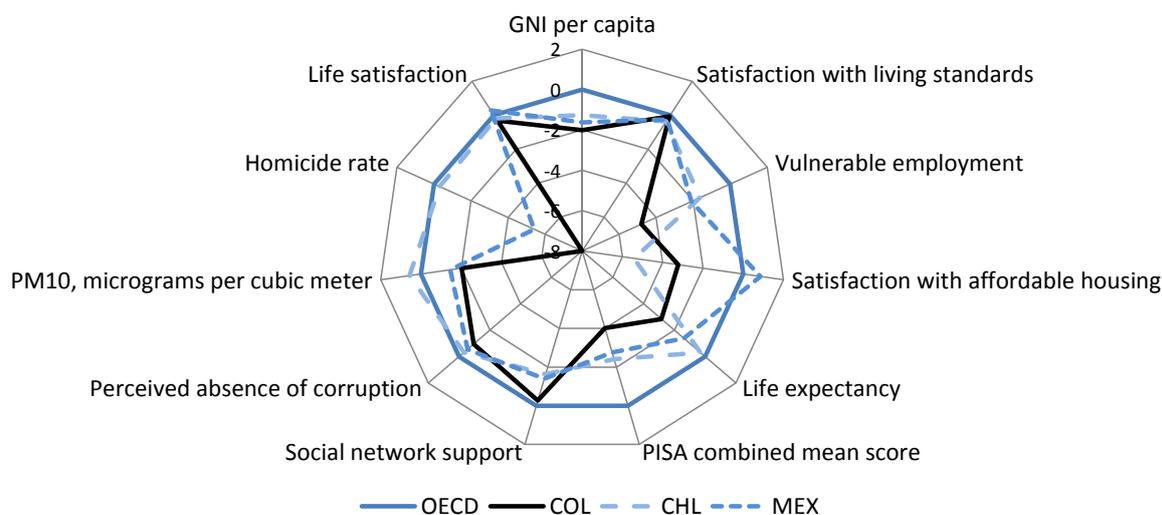
To help restore regional equity and support inclusive growth, further progress is also needed in upgrading productivity and performance in the agricultural sector, which is a key sector in terms of employment. Since 1990, the average annual growth rate of agricultural production has been over 2.5

times lower than that of other regional producers such as Brazil and Peru. In addition, more than 40% of land ownership continues to be informal, signalling the need for effectively strengthening land rights, improving access to land and modernising production strategies. Better transport and communication links between Colombian cities and regions are also necessary to boost domestic trade and productivity, as well as a more holistic approach to rural development to facilitate access to key services and build local capacities.

Building equity by cultivating skills and integrating workers in the formal economy

Equitable access to quality education and formal employment is critical for fostering social cohesion, as well as improving economic performance (**Chapter 3**). Secondary school students in Colombia ranked among the lowest performance in mathematics in the countries covered in the 2012 PISA survey. The performance gap is equivalent to 2.9 years of schooling in comparison with OECD average. Improving academic performance and ensuring that all students- particularly the most disadvantaged- achieve at least minimum skill levels will be essential for the country's long term development. This requires improving access from pre-primary to tertiary levels of education, enhancing staff capacities, increasing the hours of instruction, and effectively assessing both student and teacher performance. The need for these reforms is further reflected in some of the determinants of well-being of Colombian citizens, particularly with regards to the low levels of security, relatively low level of life expectancy, as well as limitations in education outcomes and employment opportunities (Figure 1.3).

Figure 1.3. Well-being indicators in Colombia highlight key challenges



Note: The difference between the values of the variable for the country with respect to the simple average of the OECD countries, normalised by the standard deviation. Distance from the centre delineates increasingly better results for each variable.

Source: OECD 2015 Economic Survey of Colombia.

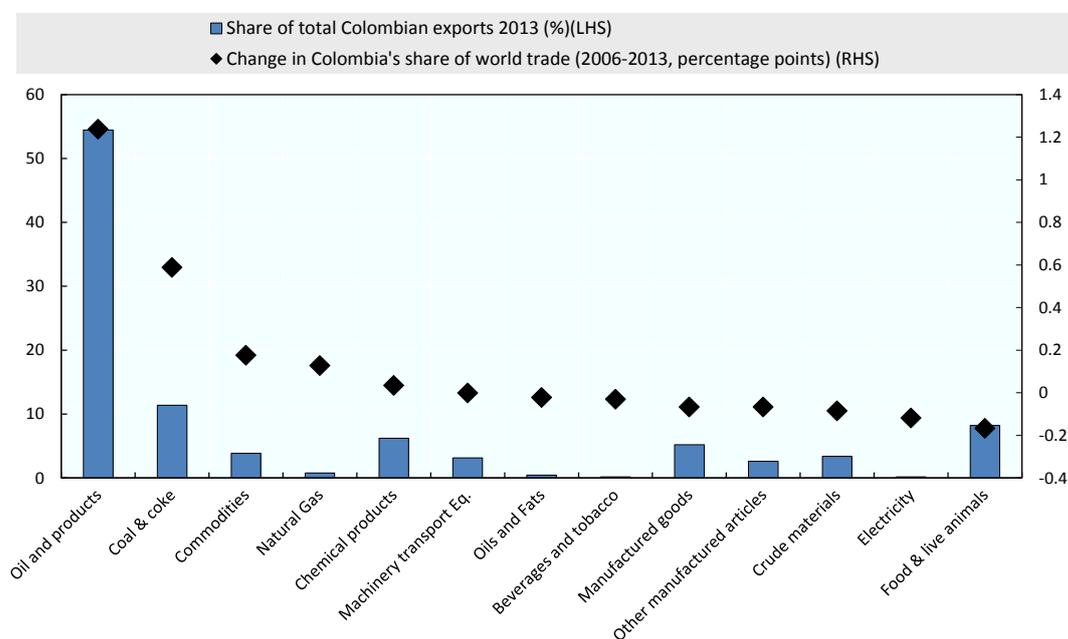
These opportunities need to be complemented with the appropriate social safety nets, in order to protect vulnerable members of society, and ensure access to key services such as health care, while maintaining incentives for formalisation. Within the context of emerging economies, it is important to look beyond these traditional wellbeing indicators and take into account other pertinent issues such as vulnerable employment. Nearly 60% of Colombian workers are employed outside of the formal sector, a very high level given the country's economic ranking which is partly explained by the relatively high non-wage labour costs and minimum wage, and underestimation of the benefits of being formal. In addition, the design of

the pension system leads to the exclusion of a large majority of workers, effectively depriving them of financial security during their retirement years. As informality and unemployment are two major drivers of inequality, addressing these social problems would go a long way towards improving equity.

Enhancing competitiveness and institutional capacity for successful implementation of the National Development Plan

The current economic structure presents notable challenges for sparking dynamic and inclusive growth. Recent trade performance signals the high and growing importance of energy and commodities in the export basket, and much lower role of the manufacturing and agricultural sectors (Figure 1.4). Energy-related industries make a limited contribution to aggregate employment creation, in addition to raising concerns over environmental sustainability. Furthermore, volatility and the recent decline of commodity prices (mainly oil prices) underscore the risks associated with this pattern of specialisation.

Figure 1.4. Extractive industries play a prominent role in Colombia's export basket



Note: Data for 2006 to 2013 in SITC Rev 2.

Source: OECD based on UNCOMTRADE data.

Creating new growth and employment opportunities and fostering innovation and entrepreneurship requires the strengthening of framework conditions as well as cohesive efforts to support territorial integration. Colombia needs to make effective use of its commodity rents towards creating better jobs, boosting productivity and promoting economic diversification. Policy priorities include a range of broad-based policies: addressing transport infrastructure and logistics bottlenecks in order to reduce transport costs, spurring competition by strengthening institutions such as the Competition Authority, as well as supporting the propagation of Information and Communication Technologies (ICTs) and innovative capacities (Chapter 4).

Successful implementation of the National Development Plan also depends on consistent and concerted public policy action (Chapter 5). Strong public sector institutions and government capacities are needed to provide the regulatory and administrative backbones for supporting economic transformation and equitable progress. Colombia has made significant progress in implementing a good-governance agenda aimed at strengthening its institutions to promote sustainable and inclusive growth throughout the country. Nevertheless, expanding coverage, and improving the quality of, public services is crucial. Further efforts are

also needed in the area of contract enforcement as well as towards enhancing government transparency and accountability. With tax revenues close to 20% of GDP, at the lower end of OECD countries, and declining public revenues from commodities, a comprehensive fiscal reform is crucial for underpinning this development strategy.

Main policy recommendations

Territorial and Agricultural Development for more inclusive and sustainable growth

- **Enhance the management and monitoring of regional investments.** Reinforce co-ordination across levels of governments to promote a multi-annual budgeting/planning framework.
- **Improve the effectiveness of regional transfers** by reducing earmarked transfers, introducing new equalisation mechanisms, and improving the coordination with the royalties system.
- **Improve land rights and the use of lands** by speeding up the process of formalisation, while strengthening the protection of existing land rights.
- **Improve the urban transport regulatory framework** through better management of entry points for commercial transportation and by increasing enforcement of the regulation of local transportation.
- **Strengthen the system of environmental management** involving different levels of government. **Promote greater use of environmentally related taxes and charges.**

Education and Equity for a Fairer Economy

- **Ensure a strong start in education, particularly for the most disadvantaged pupils,** by improving the quality of staff in schools and avoiding the prevalence of two- or even three-shift schools.
- **Undertake a comprehensive reform of the pension system to reduce old-age poverty by making the system less regressive and more sustainable.**
- **Improve incentives for employment formalisation** by smoothing eligibility for welfare benefits, including healthcare and further reducing non-wage labour costs.
- **Improve labour law enforcement** by increasing the number of inspectors and providing adequate training opportunities.

Fostering Competitiveness and Growth

- **Further improve the framework conditions for innovation and entrepreneurship,** by focusing on skills, including engineering, design and information technology, and mid-level professional skills.
- **Strengthen the efficiency of, and citizens' participation in, the allocation of environmental and social licenses in infrastructure** by avoiding discretionary environmental assessments, as well as delays and abuses in the grant of social licenses by some local communities.
- **Give the competition authority (SIC) greater independence.** Review barriers to competition in key product markets, such as financial, food, and both fixed and mobile communications markets.
- **Strengthen the governance of state-owned enterprises** by appointing more independent board directors with relevant skills and experience.

Towards more effective governance

- **Further strengthen the effectiveness and efficiency of Colombia's justice sector** by enhancing contract enforcement and increasing the specialisation of court decisions.
- **Enforce high-quality regulation and move towards a regulatory governance approach** by strengthening the autonomy, accountability and legal protection of arm's-length regulators and the *Superintendencias*.
- **Reform the tax system to increase revenues, enhance efficiency and strengthen equity.**

2. TERRITORIAL AND AGRICULTURAL DEVELOPMENT: KEY PRIORITIES FOR INCLUSIVE AND SUSTAINABLE GROWTH

The National Development Plan 2014-2018 identifies territorial, agricultural and environmental development as key priorities for inclusive growth. The Plan defines specific strategies and targets for the six regions of Colombia, as well as policies to deepen territorial integration through further investment in infrastructure and innovation. Reaping the dividends of peace in Colombia will entail significant efforts for territorial development and improvements in environmental policies, by strengthening the institutional capacities of sub-national authorities and improving the co-ordination of different fiscal resources allocated to these authorities. Citizens across Colombia will benefit from territorial development and strategies for greening growth which will improve their livelihood opportunities by making agriculture more efficient and inclusive, as well as developing instruments for cooperation between urban and rural areas.

2.1. BOOSTING REGIONAL CAPACITIES TO IMPROVE EQUITY AND PRODUCTIVITY

Wide regional disparities hinder sustainable development and inclusiveness. To improve equity, expand productivity and achieve peace in the next planning period, Colombia must tackle the spatially concentrated pockets of poverty and exclusion, and ensure that broad based policies are uniformly implemented in all regions. The effectiveness of key instruments for allocating resources, such as royalties, regional transfers (*Sistema General de Participación*) and *Contratos plan*, needs to be optimised through better coordination in the management of these mechanisms, as well as streamlining the allocation of these resources towards higher-impact regional investments.

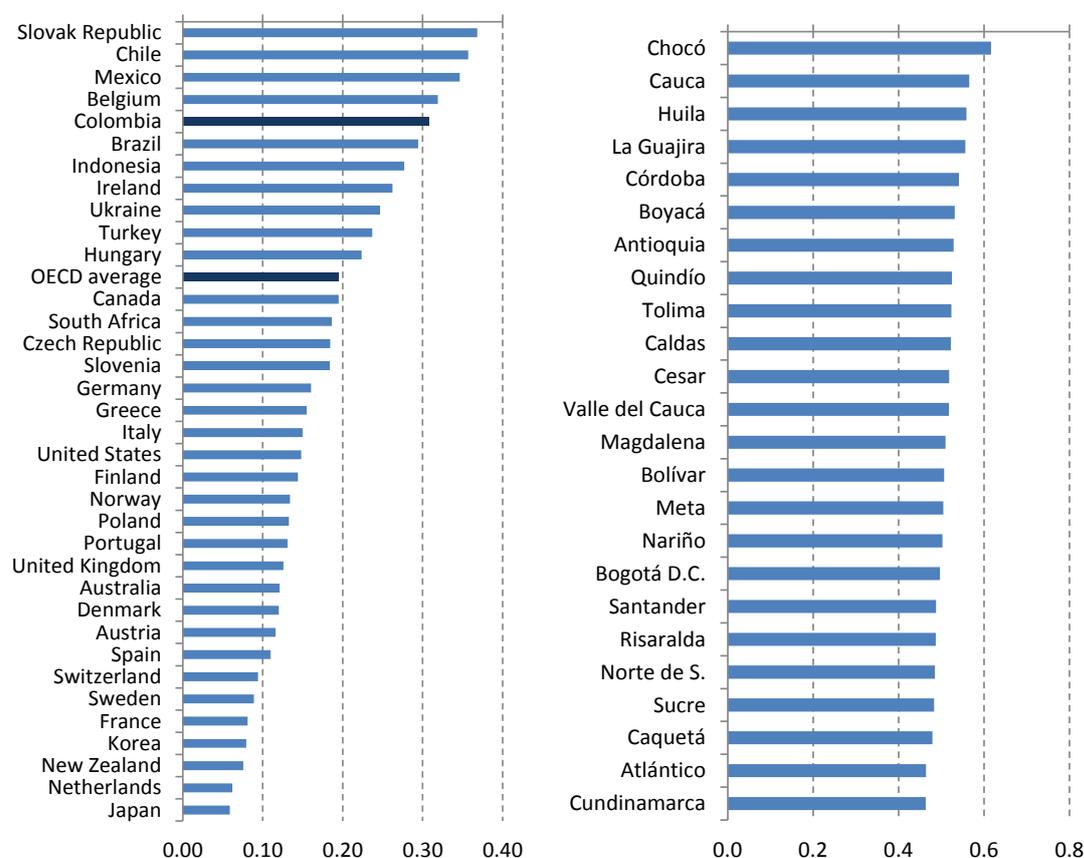
Compared to OECD economies, Colombia displays one of the highest levels of regional inequality in terms of GDP per capita (Figure 2.1, Panel A). Regional inequalities are not only 42 times higher than in Australia and more than five times higher than in the United States or Canada, but also higher than in other neighbouring Latin American countries, such as Argentina, Bolivia, Brazil or Venezuela. Income disparities are large within Colombian departments, including those that are resource-rich and have benefitted from high GDP growth (Figure 2.1, Panel B). Scarcity of regional statistics in many of Colombia's 32 departments, however, limits the capacity of the public sector to assess territorial dynamics and then to properly determine policy responses.

Most of the regions' GDP per capita gap with respect to Bogota is driven by low levels of labour productivity (OECD, 2013a). This dispersion across departments has remained nearly constant over the past decade, with the exception of commodity-producing departments, where highly productive commodity sectors have emerged with limited impacts on employment creation. Regions with low productivity levels face many of the same bottlenecks that contribute to Colombia's lag with respect to OECD countries. In addition to eradicating violence, better regional policies for improving education, fortifying infrastructure and promoting entrepreneurial development are fundamental for boosting inclusive growth and reducing regional inequalities.

Figure 2.1. Gini indexes at regional level remain high

Panel A. Selected countries

Panel B. Gini index (23 departments and Bogota)



Note: Data expanded from population projections, using the results of the 2005 Census as a base. TL2 (Territorial Level 2) data (Departamentos in Colombia). In Panel A, the Gini index measures inequality among *regions'* average income. The index takes on values between 0 and 1, with zero interpreted as no disparity among regions. Note that the Gini index assigns equal weight to each region regardless of its size. In Panel B, the Gini index is based on *DANE, Encuesta Continua de Hogares (2002-2006)* and *Gran Encuesta Integrada de Hogares (2008-2012)*, which measure inequality among *individuals* in 23 departments in Colombia.

Source: OECD (2013c) *Regions at a Glance, 2013* – and DANE, *Encuesta Continua de Hogares (2002-2006)* y *Gran Encuesta Integrada de Hogares (2008-2012)*.

Utilising the Royalties system for boosting inclusive growth

Since 2011, the government has used royalties paid by extractive activities to promote equitable regional development and to improve the effectiveness of capital investments in sub-national authorities. As a result of this reform, the *Sistema General de Regalías (SGR)* is spread out evenly across the country and distributed according to criteria related to need and population. While revenues generated by royalty payments increased by 42% between 2009 and 2012 (1.4% of GDP in 2012), royalties have not been accompanied by a reduction of poverty rates in resource-rich regions, which were the main recipient of funds in the former system.

The SGR's positive impact on inclusive regional development is reduced by governance challenges at the subnational level, and the fragmentation of investment. Many sub-national entities, especially those located in remote and small communities, are not able to adequately design and implement investment projects. In addition, despite the dramatic need for public investment in Colombia, funds allocated by the SGR to regional development in 2012 represented only 6% of total sub-national revenues (see Chapter 5

regarding the financing of royalties). Institutional deficiencies, financing and the impending electoral cycle result in that the SGR is a project-based system rather than a programme-based one: primarily funding small municipal projects. Very few projects serve a group of departments or a region. This pattern of use of funds may exacerbate the gap between areas with a strong development base and better governments and those with weaker economic, social and institutional cultures. Since there are a multitude of different territorial units serving different purposes, the current governance of regional development policy should be streamlined and responsibilities need to be allocated more clearly. Furthermore, to improve the effectiveness of investment policies, technical bodies at regional level need to work in close collaboration with national entities (e.g., National Planning Department and National Statistics Office).

