

**ECONOMICS DEPARTMENT**

**FILLING IN THE GAPS: EXPANDING SOCIAL PROTECTION IN COLOMBIA**

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By Paula Garda and Jens Arnold

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**ABSTRACT/RÉSUMÉ****Filling in the gaps: expanding social protection in Colombia**

The pandemic has highlighted significant gaps in social protection, in particular among informal workers. With around 60% of workers in informal jobs, many of those most in need of social protection are left behind. The government has attempted to fill this gap with non-contributory benefits, but coverage and benefit levels are low. Better-off formal workers have access to a full range of social protection benefits, involving large-scale public subsidies that widen the gap. Labour informality and social protection coverage are interlinked, as high social contributions are one of the main barriers to formal job creation. Ensuring some universal basic social protection, while simultaneously lowering the cost of formal employment, would reduce labour informality, poverty and inequality and raise productivity, all of which are long-standing challenges in Colombia.

Key words: Colombia, social protection, informality, employment, public policy, pensions, health  
JEL codes: H51, H53, H55, I14, J32, J43, J65

This Working Paper relates to the 2021 Economic Survey of Colombia  
<https://www.oecd.org/economy/colombia-economic-snapshot/>

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**Comblent les écarts: étendre la protection sociale en Colombie**

La pandémie a mis en évidence des écarts importants en matière de protection sociale, en particulier chez les travailleurs informels. Avec environ 60% des travailleurs occupant des emplois informels, beaucoup de ceux qui ont le plus besoin de protection sociale sont laissés pour compte. Le gouvernement a tenté de combler cet écart par des prestations non-contributives, mais la couverture et les niveaux de prestations sont faibles. Les travailleurs formels ont accès à une gamme complète de prestations de protection sociale, ce qui implique des subventions publiques à grande échelle qui creusent l'écart. L'informalité du travail et la couverture de la protection sociale sont liées, car les cotisations sociales élevées sont l'un des principaux obstacles à la création d'emplois formels. Garantir une protection sociale de base universelle, tout en abaissant le coût de l'emploi formel, permettrait de réduire l'informalité du travail, la pauvreté et les inégalités et d'augmenter la productivité, autant de défis de longue date en Colombie.

Mots clés: Colombie, protection sociale, informalité, emploi, politiques publiques, retraites, santé  
Codes: H51, H53, H55, I14, J32, J43, J65

<https://www.oecd.org/fr/economie/colombie-en-un-coup-d-oeil/>

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# Filling in the gaps: expanding social protection in Colombia

By Paula Garda and Jens Arnold<sup>1</sup>

The COVID-19 pandemic has highlighted long-standing gaps in the social protection system and is reversing decades of progress on eradicating poverty and reducing inequality. Major structural problems, including a high share of informal workers with no access to social insurance and a low coverage of social assistance programmes, have worsened and become more visible during the pandemic, when incomes at the bottom of the income distribution fell three times more than those at the top. Colombia put in place comprehensive social emergency measures that have been crucial to averting a steeper fall in incomes, particularly among the most vulnerable. These comprised both an expansion of existing benefits and the establishment of new ones, including an unconditional cash transfer programme and wage subsidies. These emergency measures prevented 4 million Colombians from falling into poverty in 2020, mitigating the increase in the poverty rate by 3.6 percentage points. Still, unfortunately, some 3.5 million Colombians fell into poverty, adding up to about 21 million (42.5% of the population).

Structural characteristics of Colombia's labour market are, at least in part, responsible for the large social impact of the pandemic. Nearly two out of three workers in Colombia are informal, with no access to contributory social insurance, such as unemployment insurance, old-age pensions or paid sick and maternity leave. Informal workers typically have low and unstable incomes and lack savings, making them particularly vulnerable in crises. On the other hand, formal workers benefit from employment protection, regulated minimum wages and contributory social protection schemes. Informality also tends to keep companies inefficiently small and their productivity low (Loyaza, 2018<sup>[1]</sup>). Informal firms have struggled to access the policy support put in place during the pandemic, such as wage subsidies and state-guaranteed loans, and had less access to digital solutions, such as teleworking or online sales. Widespread informality also reduces the bases for corporate and personal income taxes, which in turn limits the quantity and quality of public services and the capacity of the public sector.

The design of the social protection system is a key factor in determining informality, among others including low access to high-quality education and training and a weak institutional framework and labour and tax enforcement. One of the main impediments to formal job creation are the expensive mandatory social contributions and other payroll taxes that finance formal-sector benefits (IMF, 2021<sup>[2]</sup>; Meléndez et al., 2021<sup>[3]</sup>; Levy and Cruces, 2021<sup>[4]</sup>; Loyaza, 2018<sup>[1]</sup>). The sum of employers' obligations can reach 53% of the wage for earners on the minimum wage. Because regulations are imperfectly enforced, firms regularly

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evade the costs of social insurance and hire salaried workers informally. Low-income or self-employed workers with earnings below the minimum wage face prohibitively high costs of formalisation and are forced to remain informal, which is reflected in the low social insurance coverage. These high non-wage costs, bundled with a relatively high minimum wage whose level is close to the median wage, leave many workers in informal jobs.

To address the lack of coverage in social protection of informal workers, non-contributory pensions and health pillars have been established over the years. They are financed through the budget with general tax revenues, i.e. non-earmarked resources coming from different taxes, and to a lesser extent through formal workers' social contributions. They have been complemented by other social assistance programmes, such as conditional cash transfers, which have helped to reduce poverty. However, non-contributory pension and cash transfers programmes share two common problems: a low coverage, meaning that many of those in need are left behind, and low benefit levels, which in the case of non-contributory pensions amount to only around half of the extreme poverty line designed to reflect the cost of the necessary calorie intake for survival. In general, cash transfers and non-contributory pension schemes are only targeted to the very lowest end of the income distribution, leaving many informal and vulnerable workers unprotected. The non-contributory health system has achieved almost full coverage, but its financing encourages informality as informal workers receive the same benefits as their formal peers but free of charge. As a result, the non-contributory social protection regime has reduced the stark gap between formal and informal workers only to a limited extent. This became painfully obvious in 2020, when incomes at the bottom of the distribution dropped much more than those at the top.

Eradicating absolute poverty is within reach for a middle-income country like Colombia, and would lead to enormous improvements in well-being. While growth has proven the most effective driver behind falling poverty in recent decades, social protection has also played an important role, despite all the shortcomings of the current institutional setup. Building on this progress will be essential for a more inclusive and fairer recovery from the deep scars of the COVID-19 pandemic.

Effective social protection is key to protect workers against idiosyncratic shocks and old-age poverty, but also to adapt to disruptions and changes. The pandemic has been the most visible example, but the digital transformation, climate change, population ageing, migration and natural disasters are also likely to trigger adjustment processes that will require stronger social protection. This calls for strengthening and adapting the social protection system to allow it to fulfil its key role of reducing poverty and inequality. Effective social protection lays the grounds for enabling workers to access better-quality jobs. At the same time, it will allow low-income earners to invest more into their health, their human capital and that of their children, and will trigger substantial benefits for productivity and long-term growth (UNDP, 2021<sup>[5]</sup>).

Achieving the long-term goal of universal formalisation and universal social protection coverage will require deep reforms to social security and social assistance schemes, coupled with adjustments to labour market policies. Further reforms to lower social contributions and payroll taxes can be a powerful tool to reduce informality, as illustrated by Colombia's 2012 reform. These reforms need to go hand-in-hand with a cautious approach to future minimum-wage adjustments, as both levers affect the cost differential between formal and informal employment.

Lowering social contributions requires developing insurance mechanisms that are not tied to formal employment and not financed by charges on formal employment. A basic level of social protection, including in pensions and unemployment insurance, should be made available to all, while a more comprehensive set of benefits can support those who can contribute more. Delinking access to social protection from worker status in the labour market is the key challenge to break the current duality in incomes and job quality. It requires shifting the financing of social protection from social security contributions levied on formal labour proceeds to general budget resources, most of which come from income and consumption taxes. While these general budget resources include personal income taxes, these are economically different from social security contributions in this context, even if both are largely

born by households. Personal income taxes cover all income sources, not only formal-sector labour income, and they allow progressive rate schedules including zero rates on low incomes. Unifying social assistance programmes into a single cash benefit scheme, while increasing coverage and benefits and providing incentives to take up formal employment will be key to tackle poverty and raise high-quality employment opportunities. Continuous efforts to enhance labour and tax enforcement should complement improvements in formalisation incentives.

The main benefit of deep reforms would be to initiate a virtuous cycle between substantial reductions in poverty and inequality and better growth prospects. Workers in the bottom 50% of the income distribution would clearly benefit from the better formal job opportunities and take-home pay that such reforms could deliver. For current formal workers, with the exception of high incomes, the effective tax burden would not change much, as the reduced payroll taxes and social contributions would be substituted by increases in personal income taxes and possibly value-added taxes. For formal workers with relatively higher incomes, a more progressive income tax schedule would imply a higher tax burden than at present.

Financing the reforms will require raising permanently additional tax revenues by about 1% of GDP. This estimate is an upper bound, as the increase in revenue collection derived from the higher formalisation and growth derived from these reforms, are not taken into account. Colombia has space to do this, as tax revenues are low by international standards (see Chapter 1 of the Economic Survey of Colombia (OECD, 2022<sup>[6]</sup>)) and expenditures can be reallocated by discontinuing ill-targeted subsidies and less efficient social policy programmes.

In many respects, the costs will be more of a political than an economic nature. The difficulties of finding the necessary political consensus for the deep reforms discussed in this chapter should not be underestimated. The political economy of the broad overhaul of existing institutions that Colombia needs, together with the required fiscal reforms to secure additional revenues, is likely to be winded and tricky. However, the dramatic impact of the COVID-19 pandemic on social inclusion and potential growth could generate the momentum and trigger a long-overdue political debate, which the incoming administration that takes power in 2022 could foster and lead.

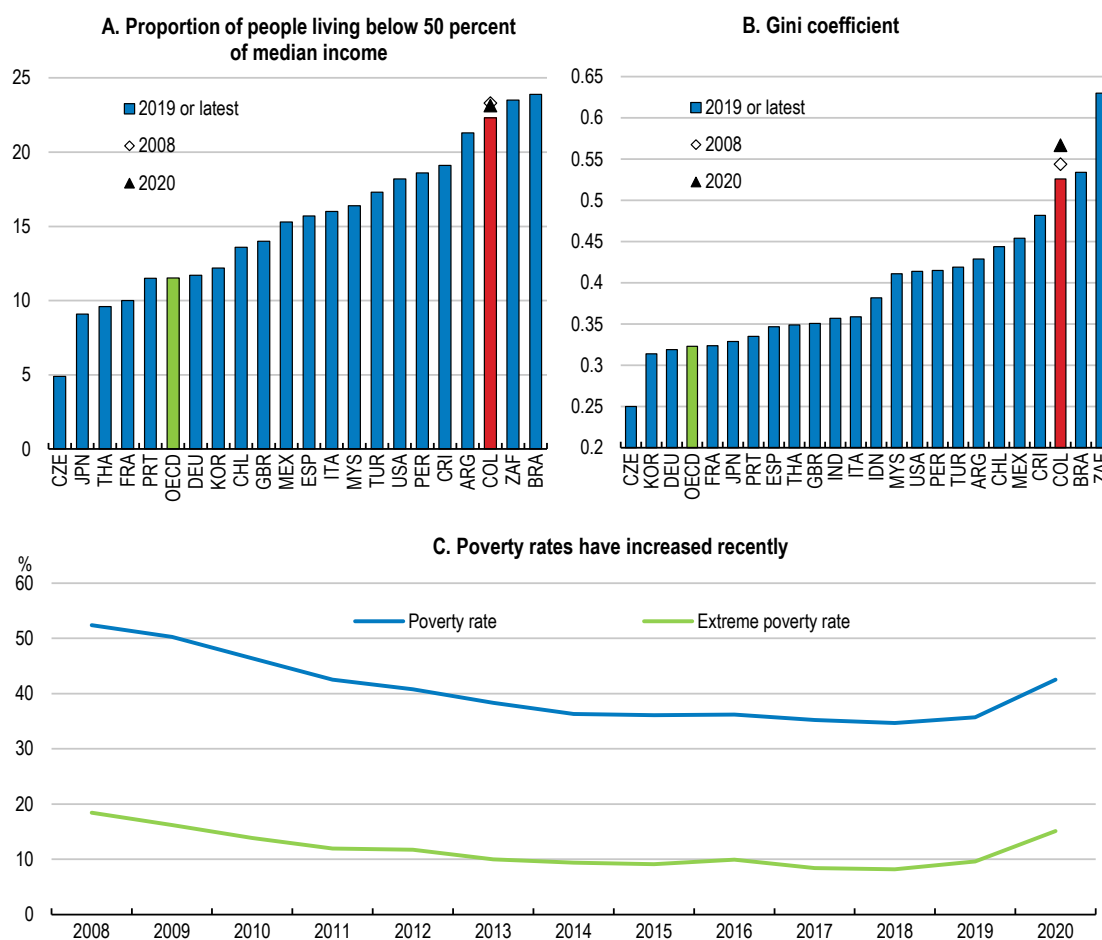
Finding the appropriate sequencing and prioritisation is essential for a politically viable reform agenda. Moving forward in a gradual manner could help to improve political acceptance. In this regard, a first priority should be to strengthen social assistance programmes and consolidate them into a single programme to tackle poverty. This should be financed by additional tax revenues, with changes to basic deductions and exemptions in personal income taxes being first in line, in addition to reducing exemptions and special rates in VAT. Continuing to reduce non-wage labour costs could then be addressed in a second step, by gradually shifting more of the financing burden from social security contributions towards tax revenues. This would reduce informality and hence be beneficial for productivity, equity and public finances at the same time. A pension reform, including a universal basic pension benefit, should then follow to tackle outstanding inequalities. A gradual approach to these reforms can be instrumental, but they should be undertaken in a coordinated manner. In the past, small patches to punctual problems have often failed to take into account the broader picture, and often created new challenges.

This chapter analyses the challenges and shortcomings of the current social protection system and reviews policy options to expand coverage while boosting formal employment, which is one of the most salient policy priorities for Colombia. The benefits of reforming social protection should be potentiated by simultaneous policy action in other policy areas, including reforms to boost the structurally low and stagnant firm' productivity and the low access to high quality education and training, as discussed in Chapter 1 of the Economic Survey of Colombia (OECD, 2022<sup>[6]</sup>) and in previous Economic Surveys (OECD, 2019<sup>[7]</sup>; OECD, 2017<sup>[8]</sup>).

