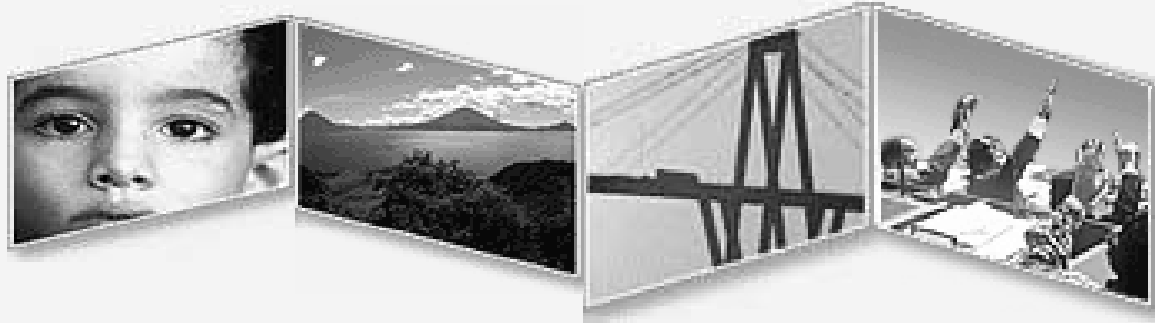


Financing Colombia's Social Safety Net: a review of recent experience and policy options

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Outline of Presentation



- I. The effects of the 1999 Crisis**
- II. The Social Safety Net**
- III. Under funding and procyclicality of the Social Safety Net**
- IV. Financing the Social Safety Net**
- V. Conclusion**

Sources of Presentation:

Inter-American Development Bank (2001) *Social Reform Program*.

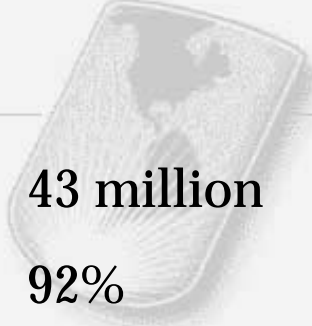
Inter-American Development Bank (2000) *Social Support Network Program*.

World Bank (2002) *Colombia Social Safety Net Assessment*.

World Bank (2002) *Colombia Poverty Assessment*.

Bouillon, Glassman and Valderrama (work in progress) *Fiscal Instruments and Social Spending in Latin America*

Colombia Basic facts:



Population (2001)	43 million
Adult literacy rate (2001)	92%
Urban population (2001)	75.5%
GDP (2001)	US\$ 83.6 billion
GDP per capita (2001)	US\$ 1940
IDB lending (cumulative)	US\$ 8.4 billion

I. The effects of the 1999 Crisis

In 1999, Colombia experienced its worst recession in 70 years:

- GDP dropped by 4.3%.
- Domestic and external reasons for crisis:
- Overspending and unsustainable debt that began in 1994 at both the central and subnational governments.
- Effects of internal conflict on economic activity, especially on private investment.
- Asian financial crisis that struck in late 1997.
- Sector deficit worsened sharply in 1999, climbing to 5.5% of GDP, after averaging 3.8% during the previous three years.

- These recent developments suggest that structural changes have made Colombia's growth more volatile. From 1950 to 1993 (the year in which decentralization was launched), Colombia only experienced two consecutive quarters of negative growth. Since 1993, this has occurred **four** times.

This has important implications for Macro and Fiscal Policies

- Country should adopt crisis avoidance policies.
- Sustainable fiscal reform that includes revision of decentralization process and rationalization of parastatal agencies (who constantly are requiring central government bail outs).
- Addressing the internal conflict.
- But, even with these actions, the country will likely still suffer from external shocks: contagion effects/globalization hazard.
- Some actions at the international level have been proposed to reduce this type of shocks (global fund for emerging markets – Calvo IDB, or International Bankruptcy laws – Krueger, IMF), but these will take time to implement.
- i.e. Crisis avoidance is not enough, country should have an adequate safety net to protect from crisis.

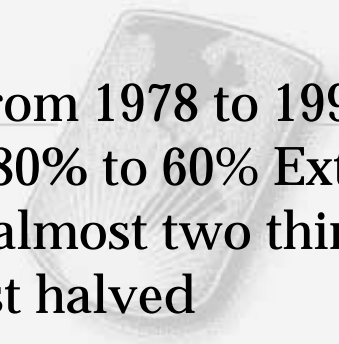
The crisis had an important effect on poverty levels



Poverty Rates 1996 – 2000
(Percentage of total population)

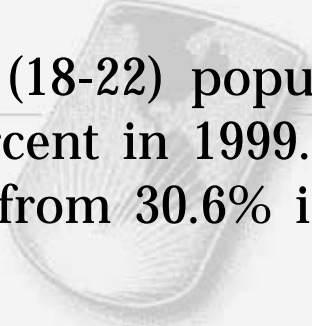
	1978	1988	1995	1999
Total poverty				
National	80	65	60	64
Urban	70	55	48	55
Rural	94	80	79	79
Extreme poverty				
National	45	29	21	23
Urban	27	17	10	14
Rural	68	48	37	37

Source: World Bank Colombia Poverty Assessment 2002, using National Household Surveys

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- During the growth period from 1978 to 1995, the national poverty rate dropped from 80% to 60% Extreme poverty in urban areas plummeted by almost two thirds while extreme poverty in rural areas almost halved
 - During the recession in the late 1990s poverty indicators deteriorated, especially in urban areas.
 - In 1999, at the height of the crisis, according to a household survey in four major cities, 37% of the sample households had experienced a decline in income, 54% had changed their consumer habits, 21% had had to reduce their savings, and 17% went into debt.
 - The impact was higher among poor households which experiencing a decrease in income 20% higher than for affluent households.