Towards an improvement in the allocation of current expenditures

The system of administration of resources available for regional development creates challenges for their effective use. Current expenditures are earmarked for departments and municipalities according to poverty rates and demographic size (*SGP Sistema General de Participación*). Yet, the lack of up-to-date territorial data makes it difficult to assess the effective distribution of these resources and the amount of funds allocated through transfers has remained virtually unchanged since 2005. These shortcomings in the national system may cause fiscal inertia as sub-national authorities lack incentives for improving their capacity to implement public investment. Furthermore, the reform of royalty payments may complicate the SGP, in the medium term. Most capital investments (e.g., roads, schools, hospitals) from royalties will generate recurrent expenditures, which will put pressure on funds from the SGP in the medium and long-term (See Chapter 5 regarding the financing of the SGP).

Promoting co-ordination between national and sub-national authorities

Contracts between the national government and departments are another key instrument for facilitating interaction between national and subnational entities and help delivering regional development policy. Since 2012, the national government has signed contracts (*contrato plan*) with seven departments. These contracts are expected to lay out an investment of USD 6.7 billion, for an overall population of 6 million. The *contrato plan* is a multi-year binding agreement between the central government and departments, and the parties commit to co-ordinate their investment agendas and focus on specific projects. Contracts focus on improving road connectivity, poverty reduction and support for regional competitiveness. The *contrato* allows departments and municipalities to co-ordinate different sources of revenues from different levels of government.

Although these contracts promote regional partnerships and local capacity, they are no more than project-based tools for implementation and do not support a broader vision for regional development. The lack of intermediate institutions that identify key investment opportunities limits the potential for long-term impact of these contracts. The *contrato plan* is probably an effective way to support regional development in areas that have already a good endowment of institutional capital. Harmonising implementation timeframes to align *contratos plans* more effectively with the National and other development plans could help build capacity at the sub-national level, ensure the sustainability of sub-national administrative capacity over time and simplify the use of these regional development contracts.

Moreover, the government should recognise the need to adapt regional strategies for inclusive growth in territories that lack institutional capital, accessibility to key services, and income-generating opportunities (OECD, 2014a). Given the persistent disparities in administrative and fiscal capacity across regions, adapting performance-monitoring capacity to measure policy and fiscal performance locally becomes crucial. Colombia also needs to enhance the use of horizontal co-ordination arrangements in rural areas and to reinforce institutions with a regional/interregional scope. At present, few projects with a regional/interregional scope and impact are able to support productivity, competitiveness and comprehensive development in the different regions that would themselves materially contribute to national growth (OECD 2014f). Making more use of the country's six planning regions to co-ordinate broader regional infrastructure projects across departments could also help identify potential for more strategic investment projects.

Key recommendations

- **Improve territorial statistics and regional taxonomy.** Collect and organise data about regional and local trends to promote evidence-based policy making, as well as monitoring and evaluation.
- **Enhance the management and monitoring of regional investments.** Reinforce co-ordination across levels of governments to promote a multi-annual budgeting/planning framework. Establish regional observatories serving as advisory technical bodies for planning, implementation and monitoring for investments at sub-national level.
- **Improve the effectiveness of the regional transfers (SGP)** by reducing earmarked transfers, simplifying the allocation criteria, and introducing new equalisation mechanisms. This will require associated capacity-building efforts at sub-national level.
- **Establish co-ordination mechanisms between the SGP and the Royalties System.**
- **The Royalties System should focus more on large-scale regional projects.** Specific institutions are needed at the regional scale. The current governance of regional development policy should be streamlined and responsibilities allocated more clearly.
- **Mainstream technical assistance within all Contrato Plans to build local expertise and facilitate evaluation of contracts' outcomes and impacts.** Capacity building and technical assistance should be provided to improve the quality of planning and monitoring activities at sub-national level.
- **Promote mutual support and exchange of good practices on Contrato Plans among sub-national authorities.**
- **Continue to strengthen sub-national administrative capacity and while continuing to improve inter-regional and multi-level policy and fiscal co-ordination.**

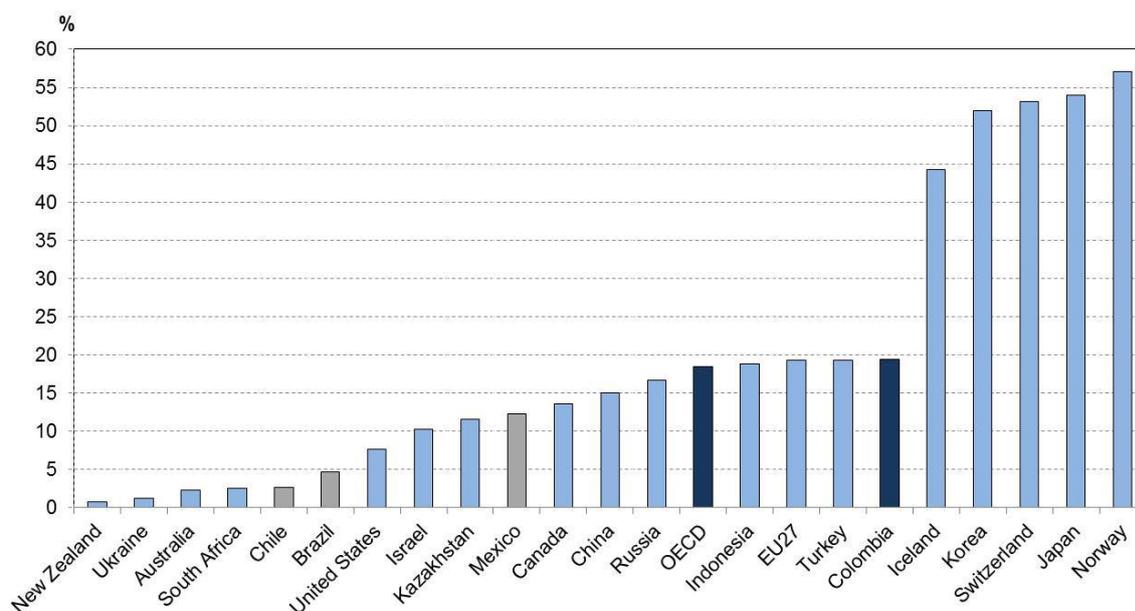
2.2. MAKING AGRICULTURE MORE EFFICIENT AND INCLUSIVE

The agricultural sector has traditionally been of key importance to the Colombian economy, but output growth has been slow while productivity has stagnated in recent years. The sector is also affected by high levels of poverty, income inequality and land concentration. Addressing these challenges requires comprehensive reform of agricultural policies that promotes the formalisation and strengthening of land rights and land access, refocuses policy efforts from trade distorting market price support to strategic investments in public goods such as infrastructure and innovation systems, and strengthens the institutional framework.

While the share of agriculture in GDP has declined from 16.5% in 1990 to 5.2% in 2013, it remains a key sector in terms of employment, although this too has decreased from a 26% share in 1990 to 17.5% in 2013. Agricultural exports currently represent approximately 11% of total Colombian exports. Annual growth rates of the value of agricultural production have fluctuated significantly over the last two decades, with a relatively low growth rate of 1.6% since 1990 compared to other Latin American economies (e.g., 5.1% and 4.1% for Peru and Brazil, respectively). The relative importance of the livestock sector has increased while crop production has declined. Agricultural labour productivity has been improving, but the pace of growth has been decelerating since the mid-2000s.

Colombia's Producer Support Estimate (PSE), which indicates how much of the gross receipts of farmers comes from agricultural support policies, is estimated at 19% for the period 2011-13 (Figure 2.2). It ranks close to OECD average (18%) and above other Latin American economies, but is lower than the levels found in highly protected agriculture sectors like those in Japan or Norway. Producer support in Colombia is predominantly based on instruments that are highly distorting and least efficient in increasing producer incomes, like border protection, and payments based on output and input subsidies. Market price support (MPS) is the predominant component of this producer support, accounting for 81% of the PSE. MPS mainly reflects the use of the Andean Price Band System for key agricultural products.

Figure 2.2. Producer Support is similar to OECD average



Note: 2011-13 data. 2010-12 average for Brazil, China, Indonesia, Kazakhstan, Russia, South Africa and Ukraine.

Source: OECD, PSE/CSE database, 2014.

The challenges faced by the Colombian agricultural sector are structural in nature. Weak institutional arrangements at the sub-national levels are key challenges for the agricultural sector. This signals a need to strengthen the institutional framework for designing and implementing agricultural policies between central and local governments. Furthermore, there are land use conflicts caused by inconsistencies between the current use and the actual suitability of agricultural land. The sector is also characterised by high levels of poverty, income inequality and land concentration, with a large number of smallholders producing mostly for their own consumption and a smaller number of large scale commercial farms accounting for a high share of output. The tax and transfer systems do little to overcome these challenges. The development of illicit crop production, together with armed conflict, has also affected agricultural output growth. As more than 40% of land ownership continues to be informal, there is a need to improve the land tenure system through access to land, land restitution, and formalisation of land rights.

The deficient stock and quality of infrastructure, as well as the structure of marketing systems, affects farmers' access to input and output markets through rising costs of transport. In addition, the use of technology is low and the quality of extension services is heterogeneous or non-existent across regions and production systems (Chapter 4). Better coordination with the private sector is needed to attract further private investment in these areas.

Reforming agricultural policies

Support for agriculture should focus on long-term structural reform. Re-focusing policy efforts on strategic investments which are currently being under-provided: public goods, with emphasis on irrigation and transport infrastructure (Chapter 4.2); a national and functional extension/training and technical assistance system that fosters technology transfer (Chapter 3.1); strong R&D and innovation capacity of the sector (Chapter 4.1); animal and plant health protection and control services; and promotion of sustainable use of natural resources.

Current agricultural policy includes several programmes that provide trade distorting domestic support. Colombia continues to resort to a price band mechanism in order to address fluctuations in world prices for a wide range of agricultural products. However, the country has recently signed and enforced several Free Trade Agreements with key trading partners. Under these trade agreements, Colombia has committed to gradually phase out a wide range of agricultural border measures.

Colombia faces the twin challenges of high concentration of land ownership and the under-exploitation of arable land. Past efforts at land reform have in practice had little or no impact on the distribution of land and its use. Most recently, peace negotiations with FARC have brought land reform to the forefront of the political agenda, with increased budgetary allocations in support of the government priority of creating more equitable access to rural land. In 2011, the government passed the Victims and Land Restitution Law, a vast land titling and redistribution law. The government is also seeking to address the under-utilisation of land to boost growth in the agriculture sector. Going forward, the government could undertake land suitability assessments taking into account the existing framework of mandated land use plans and the results of the 2014 Agricultural Census. A functional rural cadastre (a comprehensive register of state property) would be an appropriate starting point in order to complete and update the existing land records.

Key recommendations

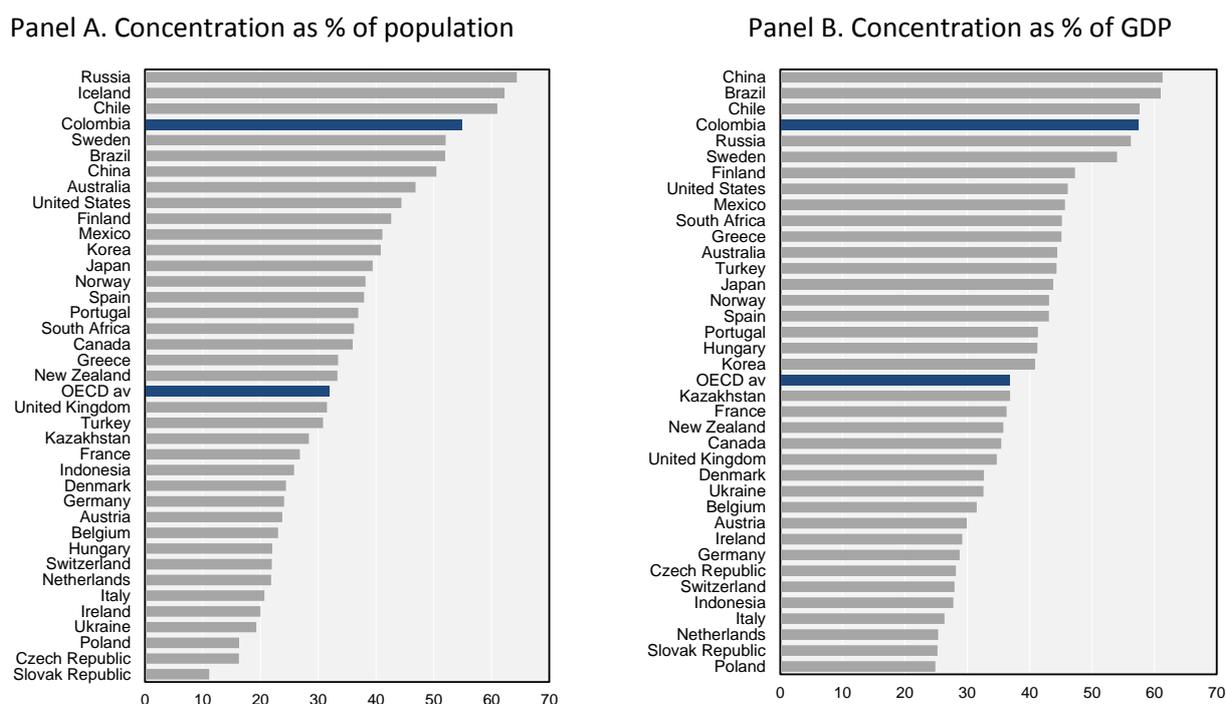
- **Improve land rights and the use of lands** by speeding up the process of formalisation, while strengthening the protection of existing land rights. Provide appropriate support services to land restitution and redistribution schemes.
- **Upgrade the cadastre system** by centralising information across municipalities and departments that can be updated when necessary. Assist subnational governments in updating cadastral property values. Link increases in transfers from the central government to subnational revenue growth.
- **Remove the distortions in the current system of taxes and transfers.** This will increase the progressivity of land taxation and encourage more productive land use .
- **Strengthen the institutional framework for designing and implementing agricultural policies.** Moving towards a more comprehensive and coherent system of monitoring, analysing and reporting of Colombia's agricultural policies will help track and improve policy performance.
- **Reinforce the Agricultural Innovation System.** Demand driven allocation mechanisms must be more intensively used in the allocation of public funds to research and development in agriculture.
- **Support for agriculture should focus on long-term structural reform.** Re-focusing policy efforts on strategic investments which are currently being under-provided in key areas such as irrigation, training and technical assistance; animal and plant health protection and control services; and promotion of sustainable use of natural resources.

2.3. URBAN AND RURAL DEVELOPMENT POLICIES FOR BETTER LIVES

Colombia's main cities underperform as engines of inclusive growth and many citizens suffer from limited access to key services as a result of living in rural areas. This Janus-faced challenge requires an integrated approach to urban and rural development. On the one hand, the government needs to work to unleash the growth potential of the main cities, harnessing the benefits of agglomeration and economies of scale. On the other hand, citizens should have the option of residing in rural regions (i.e. in small and medium-sized towns and cities), with assured access to services and economic opportunities.

Colombia urbanised faster than it developed. The country has ten cities with more than 500 thousand inhabitants; an unusual polycentric urban system in the Latin American context, comparable to Brazil and to some extent, Mexico. Due to a net urban-rural split, functional areas of main cities tend to be relatively small and isolated generating an archipelago of urban regions surrounded by poorly connected rural areas. Population and GDP are highly concentrated in urban cores, even by international standards (Figure 2.3).

Figure 2.3. Colombia is highly concentrated in urban areas



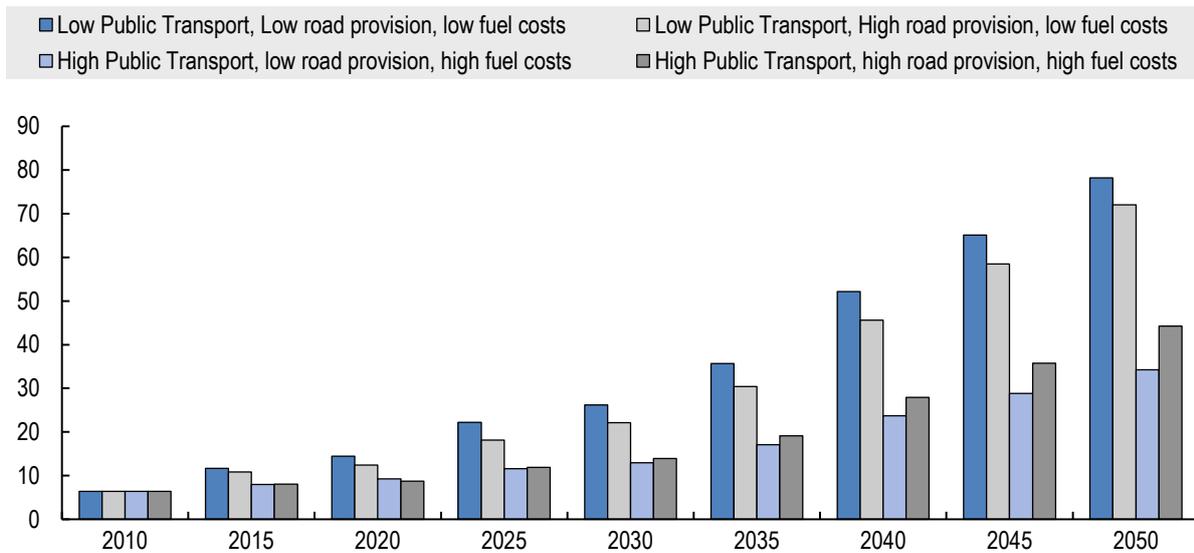
Note: 2010 TL2 (Territorial Level 2) data (departments in Colombia).