## COVID-19 is reversing progress in poverty and inequality reduction

Poverty and inequality declined significantly in the last two decades in Colombia, but remain among the highest in OECD countries (Figure). Between 2001 and 2015, poverty declined rapidly by about 22 percentage points (1.6 per year, on average), according to the national definition. The middle class also grew substantially during the same period, by around 20 percentage points to 40% of the population (De la Cruz, Manzano and Loterszpil, 2020<sup>[9]</sup>). The decline in poverty decelerated afterwards and poverty eventually started increasing again as of 2017, partly explained by a lower economic growth after the strong oil shock in 2014. Economic growth was the main driver of the reduction in poverty and inequality (Joumard and Londoño Vélez, 2013<sup>[10]</sup>), and the increase in the size of the middle class during the last decade. Beyond growth, however, new social assistance programmes and higher redistribution played an important role (Messina and Silva, 2019<sup>[11]</sup>). In-kind transfers, particularly education and healthcare services, have also contributed substantially to the reduction of inequality and poverty in the last two decades (Nuñez et al., 2020<sup>[12]</sup>; Lustig, 2016<sup>[13]</sup>). However, the redistributive impact of taxes and transfers remains relatively low compared to advanced and even other developing countries (Lustig, 2016<sup>[13]</sup>).

Figure 1. Poverty and inequality have increased during the COVID-19 pandemic

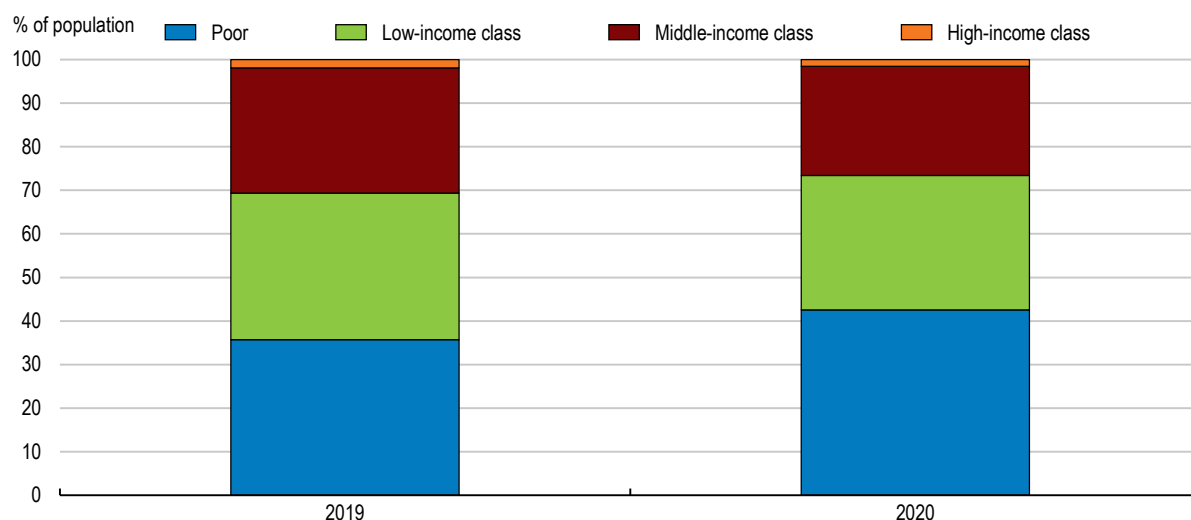


Note: In Panel A, poverty is defined as the share of people living in a household below the 50% of the median disposable household per capita income (or, in some cases, consumption expenditure). This poverty measure is different from the national definition of poverty by DANE (Departamento Administrativo Nacional de Estadística), which is used in Panel C. Gini index measures the extent to which the distribution of income after taxes and transfers (or, in some cases, consumption expenditure) among individuals or households within an economy deviates from a perfectly equal distribution. Panel C shows poverty using the national definition based on the calculation of the basic food consumption basket.

Source: World Bank, WDI; DANE

The Covid-19 pandemic had a profound impact on lives and livelihoods, increasing poverty from 36% to 42.5% in 2020 (Figure 1, Panel C). Many of these newly poor households suffered steep income declines and 1.7 million people fell out of the middle-class (Figure 2). At the end of 2020, more than 70% of the population were living in poverty or at risk of falling into poverty. Inequality, as measured by the Gini coefficient, increased by 1.8 percentage points during 2020, despite a strong policy response that included a substantial expansion of existing cash transfer programmes and the creation of new ones.

**Figure 2. The poor and the middle class have been strongly affected by the pandemic**

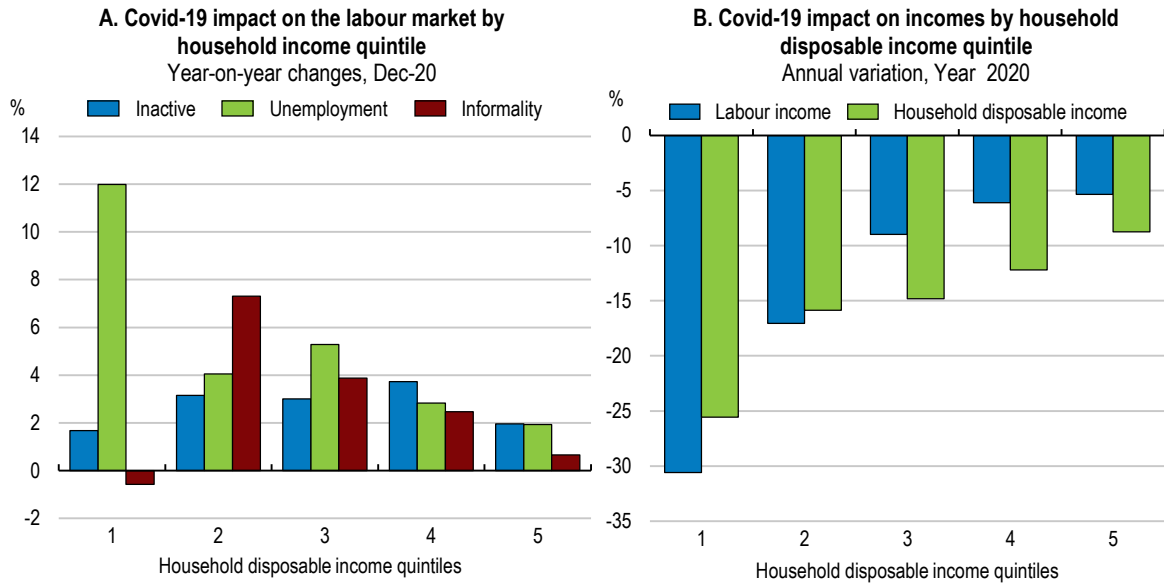


Note: Poor are those individuals in households with per capita household income below the poverty line according to the national definition; the low-income class comprises individuals in households with per capita household income between the poverty line and 2 poverty lines; the middle-income class comprises individuals in households with per capita household income between 2 and 10 poverty lines, the upper-income are individuals in households with income above 10 poverty lines.

Source: OECD calculations using GEIH 2019 and 2020.

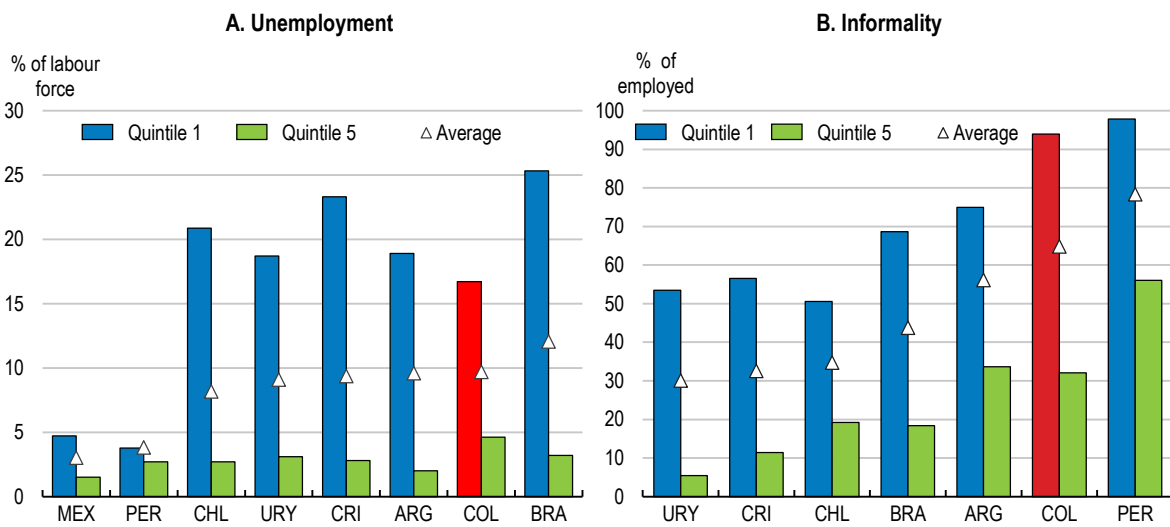
Massive losses of jobs and livelihoods have been the main drivers of the increase in poverty and inequality following the COVID-19 pandemic (Figure 3). This strong impact has its roots in the structurally high share of informal jobs (Box 1) which are excluded from social protection, and high unemployment, both affecting mostly households in the lowest part of the income distribution (Figure 4). Moreover, a traditionally patchy coverage of cash transfers benefits misses out many households in need, despite a significant benefit expansion of existing programmes and the development of new programmes in response to COVID-19. Aware of the many challenges, the authorities commissioned in mid-2020 detailed diagnosis and analysis in the context of an “Employment Mission”, which aimed at boosting job-quality for all Colombians. The mission provides useful diagnosis and recommendations to follow up on (Levy and Maldonado, 2021<sup>[14]</sup>). In addition, a temporary reduction in non-wage labour costs targeted on youth and women is meant to support these groups, which were particularly affected by the pandemic.

**Figure 3. Massive job and income losses explain the strong impact of the COVID-19**



Note: Income quintiles are based on disposable household income per capita.  
Source: OECD calculations based on GEIH 2019 and 2020.

**Figure 4. Informality and unemployment are high and concentrated among the vulnerable**



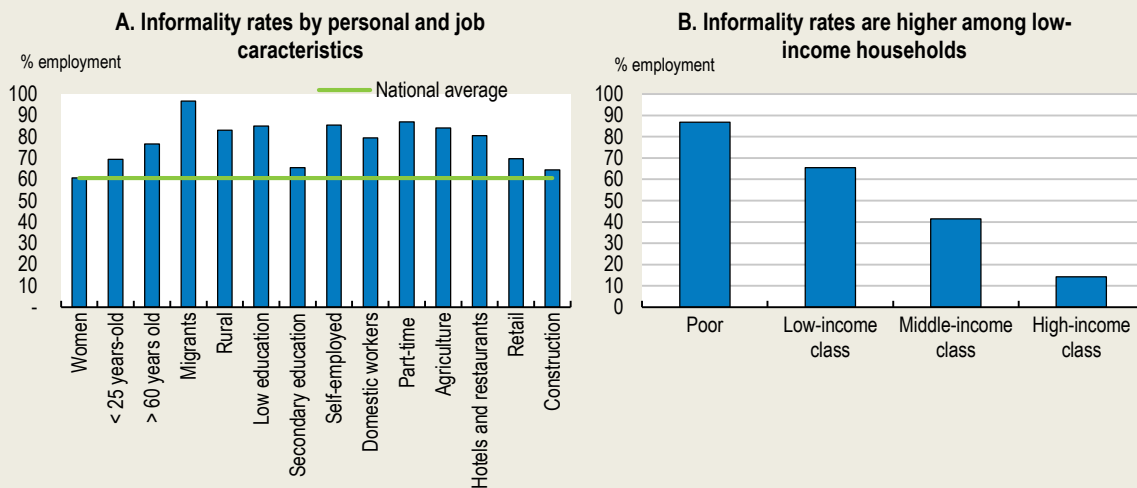
Note: Year 2019. Informal workers are defined as those not paying pension contributions.  
Source: IADB Sims Database

**Box 1. Who are the informal workers?**

There is no unique definition for informal employment. However, a generally accepted way to define it is jobs that are not taxed, registered by the government or do not comply with labour regulations. The International Labour Organisation (ILO) defines informal salaried workers as those whose employers do not contribute to the social protection system. The ILO uses a different definition for the self-employed depending on the informal nature of the business or the size of the firm (less than 5 workers). This makes both categories not comparable. This chapter defines informal employment as every type of worker not contributing to social security, i.e. the pension system. The payment of the pension contributions is highly related to all the remaining social contributions (such as health) or the non-compliance of other employment regulations.

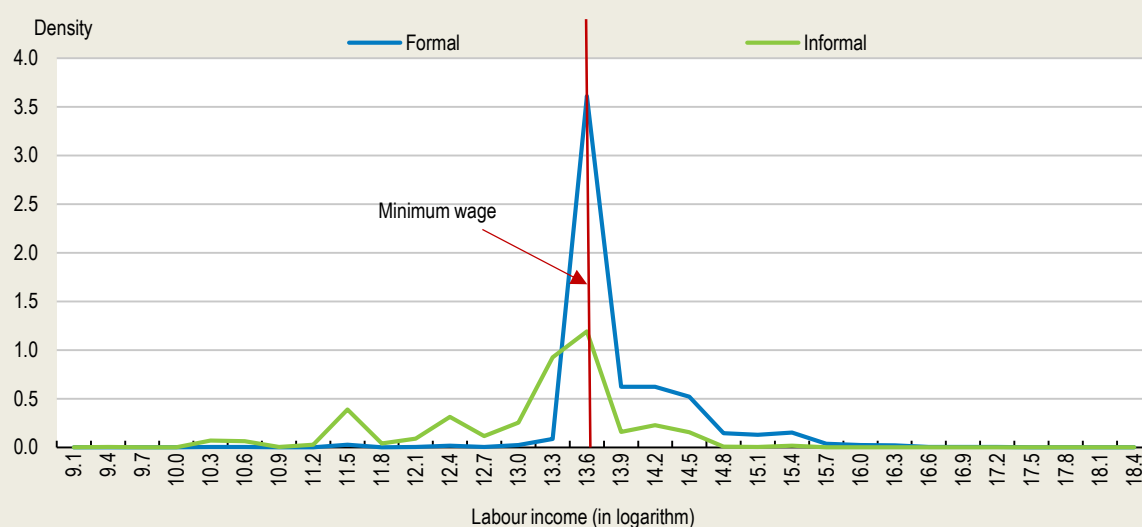
Informal employment is highly segmented by socioeconomic characteristics (Figure 5, panel A). Most migrant and rural workers regularly hold informal jobs, as do young workers, self-employed and part-time workers. Low skills and informality are strongly connected, with the informality rate decreasing for workers attaining higher education levels. The agricultural sector, retail, hotels and restaurants and the construction sector concentrate many informal workers. Poverty rates are higher among workers in informal employment, while low incomes and informality are strongly correlated (Figure 5, panel B). Furthermore, informal workers tend to have lower (Figure 6) and more unstable incomes, limiting their ability to cope with income shocks. Many workers in Colombia transit between formality and informality many times during their professional careers (Meléndez et al., 2021<sup>[3]</sup>). This implies that some workers, even when they contribute for some time, usually do not fulfil the requirements to access unemployment insurance or contributory pensions.