And on human capital accumulation

- Loss of income forced many poor households to decrease food consumption dramatically. Poor urban households reported a 39% reduction in food consumption in 1999.
- There was also a pronounced impact on school attendance: 6.5% of the households that had experienced a decline in income reported that one of their members had to drop out of school for financial reasons.
- The likelihood that a household member had to drop out of school was 8% higher in the households that reported a decrease in income than in the households that reported no decrease.
- Between 1996 and 2000 private secondary school enrollment as a percentage of total enrollment fell by close to 20% in all except the richest quintile.
- Wealthier and poorer families alike shifted children from private to public schools.

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- Drop in the university-age (18-22) population's enrollment from 41% in 1995 to 36 percent in 1999. Among the urban poor enrollment rates fell from 30.6% in 1995 to 24.9% in 1999.
 - Evidence from household surveys shows that between 1997 and 1999 school attendance declined more among poor children and youth aged 6 to 21 years in the poorest quintile, while it remained constant, or even rose, in the case of the remaining 80% of children.
 - The school dropout rate among poor students translates directly into higher unemployment rates, because when families withdraw their children from school because they are financially incapable of keeping them there, one of the alternatives is to try to put them to work in an attempt to offset the effects of the crisis.

- Child labor is procyclical with a decreasing trend but despite their decline in rural areas it still remains very high when compared to urban areas: 19% for those 10–16 years of age, versus 9.5% in urban areas, and 13% of the 10–14 year-old group employed versus 3.7% in urban areas. About 31 percent of children 15–16 participated in the labor force in 1999, a rate just under half of the adults, 65 percent of those 17–65 years old.

And on unemployment

- The recession of 1999 affected nearly all productive sectors, and struck with particular severity at two of the most important sectors in terms of employment: manufacturing and construction. In March 2000 unemployment reached a historically maximum level of 20.2% in urban areas.
- A portion of unemployment is considered to be structural, since even before the 1999 recession the rate stood at around 10%; the remaining 10 points may be attributed for the most part to the recession.
- The group most seriously affected by unemployment consists of young people, most of whom are women, who are entering the labor market for the first time, with no prior experience or training. (though with higher levels of educational attainment than their earlier cohorts).

- Individuals with intermediate education (high school dropouts and graduates) display the highest unemployment rates, at 23%, 6 percentage points above unskilled workers. All groups except college graduates saw their rates worsen by 10 percentage points between 1988 and 1999.
- The percentage of youth aged 12 to 17 who neither work nor study has increased from 10.5 to 13.3 percent between 1995 and 2000, while the percentage of those who only work has decreased from 14% to 11.3% over the same period.

II. The Social Safety Net



- Colombia's main social assistance programs were ill-equipped to offer adequate protection to those most affected by the recent crisis.

REASONS:

1. Menu of programs was inadequate: inflexibility, unfocused mandates, and poor targeting.
2. There was no funding for programs (pro-cyclical fiscal policy).



Inadequate menu of programs before the crisis

- Colombia has historically relied on economic growth and an expansion of social services as substitutes for implementing a social safety net, particularly during the 1990's.
- Most of its social assistance programs are tied to formal sector employment, thus excluding a significant fraction of the population who are employed in the substantial informal sector.
- Therefore, as WB SSN Assessments states: “Colombia, like many other countries at its income level, lacks a well-defined safety net that reaches the most poor and fails to adequately cover some key vulnerable groups”.

Colombia's Main Social Assistance Programs

<i>Program</i>	<i>Type of Assistance</i>	<i>Risks Addressed</i>	<i>Financing</i>
<i>ICBF: Colombian Institute for Family Welfare.</i>	<i>Child welfare regulation and <u>in-kind transfer</u> programs: Day care, ECD, School feeding</i>	<i>Chronic malnutrition Preschool attendance</i>	<i>Payroll tax</i>
<i>RSS: Social Solidarity Network.</i>	<i>Social fund program: <u>income support employment</u>; <u>in-kind transfers</u> for housing; and <u>cash transfers</u> to the elderly.</i>	<i>Elder poverty Internal displacement</i>	<i>General public revenues</i>
<i>INURBE: National Institute of Social Interest Housing and Urban Reform.</i>	<i><u>In-kind transfers</u> for construction and purchase of housing</i>	<i>Poor housing</i>	<i>General public revenues</i>
<i>SF and CC: Family Subsidy and Compensation Associations.</i>	<i><u>Income support scheme</u> and a variety of <u>in-kind transfers</u></i>	<i>Low income for formal sector workers</i>	<i>Payroll tax</i>
<i>PACES: Private School Vouchers.</i>	<i><u>In-kind transfer voucher</u> program to attend private secondary schools.</i>	<i>Secondary school drop-out</i>	<i>General public revenues</i>
<i>Basic Service Subsidies: Water, Sewerage, Electricity and Gas</i>	<i><u>In-kind transfer</u> to reduce cost of basic services to residents of poor neighbourhoods.</i>	<i>Low income</i>	<i>Cross-subsidization through progressive tariffs</i>

Source: Adapted from WB SSN Assessment

- Except for early childhood development, Colombia's safety net lacked attention to risk reduction items, particularly on strengthening human capital of the permanently vulnerable populations and the labor market side, where the informal sector flourishes and there are no strong labor market or child labor policies.
- Chronically vulnerable children in Colombia suffered from high levels of malnutrition and low levels schooling even before the 1999 crisis started. Chronic malnutrition among children under five years was at 15% in 1995, and this figure was double that level among rural children whose mothers had no education, or only primary school.
- In 1998, the school dropout rate was highest among the poor, particularly in the transition years (i.e. the move from home/preschool to primary, and the move from primary to secondary school). Poor children begun their studies later (at age six, 27% had not yet begun school, while for the population as a whole this figure stood at 8.5%, at age seven, 18% had not yet begun, compared to 3.7% of the total). In rural areas, attendance rates are lower for all ages, and children begin school at a later age.