Source: OECD Regional Dataset.

Strengthening urban transportation

Urban agglomeration also poses challenges for the development of the urban transport sector. High levels of congestion resulting from the increase in the use of private modes of transport hampers local competitiveness. The lack of priority towards the expansion of public transport and declining oil prices could result in dramatic increases in the CO₂ emissions from transport in cities (Figure 2.4). Except for the BRT (Bus Rapid Transit) systems such as *Transmilenio*, buses are generally very old, with limited and poorly maintained de-pollution technology. In addition, the use of private cars and especially motorcycle is the main contributor to emissions of local air pollutants (ITF, 2015). In particular, the regulation of air pollutant emissions from motorcycles continues to be weak.

Figure 2.4. CO₂ emissions could increase dramatically in Colombian cities



Note: High (Low) public transport refers to rapid (slow) growth in public transport vehicle-kilometres of service, which increases (decreases) the level of service per capita throughout the period. High (Low) road provision refers to a rapid (slow) expansion in urban road network (kms), which increases (decreases) the level of urban road infrastructure per capita throughout the period.

Source: OECD International Transport Forum (ITF).

Bridging urban and rural areas for inclusive development

The drivers of growth, particularly those based on the extraction of raw materials, are far less urban than the distribution of the population would suggest. A disjuncture persists between the contribution of rural assets to national growth (energy commodities, for instance) and the living standards of the rural population. Socio-economic indicators for rural households are significantly lower, with some remote rural communities remaining particularly vulnerable in terms of poverty rates and inadequate infrastructure. Furthermore, rural regions remain largely isolated and disconnected from urban areas, and their local institutions are generally weaker than in the rest of the country, both of which limit their capacity to support a local development strategy.

The current focus on urban development has to be balanced with a better understanding of the role that territorial features and networks play in a holistic approach to rural development. *Misión de Ciudades* helps to improve the connections between urban poles and with the outside world. Currently, the major cities do not trade much with one another and also have relatively similar production structures. Due to the high degree of autarky imposed by topography and the armed conflict, some cities perform more functions than a city of their size might in a typical urban hierarchy.

The government's current efforts to connect urban agglomerations need to adapt to satisfy needs in both urban as well as rural settings. Improved urban connectivity could result in greater specialisation and concentration of certain functions in specific places. This may raise political challenges, as the immediate benefits are likely to be more apparent in the largest cities than in rural or intermediate cities. Policymakers need to anticipate these challenges and adopt a territorial approach to urban development which also connects with rural development. In that context, national rural policy should identify and assess the opportunities for investment and growth. Measures to reduce the costs of this adjustment include the promotion of entrepreneurship and human capital in secondary cities. In this way the government can harmonise urbanisation and development, tapping also in rural assets, and avoiding that cities get choked off by an excessive concentration of low-skilled rural migrants (OECD, 2014a).

Key recommendations

- **Improve the urban transport regulatory framework** through better management of entry points for commercial transportation and by increasing enforcement of regulatory measures on local transportation (such as public buses and motorcycle-taxis).
- **Complement current strategies for strengthening urban connectivity** with policies aimed at fostering the creation of new opportunities such as by promoting entrepreneurship and human capital development in secondary cities.
- **Improve the evaluation of potential developments of agro-industry across different regions and identify linkages with manufacturing activities.**
- **Prioritise complementary investments in protected cycling and pedestrian infrastructure.**

2.4. ALIGNING POLICIES FOR A GREEN ECONOMY

Colombia is one of the world's "mega-diverse" countries and has a rich endowment of renewable (water, forests) and non-renewable (hydrocarbon, minerals) resources. However, this natural heritage and the wellbeing of its people are under growing threats from extractive industries, livestock grazing, urbanisation and motorisation. To address these challenges, a series of reforms are needed to strengthen environmental governance, phase out environmentally harmful subsidies, and limit the environmental damage caused by the mining industry.

Promoting socially inclusive and environmentally sustainable growth

Colombia's pattern of economic development has intensified environmental pressures. The increasing extraction of oil and mineral resources is a major cause of pollution of soil and water, degradation of sensitive ecosystems, and severe damage to human health. Colombia is also the world's largest mercury polluter per capita, with most of it coming from artisanal gold mining. The energy-linked CO₂ emission intensity is low owing to Colombia's heavy reliance on hydropower, but the greenhouse gas emission intensity is higher than the OECD average due to methane and other emissions from agriculture. Colombia is close to achieving the Millennium Development Goal on access to safe drinking water, but further efforts are needed for improving sanitation. Nevertheless, the annual health costs related to poor air and water quality are equivalent to 2% of GDP, and this does not take account of the impacts from exposure to highly toxic mercury. Moreover, it is the poor that lack access to environmental services and suffer most from pollution.

Colombia is vulnerable to climate change. The Caribbean region and parts of the Andean region are projected to shift from a semi-humid to semi-arid climate over the course of this century. The devastating impact of the 2010-11 *La Niña* event (equivalent to about 2% of 2010 GDP) stimulated efforts to better integrate economic and environmental policies. The inclusion of environmental sustainability and risk prevention in the 2010-2014 National Development Plan was an important step forward, as was adherence to the OECD Green Growth Declaration, the development of a comprehensive climate policy and the signing of cross-ministerial environmental agendas. Nevertheless, the lack of coherence between economic sectoral plans and environmental goals persists.

Efforts to implement the PND 2014-2018 should therefore include broadening and increasing environment-related taxes and charges (Chapter 5.2). Subsidised prices for electricity and gas, water and waste management services aim to keep prices low for poor households. However, only a small share of these subsidies actually reaches the poor, and they undermine incentives for efficient resource use and waste minimisation. User charges remain below the cost of providing environmental services.

Strengthening environmental governance

The 1991 Constitution and 1993 umbrella Law on Environmental Management established a solid policy and institutional framework for modern environmental management. However, in the first decade of the 21st century, Colombia's environmental institutions were largely overwhelmed by environmental pressures stemming from the fast pace of economic growth. In 2011, the re-establishment of a strengthened Ministry of Environment and Sustainable Development, and the establishment of the National Environmental Licensing Authority, marked important steps to redress this imbalance.

33 Autonomous Regional Corporations are responsible for implementing environmental policies at the subnational level. However, they are subject to few accountability constraints, vulnerable to capture by local interests and under-financed. Since these bodies have important responsibilities, including gathering environmental information, performing environmental impact assessments and licensing procedures, their weak performance overall is an important impediment to effective environmental management. The internal conflict has also impeded environmental management by restricting access to protected areas, thereby undermining the rule of law.

The environmental effectiveness and enforcement of waste and industrial chemicals policies in Colombia would benefit from better coordination between the numerous institutions involved in waste and chemicals management, and from comprehensive and consistent guidance, in particular through an overarching legal framework. Increased financial resources would also help to develop an appropriate waste management infrastructure, move towards waste prevention and minimisation as well as ensuring sound management of industrial chemicals.

Mainstreaming biodiversity in economic and sectoral policies

Much of Colombia's biodiversity resides in its forests, which cover more than half of its territory, considerably more than in most OECD countries. Conversion of forest to pasture for livestock grazing is the primary driver of deforestation, often supported by policy-related incentives. The expansion of mining also threatens biodiversity. Most mineral titles are in the Andes, the region with the highest level of threatened species. Illegal activities, including both mining and deforestation, are a persistent threat to biodiversity: it is estimated that 40-50% of all timber is harvested illegally, for example.

Colombia is committed to reaching the Aichi target of 17% terrestrial area and 10% marine area under protection by 2020. This will require a major effort. More generally, with more than one-quarter of the total protected area in indigenous reservations or collective territories, equitable benefit-sharing between indigenous people and companies seeking to exploit biodiversity and genetic resources requires a clear and transparent policy framework.

Lack of information remains a key obstacle to decision making; better information is particularly needed on habitat change outside forest ecosystems. Information on a finer scale will facilitate action in the decentralised environmental management system. Better scientific knowledge will also strengthen the basis for assessing the economic value of ecosystem services. Progress in this area would help mainstream biodiversity in economic and sectoral policies, and give better recognition to the role that natural capital plays in underpinning economic development (OECD, 2014b).

Key recommendations

- **Strengthen the system of environmental management involving different levels of government**, particularly by better defining their roles and responsibilities.
- **Promote greater use of environmentally related taxes and charges**; phase out environmentally harmful subsidies and tax exemptions, while mitigating any adverse impacts on poor and vulnerable groups (see also Chapter 5).
- **Make green growth a central element of the 2014-18 National Development Plan**, and make sectoral ministries accountable for the environmental impact of their policies.
- **Improve the management of the mining sector's detrimental impact on air quality, water resources and biodiversity**, particularly from the use of mercury.
- **Reduce incentives for extensive farming** and support the sustainable intensification of cattle rearing and greater use of silvopasture practices (combined grazing and agriculture with tree cultivation).
- **Strengthen the environmental information system** and build support for environmental measures by better communicating environmental information to policy makers and the public.
- **Establish a management system for industrial chemicals**. Develop an overarching legal and institutional framework to manage health and environmental risks related to industrial chemicals.
- **Promote environmentally sound management of waste**, including increased investment in waste infrastructure capacity, in line with projected future demand, as well as adequate enforcement of environmental standards for landfills.

3. EDUCATION AND EQUITY FOR A FAIRER ECONOMY

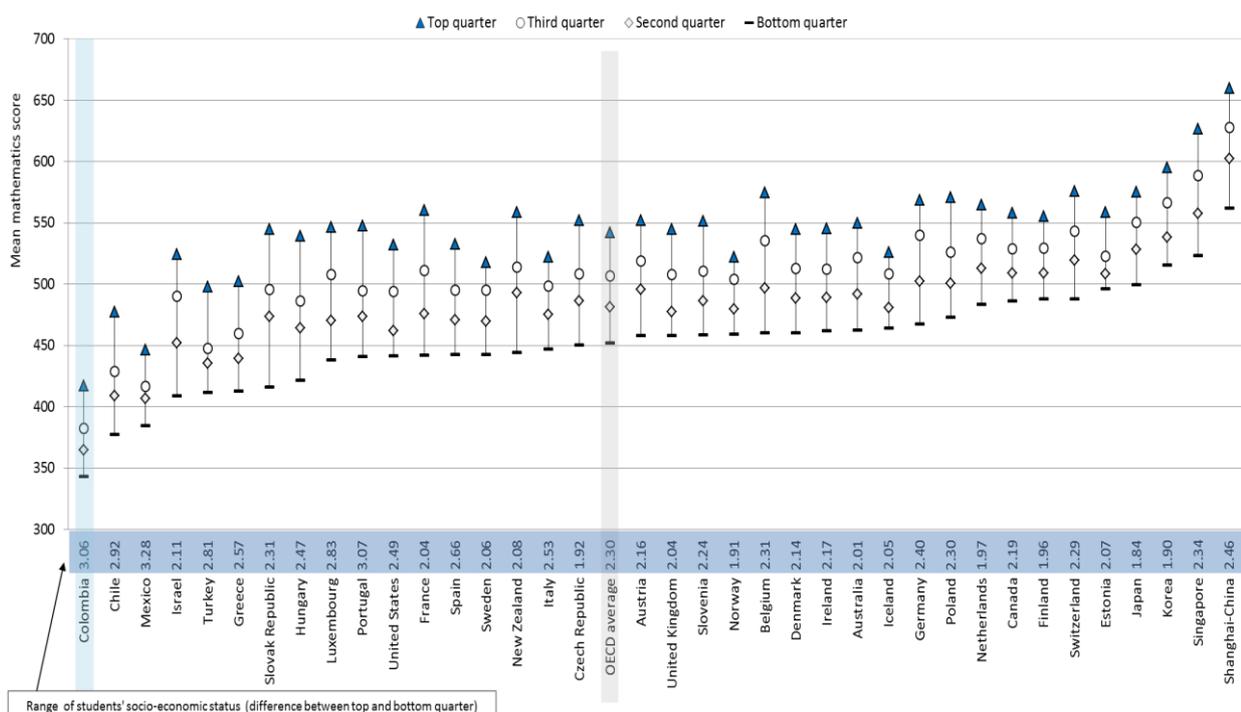
Alongside Peace, Education and Equity form the three pillars of the National Development Plan 2014-2018. Colombia remains one of the most unequal countries in Latin America and in the world, but has been taking steps towards a more inclusive growth model. As recognised in the Plan, education and equity are inextricably linked given the scope for accessible, high-quality education to be a vehicle for social mobility. Likewise, efforts to improve equity can also be expected to afford more people the opportunity of a formal education, reinforcing not only improved overall education outcomes, but also enhancing the country's stock of human capital, boosting productivity and a further broadening of economic opportunities. To achieve Colombia's ambitious education targets, there is a particular need for improvement in coverage, notably in pre-primary and tertiary sectors, and in quality, so as to ensure learning is as relevant as possible to employers' needs. To tackle inequalities head on, there is a need to do more to promote labour market formality, improve the scope and coverage of social protection and insurance schemes and enhance the quality and accessibility of essential services like healthcare.

3.1. ENSURING QUALITY, JOB RELEVANT EDUCATION FOR ALL

Education in Colombia is improving, but challenges remain. Enrolment has increased at pre-primary, secondary and tertiary levels, yet few students attend school before the age of 6 and many drop out after age 15. Only about half of 17-19 year-old secondary graduates go on to tertiary level studies. Improving the quality of education and ensuring all students - particularly the most disadvantaged - achieve at least minimum skill levels will be essential for Colombia's long-term economic and social development. Also, increasing the relevance of the education system and training programmes in the labour market are determinant to reduce unemployment and foster well-being.

While Colombia has made important efforts to improve its education and training systems, there is still much progress to be made to improve both quality and equity. Top-performing OECD countries ensure that students receive a good education and that access to opportunity is inclusive and fair (Figure 3.1). Student performance in OECD PISA 2012 shows improvement in reading results, and mathematics and science results have remained stable since 2006. The performance gap in mathematics is equivalent to 2.9 years of schooling in comparison with OECD average. As Colombia seeks to become the most educated nation in Latin America by 2025, it will have to prioritise those reforms which have the greatest capacity to raise educational outcomes. These include providing a strong start in pre-primary education, raising school leadership and teacher quality, and forging better links to the labour market.

Figure 3.1. Room for improvement in Colombia's Mathematics PISA scores
(Mean mathematics performance, by national quarter of socio-economic status)



Note: Countries and economies are ranked in descending order of the mean performance of students in the bottom quarter of the PISA index of economic, social and cultural status (ESCS).

Source: OECD PISA 2012 Results: Excellence through Equity (Volume 2): Giving Every Student a Chance to Succeed, Table II.2.4a

Improving pre-primary to basic education

At 50%, pre-primary enrolment remains well below the OECD average (close to 90%). A strong start in pre-primary education can help improve student performance later in life and reduce the performance gaps between students from different social backgrounds. PISA 2012 results, after accounting for the socio-economic background, show that students in Colombia who had attended one year or less of pre-primary school scored at least 16 points (equivalent to almost half a school year) higher than those who did not. Social programmes, such as the conditional cash transfer programme *Familias en Acción* and the recent *Estrategia de Cero a Siempre*, have aimed to improve the quality of early childhood programmes although further progress is needed to increase participation. Efforts to increase budgetary allocations for education and early childhood development in the 2015 budget are a step in the right direction, and will in turn help boost enrolment at the pre-primary and tertiary levels in the future.

In addition, improving the capacity of school leaders and teachers to identify and address students' needs is essential for improving basic education. Students from low socio-economic backgrounds, from rural areas, as well as from certain low-performing regions, face a greater risk of low performance and attending disadvantaged schools with less qualified teachers. The government has made efforts to improve the quality of primary education, particularly in the most deprived areas, by such initiatives as introducing a mentoring programme for teachers. Colombia should continue to focus on attracting, training and supporting good teachers and developing school leaders.

Evaluation at the system, school and student levels should be guided by a coherent evaluation and assessment framework. Tools such as the national student assessments (SABER assessments), administered at the end of primary, secondary and university education, can further help teachers and school leaders understand students' learning, plan their learning process, and support school improvement.

A better quality of secondary education for all

In Colombia, the impact of students' characteristics on performance is similar to that in OECD countries, while the performance gap between rich and poor is one of the lowest in Latin America for those who complete school. However, this is more a sign of a rather weak education performance across the socioeconomic distribution (even the wealthiest students rank low: 61 among 63 countries in PISA 2012). Moreover, these outcomes are explained by the high dropout rate, that primarily affects struggling and disadvantaged students. Enrolment rates for 15-19 year-olds remain low at 43%, in comparison with 84% in OECD economies (OECD, 2014c).

Improving the quality of education for all students, while increasing enrolment among the most disadvantaged, is thus crucial. Increasing the number of hours of instruction time is associated with better performance for all students. This is particularly relevant given the prevalence of teacher absenteeism and two- or even three-shift schools (Avendano *et al.*, 2015). Colombia's participation in the 2018 OECD Teaching and Learning International Study (TALIS) will help Colombia, like many other countries around the world, to address three key areas of teacher policy: how to prepare teachers ready to develop 21st century learners; how to create school and classroom environments that foster more effective teaching and learning; and how to ensure that the most efficient and equitable distribution of resources both within schools and across education systems is made.

Promoting social inclusion at school can help address inequalities and low performance. While one third of the most advantaged students attend private secondary schools, only 5% of disadvantaged students attend these schools. Such disparities contribute to significant inequalities in educational outcomes. In PISA 2012, socio-economic and cultural background of the student and the school explain the outperformance of students attending private schools (the equivalent of more than 1 year of schooling) with respect to those attending public schools (OECD/ECLAC/CAF, 2014).

Improving the quality of vocational programmes at school may be particularly beneficial for underprivileged students. In PISA 2012, Colombia registers the highest relative performance of vocational schools compared to general schools. This is especially true among disadvantaged students, who tend to perform better when enrolled in vocational programmes. Vocational tracks' orientation towards the labour market can be particularly useful in motivating the most disadvantaged students and facilitating their transition from school to work.