**Figure 5. Informality rates vary strongly with socioeconomic characteristics**



Note: Year 2019. In panel B: poor are those individuals in households with per capita household income below the poverty line; the low-income class comprises individuals in households with per capita household income between the poverty line and 2 poverty lines; the middle-income class comprises individuals in households with per capita household income between 2 and 10 poverty lines, the upper-income are individuals in households with income of more 10 poverty lines.  
Source: OECD calculations based on Households Surveys, GEIH

Figure 6. Informal workers earn less than their formal peers



Note: Kernel estimates of average monthly-equivalent labour market incomes for formal or informal workers (not contributing to the pension system) in 2019. The red vertical line represents the minimum wage in 2019.

Source: OECD calculations based on Households Surveys, GEIH.

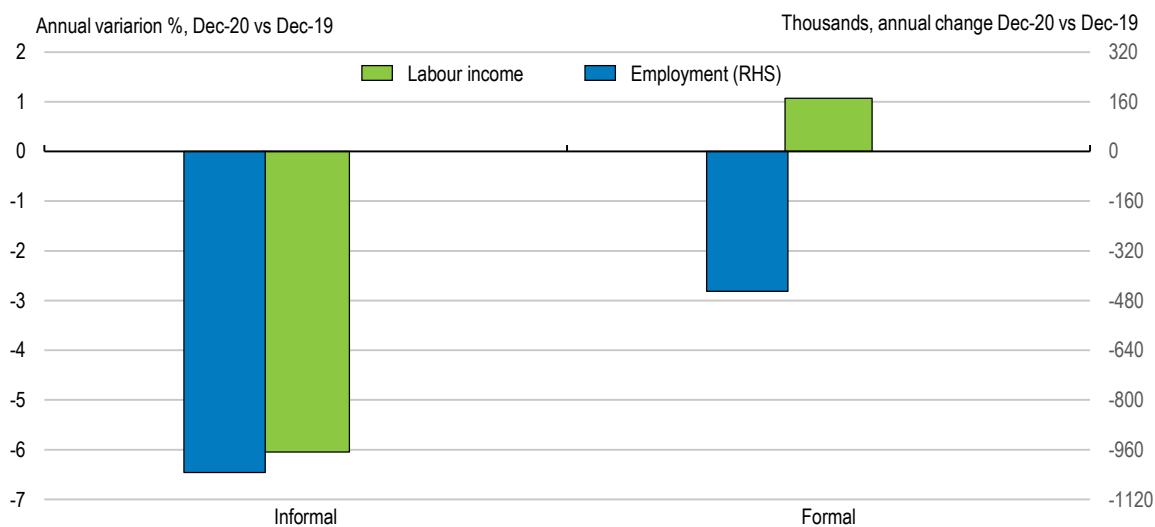
Colombia has also high levels of business informality. Around 76% of microenterprises were not registered with the tax administration and 89% were not registered in the chamber of commerce in 2020, according to the microenterprises survey of the national statistical institute. This is highly correlated with low compliance with hiring formal workers, sanitary standards, low implementation of formal accounting and tax declaration and payment (DNP, 2019<sup>[15]</sup>). Indeed, 88% of microenterprises did not contribute to health or to pension and 95% did not contribute to professional risks. Most informal jobs are concentrated in small firms with a high incidence of low skill and low-productivity occupations (Eslava, Haltiwanger and Pinzón, 2019<sup>[16]</sup>).

Informal workers suffered the most from the economic fallout of the pandemic, as job losses among informal workers were almost twice as high as among formal workers (Figure 7). This marks a break with past recessions when informality used to cushion the decline in employment and acted as a countercyclical buffer. During the pandemic, the lockdowns and mobility restrictions forced many informal workers to stay at home and leave the labour force. While informal workers saw a decline in their average labour income of 6% in 2020, driven mainly by lower hours worked, average labour income increased slightly for formal workers (Figure 7). The latter is explained by composition effects as the adjustment in formal employment was mainly done at the expense of temporary workers (ILO, 2021<sup>[17]</sup>). Precisely because informal jobs are outside the scope of the government, stimulus policies in the form of credits, wage subsidies or furlough schemes generally missed informal workers. One exception is a programme (*Unidos por Colombia*) in which informal entrepreneurs could access state-guaranteed loans. Moreover, as informal workers have usually no access to savings or any type of social protection, they depended on government cash transfers that compensated only partially for their lost income (Busso et al., 2020<sup>[18]</sup>). As the economy rebounds, the recovery in employment has been led by informal jobs, threatening to have a permanent raise in informality, which would widen gaps in incomes and job quality (Maurizio, 2021<sup>[19]</sup>).

Large firms, with a high incidence of formal jobs, were able to cope with the impact of the COVID-19 pandemic without downsizing thanks to their greater assets and financial space. Many of them have been able to benefit from increased liquidity, state-guaranteed loans and wage subsidies, some of which were

conditional on maintaining their payroll. In contrast, the more numerous micro and small, low-productivity, firms with high incidence of informal jobs were not able to access this liquidity support. They were also less ready for digital solutions, such as selling online or teleworking (OECD, 2019<sup>[20]</sup>).

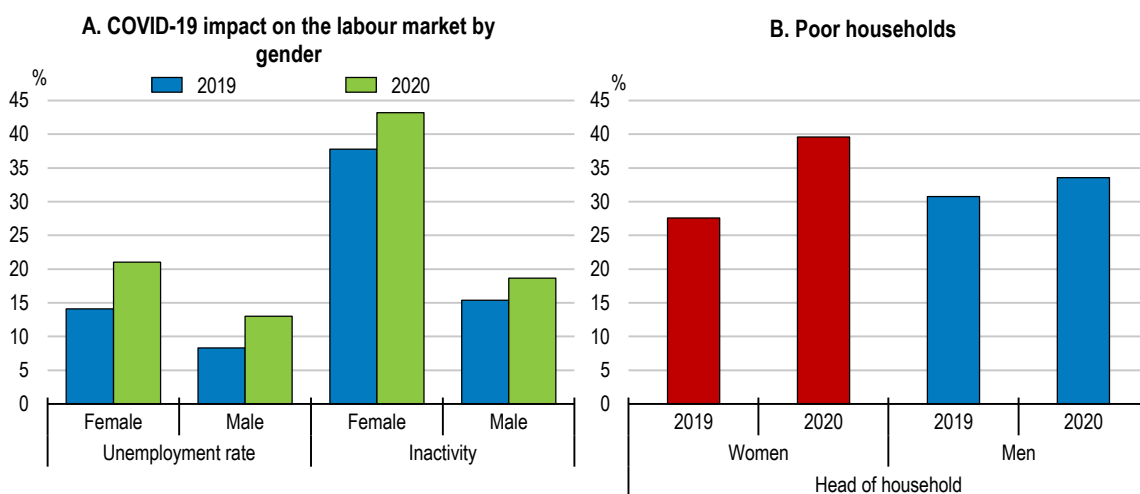
**Figure 7. Informal workers suffered large job and income losses during the pandemic**



Source: Calculations based on GEIH 2019 and 2020, DANE.

Women were also more affected by COVID-19 partly because it amplified pre-existing large employment and wage gaps (Figure 8, Panel A). Female labour force participation has seen an unprecedented reduction during 2020, and as the economy rebounds, the recovery has been slower than for men. This is, at least partly, explained by school closures, which lasted for around 30 weeks in 2020, one of the longest closures in the world. Households with a female head were disproportionately affected by increases in poverty in 2020 (Figure 8, Panel B). The impact of the crisis also varied greatly across cities and regions, reflecting significant geographical discrepancies in informality, availability and quality of public services.

**Figure 8. The pandemic has amplified pre-existing large gender inequalities**



Source: OECD calculations based on GEIH 2019 and 2020.

The migrant population has also been strongly hit by the COVID-19 pandemic. In 2021, more than 2 million migrants from Venezuela, the main country of origin of migrants, were residing in Colombia, and only the vast minority were living in regular conditions. Only 25% of Venezuelan migrants, have a standard employment contract, and around 90% of Venezuelan workers have informal employment and lack social security coverage (Farné and Sanín, 2020<sup>[21]</sup>). Migrants were covered by the policy response to the pandemic, in particular in the cash transfers programmes. However, additional requirements, such as a minimum period of residence or being registered in the social registry of beneficiaries, led to the *de-facto* exclusion of many Venezuelan families from any public aid.

Aware of these challenges, the Colombian authorities improved immigrants' access to social protection in 2021 by developing an unprecedented regularisation of immigration status for Venezuelan migrants. In March 2021, Colombia announced a 10-year Temporary Protection Permit for Venezuelan migrants resident in Colombia, granting them temporary legal status. More than 2 million Venezuelans are expected to benefit from the measure, making it one of the largest regularisations ever undertaken in the OECD (OECD, 2021<sup>[22]</sup>). Access to this mechanism guarantees regular residence states including eligibility for formal employment, education, and healthcare. However, an effective integration of migrants will require a comprehensive strategy with actions spanning several policy areas, such as education, business regulations, pensions, and labour market policies to eliminate remaining integration barriers and improve access to social protection.

Ethnic minorities, that already recorded higher poverty rates and very low access to social protection before the pandemic (ANDI, 2019<sup>[23]</sup>), have also been strongly affected by the pandemic. The Government increased cash transfer support for ethnic minorities during the pandemic. However, lack of timely statistics prevents a more detail analysis of their labour market integration and access to social protection of these groups, leading to challenges for the design and implementation of public policies.

## Social protection is fragmented, spending is low and ill-targeted

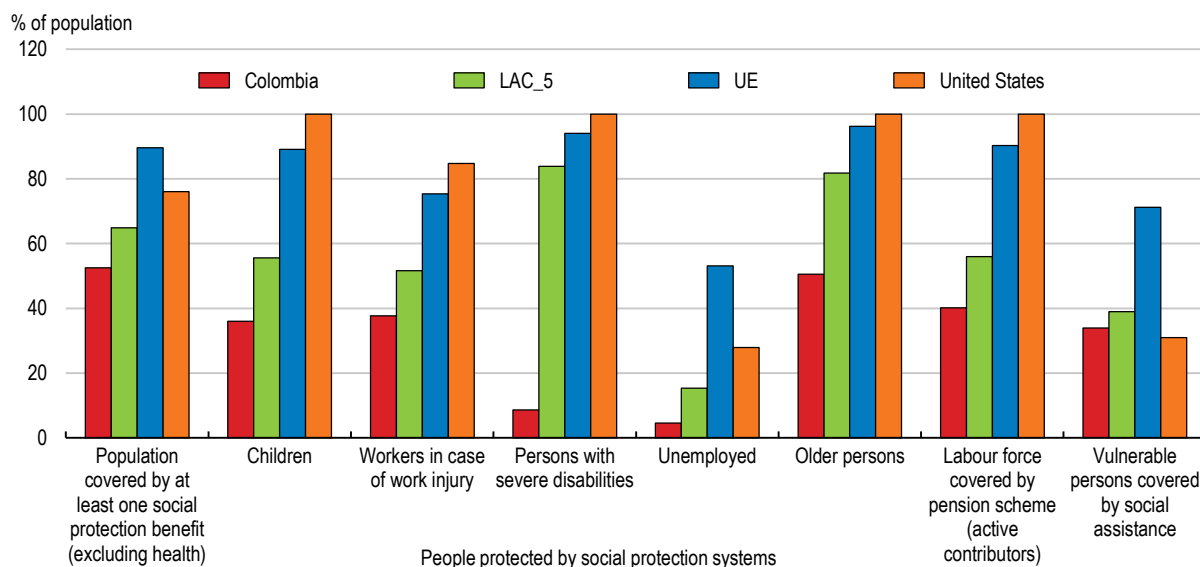
The social protection system in Colombia is fragmented with entitlements mostly determined by the labour market status (Box 2). On the one hand, “social security” benefits are associated with formal work, and, on the other hand, “social assistance policies” directed towards the poor constitute a parallel non-contributory system.

The result of this framework is a segmentation of the labour force into two categories: formal workers on one hand, covered by contributory programmes and minimum wage regulations, and informal workers on the other hand, some of which have access to non-contributory social assistance programmes. Informal workers have lower average incomes than formal workers do. However, some informal workers have incomes above the poverty line, which generally precludes them from accessing non-contributory benefits. Other informal workers may simply not be covered by the social security system because the law excludes them from contributing if they earn less than a monthly minimum wage. Self-employed workers can contribute to the social security system even if they earn less than the minimum wage, but their contributions need to be based on a monthly minimum wage. This duality has led to a low coverage of social protection (Figure 9).

This fragmentation is not only a source of inequality, but also one important factor contributing to low productivity growth (Levy and Schady, 2013<sup>[24]</sup>; Levy and Maldonado, 2021<sup>[14]</sup>). When contributory benefits from the social security system are not fully valued by workers, they tend to act as an implicit tax on formal employment. At the same time, non-contributory benefits can act as a subsidy to informality when they are perceived as similar to those enjoyed by formal workers, who pay for them. In addition, firms tend to stay inefficiently small as they attempt to fly below the radar of labour market inspections.