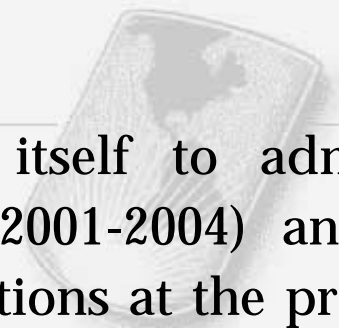
- Many of Colombia' social assistance programs were oriented toward risk coping, addressing risk after they occur. But the risk of unemployment and loss of income was not adequately addressed but the old set of programs.
- The SSN didn't include mechanisms for compensating the unemployed or for guaranteeing a minimal level of family income. Protection for unemployment is an important part of any safety net. In Colombia, the rise in unemployment associated with the 1999 recession may have had negative effects over the medium and longer term level of household welfare, since the low human capital of the poorest groups deteriorates during prolonged bouts of unemployment, and this gradually undermines the future employability of workers.

- The lack of income protection obliged the most vulnerable poor families to withdraw children from the school system because they cannot afford this investment in human capital, and the labor of these members was needed to support the family's subsistence. For a high percentage of children, this interruption implies their permanent exit from the education system, while for the few who manage to reenter it, their school performance and career prospects will suffer a negative impact that is difficult to overcome.
- Lack of income protection also had a direct impact on people's current well-being. Lower family income lead to a deterioration in diet, which had irreversible effects on nutrition and development of the smallest children, thus accentuating the vicious circle of poverty. Although there are no recent, nationwide data available, there is evidence to show that food consumption in the four major cities has declined by 39%, suggesting that the effect on nutrition, especially among the very poor, may be significant.

Red de Apoyo Social (RAS) was designed and implemented to address some important chronic vulnerabilities and to give income support and mitigate the effects of crisis



- Implementation of the RAS programs began in 2001 with support from IDB and WB and an IMF agreement that provides for public spending of an *additional* 0.3 percent of GDP per year (about US\$250-\$300 million annually), over and above current public social expenditures, to be targeted to the provision of social safety net programs through 2004.
- The program took almost two years to implement after the onset of the crisis, underscoring the need for a reformed social safety net that would be able to respond more quickly to future crises.

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- Colombia has committed itself to administering these programs for four years (2001-2004) and to review the results of the impact evaluations at the projects' conclusion to assess the desirability of their continuation as part of a broader safety net strategy.
 - The RAS safety net is composed of three principal programs designed to promote human development, employment, and job training in permanently poor populations and those affected by the crisis.

Empleo en Acción (Emergency Employment Program)



- Temporary employment to poor, unemployed, low-skilled workers by employing them in labor-intensive social and economic investment projects such as school expansion and road repair.
- Well designed to reach poor areas and users of the investments provided, but it is unable to self-target effectively due to the legal obligation to pay minimum wages.
- Program capable (with adequate self targeting) to be implemented counter-cyclically protecting minimum consumption levels during a time of crisis. Programs could be activated from a ‘simmering’ state during crisis periods, using extraordinary financing.

Familias en Acción (Conditional cash subsidy program)

- Cash subsidies to poor families conditional on keeping children in school and providing them with basic preventive health care.
- Program addresses a variety of risks –nutritional, health and educational -- with a single flexible instrument, a cash subsidy.
- Program requires strong coordination and resources for health and education systems to provide the supply-side services required to make the program effective.
- Households are forced to choose between receiving the nutrition subsidy and sending children to ICBF day care centers. These should be re-examined since they are not direct substitutes.
- Program seems best suited to address structural vulnerabilities, serving risk prevention and mitigation functions during non-crisis periods given structural levels of indigence, demand side barriers to ensuring poor children's access to education and the key role that education plays in breaking the inter-generational transmission of poverty.

Jovenes en Acción (Job training program)

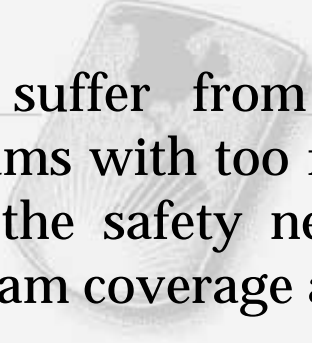


- Training/apprenticeship program for young adults based on competitive bidding among private firms and public entities.
- Similar as with Empleo en Accion, program capable (with adequate self targeting) to be implemented counter-cyclically protecting minimum consumption levels during a time of crisis. Programs could be activated from a 'simmering' state during crisis periods, using extraordinary financing.

Shortcomings of the current SSN safety net



- As WB SSN Assessment argues, with the present inclusion of the new RAS programs, Colombia has a network of social assistance programs in place designed to meet the needs of the main vulnerable groups.
- But, the efficiency and effectiveness of these programs is undermined by the the lack of an integrated approach that results in multiple programs, fragmentation of within institutions, overlapping program objectives and an insufficient budget to address key needs.