Linking tertiary education to the labour market

Minimum quality requirements for higher education institutions are low and few have high-quality accreditation. Even though any institution wishing to offer tertiary education programmes needs to register with the Ministry of Education, the minimum quality requirements to do so are low and weakly enforced. There are concerns as to quality, given relatively low academic standards and limited internal quality assurance provisions. These institutions concentrate on becoming (low-quality) universities rather than improving as technical centres. The government has sought to promote high quality accreditation and improve the teaching staff's qualifications, but more can be done in this area.

Access to tertiary education has increased, and Colombia has sought to improve links to the labour market, but these issues remain a challenge. Investment in higher education pays off: Colombian university graduates earn on average six times as much as those who only complete high school. Nevertheless, at 40%, the enrolment rate in tertiary education is well below the OECD average (close to 70%), and tertiary programmes do not teach students what they need to meet labour market demand. Moreover, university degree holders tend to be from advantaged backgrounds and/or urban areas, thereby exacerbating income inequality. The Colombian Institute of Student Credit (ICETEX, *Instituto Colombiano de Crédito Educativo y Estudios*) provides low-income students with interest-free loans although these will need to be expanded to increase access to all students wishing to enter tertiary education. Improving the quality of tertiary education can be supported by better basic education, high quality learning environments (teachers and materials) in tertiary programmes, and a focus on the needs of the labour market. Strengthening collaboration between tertiary institutions and labour market actors will help ensure that the relevant skills are being fostered in the education system and address shortages of skilled workers.

Enhancing skills relevance with better training policies

Education needs to focus more on the skills and training that are demanded by the labour market. There is a large imbalance between the needs of the productive sector and the available workforce, with a large shortage of workers and technical specialists and a surplus of unskilled workers and middle management professionals. Around 45% of formal firms in Colombia identify an inadequately educated workforce as a major constraint, compared with 36% in Latin America and 15% in OECD economies (OECD/ECLAC/CAF, 2014). Furthermore, tertiary programmes covering key professions do not teach students what the market needs. For instance, material taught at the Regional Centres of Higher Education (CERES, *Centros Regionales de Educación Superior*) has been reported to include outdated technologies and sub-par academic quality. Also, the National Training Service (SENA, *Servicio Nacional de Aprendizaje*), which accounts for more than 50% of enrolment in technical programmes, should increase its accountability. Too little is known about SENA's teaching quality and graduates' performance in the labour market, as they are still absent from most national education databases (OECD, 2012). More generally, there is a need to perform an external evaluation of the CERES and SENA to raise their added value and strengthen their coordination with the Ministry of Education.

Key recommendations

- **Ensure a strong start in education, particularly for the most disadvantaged pupils,** by improving the quality of staff in schools and avoiding the prevalence of two- or even three-shift schools.
- **Develop teachers and school leaders who can provide a quality education to all students** through strong initial training and continuous professional development.
- **Improve use of student assessment data by all key stakeholders, including teachers,** for quality assurance as well as for improvement purposes.
- **Improve the accreditation of tertiary education institutions.** Raise the minimum quality requirements for education centres to register and operate, while improving enforcement by refusing poor applications.
- **Ensure graduates have the skills needed to meet the demands of the labour market by introducing outcome indicators, and publishing them, for the national training service (SENA).** Fully integrate SENA into the tertiary education system in terms of funding, data collection and evaluation, academic planning and quality assurance mechanisms.

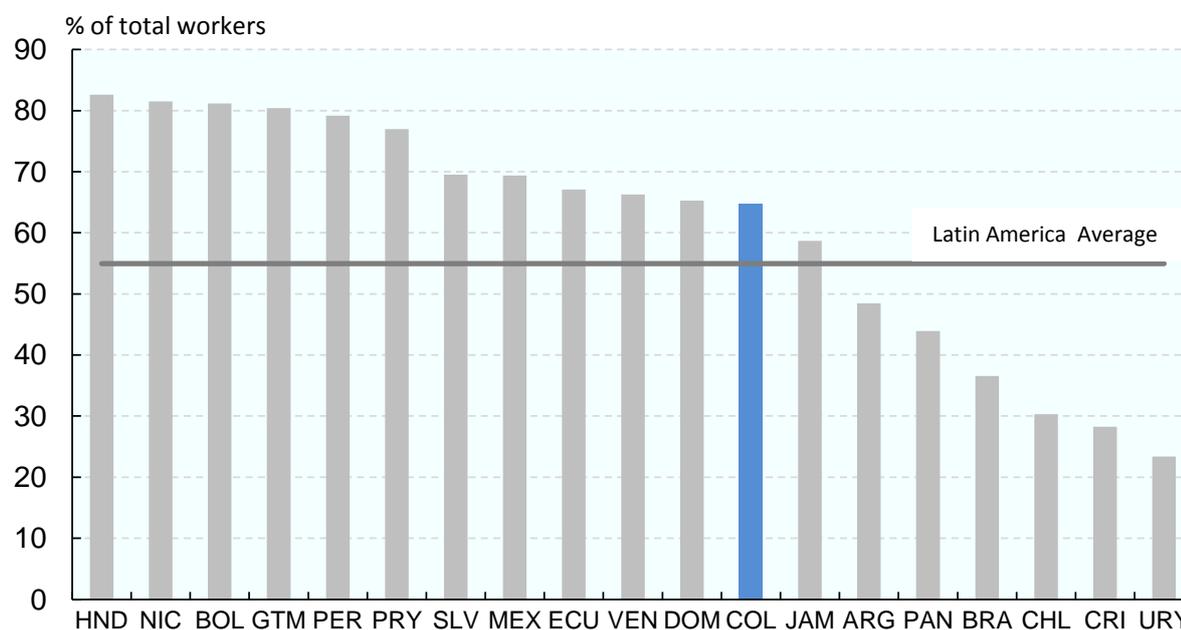
3.2. PROMOTING SOCIAL INCLUSION, MORE AND BETTER JOBS

Strong economic growth in the past decade has allowed Colombia to achieve a considerable drop in absolute poverty. Nonetheless, income inequality and relative poverty are still high by OECD standards. Inequality is largely a result of high unemployment and labour market informality, which are in turn exacerbated by the uneven quality of the education system. There is scope for further efforts to tackle informality, to improve job quality and to better target resources in the pension, social insurance and healthcare systems to achieve more equitable outcomes.

Promoting labour market formality and protecting workers' rights

Despite strong economic growth in the past decade, the Colombian labour market shows disappointing performance with poor quality of jobs. Though slowly declining, informality remains high by OECD standards and even above what would be expected given the country's level of economic development (Figure 3.2). Depending on the definition, informal employment accounts for 59% to 73% of total employment. In addition, more than one third of all formal employees have non-regular contracts, such as fixed-term, temporary work agency or civil-law contracts. Excessive use of such contracts further contributes to labour market duality in Colombia and has an adverse impact on both equity and efficiency.

Figure 3.2. Informality remains high even from a Latin American perspective



Note: Circa 2013 (2013 for Colombia). Workers contributing to a mandatory pension scheme over total workers.

Source: IDB Labor Markets and Social Security Information System (SIMS), based on household surveys.

Labour costs are high in the formal sector, pushing people with low productivity into the informal sector or into unemployment. To start, the minimum wage, at 86% of the median wage, is much higher than in any OECD country. Young people, low-skilled workers and people located in less developed regions are particularly affected. Annual adjustments of the minimum wage are set by the Constitution to match at least the past year's inflation, plus productivity gains. Given the history of large increases above inflation, future increases in the minimum wage should be limited to CPI growth. The government should also consider the implementation of a lower minimum wage for young people to encourage hiring. For example, the apprenticeship programme already allows trainees without university degrees to be paid at 75% of the minimum wage.

A tax reform in 2012 significantly lowered non-wage labour costs, but there remain some employer contributions that have unclear benefits. While social security contributions for pensions, professional risks and unemployment benefits are earmarked and can be seen as part of labour compensation, the disconnection between payments and benefits of the health care system and private family compensation funds (*Cajas de compensación familiar*) reduces incentives to pay into those systems. Workers should have the option to decide whether or not to contribute for the recreational and commercial services offered by the family compensation funds.

Disincentives to moving from the informal to the formal sector, such as the risk of losing access to free health care or conditional cash transfers, should also be addressed. The 2010 Formalisation and Job Creation Law was a step in the right direction, since granting tax relief on corporate income and payroll taxes to employers hiring young people or vulnerable workers is promoting job creation in the formal sector. Strengthening active and passive labour market policies would also contribute to improve labour market outcomes. Skills should be improved to better respond to job opportunities (see Chapter 3.1).

The overall flexibility of the Colombian employment protection legislation is similar to OECD standards. The average scores hide, however, very flexible regulations on individual dismissals and fixed-term contracts, on the one hand, and rather strict rules on collective dismissals and employment through temporary work agencies, on the other hand. Protection against unemployment was recently enhanced (*Mecanismo de protección al cesante*) by extended social protection for some unemployed, a network of public employment services, active labour market policies and a voluntary system of individual unemployment savings accounts. While it is too early to evaluate this system, it is a step in the right direction.

The extensive use of civil-law and temporary work agency contracts suggests weak enforcement of the labour legislation. Indeed, the security of trade union representatives, the freedom of association and collective bargaining, and the enforcement of labour laws more generally remain important issues for ensuring inclusive growth in Colombia. Significant actions have been undertaken in the past few years, but further improvements are needed. For example, the number of labour inspectors is far below ILO standards and insufficient resources and job security make inspectors vulnerable to improper external influences. Yet, difficult access to the justice system as well as lack of repercussions for employers violating the law make it challenging for individuals and trade unions to guarantee their rights.

Reforming the pension and social assistance programmes

Social spending in Colombia reduces income inequality and poverty, but is more generous to the top income groups. Education spending contributes most to the reduction in inequality and poverty through pre-school, primary and secondary education expenditure, followed by health spending. While benefits from the contributory pension system do reduce poverty, they also serve to increase income inequality as pension coverage is concentrated among higher income groups. Other social programmes, such as conditional cash transfers and child protection, are well targeted but the impact on poverty and inequality is limited due to their small size.

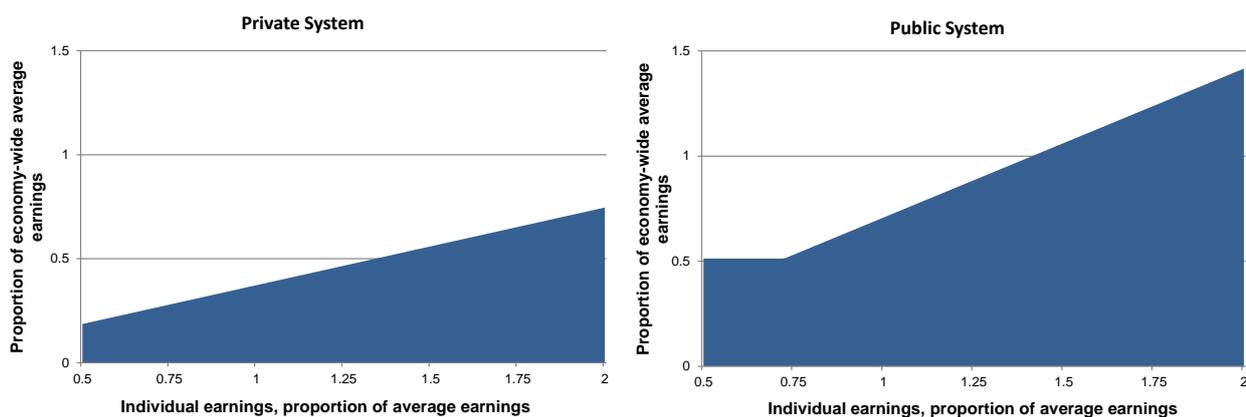
The pension system raises serious equity issues. While over 90% of the highest income quintile contributes to the pension system, less than 5% of the lowest quintile is able to do so (OECD/IDB/WB, 2014). Moreover, the coverage of the contributory system is very low compared with OECD countries

and even with Latin American peers. Only around 30% of workers contribute regularly to the pension system while slightly over 20% of the population over the age of 65 receive a pension. High informality and the absence of a first pillar minimum pension leave many elderly in poverty. The government is gradually introducing a targeted voluntary savings scheme, the *Beneficios Económicos Periódicos* (BEPS), to cover 7 million poor, elderly pensioners over the next 20 years. Together, it is expanding the social assistance programmes that protect the elderly poor (*Colombia Mayor*). The average benefit under *Colombia Mayor* is about a tenth of the minimum wage, which is in relative terms below that of most OECD countries, even and is well below the Colombian poverty line. This is also reflected in the low share of public spending on old-age income support at 0.02% of GDP (OECD, 2015). These measures will increase pension coverage, but much more will be needed as savings capacity is limited among many of the potential participants and benefits will be substantially below those of the contributory system.

An overall reform of the pension system is needed. The contributory regime – both public and private schemes – should be extended. The system allows people to choose between a defined-benefit plan (*Regimen de Prima Media* – RPM) managed by a public sector entity, and the defined-contribution plan (RAIS) managed by private pension funds (OECD/IDB/WB, 2014). Complexity should be reduced by simplifying the process to opt back and forth between both schemes, ultimately creating a unique scheme (OECD, 2015). The possibility to switch between plans makes the system complex, costly and unfair, as the public scheme is very generous to high-level earners (Figure 3.3).

Figure 3.3. Wide divergence in benefits from public and private pension systems

(Gross relative pension level - Private vs Public Systems)



Source: OECD/IDB/WB (2014), *Pensions at a Glance: Latin America and the Caribbean*, OECD Publishing.

In addition, parametric reforms to the public pension system are needed to strengthen the link between contributions and benefits, as well as to adjust the system to take account of population ageing. This will also help to guarantee the sustainability of the pension system, where pension liabilities, according to official data, are estimated at more than 110% of GDP. The retirement age should be increased again - and equalised between men and women - and ultimately tied to increases in life expectancy (OECD, 2015). The generosity of the system also makes it difficult to extend eligibility. Lowering the high replacement rate, especially among the top earners, would help finance such an extension in a sustainable way. The requirement for pensions to be at least equal to the minimum wage should also be abolished, as it leads to the exclusion of a large part of the population from the contributory system, although it requires a difficult change to the Constitution.

The conditional cash transfer programme for families with children, *Más Familias en Acción* is estimated to reduce poverty between 1 and 2%, while the Gini coefficient of inequality would be half point higher in absence of the programme. *Más Familias en Acción* also has positive effects on school enrolment and attendance, but the impact on cognitive achievement and graduation rates is less clear. Creating incentives for educational achievement and aligning the quantity and quality of educational resources are necessary to improve educational outcomes. Furthermore, the opportunity costs of education for

teenagers in low-income families need to be addressed in order to tackle school drop-out. Increasing the transfer amount with school grade helps, but the amount for pupils in 11th grade is still relatively modest (less than 10% of the minimum wage). The introduction of *Jóvenes en Acción* is a step in the right direction by creating incentives to further education. Efforts must be made to expand the coverage of the programme, including granting access to people studying in private institutions. Also, transitions from *Más Familias en Acción* to *Jóvenes en Acción* should be facilitated to prevent idleness and the risks associated to it.

Reforming the health system

Health care spending efficiency should be improved. Colombia has reached almost universal health coverage and the benefit basket has gradually been made more generous for the poor – a commendable move in a country with large income inequality. Still, refining priorities better and in particular the health benefits covered would increase health care spending efficiency. Improving the organisation of the health care system would also raise spending efficiency. Colombia's health care system relies on more than 99 private and public insurers, financed out of a pool of social security contributions. These insurance companies buy services from providers, but vertical integration between insurers and providers is frequent. This fragmented silo approach reduces competitive pressures at the provider level. It also makes it difficult to use spare resources efficiently and exploit economies of scale. Raising value for money in the health care system would require encouraging greater differentiation between purchasers and providers of health care services. Moreover, to achieve better value for money in the health sector, Colombia must also embed measurement of quality and outcomes across the health sector and apply the principles of open governance more effectively. Doing both will help patients, providers and payers ensure that money is being spent to meet health care needs and not lost to inefficiency or corruption; that quality is being continuously improved with excellence rewarded and failures corrected; and that inequities across social groups and geographical settings are being levelled out.

Key recommendations

- **Reduce the costs and increase the benefits to workers and firms of operating formally** by smoothing eligibility for social assistance and health care in the transition between the informal and formal sector, further reducing labour costs by making part of the contributions to the family compensation funds voluntary and keeping minimum wage growth close to inflation, improving educational outcomes and skills relevance, and further simplifying administrative and legal procedures to formalise firms and employees.
- **Protect the rights of trade unions** by improving the labour inspection system, amending the law consistent with ILO conventions and addressing impunity through an effective justice system.
- **Undertake a comprehensive reform of the pension system to reduce poverty by making the system less regressive and more sustainable.** Raise retirement ages, eliminate the link of the minimum pension to the minimum wage, and reduce subsidies for middle and high-income earners. Expand eligibility for *BEPS* and increase coverage and benefit levels for the *Adulto Mayor*, while reinforcing its rules (financing, indexing).
- **Improve the organisation of the health care system to raise value for money** by reducing the fragmentation of the insurance system and vertical integration between insurers and providers.

4. FOSTERING COMPETITIVENESS AND GROWTH

The National Development Plan 2014-2018 develops cross-cutting strategies to boost competitiveness and support productivity growth, which can help ensure solid economic foundations for the Plan's three pillars: equity, education and peace. Colombia has benefited greatly from the commodities boom since the turn of the century, but needs to do more to diversify its exports by promoting productivity growth in non-extractive sectors. This should lead to the development of manufacturing and service sectors that are competitive on global markets, allowing Colombia to move up the value chain. Central to this drive for economy-wide competitiveness will be further efforts to improve transport infrastructure and logistics across the country, make the most of cutting edge ICTs as a platform for innovation, and promote entrepreneurship by enhancing the business environment.