Figure 9. Social protection coverage is low

2020 or latest year available



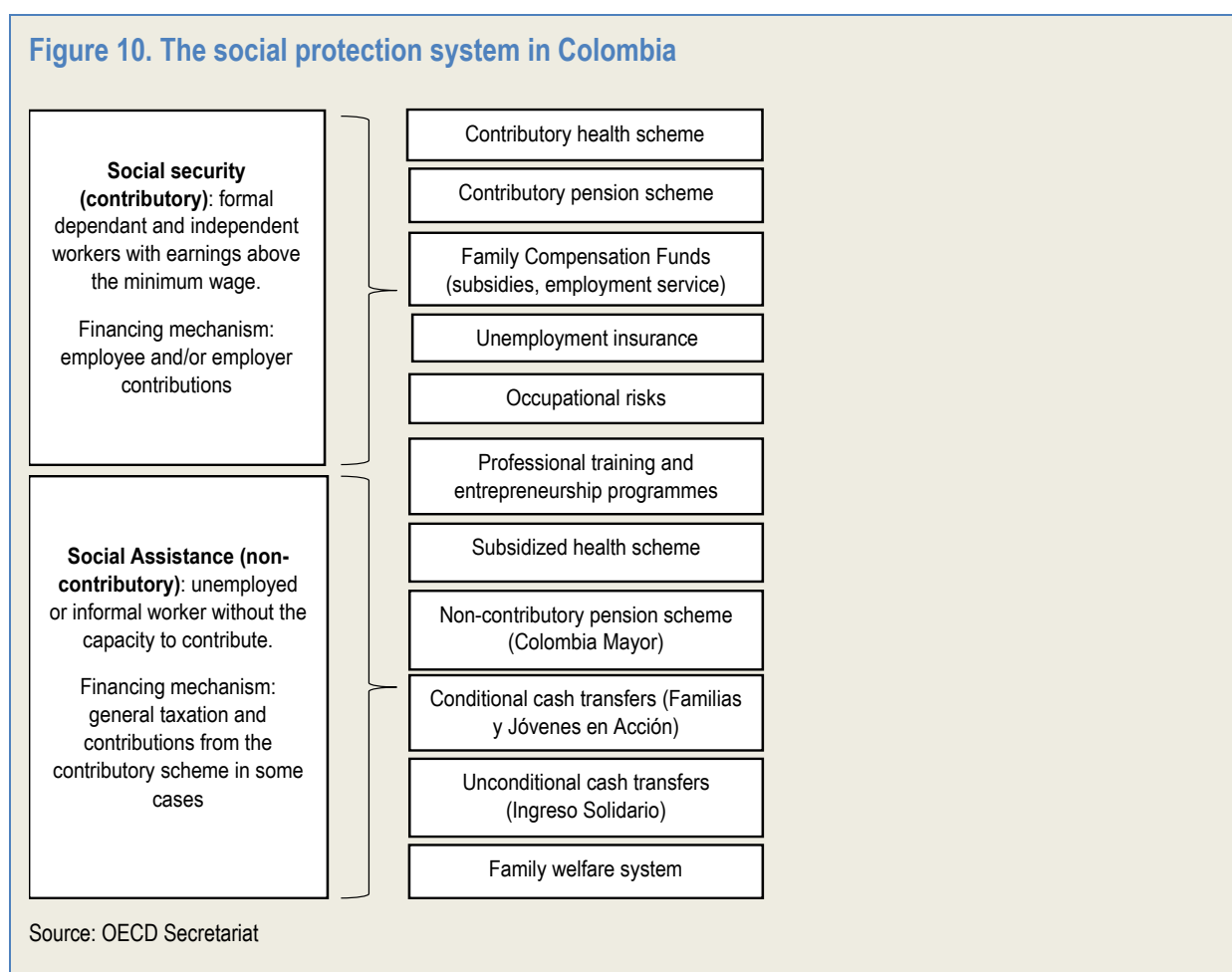
Note: Vulnerable people are defined as all children plus adults not covered by contributory benefits and people above retirement age not receiving contributory benefits (pensions). LAC5 is the unweighted average of Argentina, Brazil, Chile, Costa Rica and Mexico.  
Source: ILO, World Social Protection Database, based on the SSI; ILOSTAT; national source.

### Box 2. The social protection system in Colombia

The social security system comprises health, pension, and disability and unemployment insurance, occupational risk coverage and family benefits (Figure 10). A first component of the system is financed through contributions made by employers and/or employees which are proportional to the worker's salaries or wages, and is labelled "contributory social security scheme". Workers covered by this system are also subject to regulations on employment protection and minimum wages.

The second component of the social protection system is the social assistance system, which was created to provide insurance to those left out of the contributory social security system and is generally financed through general taxation, hence the label of "non-contributory scheme". It covers mainly the non-contributory (subsidised) health scheme; a small non-contributory pension scheme, which is a cash transfer programme to assist the elderly poor (*Colombia Mayor*); conditional cash transfer programmes (such as *Familias en Acción*); and an integrated strategy to help people in poverty ("*Estrategia Unidos*"). The national training institution (*Servicio Nacional de Aprendizaje*, SENA) offers vocational and professional training, and the Colombian Family Welfare Institute (*Instituto Colombiano de Bienestar Familiar*, ICBF) assist vulnerable and poor households. Other important programmes, such as *Familias en su tierra* ("Families on their own land"), assist the victims of forced displacement who have returned or relocated to their land to improve their living conditions through access to food, promotion of productive initiatives and improvement of their living conditions. Other programmes targeted at the poor aim at strengthening entrepreneurship and promoting productive activities to sustain self-generating income activities.

Figure 10. The social protection system in Colombia



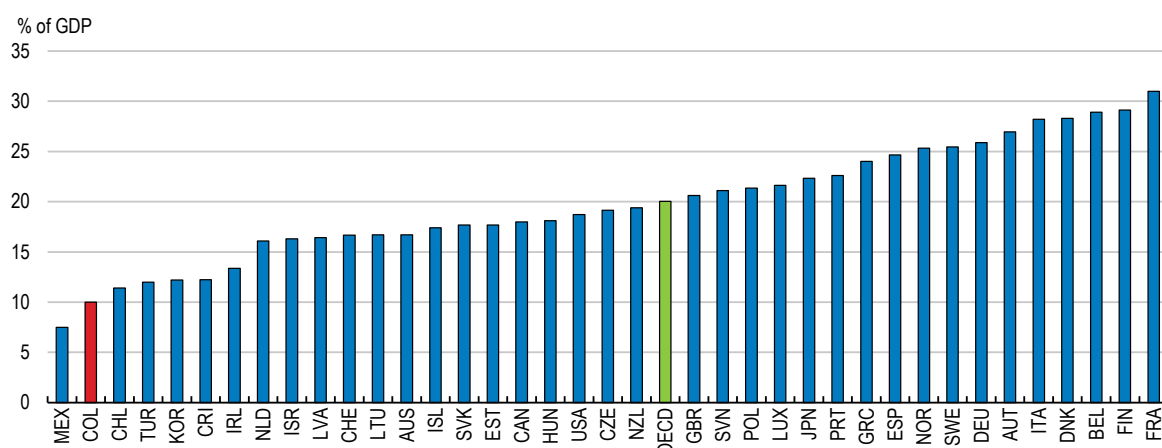
Coverage gaps are associated with low spending in social protection. Although social spending has increased substantially in the last two decades from 5.7% of GDP in 1990 (Melo-Becerra and Ramos-Forero, 2017<sup>[25]</sup>) to 10% of GDP in 2019, it remains low in international perspective (Figure 11). Spending in social protection is around 8% of GDP, but 60% of this spending is allocated to pensions, while less than 3% is allocated to social assistance programmes supporting the poor.

Moreover, the targeting of the social spending is poor, with a significant part of it benefiting non-poor households (Table 1). This is especially true in the case of pensions, housing, education subsidies and public utilities, such as electricity or telecommunications. Pension spending is the most ill-targeted: 73% of subsidies go to high-income households, while only 5% goes to the poorest households. In fact, Colombia is the only country in the region in which contributory pensions increase inequality (Lustig, 2016<sup>[13]</sup>). This is driven by the high share of informal workers that lack pension coverage. Pre-school and primary education expenditure is well targeted to the poor, but the benefits of public spending on tertiary-level education mostly accrue to high-income households (Joumard and Londoño Vélez, 2013<sup>[10]</sup>). Social assistance programmes, such as *Familias en Acción*, are best at targeting vulnerable households, but still almost 40% of the spending in these programmes went to non-poor households in 2016 (Fedesarrollo, 2021<sup>[26]</sup>), though targeting has improved since.

Subsidies for public utilities are the second most ill-targeted item of the social spending, with 80% of the public spending accrued to non-poor households. Usually, subsidies for public utilities are inefficient as they distort price signals and can result in harmful consumption decisions, such as low incentives to save energy. A cost-benefit analysis of each subsidy for public utilities could be conducted to eliminate those that are socially and environmentally harmful. Vulnerable households can be better supported by cash

transfers. If subsidies cannot be eliminated, improving their targeting would at least increase the efficiency of public spending and help those that need it the most (see section 0). For example, 90% of households receive a subsidy for electricity and 60% for gas (Eslava, Revolo and Ortiz, 2020<sup>[27]</sup>).

**Figure 11. Social spending is low**



Note: Year 2019. Social expenditure comprises cash benefits, direct in-kind provision of goods and services, and tax breaks with social purposes. In the OECD Social expenditure database Colombia shows a 13.1% of GDP in 2018 of social spending. Source: DNP and OECD Social expenditure database.

**Table 1. Social spending is poorly targeted**

	Per capita household income quintile					Spending in non-poor households, % of total	Budget (%GDP)
	1	2	3	4	5		
Education	42.2	25.2	16.9	10.6	5.1	46.4	3.7
Pensions	5	9.2	12.7	18.9	54.2	89.8	2.6
Health	48.8	26.1	14.7	7.9	2.5	42.6	1.9
Programmes for conflict victims	43.2	22.9	12.9	17.3	3.7	51.5	1.5
Public services	21.9	20.6	19.4	20.1	17.9	81	0.5
Housing	7.1	18.9	23.1	24.8	26.1	93.2	0.4
Familias en Acción	56.2	24.7	12	5.5	1.6	38.4	0.2
Education grants	10.3	18.9	7.9	28.1	34.8	59.5	0.1
Colombia Mayor	51.2	23.8	15.1	7.1	2.8	42	0.1
Unemployment subsidy	15.1	25.4	21	18.4	20.1	66.7	0.02
Jóvenes en acción	39.5	23	21.3	13.3	2.8	51.7	0.02
Familias en su Tierra	41.6	30.7	16.6	9.2	1.9	45.2	0.01
Other transfers	27.6	23.9	16.9	28.6	2.9	67.2	
<b>Total without pensions</b>	<b>39.6</b>	<b>24.3</b>	<b>16.6</b>	<b>12.1</b>	<b>7.4</b>	<b>50</b>	
<b>Total</b>	<b>31.1</b>	<b>20.6</b>	<b>15.6</b>	<b>13.7</b>	<b>18.8</b>	<b>59.8</b>	<b>11.1</b>

Note: Year 2017. Poor households are defined according to the national poverty line. The value reported for pensions in the table reflects only the implicit subsidy. Education covers all public education institutions, while education grants refers to educational subsidies and scholarships. Public services includes subsidies for public utilities such as energy, water, sewerage and communications. Source: (Fedesarrollo, 2021<sup>[26]</sup>) based on ENPH-DANE.

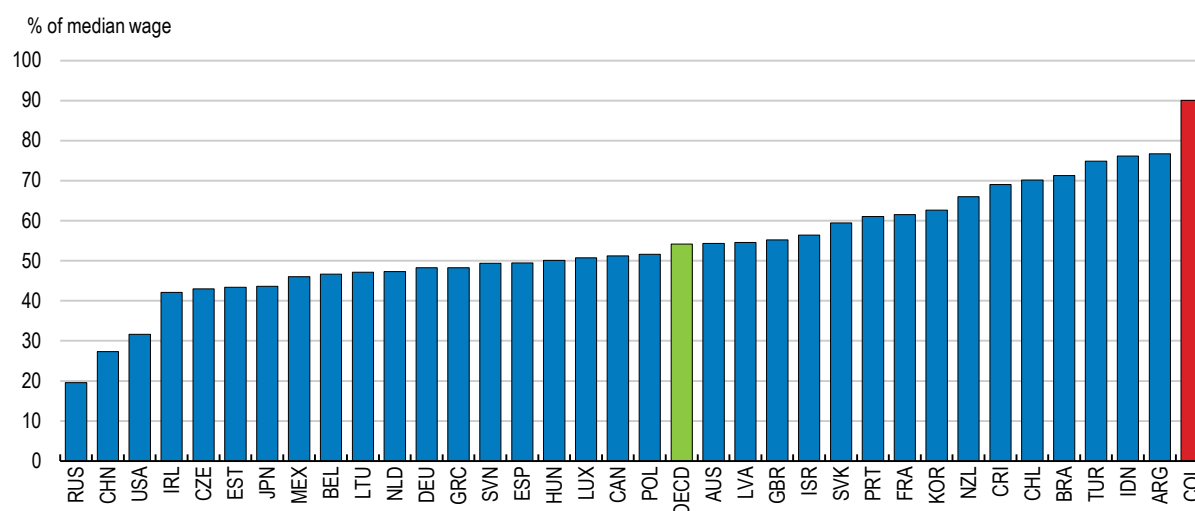
## High formal labour costs explain large gaps in social insurance coverage

### *A relatively high minimum wage raises formal salaries but exacerbates informality*

The minimum wage in Colombia - at 90% of the median wage and 62% of the mean wage of full-time formal employees - is high in comparison with OECD countries (Figure 12). Moreover, the minimum wage is around 2,7 times the poverty line. International evidence on the impact of minimum wages on employment is not conclusive (Broecke, Forti and Vandeweyer, 2017<sup>[28]</sup>). However, evidence for Colombia clearly indicates that the relatively high minimum wage has a negative effect on employment, especially for workers earning close to the minimum wage (Maloney and Nuñez, 2000<sup>[29]</sup>; Pérez Pérez, 2020<sup>[30]</sup>; Mora and Muro, 2019<sup>[31]</sup>), and induces informality (Arango, Flórez and Guerrero, 2020<sup>[32]</sup>; Mondragón-Vélez et al., 2010<sup>[33]</sup>; OCDE, 2019<sup>[34]</sup>; Arango and Flórez, 2017<sup>[35]</sup>; Olarte Delgado, 2018<sup>[36]</sup>). Additionally, higher minimum wages in Colombia had a modest impact on poverty and no impact on the incomes of the poorest households (Gindling, 2018<sup>[37]</sup>). This high relative minimum wage is, at least in part, symptomatic of a significant fraction of workers with lower labour productivity than the minimum wage, which makes it unattractive for firms to hire them as formal employees.