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- ICBF and RSS, seem to suffer from fragmentation of programs, too many programs with too few resources to be able to fill in the gaps in the safety net and a dearth of information regarding program coverage and effectiveness.
 - RAS was implemented without engaging in a broader strategic reform of the safety net.
 - RAS programs' performance needs to be evaluated and decide on their future role as part of an overall safety net reform resulting in the establishment of an agile, efficient and effective social risk management system with specific functions in crisis and non-crisis periods.

- Financing for the RAS programs is inadequate to meeting existing demands and is unsustainable over time. The RAS programs are presently meeting only a fraction of the demand for the type of assistance required. *Fedesarrollo* estimates that:
 1. The cash transfer program will reach 300,000 poor households out of a total demand of 1.95 million.
 2. The youth training program will enroll 100,000 youth out of a total of 305,000 in need of assistance.
 3. The workfare program will generate up to 154,000 short-term jobs next to the need for 810,000.
- This implies that funding for these programs should be increased more than five times, for them to reach the universe of their targeted populations.

- It is necessary to determine the specific norms and procedures under which the country counter-cyclical safety net would operate. This includes determining which indicators would serve as ‘triggers’ for activating countercyclical elements of the safety net and directing operations to specific population groups.
- With the notable exception of health insurance, risk mitigation elements are still not well-developed for Colombia—the pension system essentially covers only workers in the formal sector and there is no unemployment insurance.
- The formal sector is over-protected, with high severance payments, vacations, 13th month salary and other benefits, resulting in incentives for a large informal sector and high unemployment. When considering the reform of the social safety net in Colombia, this high tax burden should be kept in mind, particularly since the poor bear a disproportional burden of unemployment and informality.

III. Under funding and procyclicality of the Social Safety Net

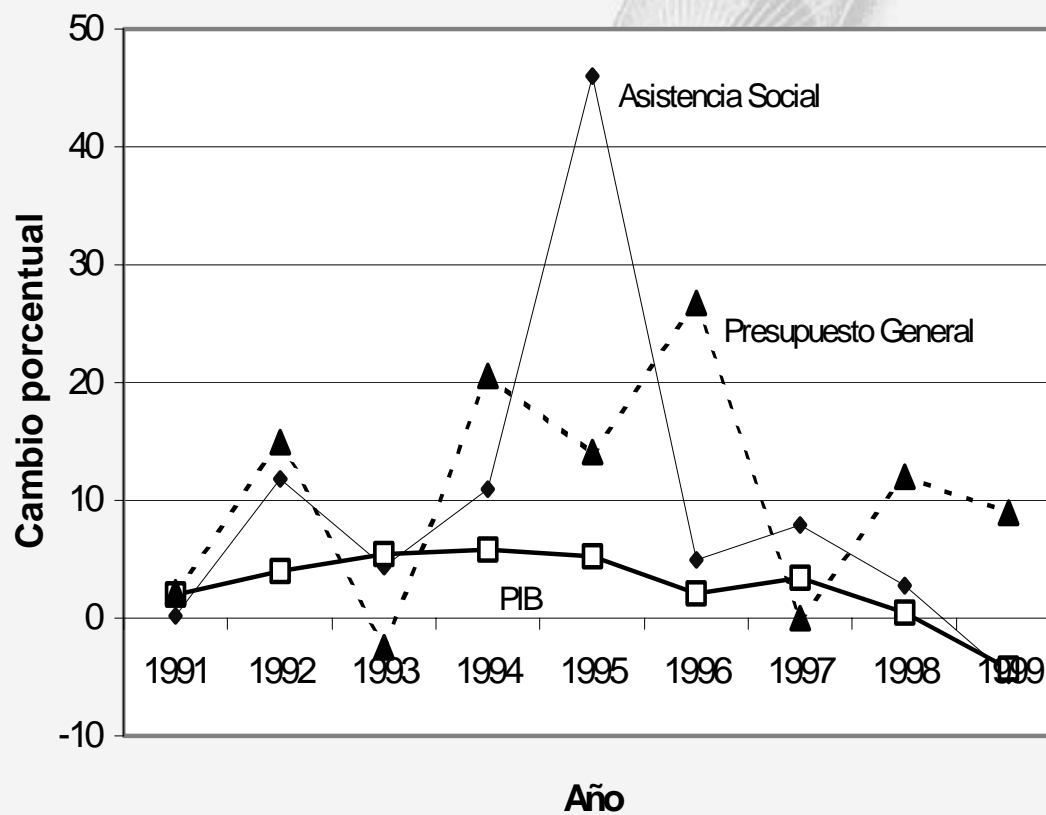


Social assistance is under-funded in Colombia and its funding is procyclical

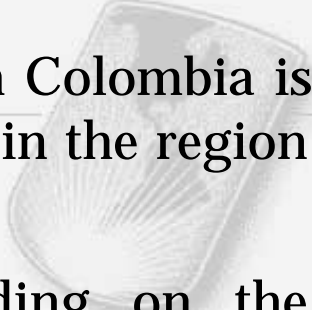
- The onset of the economic crisis in 1998 curtailed Colombia's ability to continue its expansion of social sector spending, thereby undermining Colombia's de-facto safety net.
- Solid economic growth allowed for a dramatic expansion in social sector spending through the late 1990's.
- Public spending as a proportion of GDP increased considerably during the 1990s. Beginning in 1993, the central government budget as a percentage of GDP grew rapidly, reaching 45% of GDP by 2000, a 20% increase over the figure in the early 1990s.