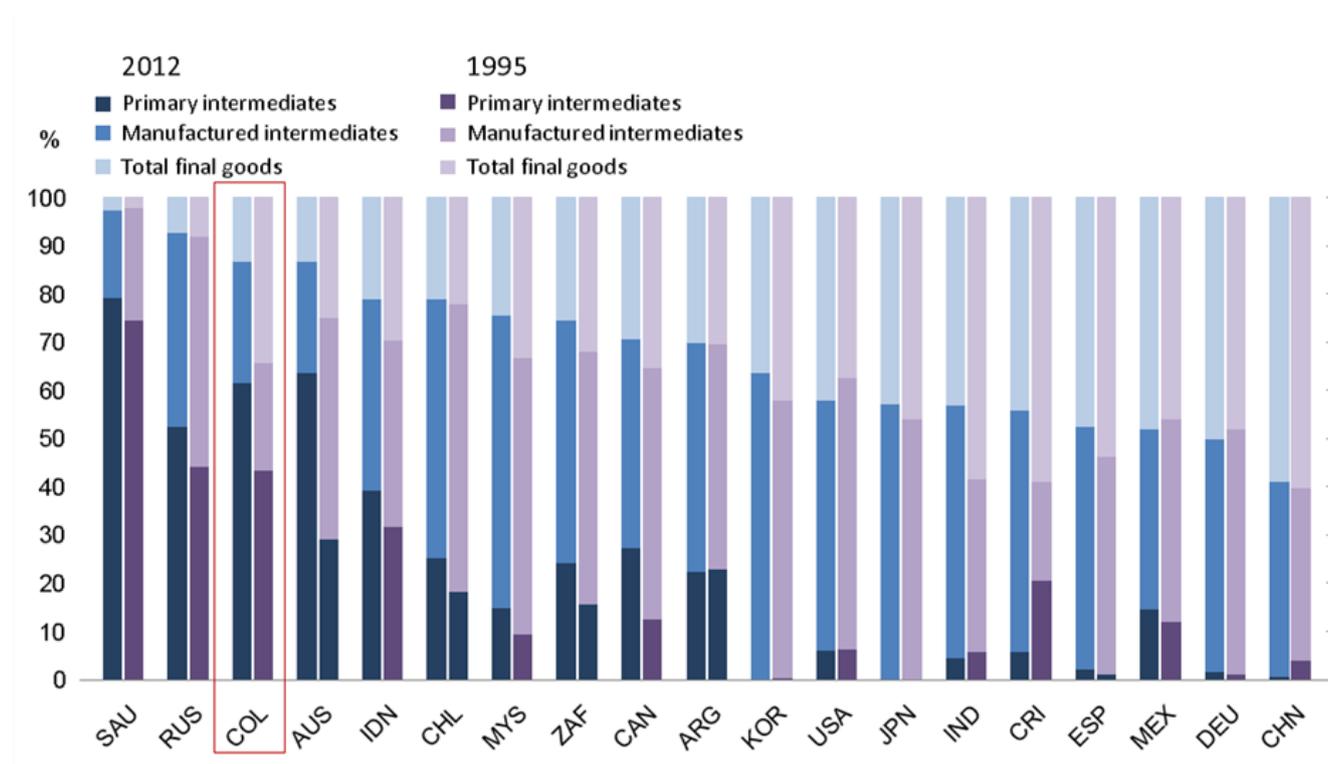
4.1. BOOSTING INNOVATION AND ENTREPRENEURSHIP TO MOVE UP VALUE CHAINS

Colombia faces challenges to boost productivity, diversify the economy away from commodities, and move up the value chain to make economic growth more sustainable. Stronger performance in all these areas is critical to achieve convergence with OECD countries in per capita income. Entrepreneurship and innovation are important steps to this end.

Diversification and value chain upgrading

Colombia's economy has shifted toward the production of commodities, driven by rapid growth in mineral exports (especially oil) amid rising commodity prices (Figure 4.1). Further efforts are needed to make growth more resilient and greener by strengthening the role of higher-value agriculture, manufacturing and tradable services. Colombia's integration in global value chains and knowledge and innovation networks offers new opportunities, but successful competition on international markets requires more investment in innovation, particularly by firms, to boost productivity and competitiveness.

Figure 4.1. Commodities play a growing role in exports (%)



Source: OECD, STAN Bilateral Trade Database by Industry and End-use (BTDiXE), www.oecd.org/sti/btd, May 2014.

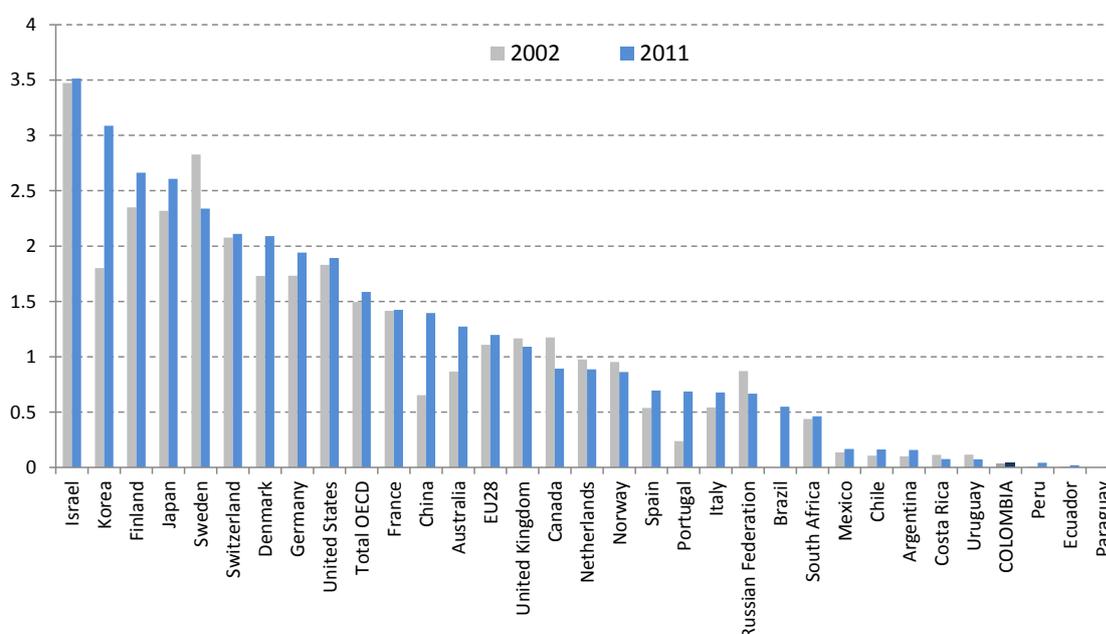
Boosting innovation and entrepreneurship

Innovation can help develop new economic activities, boost productivity to sustain income and employment growth for the urban population, foster agricultural diversification to improve rural livelihoods, and raise environmental sustainability. Colombia's innovation system, needs to be strengthened. Gross R&D expenditure is only 0.2% of GDP, compared with 1.2% in Brazil and 2.4% in the OECD area. Other measures of innovation such as patent registrations and scientific publications per capita place Colombia below neighbours such as Argentina, Brazil, and Chile (OECD, 2014d).

Colombia's innovation system lacks a strong business core. Business R&D expenditure relative to GDP is negligible in relation to the size of its economy (Figure 4.2) and only 30% of total R&D is performed by the business sector compared to 65-70% in leading OECD countries and China. Tackling the low level of business innovation is the key task for policymakers to boost productivity. Policy has thus far emphasised support for research-driven enterprises and university-industry linkages. This is important, but the potential for innovation goes far beyond such firms, and includes the broader base of small and medium-sized enterprises and young firms.

Figure 4.2. Expenditure on R&D is minimal in comparison with that of OECD countries

Selected countries, 2002 and 2011 (as a % of GDP)



Note: Australia: 2010, Chile: 2007 and 2010, Netherlands: 2010, Sweden: 2003, Switzerland: 2004 and 2008, South Africa: 2003 and 2009.

Sources: OECD (2014), *Main Science and Technology Indicators, Volume 2013 Issue 2*, OECD Publishing and RICYT. Brazil based on Ministry of Science, Technology and Innovation (MCTI).

The SME sector in Colombia employs about 81% of the workforce and contributes to 40% of GDP and 13% of total exports. Micro and small firms constitute about 68% of the business population. Informality is common, and access to finance represents a major constraint for the creation, survival and growth of small firms, especially innovative ones. Recent policy measures to alleviate financial constraints have been introduced in the business sector in an effort to foster innovation and productivity. In particular, Bancóldex, a public development bank, manages special programmes targeting SME innovation, development and promotion (iNNpulsa Colombia, iNNpulsa Mipymes). Moreover, in the framework of the previous National Development Plan, a specific unit has been created in Bancóldex to foster innovation and dynamic entrepreneurship, by providing non-refundable resources and co-financing lines (OECD, 2014e).

Raising the level of business innovation will require further investment in skills, particularly engineering, design, management and information and communication technology (ICT; see chapter 4.3 below). Policymakers should encourage mobility between firms and public research institutes, facilitate student placements in industry and foster increased business investment in human resources. In addition to focusing on doctoral graduates and other high-level skills, more attention should be devoted to professional technical degrees (see Chapter 3.1).

The new system for distributing royalties allocates 10% of non-renewable resource revenues to a science, technology and innovation (STI) fund. This increased investment in STI can strengthen the innovation system and address imbalances between public and private innovation and among regions. To ensure its effective absorption and coherence requires increased capacities in the regions as well as better governance and evaluation (OECD, 2013a). However, to maintain coherence, support through the STI fund must not crowd out existing funding streams for R&D and innovation.

The effective implementation and delivery of innovation policy will also require better co-ordination across the various parts of government and between the central government and the regions. Improved coordination would also help tackle “horizontal” challenges, such as environmental issues, that affect many ministries and parts of society.

Key recommendations

- **Further improve the framework conditions for innovation and entrepreneurship and Colombia’s attractiveness for FDI**, by focusing on skills, including engineering, design, management and information and communication technology, and mid-level professional skills.
- **Strongly encourage business investment in innovation capabilities, e.g. by using co-funding, inter-firm networks and rewards.**
- **Increase awareness and uptake of programmes to finance innovation for SMEs and entrepreneurs.**
- **Strengthen research at universities and modernise Public Research Institutes.** Review regulatory and other impediments to collaboration with industry and spin-offs and foster the creation of durable academia-industry links.
- **Improve institutional coordination between entities (Colciencias and National Planning Department)** and actively involve the private sector in the design of innovation programmes.
- **Strengthen the capabilities of sub-national authorities so that they can define and implement suitable projects supported by the STI fund, whilst ensuring coherence at national level.**

4.2. ENHANCING INFRASTRUCTURE AND LOGISTICS TO IMPROVE COMPETITIVENESS

Colombia should further develop transport infrastructure and logistics to increase productivity. Despite recent improvements in the regulatory and institutional framework, transport costs remain high. It is necessary to accompany the measures aimed at boosting “hard” components of logistics, associated with transport infrastructure, with improvements in “soft” aspects that would have results over a shorter timeframe.

Inadequate policies in transport infrastructure have contributed to the infrastructure gap

Colombia exhibits a larger transport infrastructure gap than other emerging and developed economies, and costs of internal freight transport rank among the highest in the world. The quality of roads is low, and rail and river transports represent only 15% and 5% of the freight market, respectively. Even taking into account all other components of the logistics system (i.e., all services and processes needed to transport goods from production place to the end of consumer), the infrastructure deficit is the main factor behind Colombia’s poor logistics performance with respect to OECD countries. Furthermore, the progress made in approving trade agreements in comparison with high transportation costs makes the ratio of freight costs to trade tariffs close to 15 times that of the OECD countries (OECD/ECLAC/CAF, 2013). Reducing transport and logistics costs would therefore allow to diversify the economy by raising significantly the competitiveness of many tradable goods.

In the past, the lack of ex-ante feasibility assessment and, in general, ineffective prioritisation and planning have hampered transport infrastructure. In particular, investment in new projects has been consistently preferred over the maintenance of existing infrastructure while current road conditions require around 50% of road investments to be spent on maintenance. Furthermore, significant changes of the National Development Plans during the approval process in Congress have in the past affected the value-for-money of infrastructure projects (Nieto-Parra *et al.*, 2013). Finally, private sector involvement in transport infrastructure has suffered from weaknesses in regulatory and institutional designs (OECD, 2013a). This was reflected in continuous renegotiations, costlier and more recurrent than in other Latin American economies, which in turn raised the ultimate fiscal cost to the equivalent of more than 3 times the initial cost of concessions (Figure 4.3). More broadly, there is a need to explore innovative financing options for PPPs, including private banks, pension funds and private equity.

Recent reforms have improved the regulatory and institutional frameworks in infrastructure

The overall regulatory and institutional framework for PPPs has improved recently. A unified regulatory framework exclusively dealing with PPPs was approved in 2012. This new framework sets limits on renegotiations, as the contract term and public resources committed to it cannot be increased by more than 20%. It also requires value-for-money analysis to justify executing projects through a PPP instead of through regular public procurement. A National Infrastructure Agency has been created with greater administrative capacity and technical expertise in the design, structuring, tendering and monitoring of contracts. Subnational would also benefit from support in carrying out value-for-money exercises.

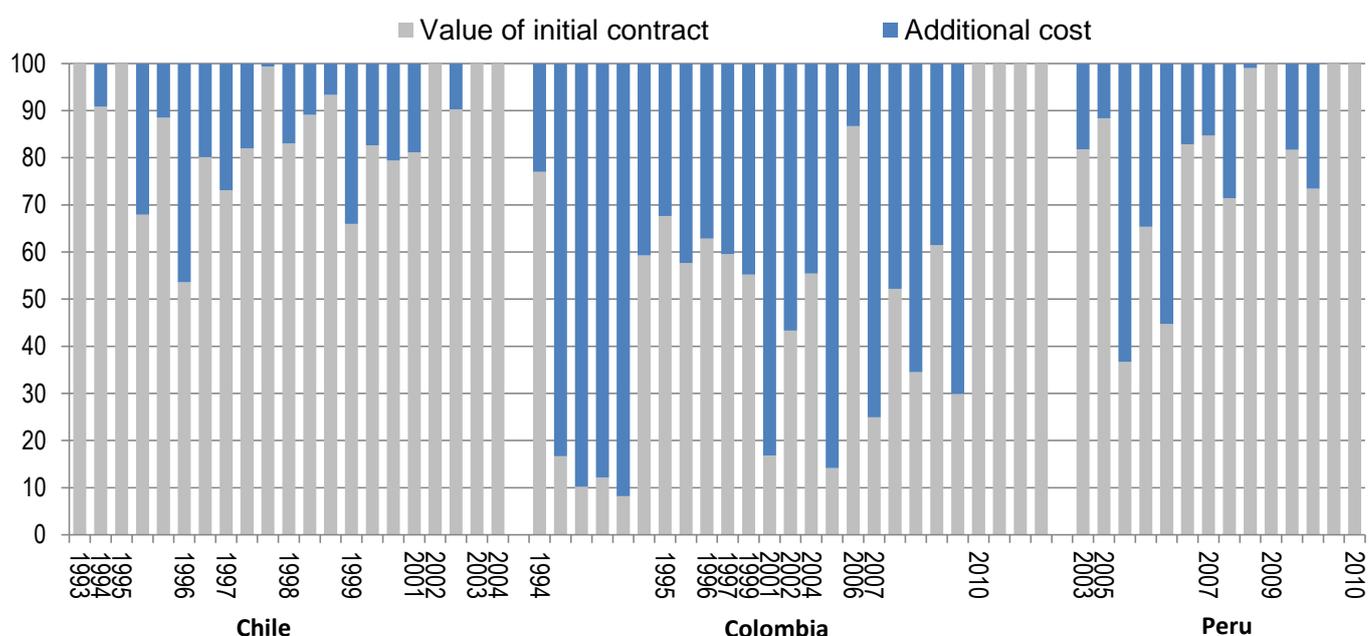
New infrastructure legislation has recently been approved in order to streamline the land acquisition process and to enhance the institutional framework of environmental licenses. This also establishes clearer rules to define the area used for the different types of infrastructure (e.g., water, energy, transport infrastructure). Recent changes also mean that the significant subnational investment and private road infrastructure investment foreseen under the fourth generation (so-called 4G) public-private partnership (PPP) concession plan during 2015 and 2016 will take place in a more transparent regulatory environment. These recent improvements should facilitate transport infrastructure

development and improve transparency over costs. The overall effect remains to be seen as much of the investment in infrastructure has traditionally flowed through extensions to previous concessions that escaped fiscal limits and planning processes. The improved capacity for designing PPP projects needs to be complemented by improved capacity for planning and assessment of infrastructure investment through public procurement.

To maximise the benefits from these investments, the prioritisation, planning and structuring phases, and value-for-money analysis need to be undertaken in a more rigorous manner to improve accuracy, especially at the sub-national level. In addition, environmental and social assessments, including consultation processes with local communities, need to be performed more efficiently and transparently, and completed before awarding contracts. Better census of population affected by infrastructure works would avoid delays and abuses by some communities in their grant of social licenses.

The new oil and mining revenue sharing system decentralises planning and execution of projects, which improves the framework for subnational infrastructure investment. However, more capacity building and technical assistance would strengthen local planning and execution. Despite better co-ordination of investment across levels of government in the new framework, the system remains complex. Furthermore, most resources are allocated to municipalities, which tend to favour small local projects. This fragmentation means that large scale infrastructure projects with higher social returns might not be prioritised sufficiently (OECD, 2014a). Using incentives such as matching grants and building institutions to co-ordinate broader regional infrastructure projects across departments could be a solution. In this sense, a recent proposal of extending performance contracts, which include financial incentives to prioritise these investments and penalties for non-compliance through the National Development Plan 2014-18, should be implemented.

Figure 4.3. Contract renegotiations significantly magnify the cost of infrastructure
(% of total cost)



Note: The x-axis indicates the year in which the concession contract was initially signed.