**Figure 12. The minimum wage is the highest in the OECD**

As a percentage of median wages of full-time workers in 2019



Note: Exactly half of all workers have wages either below or above the median wage. Percentage of minimum to average wage 2017 for China, Indonesia and the Russian Federation.

Source: OECD, OECD Employment Outlook Database; China Ministry of Human Resources and Social Security, National Bureau of Statistics; Instituto Brasileiro de Geografia e Estatística (Pesquisa Nacional por Amostra de Domicílios); International Labour Organisation (ILO) Database on Conditions of Work and Employment Laws; Ministry of Man Power and Transmigration of the Republic of Indonesia and Statistics Indonesia (BPS); Russia Federal State Statistics Service; National Institute of Statistics and Census of Argentina.

This high minimum wage has likely left many workers in informal jobs, self-employment and unemployment. Almost half of the total workforce earns less than the minimum wage, and this number is higher for self-employed, women, informal, young, low-skilled and rural workers (Figure 13), whose labour productivity is likely lower. As argued in OECD (2016<sup>[38]</sup>), the high minimum wage should also be seen in the context of the limited role of collective bargaining in Colombia. Since the minimum wage is one of the few ways for trade unions to improve working conditions for their affiliates, they tend to put strong pressure on raising it. These attempts can fail to consider the effect of minimum wage increases on informal workers.

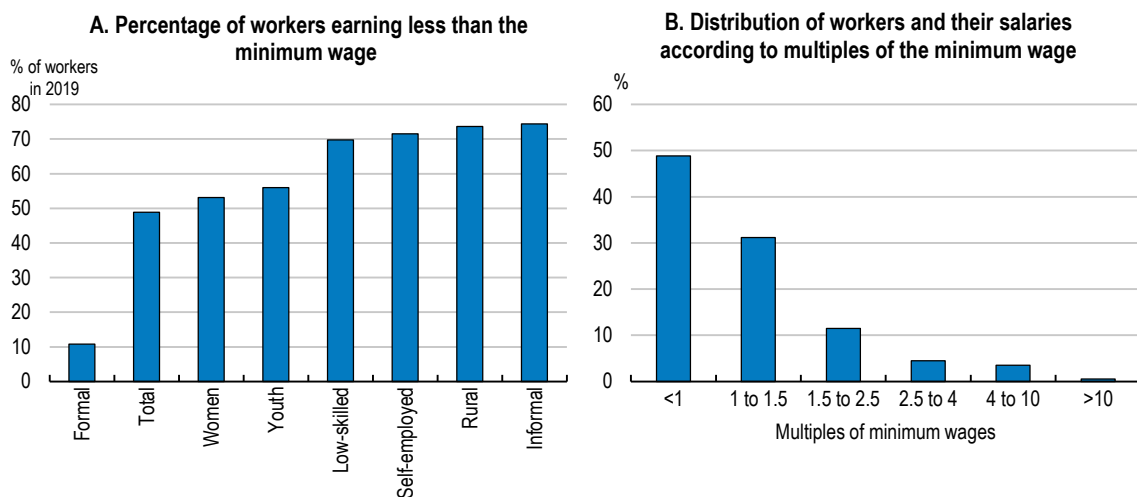
At the current high level, marginal increases in the minimum wage are likely to have regressive income effects as they reduce formal employment prospects for low-skilled workers, youth and people located in rural and less developed regions (OECD, 2015<sup>[39]</sup>).

Over time, the value of the minimum wage has increased more rapidly than consumer prices and labour productivity. Between 2011 and 2019, the average annual increase in the minimum wage exceeded inflation by about 1.6 percentage points. As labour productivity grew by an annual average of 0.3% during the same period, the real minimum wage has constantly increased. For 2022, the minimum wage has been increased by 10%, while inflation in 2021 was 5.6%.

Colombia’s minimum wage is used as a gatekeeper for accessing the contributory social security system. Only salaried workers earning at least one minimum wage can contribute to the contributory pension system. For self-employed workers, social contributions cannot be based on a monthly income of less than the minimum wage. As a result, social security contributions amount to a significantly higher proportion of the remuneration for self-employed workers earning below the minimum wage, which adds to the regressive nature of current arrangements. Allowing workers with incomes below the minimum wage to participate in the contributory social security, and calculating their contributions bases on their actual incomes, would improve incentives for low-income and vulnerable workers to get a formal job and social insurance coverage.

In the context of the current crisis, which has disproportionately affected young people and low-skilled workers, future minimum wage increases should be approached with caution, evaluating both the effects on formal and informal workers, an issue that has been discussed in past Economic Surveys (OECD, 2015<sup>[39]</sup>; OECD, 2019<sup>[40]</sup>). Given the current level of the minimum wage, adjusting it only for changes in prices would be a reasonable approach for the next few years, as recommended in the past Colombia Economic Survey (OECD, 2019<sup>[41]</sup>).

**Figure 13. The relative high minimum wage excludes many Colombians from high-quality jobs**



Note: Informality is defined as those not contributing to the pension system.  
 Source: OECD calculations using Households Surveys from DANE-GEIH.

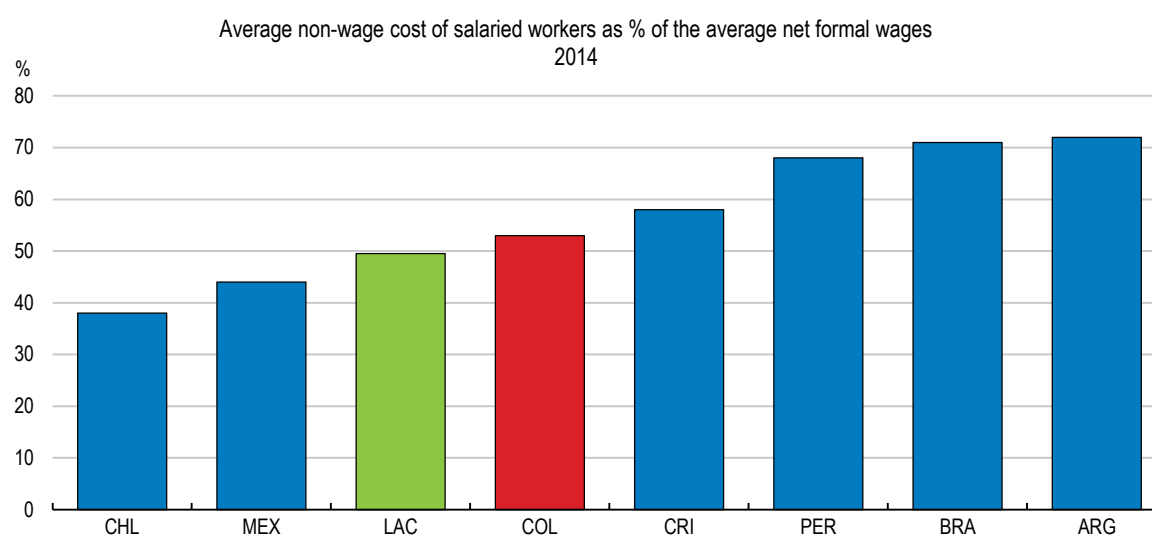
In the medium term, a permanent and independent commission could provide recommendations on setting minimum wage increases, as in other OECD countries. For example, the process of setting minimum wages in Germany and the United Kingdom includes a systematic monitoring of its potential impact by specific independent bodies mandated to evaluate and provide recommendations (Low Pay Commission UK, 2018<sup>[42]</sup>; Eurofound, 2018<sup>[43]</sup>; Vacas-Soriano, 2019<sup>[44]</sup>). The Low Pay Commission in UK is formed by experts and academics, and is mandated to evaluate and advise the government on the impact of increasing the minimum wage. The commission conducts research and publishes annual reports to inform the debate on minimum wages and its impact on employment. In Colombia, such an independent commission could advise on the impact of increases in minimum wages on formal and informal workers. This advice could then feed into the decisions of the existing commission responsible for setting the minimum wage via social dialogue and negotiations.

Colombia could also consider to differentiate the minimum wage by age (OECD, 2015<sup>[39]</sup>) or by region (OECD, 2017<sup>[8]</sup>), as proposed in past Economic Surveys. These measures would particularly help formalisation in rural areas. For younger workers, a differentiated minimum wage would facilitate their entry into the labour market and reduce youth unemployment. While a unique national minimum wage is easier to operate, communicate and enforce, it offers less scope to take into account the particular circumstances of different age groups or regions, such as the cost of living and labour productivity.

### ***Non-wage labour costs are high increasing informality***

In addition to the high minimum wage, non-wage labour costs represent 50% of the labour costs of an average-wage worker (Figure 14). However, for informal workers, non-wage labour costs usually add up to 120% to their average wages (Alaimo et al., 2017<sup>[45]</sup>). Such high costs perpetuate a high incidence of informality, self-employment and unemployment.

**Figure 14. There is room to reduce non-wage labour costs**

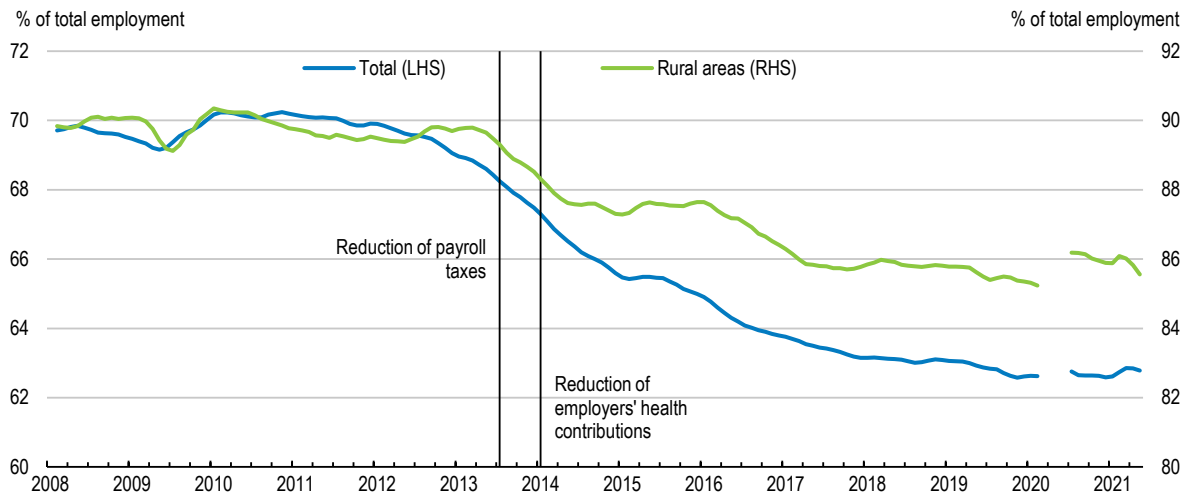


Note: LAC refers to the average of 20 countries in the region. Estimations include mandatory contributions (such as social security contributions for health and pensions, professional risk, transport subsidy), 13th salary in the form of bonuses, annual leave, severance payment and firing notice.

Source: Alaimo et al. (2017), "Measuring the Cost of Salaried Labour in Latin America and the Caribbean", IDB Technical Note N. 1291, <https://publications.iadb.org/handle/11319/8430>.

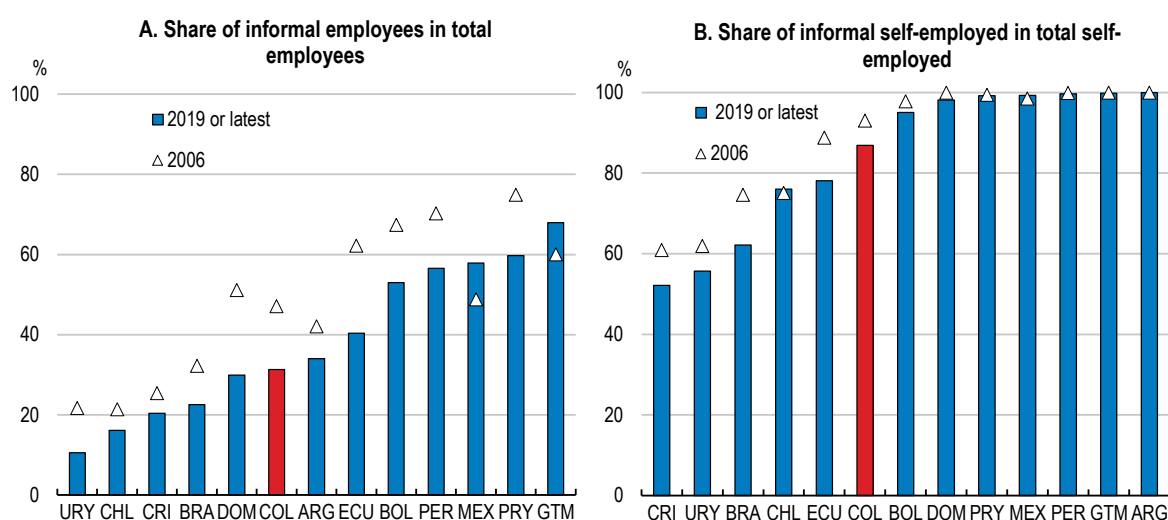
The 2012 tax reform that reduced payroll taxes and employer’s health contributions (Box 3) shows that reducing non-wage labour costs helps to reduce informality. In the aftermath of the reform, labour informality declined visibly (Figure 15). Available impact evaluations suggest that the reform led to a 2 to 4 percentage-point reduction in the informality rate (Kugler et al., 2017<sup>[46]</sup>; Morales and Medina, 2017<sup>[47]</sup>; Fernández and Villar, 2017<sup>[48]</sup>; Bernal et al., 2017<sup>[49]</sup>). For self-employed workers, the reform implied no changes in social contributions and the beneficial effects on formality were concentrated among employees (Figure 16). Formalisation increased more among workers in smaller firms, as larger firms were more impacted by the simultaneous increase in corporate taxes (Bernal et al., 2017<sup>[49]</sup>). Estimates of wage effects of the reform vary, ranging from only a small effect (Morales and Medina, 2017<sup>[47]</sup>), to a positive effect of 2.7% on average wages (Bernal et al., 2017<sup>[49]</sup>). Overall, the effects of the reform have been broad-based and long-lasting, with the manufacturing, services and agricultural sectors experiencing reduced informality rates (Garlati-Bertoldi, 2018<sup>[50]</sup>).