- Social spending as a share of the overall budget also increased during the first half of the 1990s, rising by 15% (from 30% to 45%) between 1990 and 1996. However, after 1996, precisely when the economy began to slow down, the share of social spending decreased, reaching 35% by the end of the decade.
- The main impetus for the growth in social expenditure and a strong shift toward decentralization came from the social sector policy reforms introduced in the 1991 Constitution, Law 60 and Law 100 (introduced in 1993).
- Social assistance was not included in the dramatic social sector reforms of the 1990's that resulted in increased spending and decentralization for health and education. As a consequence, social assistance programs remain underfunded, centralized and lack a strategic focus.
- The share of social welfare remained constant during the first half of the 1990s, increased briefly in 1995, then fell at the end of the decade during the economic recession.

Grafico 1: Crecimiento en el PIB y Gastos



- These cutbacks in social welfare spending, partially as a result of the direct connection between GDP and social welfare spending, led to lower program coverage precisely when it needed to be maintained or expanded to offset the impact of the recession.
- Funding for health and education doubled from approximately 4% to 8% of GDP over the period 1990-2000, but central government expenditures on “other social expenditures”, including spending on the main social assistance programs and SENA, were essentially constant at approximately 2% of GDP.
- Compared to other countries, public social spending in Colombia in 1996 as a percentage of GDP was slightly below the average of the selected Latin American countries. Spending on social security and welfare (4.9%) was below the Latin American selected country average of 7.1%, whereas spending on education (5.1%), health (2.0%) and housing (0.7%) was closer to regional averages.

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- Social assistance spending in Colombia is at a very low level compared to other countries in the region and to the needs of key vulnerable populations.
 - In 2000, Colombia's spending on the four main social assistance programs – ICBF family welfare, INURBE housing, the RSS social fund and water and sewerage subsidies – was less than .7% of GDP, the lowest rate of social assistance spending of the countries reviewed.
 - From 2001-2004 the implementation of the RAS programs will raise spending on social assistance by an additional .3% of GDP, bringing total social assistance spending the .9% of GDP, more in line with regional allocations. Nonetheless, without reforms or continued international borrowing, the sustainability of this additional spending beyond 2004 cannot be assured.

**Latin America and the Caribbean: Cross-country Comparison of
Total Public Social Assistance Spending**

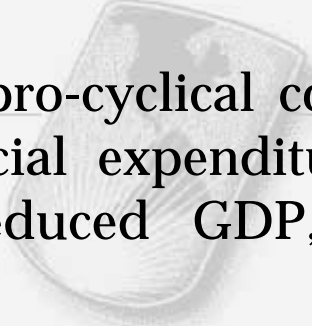
Country	SA Spending	Main Types of SA Programs (% of SA Spending)
Argentina	0.9% of GDP	Some 60 federal programs, including: housing and social infrastructure (38%), income transfers (27%), social and community development programs (8.7%), training and employment (7.9%), education-based programs (7.5%), health-based programs (6%), food and nutrition (5.4%)
Colombia	0.65% of GDP**	Colombian Institute for Family Welfare (ICBF) programs, including early childhood development and school feeding (72.3%); water and sewerage subsidies (15.4%); <i>INURBE</i> housing program (6%); <i>Red de Solidaridad</i> social fund, including workfare and elderly programs (6%).
Dominican Republic	1.14% of GDP	Housing Programs (25%); food assistance programs (29%); school lunch program (23%); health-based assistance (<i>Promese</i> , 7%), elderly assistance (3.5%), programs for youth and small children (1%), other programs (12%)
Jamaica	1.16% of GDP	Income support programs (30%), including: food stamps (15%), poor relief (11%), Economic and Social Assistance (4.4%); School-based welfare programs (24%), of which school feeding (16%) and school fee assistance (5.4%), etc. Variety of other programs (46%): community-based, labor-market, subsidized drugs, housing, feeding programs, etc.
Mexico	1.1% of GDP	Sectoral social assistance (30%); income transfers/subsidies (28%) – including PROGRESA (18%) and food programs (9.6%); income generation (29%); social infrastructure (4.2%), natural disaster protection (9%)
Nicaragua	1.1% of GDP	Programs for children and adolescents (under MIFAM, 65%); programs for hurricane Mitch victims (18%); community employment programs (6%); social assistance under social fund (9.2%); natural disaster program (2%), etc.
Peru	1.44% of GDP	“Programas de alivio a la pobreza extrema”: FONCODES, gasto social básico, numerous feeding programs, school feeding (vaso de leche), etc.
Uruguay	3.4% of GDP*	Health-based in-kind transfers (60%), 4 different cash transfer programs (23%), housing programs (12%), numerous feeding programs (3%), and ECD program (1.6%)
Venezuela	1% of GDP	Cash transfers to poor families, numerous subsidies (food, medicine, transport), school feeding programs, school uniform programs, health-based programs, child care programs, employment and training programs

Source: WB SSN Assessment, adapted from Dulitzky, Gagnaloti and Lindert “Social Protection Expenditure Review” August 2001, World Bank.



*Financing of social safety net programs has been historically pro-cyclical
– the opposite of what is desirable in an effective safety net.*

- Social spending and fiscal policy generally tend to be procyclical in developing countries.
- However, in the case of Colombia, a review of social spending trends during economic cycles over the past 50 years showed a different pattern. During the period from 1950 to 2000, the pattern of overall social spending was acyclical (neutral). But the pattern of certain components, such as social welfare and housing, was procyclical.
- But procyclicality has increased during the 1990s, four of the social spending components decreased during crisis periods: social assistance, social security, housing, and other social services.