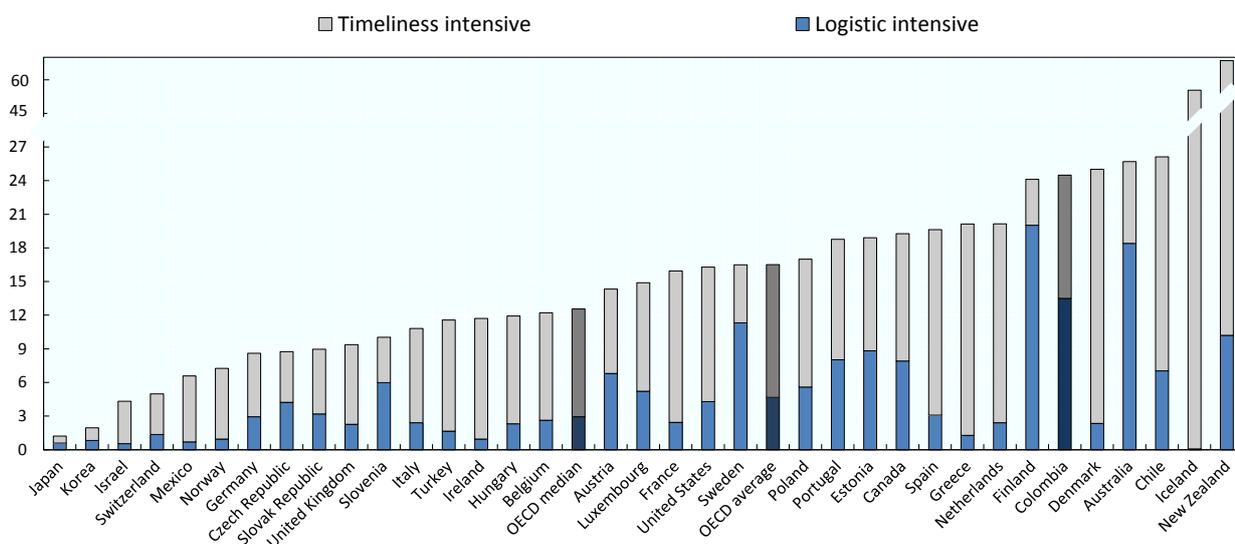
Source: Bitran, E., S. Nieto-Parra and J.S. Robledo (2013), "Opening the black box of contract renegotiations: An analysis of road concessions in Chile, Colombia and Peru", OECD Development Centre Working Papers, No. 317, OECD Publishing, Paris.

A combination of hard and soft components of logistics need to be addressed

Efforts are needed to increase the effectiveness of recent and future investments in infrastructure in Colombia. In the period 2000-2011 public and private investments in transport infrastructure increased 1.1 percentage points to 1.8% of GDP in 2011, a level much higher than the average for the OECD (0.85% of GDP in 2011), reflecting the existing infrastructure gap. The new Fourth Generation of private infrastructure projects is estimated at USD 20 billion for the period 2016-2021, requiring further private investment. Furthermore, despite recent encouraging efforts to invest in river and railway infrastructure, more should be done to develop Colombia's large potential for multimodal transport. This would reduce transport costs while minimising the impact on the environment OECD (2013a).

While infrastructure is the main factor behind the low logistics performance, some "soft" solutions could considerably reduce transport costs in the short run. Improving all components of logistics performance is essential because the share of logistics-intensive or time-sensitive exports is almost 2 times higher than OECD standards (Figure 4.4). Such 'soft' measures include improved customs and inspection procedures and strengthened institutional coordination of logistics and infrastructure policy. There is probably scope for improved port gate management through the introduction of ICT systems to schedule pick up and delivery and reduce congestion at port terminals. These elements can be used to encourage efficient use of available infrastructure and thus reduce logistics costs.

Figure 4.4. Colombia's time and logistics-intensive exports nearly double the OECD countries
(% of total exports, 2012)



Note: Logistic-intensive sectors include mining, forestry and logging, wood manufacturing, paper publishing and printing. Time-sensitive sectors include agriculture, fisheries, food and drink manufacturing and horticulture.

Source: UN COMTRADE

Key recommendations

- **Strengthen the efficiency and real participation of citizens in the grant process for environmental and social licenses** by avoiding discretionary environmental assessments, as well as delays and abuses in the grant of social licenses by some local communities.
- **Reduce transport costs in the short term by focusing on 'soft' components of logistics** such as better use of ICTs to track and facilitate the movement of goods, and to continue improvements in the customs procedures.
- **Provide further assistance to sub-national governments** by pursuing more accurate value-for-money analyses.
- **Explore further the financing options for PPPs.** Different forms of participation between the government and financial intermediaries (e.g., private banks, pension funds, private equity funds) should be studied.

4.3. BETTER ICT POLICIES TO PROMOTE INNOVATION

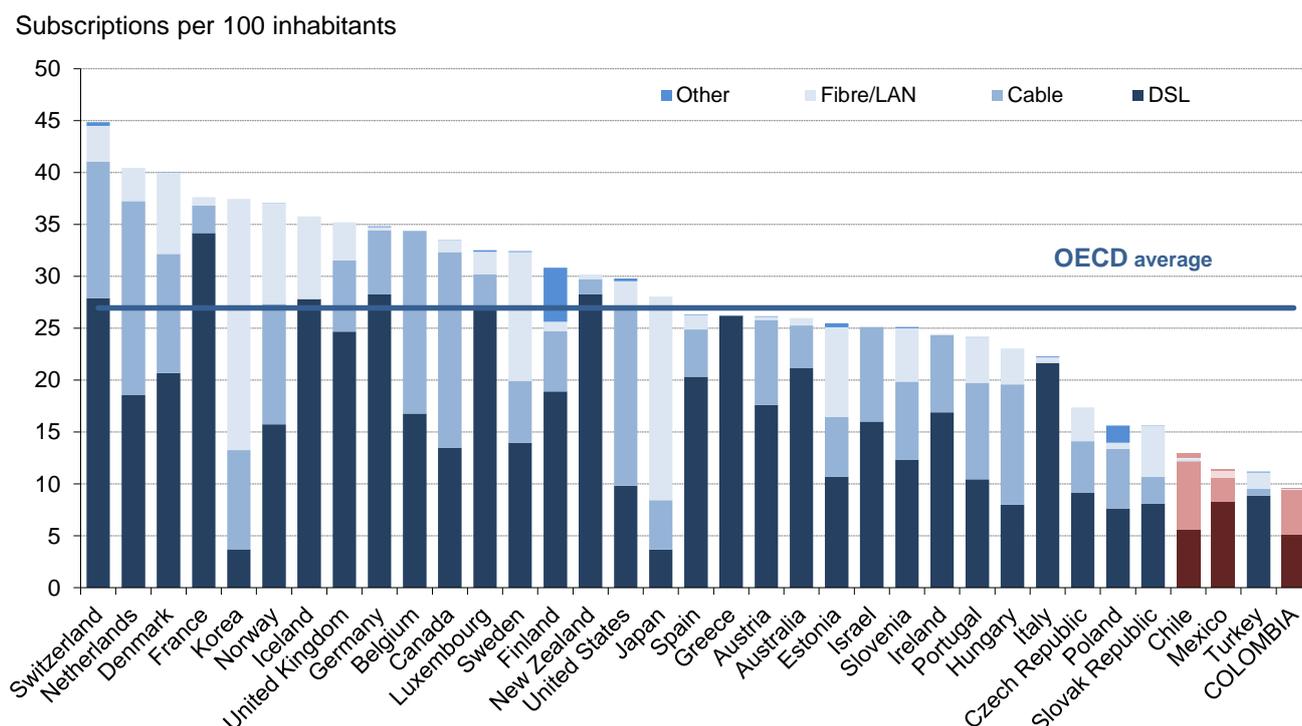
The Colombian government is aware of the importance of the Internet and ICTs as a driver of innovation. The “Vive Digital” strategy by MINTIC (Colombian Ministry of ICTs) is a comprehensive set of Internet and ICT policies that address both the supply and demand of these technologies. In September 2014, President Santos presented the new “Plan Vive Digital 2014-2018”, which includes the promotion of ICT entrepreneurship as a priority.

Pervasive ICT infrastructure and affordable access to services

Effective ICT availability and use can lower the cost of accessing information, reducing transaction costs and facilitating knowledge diffusion. And as data processing, storage and transmission technologies become more efficient, firms can access cloud computing resources without incurring capital-intensive investments in IT infrastructure and software.

But, notwithstanding the progress made in the 2010-2014 period, Colombia still faces significant challenges to make ICT infrastructure a lever for growth and innovation. Fixed broadband penetration is low by OECD standards, with 9.6 lines per 100 inhabitants in December 2013, against an OECD average of 27 lines (Figure 4.5). MINTIC aims to increase four-fold the total number of broadband subscriptions (wired and wireless). In terms of opportunities for innovation, it is critical to expand the use of ICTs by small and micro firms.

Figure 4.5. Fixed broadband penetration remains well below OECD average



Note: OECD Fixed (wired) broadband subscriptions per 100 inhabitants, by technology (December 2013)

Source: OECD Broadband Portal and MINTIC for Colombia

Crucially, ICT infrastructures must reach remote and rural areas and communication services must be affordable for lower income groups. Colombia should increase competition in mobile and fixed markets (Chapter 4.4), expand backhaul infrastructure (e.g. through the National Fibre Network), and further develop Internet Exchange Points and hosting markets. Many Colombian firms and government entities host Internet content in foreign countries, especially the United States, due to high costs in Colombia.

Beyond connectivity: promoting local content for innovation

As well as improving ICT infrastructure and connectivity, a parallel effort must be made to increase users' perceived utility from connecting to the Internet. The development of local content and applications can greatly enhance business incentives to innovate and promote entrepreneurship.

Mobile apps are an important source of innovation in many countries and usually create communities of developers with a positive impact on employment. They can also promote local content and target users' and business needs – a Colombian example is Vive Digital's Apps.co programme, launched in 2012. One successful application supported by this programme is Tappsi.co, a popular service that connects taxi drivers and passengers.

The government can leverage ICTs to streamline administrative processes and improve the business environment. For instance, the government can promote the use of ICTs and good governance through making better use of such technologies in the public sector and with enhanced e-government services. Meanwhile, MINTIC's "MiPyME Vive Digital" strategy has contributed to the development of applications that spur an increase in the number of Internet-connected SMEs while increasing their productivity.

Effective co-ordination with other government agencies is critical. MINTIC and Colciencias (the innovation agency) already have various partnerships, such as that promoting R&D in the ICT sector and the Vivelabs project on digital content.

Ensuring the right skill sets

Colombia recognises that ICT skills are currently basic, and relatively scarce, across society at large and the ICT sector in particular. This needs to be addressed if ICT access is to drive innovation. Colombian companies face difficulties in finding sufficient and sufficiently qualified workers to increase productivity, improve competitiveness and grow through better ICT usage.

Public investment and reform in the education sector could help to reinforce the necessary skills. Primary and secondary education institutions could be further equipped with computers, while revised curricula and teacher training could help optimise their use. ICTs need to become practically relevant to students' daily lives and more attractive as an employment opportunity. Higher education and lifelong learning programmes could promote essential e-skills for innovation and entrepreneurship, such as web creation and software design.

Inclusive innovation through ICTs

Inclusiveness is a top priority for Colombia's innovation agenda. Mobile and ICT-based applications can deliver new high-quality services in education, health and banking through better coverage. These services can thus reach more people with fewer qualified staff, and offer opportunities to flexibly tailor to specific needs and circumstances. Lower-income groups and populations located in remote areas, which traditionally have more limited access to these services, could particularly benefit.

Key recommendations

- **Improve the functioning of Internet Exchange Points (IXPs) and hosting markets** in order to host Internet content locally.
- **Promote ICT platforms, applications and local digital content** that meet the needs of small enterprises and increase the utility of ICTs and the Internet.
- **Develop an ICT skills strategy** to increase the availability and quality of ICT skills across society and the ICT sector.
- **Encourage ICT-based applications that deliver new high-quality services in education, health and banking with better coverage.**

4.4. A BETTER BUSINESS ENVIRONMENT FOR ENTREPRENEURS

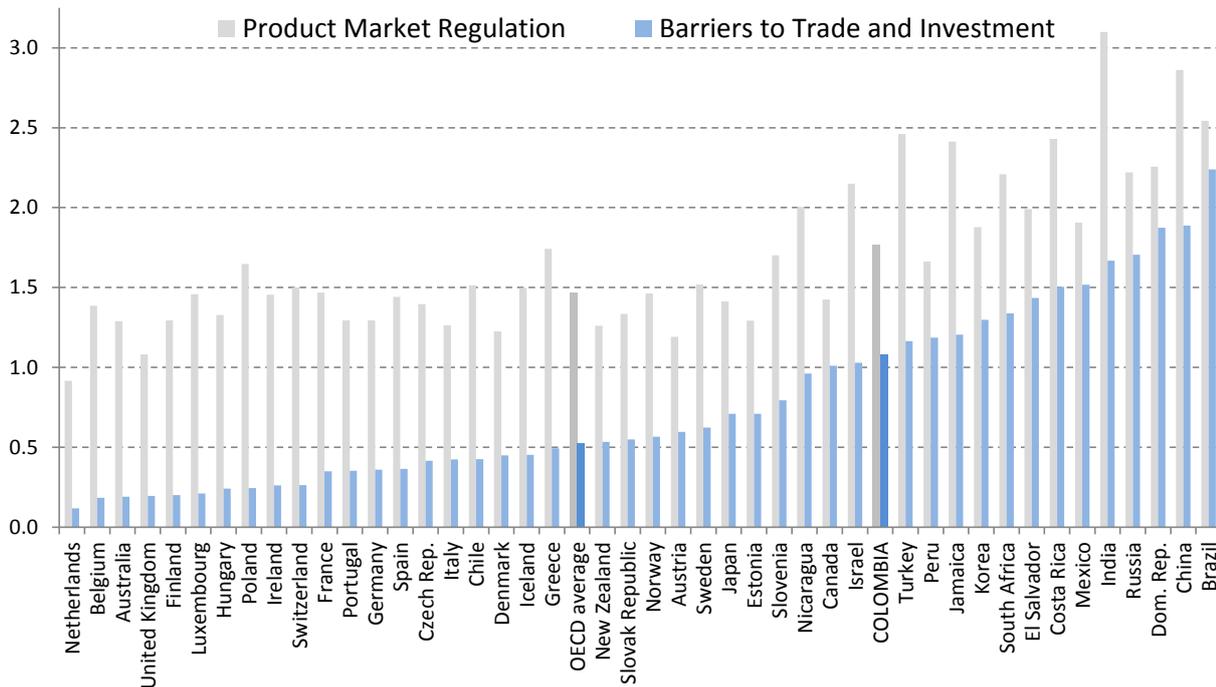
Colombia's low productivity is in part explained by weak competition in product markets, such as telecommunications, food and the retail sectors. The competition law of 2009 improved the basic framework for competition in the country, but resources and powers of the competition authority need to be reinforced. Administrative burdens for sole proprietor firms and for start-ups in some sectors also need to be lowered.

Productivity growth is hindered by weak competitive pressure in product markets. These have been related to rules of conduct imposed by regulators, entry barriers and targeted preferential treatment. There are also a number of sectors in which high levels of concentration indicate the absence of significant competition, including food products, apparel and textiles and the flower industry.¹ Also, there is room for deepening financial markets by increasing efficiency and competition in the banking system (Daude and Pascal, 2015). Profitability indicators and net interest margins remain high in the financial sector compared to OECD economies, suggesting significant intermediation margins.

In addition, Colombia's financial sector is characterised by a strong presence of financial conglomerates, while Colombia's Financial Superintendency (SFC) lacks the full authority required to oversee these conglomerates effectively. In this context, the OECD has recommended that the SFC be granted increased authority to supervise holding companies of financial conglomerates, as well as their relationships with non-financial companies that are part of the same group. The SFC's and Superintendency of Company's authority and effectiveness could be further strengthened by establishing fixed term appointments independent of the political cycle, along with requirements for the disclosure of reasons for dismissal to ensure an appropriate level of independence in their regulatory and supervisory functions.

¹ The April 2014 Competition Committee Report on Colombia states that "The SIC has analysed company operating revenues economy-wide to identify markets with a HHI exceeding 2500. The resulting list includes air transportation; collection, purification and distribution of water; research and development; production of coking coal; production of refined petroleum and nuclear fuel; manufacture of radio, television and communication equipment; health and social services; tobacco manufacture; coal mining; cocoa processing; rice mills; and certain branches of the residential construction sector."

Figure 4.6. Barriers to trade and investment are above the OECD average (2013)



Note: The scale of the indicator is from least to most restrictive (from 0 to 6). The chart includes OECD countries and selected emerging economies. Barriers to trade and investment is one of the three components of the Product Market Regulation.

Source: OECD Product Market Regulation database (2013 data).

Overall Colombia's product market regulation is less restrictive than most non-OECD countries and Latin American countries but more restrictive than the OECD average (Figure 4.6). In particular, barriers to trade and investment are above the OECD average, driven largely by trade measures (Colombia is characterised by a relatively open regime for inward FDI). The non-discrimination principle is generally applied in Colombia's overall regulatory, trade and investment framework (explicit barriers such as tariffs, for example, are comparatively low), and there are few national treatment exceptions. However, there are some *de facto* discriminatory market practices that discriminate against foreign suppliers. This concerns practices such as the national excise tax system for alcohol, regional alcohol monopolies, and scrappage policies for trucks. The government needs to review these policies and ensure the principle of national treatment is not compromised in practice. Internationally harmonised standards are increasingly used by Colombian regulatory authorities and standard-setting bodies, but those best practices for elaborating and adopting technical regulations and standards are still discretionary, and require further political support.

The country is clearly working towards addressing many of these issues, aligning its policies with OECD best practice and introducing new structural reform initiatives, including trade-related policies, such as improved regulatory quality as well as a range of trade facilitation measures. For example, Colombia has taken steps in the right direction to streamline conformity assessment procedures and reinforce accreditation practices, but these efforts are still at early stages and have not yet fully produced results. Colombia would need to consolidate and reinforce the regulatory framework, as it has already engaged in doing, and detach that framework from the political agenda. It should pursue efforts to reinforce laboratory and testing infrastructure; insufficient capacity remains a central challenge for the Colombian standardisation, metrology, certification, and accreditation system, and restricts industry's capacity to expand globally by meeting requirements and demand for certified products worldwide.