Figure 15. Informality has declined but remains high



Note: 12-month averages. Informality is defined as the percentage of workers in employment not contributing to the pension system. The statistical definition is different from the one followed by DANE. Months from April to August 2020 are missing because of the pandemic some questions were not asked in household surveys.  
Source: DANE

**Figure 16. The decrease in informality has been much stronger among employees than among the self-employed**



Note: A worker is considered informally employed if she/he does not contribute to social security.  
Source: IADB SIMs database.

Despite the 2012 tax reform, social contributions remain high (Box 3) and prevent particularly low-income workers from accessing formal employment. For a dependent formal worker earning the minimum wage, the cost of contributions and other payroll taxes amounts to 53% of the wage for an employer. Among the most costly non-wage cost items is a transport allowance, which is mandatory only for workers earning less than two minimum wages and is not considered in the calculation of social contributions. The only rationale behind this allowance is its exemption from social contributions, but it constitutes a big disincentive to formal hiring.

### Box 3. The 2012 tax reform and non-wage labour costs

In December 2012, Colombia's Congress approved a reform that reduced payroll taxes by 13 percentage points of wage earnings. In particular, it eliminated employers' contributions to SENA (the public training agency) and ICBF (the childhood services agency), previously set at 2% and 3% of firms' payrolls respectively. The reform also eliminated employers' contributions to the health system that amounted to 8.5% of the payroll. These payroll tax reductions applied only for workers with wages below ten minimum monthly wages (around 98% of formal workers). SENA and ICBF contributions were eliminated by mid-2013, while health contributions were eliminated starting in January 2014.

To finance this reduction of payroll taxes, authorities implemented a new corporate income tax (the "CREE") of 9% over total profits, while reducing the existing corporate income tax from 33% to 25%. The goal of the reform was to stimulate formal employment, while keeping tax revenue unchanged. The reduction in payroll taxes did not apply to employers not subject to corporate income taxes, including firms in the special tax regime and, in particular, non-for-profit organizations, which operate mainly in the education and health sector.

Table 2.2. shows all non-wage labour costs for employers, employees and the self-employed after the 2012 tax reform. The largest single elements of the tax wedge are pension contributions (12% for the employer), transport and severance allowances (11.7% and 8.3%, respectively) for the employer and pension and health benefits (8%) for the employee.

Table 2. Non-wage labour costs in detail

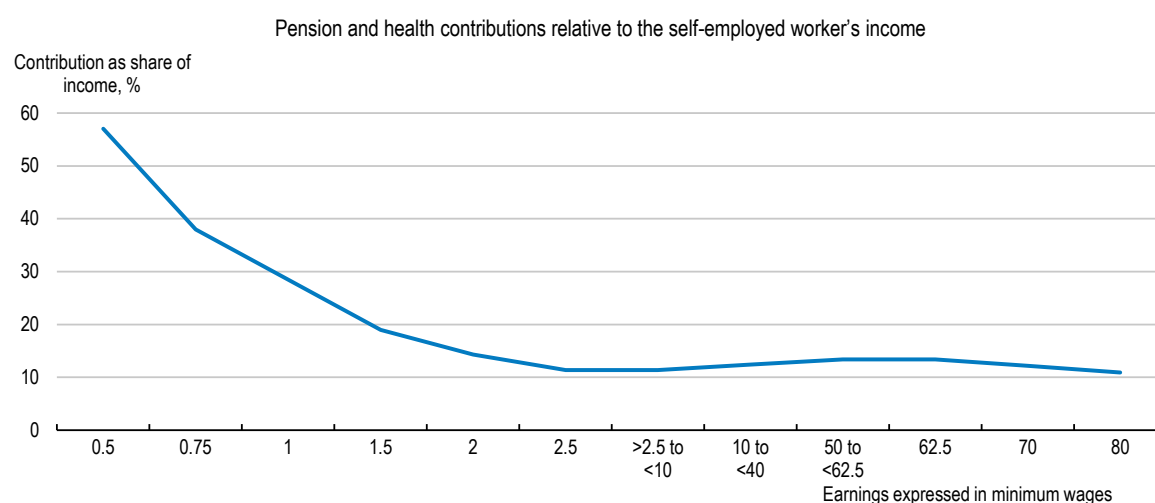
% of wage	Employer		Employee	Self-employed
Pensions	12%		4%	16%
Health insurance	0% for employees earning less than ten minimum wages	8.5% only for employees who earn more than 10 times the minimum wage or for firms in the special tax regime	4%	12.5%
Contributions for professional risks	From 0.522% to 6.960% depending on the risk profile of the occupation		-	Between 0.522% and 6.960%
Family compensation funds	4%		-	-
SENA	0% for employees earning less than ten minimum wages	2% only for employees who earn more than 10 times the minimum wage or for firms in the special tax regime		
ICBF	0% for employees earning less than ten minimum wages	3% only for employees who earn more than 10 times the minimum wage or for firms in the special tax regime		
Severance	8,3%			
Interest on severance	1%			
Transport allowance	11.7% for those earning less than 2 minimum wages			
Holidays	4.2%			
Footwear and clothing	3%			
Service bonuses	8.3%			

Source: Ministry of Labour of Colombia.

Vast evidence shows that these high mandatory contributions for social security can explain high informality in Colombia (Camacho, Conover and Hoyos, 2013<sup>[51]</sup>; Cuesta and Olivera, 2014<sup>[52]</sup>; Kugler, Kugler and Prada, 2017<sup>[53]</sup>; Kugler and Kugler, 2008<sup>[54]</sup>). The current high costs of formal labour also explain the large share of self-employment in Colombia, as firms usually evade social contributions when these are bundled with stringent labour regulations or high minimum wages (Levy, 2019<sup>[55]</sup>). Self-employed workers' contributions are always calculated based on the minimum wage, even when they earn less. As a result, their social contributions are highest for those with low incomes (Figure 17). This acts as a particularly strong impediment to becoming formal (Meléndez et al., 2021<sup>[3]</sup>).

Other non-wage labour costs are related to costly and complex business regulations that hamper the formalisation of firms and jobs. The Government has been implementing a one-stop shop mechanism for all registration procedures (Ventanilla Única Empresarial), and should keep up efforts to integrate all the commercial, tax and social security procedures necessary for the opening of companies and registering of formal workers (see Chapter 1 of the Economic Survey of Colombia (OECD, 2022<sup>[6]</sup>)). Increasing the use of digital tools would also offer the double dividend of reducing the regulatory burden, opportunities for corruption and the scope for non-compliance. The simplification of the tax system, particularly for SMEs, can be also a powerful tool to increase business, and hence employment formalisation. Efforts in this direction have been undertaken with the new SIMPLE tax regime that will not only reduce the tax burden but also facilitate compliance with tax obligations for micro and small firms. Authorities have also implemented programmes, such as *Programa para la Formalización* and *Crecimiento Empresarial*, aiming to formalise micro and small firms.

**Figure 17. High social contributions leave many self-employed with no other choice than being informal**



Source: (Meléndez et al., 2021<sup>[31]</sup>)

## The pension system needs a comprehensive redesign

### *The pension system has low coverage and is a key driver of high inequality*

The Colombian pension system is complex and its coverage is low, with 45% of those aged 65 and above receiving no old-age pension at all. The pension system comprises a contributory pillar formed by a public benefit-defined system and a parallel private system based on capitalisation and defined contributions (Table 3). Only formal-sector workers earning at least the minimum wage can contribute to these two plans. Colombia stands out in the region as one of only two countries (with Peru) with both defined-contribution and defined-benefit schemes operating at the same time. An individual worker can only contribute to or receive benefits from one system at a time, but the coexistence of two schemes operating under different rules means that two workers with identical contribution histories can acquire different pension entitlements at retirement. Additionally, a small non-contributory pillar (Colombia Mayor) provides small cash transfers to the poorest of the elderly.

**Table 3. The Colombian pension system**

	Contributory system			Non-contributory
	Public defined-benefit	Private capitalisation	Periodic Economic Benefits Scheme (BEPS)	Colombia Mayor
Contributions	16% of base salary (75% by the employer and 25% by the employee, 100% if self-employed earning more the one minimum wage)		Voluntary for all self-employed workers earning less than the minimum wage; mandatory for part-time workers, employers contribute 14% of wages (the social protection floor)	
Requirements for getting the pension or benefit	Age of retirement of 57 for women and 62 for men and 1,300 weeks of work	Sufficient capital to receive a pension equivalent to 110% of one minimum wage or attain retirement age (57/62) and 1,150 weeks of work	Attain retirement age (57/62)	Extremely poor and aged more than 54 for women and 59 for men. Priority targeting for aged over 65.

Benefit	By constitution, contributory pensions cannot be lower than one minimum wage		Accumulated savings plus Government subsidy (20% of the stock of savings accumulated at retirement)	COP 80,000 monthly (USD 25 or 60% of the extreme poverty line in 2019)
	Percentage over the last 10 years of earnings. Maximum pension of 20 minimum wages.	Based on accumulated savings. If the calculated pension is below the minimum wage, workers can access a fund to achieve the minimum wage, which is financed by allocating on average 1.5% of the contributions of affiliated workers with earnings above 4 minimum wages.		
If requirements are not met	Get their balances book adjusted for inflation without interest accrued on the savings ( <i>indemnización sustitutiva</i> )	Get back the capital with financial returns	--	--
Coverage	6.5 million affiliated individuals (but less than one-third are active contributors); 1.2 million pensioners	14 million affiliated individuals (but less than one-third are active contributors); 120,000 pensioners	667,000 are active contributors and 13,000 received annuities in 2019	2 million beneficiaries, around 25% of those aged above 65
Administration	The Government ( <i>Colpensiones</i> )	Private pension funds	The Government ( <i>Colpensiones</i> )	Solidarity Pension Fund; Ministry of Labour

Source: OECD Secretariat.

The contributory pension system adds to income inequalities mainly because of the low coverage among low-income earners (Figure 18, Panels A and B). Currently, 25% of Colombians in retirement age receive a contributory pension and, under current requirements, less than 20% of the old-aged by 2050 are expected to access contributory pensions (Bosch et al., 2015<sup>[56]</sup>). There are marked differences in pension coverage across populations groups. The coverage rate for women is at 21%, while for men it is around 30%. In rural areas, less than 10% of the elderly are covered.

The low coverage of the contributory pension system reflects the low share of workers paying contributions in the context of widespread informality. Many workers who have contributed at least at some point of their careers do not manage to get a contributory pension. An additional disincentive to contribute is that when workers get their savings back, they typically get a lower return than if they had saved in financial assets. This is driven by the fact that returned savings are only adjusted for inflation in the public system and that there are relatively high commissions in the private funds.

The non-contributory scheme *Colombia Mayor* has expanded in recent years, helping to reduce old-age poverty (DNP, 2016<sup>[57]</sup>; Econometria, 2017<sup>[58]</sup>). However, this scheme covers only 39% of those older than 65 years of age with no contributory pensions in 2019, or 29% of the population aged 65 and above. Average benefits are low, at about 60% of the extreme poverty line or USD 25 per month, which makes *Colombia Mayor* one of the least generous non-contributory pension systems among emerging market economies (ILO, 2021<sup>[59]</sup>). *Colombia Mayor* beneficiaries are in the poorest 10% of the household income distribution and receive, on average, just 0.9% of what old-age adults in the richest 10% receive (Figure 18, Panel C). During 2020 and related to the pandemic, *Colombia Mayor* reached 1.7 million beneficiaries and the amount of the transfer was doubled. Additionally, the 2021 tax reform establishes a gradual benefit convergence with the national extreme poverty line, subject to budget availability, which would increase the budget for non-contributory pensions by 50%.