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- Social assistance the most pro-cyclical component of social sector spending. Public social expenditure review reveals that for each peso of reduced GDP, social assistance spending fell by 9 pesos.
 - Programs earmarked from payroll taxes such as the Colombian Institute for Family Welfare (ICBF) and the National Training Service (SENA) suffered less dramatic budget cuts during the last crisis than those financed through general revenues including the Social Solidarity Network (RSS) programs for the indigent elderly and internally displaced people whose programmed budgets were halved during the recession.

- Considering that social welfare spending is precisely designed to support the most vulnerable population, cuts in that category during times of crisis jeopardize the main protection mechanism for that segment of the population.
- There are a number of reasons for such procyclical spending: financing for some of these programs is highly dependent on income tax revenues; Colombian tax revenues have procyclical behavior during phases of recession; and welfare spending is one of the budget items that suffers the first cuts whenever public finances need to be adjusted during times of crisis.
- The procyclical pattern of social welfare spending demonstrates that the current systems for resource allocation also lack the flexibility they need to respond to demand for higher spending in order to maintain and in some cases expand coverage during a crisis.

Financing and reducing the procyclicality of the Social safety net



Increasing the funding to the SSN

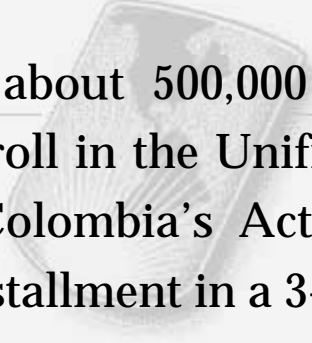
- Colombia's social assistance budget is inadequate to meeting the needs of vulnerable populations, even during normal times.
- Today the Colombian public sector has more than enough resources to tackle the poverty problem without abandoning other core mandates. In 1999 public social expenditure was 15 percent of GDP, while *total* public expenditure was approximately three times larger. A reallocation of 10 percent of public expenditure—a moderate amount—would have a major impact on the welfare of the poor.

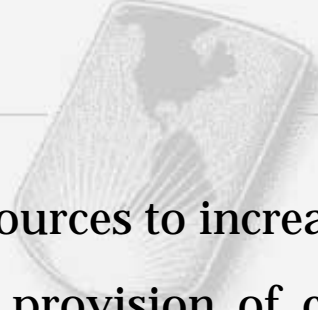


Share of total household income required to	1978	1988	1995	1999
To close extreme poverty gap	4.8	1.2	0.5	0.6
To close the poverty gap	46.4	16.5	11.9	16.2

Source: WB Poverty Assessment

- According to the studies financed by the IDB and the WB, using the unit costs of the RAS programs, the cost of covering indigent children, the indigent elderly, and the IDPs with existing programs for one year are:
- Supplying all indigent children 0-6 years with the nutrition component of the RAS '*Familias en Acción*' program would require US\$257 million.
- Covering all indigent children under the primary education component (7-12 years) or the secondary education component (13-17 years) of the RAS '*Familias en Acción*' program would require respectively US\$97 million and US\$176 million.
- Implementing the RSS *Revivir* program for all indigent elderly 65 and over would cost about US\$70 million.

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- Addressing the needs of the about 500,000 internally displaced people who are expected to enroll in the Unified National Registry through the Government of Colombia's Action Plan would cost US\$155 million a year, a first installment in a 3-year program.
 - This adds to 755 million dollars or around 0.93% of GDP. Consistent with this figure, the recommendations of the WB SSN Assessment, Colombia should consider redirecting funding to social assistance programs to bring levels up to at least 1% of GDP.
 - If we add to this the requirements to expand coverage of RAS programs during crisis, currently at 0.3% of GDP (but the optimum should be 1.6%) the financing requirements of the SSN during crisis will be between 1.3 and 1.9% of GDP.
 - To this we should add the risk mitigation elements that are still not well-developed for Colombia: extension of health insurance, pension systems and implementation of unemployment insurance.



- Many actions could lead to resources to increase SSN funding:
- Spending not directed to the provision of critical social services (health and education), social insurance or social assistance should be examined. For example, full redirection of the *Servicio Nacional de Aprendizaje* (National Training Service, SENA) would bring budgeted expenditures for social assistance from 0.7% of GDP to 1%.
- Improved targeting will generate savings of 600 million around 0.7% of GDP.
- Provincial and local governments (that spend around 15% of GDP) should share the financing of the SSN.
- Reduction in earmarked taxes for social assistance programs not targeted to the poor and redirection of alternative sources of revenue to finance a progressive, strengthened social safety net.

Reducing the procyclicality of social welfare spending: The fiscal stabilization fund (FSF)



Brief review of instruments available to maintain and increase social spending financing during crisis:

- Debt
- Expenditure controls
- Fiscal stabilization funds
- Contingent credit programs
- Tax and budgetary rules

1) *Debt*

- During crisis industrialized governments allow deficits to rise without cutting expenditures in a significant way by borrowing in internal or external financial markets, i.e. capital markets are counter-cyclical for developed countries. In developing countries, the situation is the opposite, because of credibility problems during crises, borrowing becomes more expensive, capital markets become procyclical, and thus, governments can not borrow during these periods.