In addition, the large difference between tariffs on inputs and those on final goods creates a bias against high-value-added sectors and negative protection for food-producing industries. Lower prices resulting from competitive pressures and the increase in product variety would also make consumers better off, with potential redistribution in favour of low-income groups. Overall productivity is hindered by the lack of competition in certain sectors, including telecommunications. Also, in some other sectors, including food and beverage products, there is a lack of competition while there is a need for a comprehensive assessment of the price stabilisation funds. These funds provide income support to producers of cotton, palm oil, sugar cane, cocoa, beef meat, and milk. And, even when they are financed and administered by farmer associations, they may act as an implicit export subsidy, particularly in the sugar and palm oil sub-sectors, therefore an evaluation of this mechanism should take place and its use should be reconsidered. Lowering such barriers to competition could increase productivity and thus GDP *per capita*.

Reviewing regulatory barriers and the governance of State-Owned Enterprises

Pervasive state control over business activities should also be reduced as it potentially hinders the allocation of resources to the most productive firms and sectors. The use of command and control regulation is particularly high in comparison with the OECD average and some other Latin American countries (Chile or Mexico). It indicates the extent to which the government uses coercive (as opposed to incentive-based) regulation in general, and in specific service sectors in particular², irrespective of whether businesses in the sector are publicly or privately operated.

The central government-owned State-Owned Enterprise (SOE) sector includes about 70 SOEs. The valuation of its assets at the end of 2012 accounted for around 30% of Colombia's GDP, a level not far from other OECD countries. In general, Colombian SOEs do well in matters relating to equal treatment of shareholders or stakeholders' engagement. However, improvements are possible in some areas. There is a need to centralise SOE ownership functions and to have a more consistent implementation of its ownership policy (Lehuedé, 2013). The current system of fragmented ownership leads to a lack of coordination and fails to exploit synergies. Also, political appointments to SOEs boards could be gradually replaced by independent directors, ideally with private-sector experience and complementary skills. CEOs should be appointed by the board with independence from the political cycle.

The competition law of 2009 (1340/09) has improved competition policy settings but lacks teeth in several respects. The independence of the Superintendency of Industry and Commerce (SIC) from politics should be guaranteed in order for it to function effectively. Other areas that warrant improvement include making the SIC's law enforcement policies more fully transparent; increasing the identification and prosecution of unlawful conduct, especially with respect to bid rigging; enhancing competition in public procurement processes; modifying the competition advocacy system to ensure effective competition assessment; and improving the public's understanding of competition and the role it serves in promoting economic prosperity. In addition, further efforts are needed to address the strong resistance to competition policy principles exhibited by the agricultural sector and, to a lesser degree, by the aeronautical sector. These actions may require a larger technical staff and a reduction in staff turnover for the competition authority.

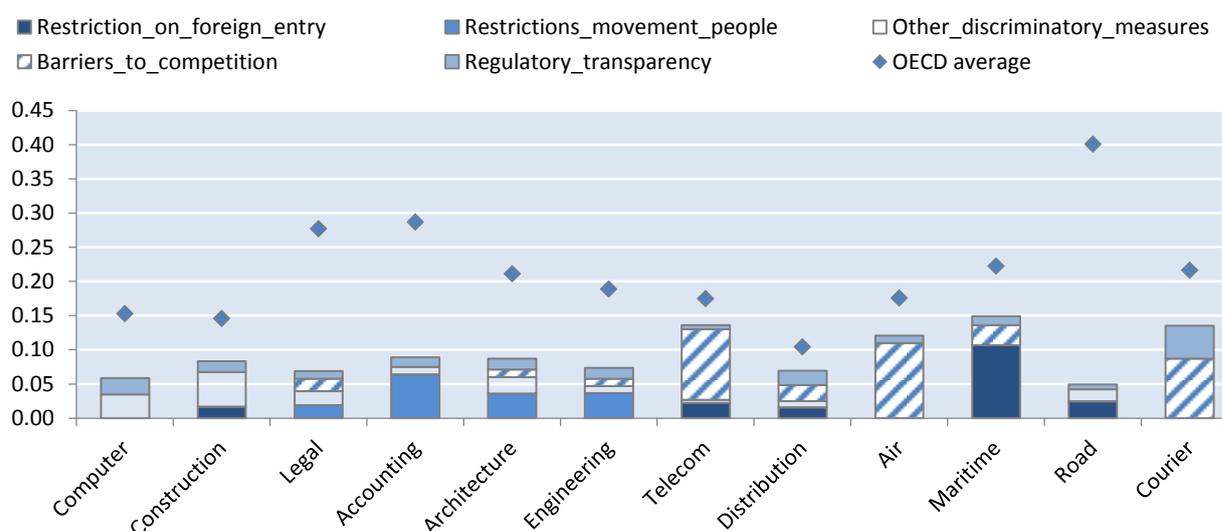
Further Improving Competitiveness in Services and Facilitating Trade

Colombia's score on the OECD Services Trade Restrictiveness Index (STRI) also reveals an open regulatory regime in the areas of computer, construction, distribution, professional services, telecommunications and transport (Figure 4.7). Reform efforts should be continued, including at the sub-national level. In addition, further action is needed to improve the efficiency of the border process by targeting controls on high risk shipments and streamlining documents with the help of the single window (VUCE).

² An example would be retail opening hours.

Figure 4.7. Colombia services sector is relatively open

All sectors index from 0 to 1, 2013



Note: The STRI index compares services trade restrictiveness across 18 sectors, although in Colombia's case only 9 sectors are covered. The index ranges from 0 (least restrictive) to 1 (most restrictive). A STRI score of 1 represents a totally closed sector. A sector score above 0.1 is significant, and scores between 0.2 and 0.3 represent quite significant restrictions on international trade.

Source: OECD Services Trade Restrictiveness database.

One sector in which Colombia has made significant and instructive progress is Information and Communication Technology (ICT). It has improved its telecommunication regulatory framework and promoted the Internet Economy. Notwithstanding the strengths of the current framework, however, fixed telephony and broadband adoption levels are far below those that would be expected in a vibrant, competitive market. Mobile markets are highly concentrated, with the largest operator having 60% of the market, as are most regional and local fixed line markets. Despite the last successful auction in 2013 of 4G mobile licenses, that allowed the entry of two new companies to the mobile market, stronger competition in this sector is still needed to increase adoption rates, stimulate innovation (see chapter 4.3) and extend the benefits of telecommunication services to all Colombians.

To achieve this goal, the regulator should be made truly independent from the government and be granted full enforcement and sanctioning powers. Although Colombia's telecommunication regulatory framework (ICT Law of 2009) is relatively advanced, and includes most regulatory instruments needed to curb situations of dominance in telecommunication markets, these tools are not being put to full use because the Communications Regulation Commission (CRC) lacks independence and sanctioning powers. One of the key shortcomings is lack of separation between regulation and policy making in the sector: two out of five commissioners of the CRC belong to the central government. The government also owns a significant share in the second largest operator in the country (30%), raising potential risks of political interference in the regulator's everyday activities. Thus, one of the main recommendations of the OECD in this area is to ensure an independent Telecommunications Regulator (OECD, 2014f). Also, while the CRC has issued regulations to tackle the dominance in mobile markets (e.g. off-net/on-net price and lowering termination rates), more could be done to promote competition in fixed markets (e.g. local loop unbundling and wholesale obligations).

Effective enforcement of intellectual property protection

Colombia's aggressive policy in favour of IP rights protection as part of the country's strategy to improve the investment climate and attract foreign investors has produced a legal framework that is well developed, especially given the country's per capita income levels. Enforcement, however, still remains problematic with optical disk and digital piracy at endemic levels and low detection rates. As a result, IP instruments are not widely used by the domestic industry, and challenges remain from an internal perspective to maximise the benefits of the IP system for growth. With the increasing sophistication of the legal framework, including through changes required under the country's recent FTAs, the focus should gradually shift towards improved enforcement, institutional capacity-building, and IP promotion. This would imply in particular better coordination among public entities involved in intellectual property protection, greater priority in prosecuting infringements, and strengthening the capacity of the judicial system to deal with them. With this approach, and in tandem with robust innovation policy, the laws on the books can more credibly contribute towards greater IP use and IP generation in the economy.

Key recommendations

- **Consolidate the regulatory framework governing the standardisation and certification in Colombia**, and pursue efforts to expand and upgrade existing testing and certification capacity.
- **Review alleged cases of *de facto* discrimination** to ensure that the principle of national treatment is not compromised in practice.
- **Reduce obstacles to the participation of foreign suppliers and barriers to entry in service sectors.**
- **Remove barriers to building new telecoms infrastructure, and promote competition in mobile and in fixed-line communications** by reducing termination rates to close to zero for all operators except new entrants and through bitstream access and local loop unbundling.
- **Ensure the effective independence of regulators, including the telecommunication regulator (CRC)**, in order to promote competition and effective, even-handed supervision of companies.
- **Review barriers to competition in some other product markets, including food production and the financial sector** to ensure that product market regulations do not act as barriers to entrepreneurship. Establish a comprehensive competition assessment system for proposed and existing government regulations and target price stabilisation funds for early evaluation. Enhance competition in public procurement processes. Give the competition authority (SIC) greater independence and more qualified staff to increase its effectiveness. **Provide the Financial Superintendency with increased authority to supervise holding companies of financial conglomerates** and their relationships with non-financial companies that are part of the same group in order to ensure their effective supervision.
- **Strengthen the governance of state-owned enterprises** by appointing more independent board directors with relevant skills and experience.
- **Develop further the institutional capacity to deal with IP-related issues and improve the efficiency of enforcement efforts**, in particular as regards prosecution of infringements and the capacity of the judicial system to deal with them.

5. TOWARDS MORE EFFECTIVE GOVERNANCE

Delivering on the objectives of the National Development Plan 2014-2018 will require improvements to Colombia's institutional and governance framework as well as comprehensive fiscal reform to ensure funding. In light of these imperatives, measures to promote 'good governance' are critical for the successful implementation of the National Development Plan. To this end, there is a need to increase public transparency to earn citizens' trust and to improve the production and use of national statistics. To ensure balanced, sustainable development across the country it will also be essential to deepen the modernisation of administrative structures and decision-making capacity, along with service delivery at the national and sub-national levels. Improved coordination among different levels of government will be critical in addressing pronounced regional disparities. The multi-year investment plan for 2015-2018 projected in the National Development Plan represents close to 330 USD billion (slightly higher than 100% of GDP in 2014). Although 35% of this is expected to be financed by the private sector, given that the tax take is relatively low in Colombia, while falling oil prices could undermine public revenues further, there will be a need to go further than currently envisaged in the direction of tax reform. These reforms can be complemented through moves towards performance-based budgeting.

5.1. MORE EFFECTIVE GOVERNANCE TO IMPLEMENT REFORMS

Colombia has undergone profound political and administrative change over the last ten years. It has made significant progress in implementing a good-governance agenda aimed at strengthening its institutions to promote democracy, the rule of law, and sustainable and inclusive growth in all regions of the country. The government is pursuing an integrated approach to modernising its administrative structures and decision-making capacity, along with service delivery at the national and sub-national levels. While these efforts are addressing acute poverty and lessening pronounced regional disparities, more work needs to be done to build upon these achievements and further improve the efficiency and effectiveness of the public sector across the country to meet the needs of citizens and businesses in all regions.

Beginning in 1991, Colombia has pursued a robust governance-reform agenda to modernise the country's political and economic institutions. The government has implemented ambitious programmes for more inclusive and participative government. The government has pursued several initiatives to promote participation and access to information, including the Economic Transparency Portal, the Portal of the Colombian State and the Crystal Urn (*Urna de Cristal*), a multichannel engagement platform enabling participatory policy-making by citizens that is advanced by OECD standards. Following 50 years of internal armed conflict, the government has embarked on a comprehensive Peace Process aimed at securing a permanent resolution to the conflict. And while local administrative and security capacity remains weak, important social-welfare and victim-restitution programming for people affected by the conflict have been instituted. Securing this Peace is a core pillar of the National Development Plan.

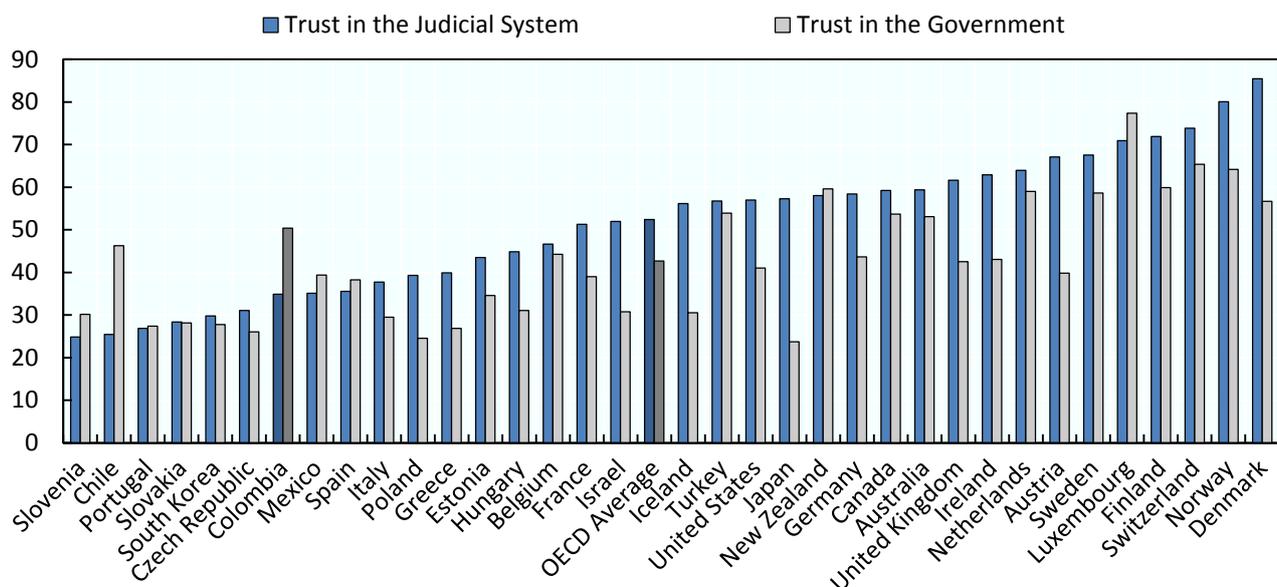
Improving integrity in public institutions to win citizens' trust

Colombia is engaged in creating a more transparent, accountable, and open and participatory government. This is shown by the country's accession to the Open Government Partnership (OGP). In April 2012, Colombia presented an OGP Action Plan including commitments on access to information, e-government as well as on accountability and citizens' engagement. Recent achievements include the implementation of successful e-government and open data programmes as well as the elaboration of a new Law on Transparency and Access to Public Information. To reach the full impact of Open Government policies, Colombia will have to sustain implementation efforts, especially at the local level, and link its efforts more consistently to its economic development policies. In addition, to increase credibility, data coverage and coherence of official statistics, the prompt adoption of a framework statistical law confirming the professional independence and the coordinating role of the National Statistical Office (DANE) is recommended.

Colombia has also made major efforts to fight corruption and has ratified the OECD Convention on Combating Bribery of Foreign Public Officials in International Business Transactions. Still, corruption remains an issue and perceptions of corruption affect the ease of doing business. Corruption affects in particular sub-national governments. In 2011, more than 100 mayors (out of 1123 municipalities) were punished by the Inspector General. Public policies improving co-ordination between central and sub-national governments and control agencies need to be implemented in order to adopt a comprehensive anti-corruption policy, while it is important that Congress finalises the necessary legislation ensure adherence to the OECD Anti-bribery Convention. Public procurement practices also need to be further strengthened, making greater use of public tendering. In 2011, fewer than 30% of all procurement operations included a public tendering process. The National Public Procurement Agency (ANCP, *Agencia Nacional de Contratación Pública*) was created in 2011 to centralise public procurement and improve its efficiency and transparency. But it needs greater capacity and resources to meet its goals effectively.

In Colombia, trust in the judicial system lags with respect to trust in the government and with trust in the judicial system in OECD countries (Figure 5.1). Colombia's justice system faces significant challenges with respect to impunity for crimes of corruption (including within the judiciary itself) and violence, however, including against trade unionists, but recent data suggests that access to justice and the speed of case resolution are beginning to improve. These high levels of impunity constitute an important challenge to the effectiveness and efficiency of the Justice sector in Colombia. Access to the judicial system, and the speed at which cases are concluded, continue to affect public trust in the judiciary – access continues to be affected by high costs, lack of availability of legal representation and citizens' lack of awareness of their legal rights. Some of Colombia's judicial institutions enjoy high approval ratings, however, notably the Constitutional Court, given its role in upholding the social and economic rights of individuals. Moreover, the current judicial arrangements do not promote the specialisation of courts and judges for regulatory decision making. There is a need for improved training and specialisation on technical issues surrounding regulatory decisions. Even if judges use technical analyses and reports to base their decisions, there is scope for improvement in this area. The specialisation of court decisions might help in improving the overall quality of the judicial process. The set-up of specialised courts would require a major institutional change, which will only happen if there is sufficient political leverage and consensus (OECD, 2013b).

Figure 5.1. Trust in the judicial system is low in Colombia (2013, %)



Note: Percentage of the population that answered “Yes” to the following questions: Do you have confidence in the judicial system and courts? Do you have confidence in the national government?.

Source: Gallup World Poll (November 2013).

The proliferation of institutions tasked with fighting corruption is characterised by poor co-ordination and trust between them as each pursues its own agenda, creating inefficiencies in the system. The Auditor General (*Auditoría*) appears to be overseen by the authority it is mandated to control - the Comptroller General (*Contraloría*). This governance and accountability model calls into question the independence of these institutions, as well as their overall effectiveness. In addition, territorial sections of the *Contraloría* are funded locally and can therefore be exposed to local political influence, particularly in the context of inter-regional disparities in administrative and regulatory capacity (Chapter 2.1). Furthermore, the Inspector General of Colombia (*Procuraduría*) currently has the power to remove elected officials and autonomous regulators from office. As currently distributed, these powers enable the Inspector General to act as prosecutor, judge and jury in its disciplinary investigations, which calls into question the constitutional autonomy of the Executive and Legislative branches of government.