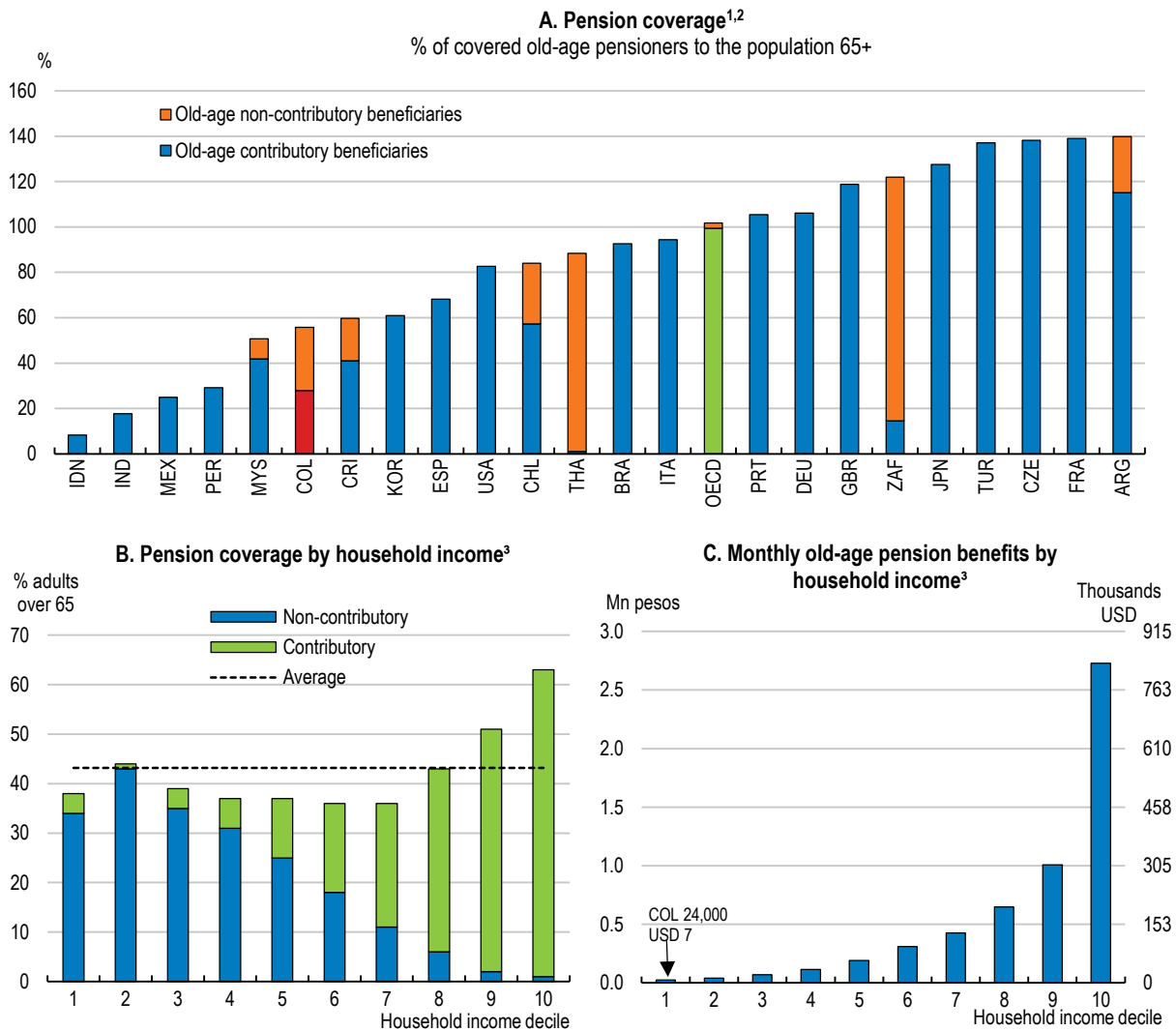
Inequities in the pension system are also driven by significant subsidies for high-income earners. In the public regime, the government fills the gap when contributions fall short of outlays, which gives rise to high implicit subsidies towards relatively high-income beneficiaries. Indeed, 51% of those with contributory pensions belongs to the 20% of the richest population (Fedesarollo, 2021<sup>[26]</sup>). The average replacement rate in the public benefit-defined scheme of 73% is much higher than the 39% of the private capitalisation scheme (López and Sarmiento, 2019<sup>[60]</sup>), or the average 58% in the OECD. The fiscal cost of the pension system, which includes several special regimes for the public sector, such as military forces and teachers, is also high in relation to its coverage. It was 3.9% of GDP and nearly 30% of the government tax revenues in 2019, and nearly three quarters of it were subsidised to the public scheme.

The so-called Periodic Economic Benefits Scheme (BEPS) is the third component in the Colombian pension system that aims at encouraging voluntary savings among low-income Colombians. However, design problems and the fact that the programme relies on voluntary savings by a low-income population, who has little spare income, have limited its impact and development. Although the programme's coverage has grown in recent years, the number of people participating in it (around 1.6% of the old aged in 2020) and the volume of savings collected are low (16% of extreme poverty line).

To increase pension coverage, the government implemented a new regime in 2020 to allow workers earning less than the minimum wage to contribute to the BEPS. This regime, named “social protection floor”, allows part-time workers earning less than one minimum wage to access old-age pensions through BEPS instead of the contributory scheme, in addition to health coverage in the non-contributory regime and additional insurance cover against labour risks (for which the employer contributes at 1% of the wage). The system is mandatory for dependent and independent workers providing services and earning less than a minimum wage. Authorities are working on a system of equivalences between the contributory and BEPS systems to allow workers to save in the two systems and transfer savings from one to the other.

The potential coverage of the mandatory social protection floor, 27% of informal workers earning less than a minimum wage in 2019, is rather limited. For the rest, the social protection floor is voluntary, notably for self-employed workers who earn less than the minimum wage. One year after its implementation, only 7000 out of 9 million of potential workers have started contributing through this system (El Tiempo, 2021<sup>[61]</sup>). Having added this third element in the pension contributory scheme, operating at different contribution rates and under different rules, has however added to the complexity of the pension system. It might also produce awkward incentives, as formal workers need to pay the 4% contribution for healthcare once their wage reaches the minimum wage. At the same time, it does not solve the issue of low level of pension benefits and low coverage.

Figure 18. The pension system is characterised by low coverage and high inequality



1. OECD refers to the unweighted average of latest available data of its member countries excluding Australia, Israel and Switzerland.

2. Data refer to 2018 for Colombia. Latest available data for the remaining countries.

3. Year 2019 based on GEIH.

Source: Colpensiones; Finance Ministry of Brazil; Ministry of Economy of Argentina; OECD Pensions at a Glance: Latin America and the Caribbean (2014); OECD Pensions at a Glance 2019, OECD Stat Pension spending, OECD/IDB/The World Bank (2014), Pensions at a Glance: Latin America and the Caribbean and Fedesarrollo (2021).

### Achieving universal pension coverage

A universal minimum pension coverage would allow Colombia to achieve significant reductions in income inequalities. Universal pension coverage could be achieved by transitioning from the current complex pension system to a simpler system with three components. A first, non-contributory universal tier would provide minimum pension benefits for all residents aged 65 and above. Benefit levels would focus on reducing old-age poverty, while leaving consumption-smoothing objectives for the other components. Beyond the obvious benefits of improving fairness and social cohesion, evidence from Bolivia shows that universal non-contributory pensions helped many households to avoid poverty during a crisis such as the pandemic (Box 4).

The need to strengthen the incentives for formal job creation calls for shifting the financing burden of pensions away from (formal) labour charges to general taxation revenues. This would generate a need for mobilising additional tax revenues, which is a key priority for Colombia. As labour charges are reduced, additional tax revenues could come principally from personal income taxes, which few Colombians currently pay and whose potential progressivity is undermined by a wide array of exemptions and special regimes, and from value-added taxes whose collection is undermined by exemptions and reduced rates (see Chapter 1 of the Economic Survey of Colombia (OECD, 2022<sup>[61]</sup>)).

#### Box 4. A universal non-contributory pension programme in Bolivia

Bolivia is the only Latin American country to have established a near-universal non-contributory pension programme in 2008 (*Renta Dignidad*). This is the first component of a pension system that includes a mandatory scheme of individual accounts and a solidarity scheme. The programme disburses around USD 50 each month to individuals aged 60 or older, regardless of their income, and reaches around 28% of Bolivian households. Disbursements per beneficiary represent around 80% of the poverty line.

Evidence shows that this programme has significantly reduced poverty and increased income security (UDAPE, 2013<sup>[62]</sup>). During the pandemic, the programme was crucial for preventing a decline in food security, reduced financial insecurity and stress, with the greatest impacts on low-income households and those that experienced a large labour market shock. This evidence suggests that, during an economic crisis, an established, near-universal non-contributory pension programme can protect poor and vulnerable households against economic shocks (Bottan, Hoffmann and Vera-Cossio, 2021<sup>[63]</sup>).

The second component of the pension system would be a mandatory contributory scheme, financed by workers and employers' contributions. Benefits from this scheme would top up the benefits from the first universal component. This second component should be mandatory, as workers usually do not save enough for consumption smoothing over their lives. Mandatory contributory rates could be progressive, starting at zero for wage earners below and around the minimum wage and increasing gradually for higher wages. To ensure adequate pensions and fiscal sustainability, contribution rates could be calibrated to achieve replacement rates of at least 50% of pre-retirement earnings, close to the average OECD replacement rate for men (59%). Finally, a third tier of individual voluntary savings could complement the other two pillars.

This second component could be based on the current contributory pension system, which requires a deep reform to reduce its current excessive complexity, as analysed in a thematic chapter in the 2015 OECD Economic Assessment of Colombia (OECD, 2015<sup>[39]</sup>). This need for a comprehensive reform is also acknowledged in several reform proposals in Colombia, including by major domestic institutions such as ANIF, Colpensiones, Fedesarrollo and by Bernal, et al. (2017<sup>[64]</sup>). The track record of systems with a co-existence of parallel pay-as-you-go and capitalisation set-ups is rather weak as they add to complexity and distortions, especially when beneficiaries can arbitrage between the systems through frequent opportunistic switches. If the public defined-benefit scheme continues to exist, phasing out ill-targeted subsidies and eliminating competition between private and public schemes would be key for equity and fiscal sustainability. This would benefit from a reform that links the retirement age to life expectancy and determines benefits based on lifetime wages instead of the last ten years of wages, as the latter leads to high implicit subsidies.

An alternative would be a defined-contribution notional-account pension scheme. This would reduce fiscal uncertainty and support financial sustainability, as it would not be vulnerable to potential imbalances arising from demographic or economic changes (Lora, 2014<sup>[65]</sup>). The accounts would be "notional" in that the balances exist only on the books of the managing institution and, upon retirement, the accumulated notional capital is converted into a stream of pension payments. Notional-accounts schemes exist in five

OECD countries (Italy, Latvia, Norway, Poland and Sweden). They have proven effective in some countries for advancing reforms of pay-as-you-go systems that would face more political resistance to more traditional reforms of the defined benefit formulas, such as the use of lifetime wages for determining benefits, adjustments to reflect growing longevity and declining fertility, and incentives for older workers to remain longer in the labour force.

Maintaining the private capitalisation scheme instead would have the advantage of establishing a clear link between contributions and benefits, incentivising workers to contribute regularly. As the first component of the system is financed through general taxation, a second tier based on private capitalisation would allow for diversifying funding sources, which is generally considered an advantage (OECD, 2016<sup>[66]</sup>). However, under private capitalisation schemes, workers tend to face some uncertainty about their future pensions, as these are defined at retirement and are sensitive to current capital returns.

The Chilean pension system provides an interesting model to consider (Box 5), as it is efficient in redistributing resources to the most vulnerable while minimising the distortions on the labour market caused by funding (Morales and Olate, 2021<sup>[67]</sup>). Colombia could consider a pension reform in which a universal basic pension could be integrated with individual accounts, and where public subsidies would intervene for those with low accumulated contributions to ensure a guaranteed minimum pension. Another good example from OECD countries is the Australian pension system. It has three components: a means-tested non-contributory component (“Age Pension”) that reaches 75% of the elderly; a superannuation guarantee funded through a compulsory employer contribution to private superannuation savings fund; and a voluntary superannuation contribution and other private savings (OECD, 2021<sup>[68]</sup>). Superannuation savings are encouraged through tax incentives. The Age Pension is designed to provide a safety net for those unable to save enough through their working life and to supplement the retirement savings of others. The Superannuation system, a defined-contribution scheme, is not subject to financial sustainability issues and as the system reaches full maturity, fewer individuals will be reliant on the Age Pension safety net.

### Box 5. The Chilean pension system

Chile’s pension system has three components: a redistributive first tier, a second tier of mandatory individual accounts and a voluntary third tier. These components complement each other and act as a guaranteed minimum pension. The individual accounts system was introduced in 1981, while the redistributive tier was introduced in 2008 to expand coverage and provide a basic benefit to a larger share of the population.

In Chile, pensions are based on defined contributions, but the government provides subsidies to ensure that everyone receives a pension of at least a defined threshold, the basic solidarity pension. The basic solidarity pension is payable from the age of 65 to the poorest 60% of the population. For those without accumulated savings in the individual accounts, the minimum pension is equivalent to a third of the minimum wage (USD 150 equivalent to 60% of the poverty line). For those having at least some accumulated savings, the government provides subsidies that decline as the pension obtained through a worker’s own resources increases in value, up to another threshold, the maximum pension with solidarity support (equivalent to USD 450 or 1.2 minimum wages). The mechanism is progressive because, even if workers have the same spells of formality during their lifetimes, low-income workers would, in absolute terms, accumulate less than high-income workers and thus receive larger subsidies (UNDP, 2021<sup>[5]</sup>). Workers never lose their contributions, and pensions increase with individual savings. The system also provides women with children with an additional one-time monetary transfer at retirement age.

The Chilean system suffers from low replacement rates of around 52% for men and 29% for women when including the solidarity pillar (Morales and Olate, 2021<sup>[67]</sup>). This is partly related to the relatively low total contributions during working years. The government allocated 0.7% of GDP to subsidise

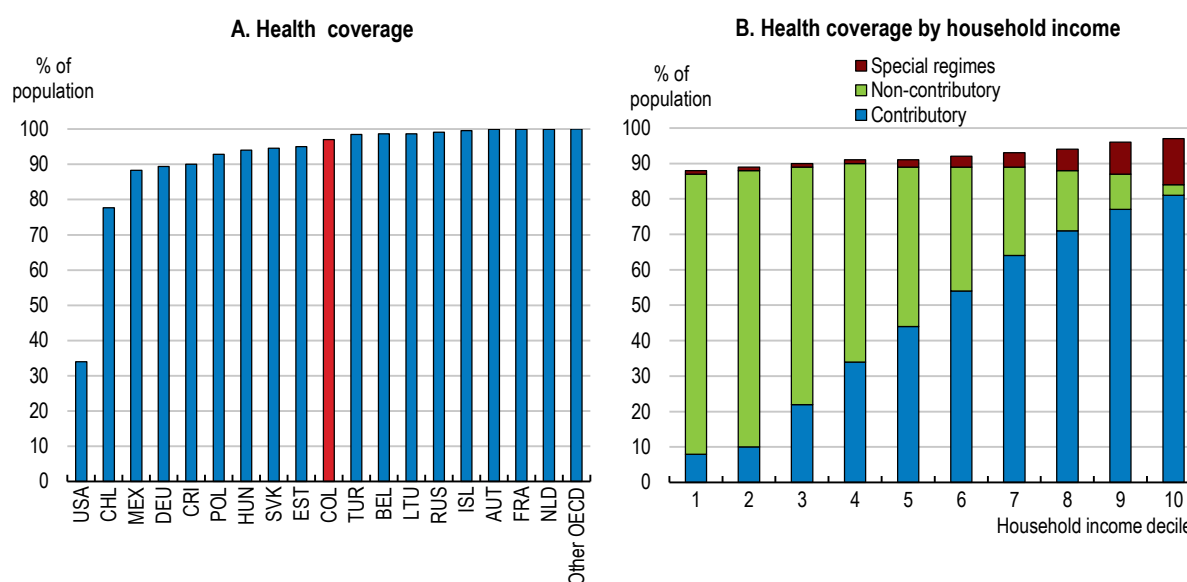
pensions for 1.5 million retirees in 2018. Recently, the authorities have increased the amounts of the solidarity pensions (by 50% for the basic pension and 34% for those receiving subsidies) in response to social unrest at the end of 2019. This is a first step towards improving the pension amounts of the lower-income population. The spending on pensions subsidies increased to 0.9% of GDP in 2020. A pension reform has been in discussion for a long time, increasing the contribution from employers, who currently do not contribute (only workers contribute 10% of their wages), to the individual accounts of workers. Under this proposed reform, the total contribution rate will be 16% of wages (OECD, 2021<sup>[69]</sup>).