2) *Spending growth caps*

- The objective of these is to moderate spending growth during boom periods in order to enter crisis periods with a solid fiscal and financial position. Research shows that expenditure cuts during recessions tend to be much deeper if an economy enters recessions with a precarious fiscal position.

3) *Fiscal Stabilization Funds*



- Even if countries control spending and reduce their debt level, the credibility problems (investor perceive that there is an increase in the probability of default) that arise during the crisis make it difficult to borrow during crisis.
- Stabilization funds are one way to ensure that additional resources generated during a period of high growth are saved, and therefore that public spending is smoothed across the economic cycle.
- Stabilization funds originated to compensate for drops in revenues from exports of raw materials (Copper Compensation Fund in Chile and the Oil Stabilization Fund in Colombia). Now this type of instrument is being use to stabilize fiscal revenues over the business cycle.

4) *Contingent Credit Programs*

- IFI could start a line of financing for developing countries to be used during crises for financing of social programs.

5) *Budgetary Rules*

- Countries tend to prepare budgets based on over-optimistic growth forecasts, once they realize that growth is lower than predicted spending is cut in an *ad-hoc* manner, especially during crisis periods.
- At the time of approval, budgets should include different growth scenarios and alternative allocation of resources in the event that growth is less than predicted.
- Budgets should prioritize spending and specify which expenditures should or should not be reduce once real revenues are below expectations.

Among these instruments Colombia opted for a Fiscal Stabilization Fund:

- The objective of the FSF, scheduled to begin at the end of 2002, is to mitigate the impact of macroeconomic crises on the poorest segments of the population. This instrument will be used to mobilize resources during periods of growth that can be used for programs targeting the most vulnerable segments of the population during times of crisis, according to clear, transparent rules.
- The FSF will supplement public spending on social welfare programs during times of economic downturn, so as to expand coverage to the lowest-income groups. The main features of the Fund are the following:

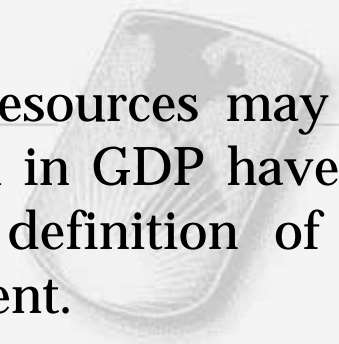
- **Size of the Fund.** The size of the Fund will be approximately 0.5% to 1% of GDP. Preliminary DNP estimates suggest that some 0.8% of GDP would be necessary to address the cyclical component of a severe crisis, based on the experience gained during the crisis in the late 1990s. To avoid oversaving, the Fund will have a cap of 1% of GDP.
- **Source of funding.** Regular central government resources, according to a preset formula, will feed the Fund in years in which economic growth exceeds certain parameters.
- Given that the long-term elasticity of tax revenues with respect to economic growth is unitary (in Colombia), it can be assumed that economic growth will generate a proportionate increase in tax revenue.
- However, the Fund will not necessarily be fed exclusively from these resources. Through its institutional operating mechanisms, other special resources may be channeled into the Fund, such as capital income or external credit.

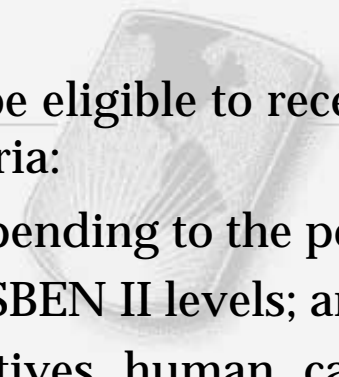
- **Saving rule.** The Fund will be governed by a specific saving rule for the period from 2002 to 2008, based on estimated economic growth in the country in the medium term, which will be approximately 4% per annum.
- The rule will be as follows for the period: at the end of each year with a growth rate of more than 4%, the Fund must have accrued the equivalent of 50% of the difference in effectively collected revenues and the estimated revenues for the year assuming an economic growth rate of 4%, according to the following formula:

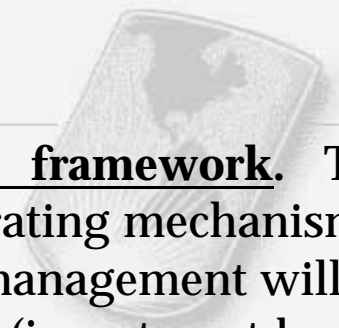
$$A_t = 0.5[T_t - E(T_t)]$$

where A_t is the saving for the Fund in year t , T_t the sum of all current revenue effectively received by the central government in year t , and $E(T_t)$ the hypothetical calculation of current revenue for year t assuming an economic growth rate of 4%.

- The methodology for calculating Fund income will be reviewed in 2009, since the formula for calculation of estimated income for computation of transfers to subnational governments will end that year. In addition, the 4% basic economic growth rate scenario will have to be reviewed. As for the period 2002-2008, the formula will have to be adjusted to offset the impact of any changes in tax policy.

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- **Rules for use.** The Fund resources may be used once two quarters of negative growth in GDP have been documented, which will constitute the definition of a “crisis” for the purposes of Fund management.
 - Use of the Fund resources will be discontinued once per capital GDP has been equal to or greater than what it was the quarter prior to the crisis for four consecutive quarters, and may be discontinued earlier if deemed appropriate by the governing body of the Fund.
 - Use of the resources may not exceed 0.3% of GDP each fiscal year, calculated on the basis of a review of the unmet needs resulting from the increase in poverty associated with the crisis in the late 1990s.