Leveraging decision-making capacity and service delivery at the national and sub-national levels

The National Development Plan provides an integrated multi-year national development strategy that lays out a clear strategic framework for the Colombian public administration as a whole. This steering instrument can be further leveraged through a stronger whole-of-government strategy-setting and implementation supported by an integrated, more flexible civil service. Progress in this direction is taking place, with measures to strengthen capacity at the centre of government and an overall commitment to modernise the government's human resources management. Merit-based recruitment at a whole-of-government level together with better alignment of civil service career paths through an institutional framework would help deepen these efforts.

At the regional level, while Colombia's aggregate Gini coefficient has decreased significantly in recent years acute inter-regional disparities in income and service-availability persist, prompting the government to identify regional growth as a strategic focus in the 2014-2018 NDP (Chapter 2.1). Territorial disparities, disparities in sub-national capacities – financial, administrative/institutional, management capacities – are large and reflect an urban-rural gap (Chapter 2.3).

While regulatory frameworks are improving, contract enforcement is weak

Over recent years, Colombia has made major improvements to its regulatory framework. It has introduced quality requirements for the preparation of regulations (including the economic and social impact of regulations), improved transparency in the preparation of regulations (including by developing a centralised registry of the stock of regulations, called the Single System of Formalities Information; SUIT in its Spanish acronym) and promoted information-sharing and the use of ICTs to encourage dialogue with stakeholders of regulation. The Government has also approved a horizontal regulatory policy. It has developed two draft documents for the review and approval of the National Council on Economic and Social Policy (CONPES), which are set to represent a horizontal regulatory policy for the Executive branch of the central government.

The Government has also taken steps to lay the groundwork for the development of its regulatory policy, including implementing a policy for administrative simplification (*Anti-trámites*) to address issues such as unnecessary bureaucratic procedures, red tape, and rules hindering efficiency, effectiveness, and transparency, as well as to build a modern, citizen-friendly administration, and its Government online (GEL) strategy that focuses on harnessing ICTs to build a more efficient, transparent and participative state. It has facilitated transparency and citizen participation in the regulatory process by developing channels for public consultation via ICTs. It has also facilitated interactions between citizens and the public administration by setting up electronic mechanisms to comply with regulatory requirements and access public services. It has established one-stop shops for starting up a business, registering property or conducting foreign trade operations, as well as set up participatory mechanisms, such as the portal *Urna de Cristal* (OECD, 2013b).

While these regulatory changes have improved the business environment, cumbersome and costly contract enforcement is still a barrier to a more dynamic private sector. Recent improvements to accelerate the judicial processes include a national plan to reduce judicial bottlenecks (*Plan Nacional de Descongestión*) and the creation of a specialised court to solve commercial procedures at the Superintendence of Companies. However, the efficiency of contract enforcement of a sale of goods remains low in terms of timing, as well as in cost and number of procedures involved, from the moment the plaintiff files the lawsuit until actual payment. Moreover, differences across cities are striking, with enforcement taking almost three years less in the best performing cities compared to the worst performers. There is a need to strengthen the autonomy, accountability and legal protection of arm's-length regulators and the *Superintendencias*. There is also a need to improve the role and practices of the legal institutions that support the effective implementation of contract law. The creation of new municipal courts and increasing the number of staff are needed in order to reduce the backlog of unsolved cases.

Key recommendations

- **Pursue efforts to strengthen the effectiveness and efficiency of Colombia's justice sector within the framework of the rule of law** in order to address high levels of impunity and build public trust in the judiciary.
- **Enhance contract enforcement and increase the specialisation of court decisions.** Arbitration and other alternative dispute mechanisms should be promoted to reduce the pressure on the overstretched national courts. There is also a need for training and capacity-building activities on regulatory issues for judges.
- **Pursue efforts to strengthen the equilibrium of powers between Colombia's external audit and control institutions and the Legislative, Executive and Judiciary branches,** within the framework of the rule of law.
- **Sustain high-quality regulation and move to a regulatory governance approach,** by (i) establishing a regulatory oversight body at the centre of the Government to promote regulatory quality, (ii) developing a common compulsory set of standards and requirements to prepare regulations, including consultation and ex-ante impact assessment (i.e., RIA); (iii) making explicit the roles territorial entities should play in delivering better regulation; and (iv) strengthening the autonomy, accountability and legal protection of arm's-length regulators and the *Superintendencias*.
- **Confirm via a framework statistical law the independence and coordinating role of the National Statistical Office (DANE).**
- **Continue to enhance government transparency and accountability and step up the fight against corruption,** by improving coordination between agencies, further strengthening the National Public Procurement Agency and building and sustaining capacity to fight corruption at the sub-national and local levels.

5.2. FISCAL REFORM FOR MOBILISING RESOURCES TO SUPPORT THE NATIONAL DEVELOPMENT PLAN

Colombia has taken steps to strengthen its fiscal policy framework and improve its tax system, and will continue on its path towards a comprehensive fiscal reform. There is significant scope for improving fiscal policies and to turn them into a more effective tool for economic and social development. The current tax system does not raise sufficient revenues to finance the provision of services that can stimulate inclusive and sustainable economic growth. More revenues need to be raised to finance investment in infrastructure, education and innovation, as well as to expand its social safety net, reduce poverty and inequalities. Furthermore, the tax system does little to foster investment or reduce inequality. Tax bases should be broadened, corporate taxes lowered and the tax system should be made more progressive and green.

Recent fiscal reforms have improved the sustainability of public finances

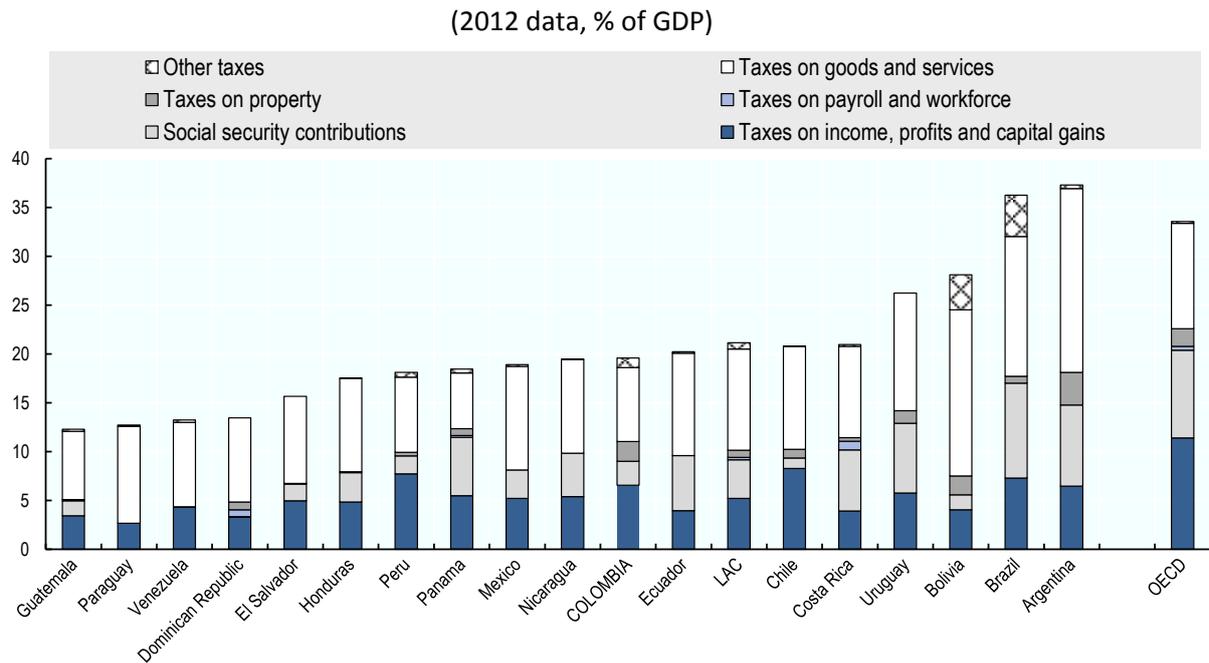
Colombia's recent fiscal reforms represent progress in fostering efficiency, equity and environmental goals. The 2012 tax reform reduced the non-wage labour costs, simplified the VAT system, increased personal income taxes on high-income earners and eliminated certain tax exemptions on fuels. In December 2014, Congress approved a law that modifies some taxes to consolidate public finances. It extends a financial transaction tax that was scheduled to be phased out in 2015 for an additional four years. The reform will also gradually eliminate the net wealth tax on businesses, which will be compensated by an increase in corporate income taxation. Furthermore, the net wealth tax on individuals was extended also for four years, with some changes to the rate structure and wealth brackets. The reform includes some measures to tackle tax evasion. Moreover, Congress approved the creation of a commission to discuss the design of a future comprehensive tax reform.

At the same time, a structural fiscal balance rule and a stabilisation fund were created to lock in the gains from the ongoing commodity boom and to strengthen fiscal sustainability. The fiscal rule establishes annual targets, such that the adjusted budget deficit will gradually decrease from around 2.4% of GDP in 2014 to 1% by 2022. In addition, in 2011, fiscal sustainability was included in the Constitution as a key guideline for public policy, and public debt remains low at 43% of GDP in 2013 (OECD, 2015).

Reforming the tax system to support inclusive and green growth

Social expenditure and infrastructure needs will require more revenues in the near future. Tax revenues as a share of GDP have increased by almost 3 percentage points in the last decade, mainly driven by higher economic growth and improvements in tax administration. Nevertheless, at slightly less than 20% of GDP, tax revenues are far below the OECD average (Figure 5.2). OECD countries at similar levels of per capita income were able to mobilise more fiscal resources than the current level in Colombia.

Figure 5.2. Greater efforts are needed to mobilise domestic resources



Source: OECD Revenue Statistics 2014 and OECD Revenue Statistics in Latin America 2014.

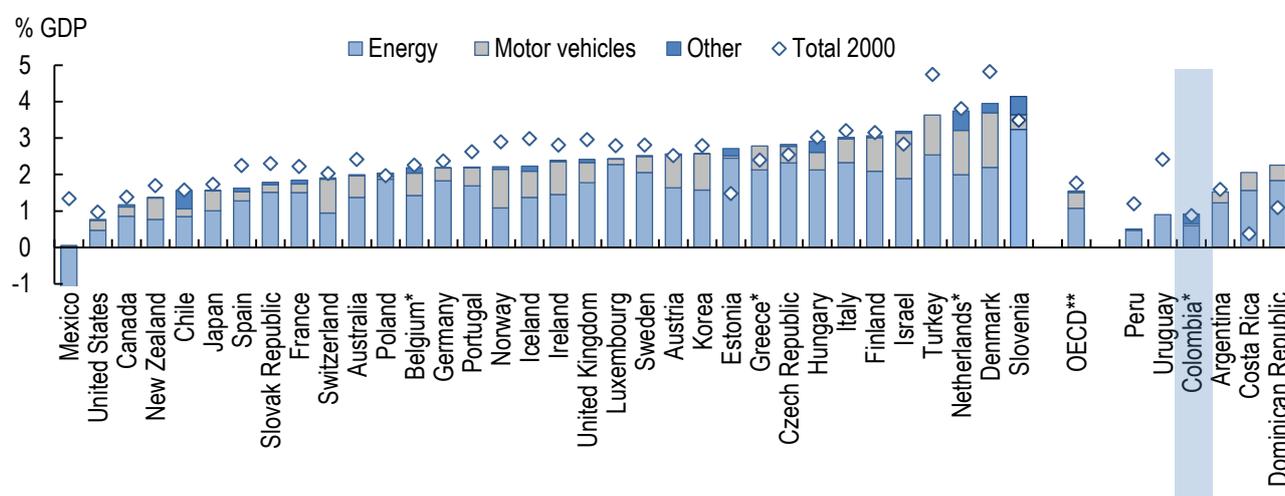
Taxes have a limited effect in reducing income inequality in Colombia. In part, this is due to a high share of consumption taxes in Colombia's tax revenues, although VAT rates are relatively low. Despite progress being made in simplifying the VAT structure, tax exemptions and reduced rates remain pervasive with richer households capturing a large part of this implicit subsidy. Removing VAT exemptions, especially on non-essential goods, and increasing VAT at reduced rates, while compensating the poor by increasing cash transfers, would make the VAT more neutral and reduce compliance and administration costs. The personal income tax (PIT) is also not very progressive, as it is characterised by tax exemptions that benefit mostly the rich. Revenues from PIT in Colombia at 0.7% of GDP are low in comparison with Latin American countries and the OECD average (1.2% of GDP and 8.5% of GDP, respectively). The tax-free basic allowance is generous, which partly explains why only around 5% of the adult population actually pays PIT. Dividends are not taxed at the personal level, which reduces the progressivity of the tax system.

The corporate tax system is also highly distortive and could deter domestic and foreign investment in the future. The total effective tax burden that weighs on businesses is very high due to the combined effect of corporate income taxes, the wealth tax on companies' net assets and the production-based VAT system under which VAT on purchases of fixed assets is not creditable against output VAT. In addition, generous incentives and special regimes, such as the free trade zone regime, continue to reduce revenues from corporate taxes and to generate distortions between different types of companies and industry sectors. While positive changes will be introduced starting in 2015, including the gradual elimination of the wealth tax on businesses, these reforms will not be sufficient to significantly lower the tax burden on investment. Therefore, Colombia will need a comprehensive reform of its regime for taxing businesses and a partial shift in its tax burden away from corporate to personal (OECD, 2015). In this regard, the establishment of a Commission in charge of preparing a comprehensive tax reform is a welcome development.

Tax reform could also stimulate green growth. Revenue from environmentally related taxes currently amounts to only 0.7% of GDP (3.7% of total tax revenue), which is significantly below the OECD average of 1.6% of GDP. Currently only one quarter of energy use is taxed, namely transport fuels. A more coherent taxation regime would also tax the remaining three quarters of energy use, that is heating and process use as well as electricity, and thereby increase revenues. In addition, a carbon tax could boost environment-related revenues while also dealing with emissions in a cost efficient way (OECD, 2015).

Figure 5.3. Environment-related tax revenues remain low

% of GDP in 2000 and 2012



Note: * 2011 data; ** refers to OECD simple average.

Source: OECD Environmental Performance Reviews: Colombia 2014

Exemptions and preferential tax treatments continue to limit the transport fuel tax base, reduce potential revenue and inhibit incentives to reduce energy use. Lower taxes on diesel than petrol have seen demand for more environmentally-damaging diesel more than double over the past decade. The reduction in fuel subsidies has been a significant step taken in the 2012 reform, but environment-related taxes could be increased, while recognising the need to introduce complementary measures to tackle cross-border smuggling. Although Colombia taxes transport fuels more than many oil producing countries, taxes on transport fuels are low compared to other Latin American countries and significantly lower than the OECD average (Table 1.1).

Table 1.1. Tax rates on gasoline and diesel

Selected Latin American countries and OECD average

	Colombia	Chile	Argentina	Uruguay	OECD average
Gasoline (EUR/GJ)	4.7	10.3	7.0	13.3	15.5
Diesel (EUR/GJ)	3.3	2.3	4.2	12.6	10.5

Note: Tax rates are as of August 2014 for Latin American countries and as of 1 April 2012 for the OECD average. GJ refers to Gigajoule.

Source: OECD calculations based on Colombian Government (2014) and OECD data.

Inclusiveness also requires Colombia to ensure that the fairness and integrity of the tax system is not undermined by tax avoidance or evasion. Encouraging and facilitating voluntary compliance through a simplified tax system and administrative process, coupled with strong deterrent measures for non-compliance are both important in this regard. Colombia's recent measures to simplify online filing for large taxpayers through the use of digital signatures exceeded its uptake target by 140% with an increase in the tax base and voluntary compliance levels, demonstrating the high impact of effective

measures to prevent tax avoidance. These efforts should be continued. More can be done however to combat tax evasion, for example through tougher sanctions. Strong and effective sanctions against tax evasion will also build trust in the tax system and the government, and encourage future voluntary compliance. Such a move would be consistent with Colombia's commitments to the international standard to prevent and to combat money laundering and terrorist financing under the Financial Action Task Force recommendations, which in 2012 were updated to introduce tax crimes as a predicate offence for money laundering.

Enhancing fiscal responsibility at the subnational level

Subnational governments in Colombia play a crucial role in the delivery of public services (Chapter 2) but lack the appropriate financial resources and institutional capacities. While during the last two decades there has been a trend towards more decentralisation of key expenditures to departments and municipalities, it has not been matched with key institutional changes in the tax revenue sharing system. There is a mismatch between responsibilities allocated to subnational governments and their funding. Subnational governments have little power to tailor public goods to local needs, as most transfers are earmarked, and have limited incentives to raise local taxes. In addition, the rules for financing current expenditures at sub-national level (*Sistema General de Participación*) have undergone numerous changes creating uncertainty for local authorities as to the funding allocations they receive from the central government. After 2016, a new rule will govern these transfers, which could impose higher fiscal costs, and thus require additional fiscal revenues or adjustments to counteract these potential effects. For example, linking increases in transfers from central government to increases in structural revenues, in line with the central government's fiscal rule, may be a better approach.

Key recommendations

- **Reform the tax system to raise more revenues, increase efficiency and strengthen equity.** The VAT and PIT tax bases should be broadened by eliminating exemptions that benefit mainly the rich, while poorer households should be compensated through direct cash transfers. Taxes on dividends should be levied at the level of the individual shareholder.
- **Reduce the tax burden on domestic and foreign investment** by gradually lowering the corporate income tax rates, phasing out the net wealth tax on firms and eliminating VAT on fixed assets.
- **Strengthen the tax administration and increase penalties to reduce tax evasion.**
- **Increase environment-related taxes and reduce environmental tax expenditures.** The energy tax base should be broadened to include fuels used for heating and processing as well as for electricity generation. Introducing a carbon tax into account.
- **Reduce uncertainty for the financing of regional transfers** by linking increases in those transfers to increases in structural revenues, in line with the central government's fiscal rule.

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