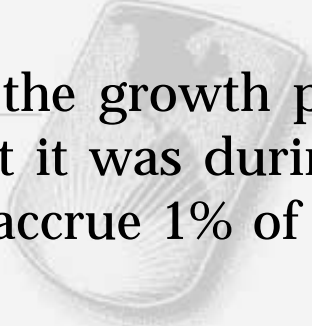
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- **Eligible uses.** A program will be eligible to receive Fund resources if it meets the following four criteria:
 1. Uses SISBEN to target its spending to the poorest groups;
 2. Targets to SISBEN I and SISBEN II levels; and
 3. Includes among its objectives human capital protection and promotion.
 - Examples of current programs that would be eligible for financing under the Fund are the RAS and RSS subprograms and certain ICBF programs.
 - The Fund proceeds will be used exclusively to expand coverage for the newly poor during crisis periods and may not replace current structural spending allocated annually in the central government budget to the targeted social programs that are eligible for financing from the Fund. The operating regulations of the fund must specify the levels of structural spending that should be maintained as a condition for use of the Fund resources during crisis periods.

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- **Operating and institutional framework.** The Fund must be established by law and its operating mechanisms must be regulated by an executive decree. Fund management will be the responsibility of a reliable private institution (investment bank or another type of administrator).
 - Fund resources, initially collected in local currency, will be converted into foreign currency and invested in highly secure, liquid financial instruments on the international capital market.
 - **Fund capacity for savings.** A series of simulations was conducted to model the savings capacity of the Fund based on macroeconomic scenarios for central government revenue developed by the government and used by the IMF.
 - The estimates were based on the saving rules discussed in chapter 11, according to different economic growth scenarios for the period from 2003 to 2010. The scenarios, average saving rate, years of saving, and accrued savings are shown in the following table:



Simulated Fund Savings*

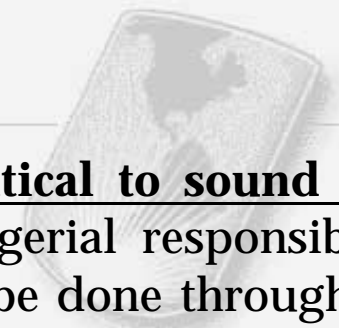
Assumed growth rate during 2003 -2010 period	Average increase	Years of savings	Savings (% of GDP)
1. Equal to growth pattern in 1990 - 1997	4.13	4	0.56
2. Equal to growth pattern in 1989 - 1996	4.11	4	0.76
3. Equal to growth pattern in 1988 - 1995	4.38	4	1.00
4. Equal to growth pattern in 1987 - 1994	4.38	4	0.84
5. Equal to growth pattern in 1986 - 1993	4.38	4	0.48
6. Equal to growth pattern in 1985 - 1992	4.06	3	0.20
Average accrued savings:			0.64

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- The exercise showed that if the growth pattern for the next eight years stays the same as it was during the period from 1988 to 1995, the Fund will accrue 1% of GDP, the best-case scenario.
 - However, if the pattern is the same as for the period from 1985 to 1992, the fund will accrue barely 0.2% of GDP, the worst-case scenario. The government would then only have enough resources for a one-year crisis and would have to seek other sources of financing to respond to a longer one.

The risks of the FSF

Put evidence also from the experience in Peru

- Based on a review of the operational modalities and experience of six oil and copper funds in Norway, Chile, the State of Alaska, Venezuela, Kuwait and Oman, (reviewed in Fasano 2000) it is possible to identify the following risks for these types of fiscal policy instruments following:
- **Strong political commitment and consensus is needed to make the Funds effective.** Good policy stems from clear savings and spending rules, but these have often been undermined through rapid changes to these rules or abandonment of the established rules. The case of Chile and Kuwait summarized above illustrate that fund revenues can be used successfully (ie without undermining the overall viability of the fund) to finance extraordinary expenditures not contemplated under the fund operations. However, Fasano warns that “in Venezuela and Oman the experience with stabilization funds has been less than successful because of frequent changes to the fund’s rules and deviation from its intended purposes.”

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- **The institutional set-up is critical to sound management of the fund.** Funds need clear managerial responsibilities for their core areas of operation. This could be done through specific institutions in the Ministry of Finance (Oman), or the central bank (Chile), or independent entities (such as the Kuwait Investment Authority).
 - **The country or state's fiscal discipline is critical to the success of the fund.** Stabilization funds cannot substitute for sound fiscal management and the success of stabilization funds can be attributed as much to fiscal discipline as to the funds' management. Ensuring an overall fiscal surplus lessens temptations to draw from the fund to finance general budget deficits. In most cases reviewed stabilization funds have also contributed to enhancing the effectiveness of fiscal policy by making budget expenditures less driven by revenue availability. By channeling a portion of revenue away from the budget in good times, the funds may have lessened spending pressure.

V. Conclusion

- Crisis avoidance should obviously be a top priority in any anti-poverty and safety net strategy. But although many countries have substantially improved macroeconomic and fiscal management, the “globalization hazard” implies that countries will still be affected by crises of external origin.
- Policy and programs together make up a safety net. Without available counter-cyclical financing and clear fiscal policies for the protection of key pro-poor spending, safety net programs lose their *raison d’etre*. In a context that requires fiscal discipline, inability to demonstrate results puts safety net programs at deservedly high risk of cuts. This reality suggests that countries should have a set of proven cost-effective programs ready to expand during crisis; but it also implies that reform or elimination of proven ineffective programs should occur concurrently.