## A dual public health system achieves almost universal coverage but its financing induces informality

Colombia has achieved almost universal healthcare coverage, with 97% of the population covered by the public health system in 2020. This system achieves very high financial protection, with out-of-pocket expenditures below the OECD average and the lowest in the LAC region. This is a remarkable achievement and one of the highest coverage rates in the region (Figure 19).

However, the design of the public health system, which consists of two parallel schemes, a contributory scheme for formal workers and a non-contributory scheme, incentivise informality for a number of reasons. First, the non-contributory system offers nearly the same services as the contributory one, with the exception of disability allowance and maternity leave, but is free of charge. Second, part of formal workers' healthcare contribution is used to cross-finance the non-contributory system and thus is effectively taxed away. Finally, workers face a temporary discontinuity in healthcare coverage when switching between systems because of a change in employment status. These switches can also affect the quality of care as medical files and treatment histories are usually not shared across the two systems.

**Figure 19. The health coverage is almost universal but its financing generates incentives for informality**



Source: OECD Health at a Glance, 2020 and (Fedesarrollo, 2021<sup>[26]</sup>)

### **Fostering formalisation without jeopardising universal health care coverage**

Improving incentives to formalise while keeping good health coverage would require shifting much of the financing burden of public healthcare away from formal labour charges and towards general taxation, especially for workers earning around the minimum wage where disincentives are highest.

Moving towards a single, universal health care system financed through general taxation, as opposed to social contributions paid by formal workers, would reduce by 4 percentage points the cost differential between formal and informal employment, which is currently paid by the employee. For self-employed workers, this would reduce the cost differential between formal and informal labour by 12.5 percentage points, or even more for those earning less than a minimum wage. Funding the health system by not discriminating between formal and informal workers, that is between contributing or non-contributing workers, would boost formality (Levy, 2019<sup>[55]</sup>).

A second option that could be implemented at no fiscal cost is to unify the two systems and keep the financing through labour charges, but shifting the burden of contributions more on higher income workers and less on workers earning around the minimum wage. One recent proposal is to set at zero the contribution rate for salaried or self-employed workers earning up to one minimum wage, and then increase the rate gradually up to a maximum for workers earning 25 minimum wages (Fedesarrollo, 2021<sup>[26]</sup>). This would leave the average contribution rate at around 4% of wages, implying no fiscal cost, and making contributions more progressive.

Health contributions generate even stronger disincentives to formal job creation in firms subject to the “special tax regimes”. This tax regime features an additional 8.5% employer health contribution, as the regime was not included in the 2012 reform due to its exemption from corporate taxes. Reducing healthcare-related labour charges and the associated distortions is particularly important for these firms, which account for 16% of all formal employment, mainly in the sectors of education and health. Moreover, as these sectors employ 26% of female workers, reforming them would help to improve gender equality.

### **Family compensation funds could be reorganised to fight informality**

In addition to pension and health contributions, employers pay a 4% contribution to finance the family compensation funds (*Cajas de Compensación Familiar*), which offer a wide range of services from housing, education, and training programmes to sports and entertainment. Family compensation funds have increasingly been mandated by the government to provide benefits and services to non-affiliates. Still, their financing continues to rely uniquely on formal-sector labour charges (OECD, 2016<sup>[38]</sup>). Moreover, many of the funds' services are located in the regional capitals and are unavailable to formal employees living in smaller cities or the periphery. As a result, an increasing part of the contributions to the family compensation funds is in reality a tax on formal labour that is used to finance social policy programmes for which formal workers are not eligible. For most formal workers, the benefits perceived fall short of the costs, thus incentivising informality (Levy, 2019<sup>[55]</sup>).

Services currently provided by Family Compensation Funds could undergo a comprehensive cost-benefit and impact evaluation analysis to determine which services offer sufficient value for money to be maintained, particularly in light of other changes in social benefits. These services could then be made available to individuals regardless of their labour status, and their offer extended across all the country. The substantial variation in the quality of the services offered by the different family compensation funds currently exacerbates inequalities.

As with pensions, the unintended consequences of non-wage labour charges on formal job creation call for a broader approach to raising revenues for financing general social services and benefits, including the benefits provided by Family Compensation Funds. A shift towards financing those services deemed worth

maintaining through general tax revenues can subtract 4 percentage points from labour charges and significantly strengthen the incentives for formal job creation.

If this proves to be politically too difficult, a temporary improvement would be to transform the current flat contribution rate into a progressive rate that spares out low-income workers, for whom formalisation incentives are most relevant. A recent revenue-neutral proposal suggests that the contribution should be set at zero up to the minimum wage, and then rise for higher wages, though remaining low for salaries below two minimum wages (Fedesarrollo, 2021<sup>[26]</sup>). In this case, a centralised contribution collection system would transfer resources to the funds based on the services actually provided to low-wage members and on the number of members, considering the quality of services delivered. This would be a fundamental first step towards ensuring the progressivity of the contribution scheme to the funds and strengthening the government's position on the use of resources.

## Strengthening protection against poverty

### ***Social assistance programmes have low coverage***

Due to the low coverage of social insurance contributory schemes, cash transfers programmes aim at protecting those left behind by social security schemes, typically informal workers in poor households. Among poor households, 83% of their employed members had worked informally in 2019. The main conditional cash transfer programmes (Table 4) is *Familias en Acción* (Families in Action), which targets poor households; *Jóvenes en Acción* (Youth in Action), which provides incentives to young people for entering and completing higher education; and *Colombia Mayor*, the non-contributory pension scheme described above.

**Table 4. Main pre-COVID conditional cash transfer programmes in Colombia**

	<b>Familias en Acción</b>	<b>Jóvenes en Acción</b>
Target population	Households below the poverty line, conflict-displaced and indigenous families with children under the age of 18	Vulnerable young students (16-24 years-old)
Conditionality	Education attendance and health controls in children	Successful continuation of studies in post-secondary education
Benefits	Varies depending on the number of children and their level of education. On average a household receives COL 145 thousand (USD 56) every two months, or the monthly equivalent of 22% of the poverty line	Contributions to tuition fees and direct cash payments. On average COL 365 thousand (USD 141)
Coverage	2.3 million households; 3.7 million children and teenagers in 2019	270,000 young people in 2019
Budget	Joint annual cost of COL 2.4 trillion (0.3% of GDP).	
Administration	Colombian Department for Social Prosperity	

Source: OECD based on Social Prosperity Department Management Report (2019).

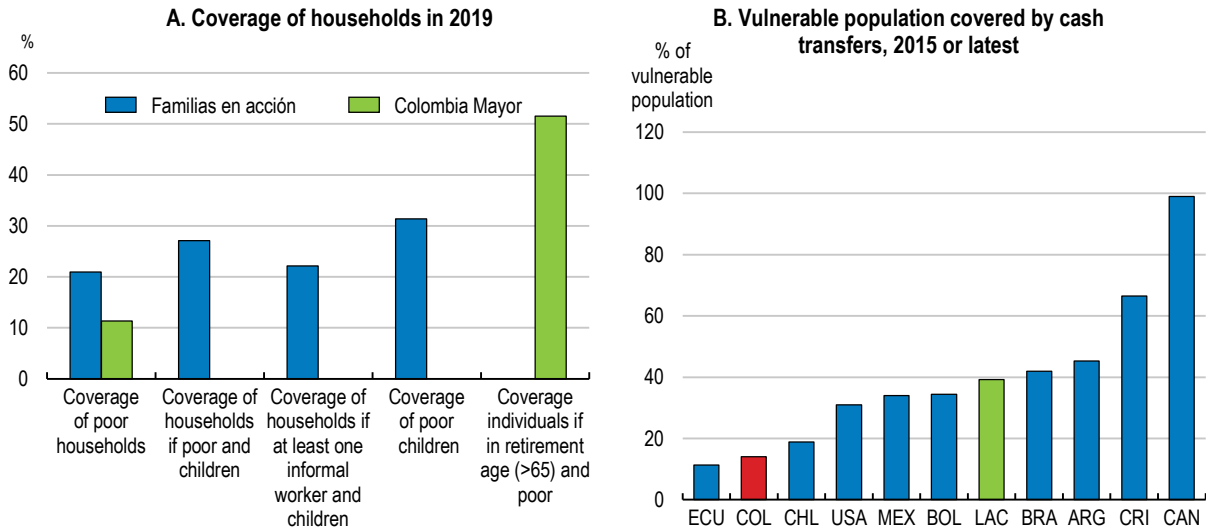
Evaluations suggest that these social programmes have contributed to reducing poverty and raising well-being of households. *Familias en Acción* has had a significant impact on educational attainment, nutrition and other dimensions of life quality (Angulo, 2016<sup>[70]</sup>), in addition to reducing extreme poverty, poverty and multidimensional poverty (DNP, 2008<sup>[71]</sup>; DPS, 2020<sup>[72]</sup>). On the other hand, some evidence suggests that being a beneficiary of *Familias en Acción* may increase the probability of being informal, since having a job in the formal sector increases individual income and reduces the probability of being eligible (Saavedra-Caballero and Ospina Londoño, 2018<sup>[73]</sup>). *Jóvenes en Acción* has had positive effects on earnings and employment prospects, including formality, in the short and in the long run, and increased educational attainment for participants and their relatives (Attanasio, Kugler and Meghir, 2011<sup>[74]</sup>; Attanasio et al., 2017<sup>[75]</sup>; Kugler et al., 2020<sup>[76]</sup>).

The coverage of cash transfers programmes is low, leaving many poor households without any support (Figure 20). 52% of poor households do not receive any support from the state. Only 13% of households with all his members working informally received support through *Familias en Acción* in 2019. Insufficient programme resources are the main reason for this low coverage. In 2019, only 2.7 million out of 4.3 million poor families were targeted. The coverage is similar in rural and urban areas, but poverty is higher in rural areas, although less-educated households in remote areas are more difficult to reach. Moreover, the system lacks policies to protect the middle class from temporary shocks that may affect their income or assets.

Benefit levels of social assistance transfers are low. *Familias en Acción* provides financial support equivalent to less than 5% of average monthly GDP per capita in 2019 (USD 23 or 22% of the poverty line), one of the lowest in emerging markets (ILO, 2017<sup>[77]</sup>), where on average is 15% (Gentilini et al., 2021<sup>[78]</sup>).

Other social assistance programmes are designed to support productive inclusion and entrepreneurship, or to cover specific needs of certain population groups. The design of these programmes aims to cover all the life stages and the conditions necessary for a person or family to enter the labour market, self-generate income and improve their life quality. However, there is a lack of coordination in these efforts, a lack of comprehensiveness in the strategies defined to cover different risks, which reduces the efficiency of the social assistance system. Aware of these challenges, authorities set up an equity roundtable (*Mesa de equidad*) in 2019 formed by the president and all the ministries, to coordinate and prioritise the offer of social programmes among all institutions offering social services and the implementation of the poverty alleviation route. In 2020, the management of all cash transfers programmes was centralised under a single public entity, which is a welcome step to reduce fragmentation.

**Figure 20. Cash transfers programmes leave many poor households without any support**



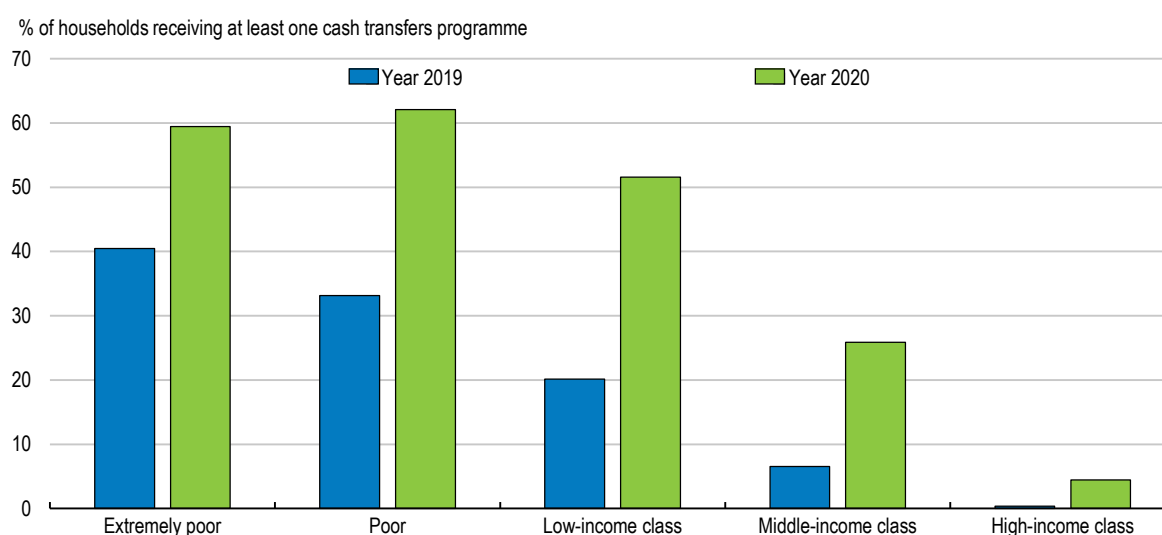
Note: in Panel B, vulnerable population is defined as (a) all children; (b) persons of working age not contributing to a social insurance scheme or receiving contributory benefits; and (c) persons above retirement age not receiving contributory benefits (pensions). Social assistance is defined as all forms of non-contributory cash transfers financed from general taxation or other sources (other than social insurance).

Source: OECD calculations using GEIH 2019 and ILO, World Social Protection Database.

### The COVID-19 pandemic accelerated some important changes in social policy

In response to the pandemic, the authorities launched a comprehensive social response to protect the poor and vulnerable (Figure 21). Policies included a series of additional emergency cash transfers through the pre-existing programmes (*Colombia Mayor*, *Jóvenes en Acción*, and *Familias en Acción*) and two new programmes: *Ingreso Solidario* (Solidarity Income) and a VAT compensation programme. In addition, discounts on the payment of basic services have been implemented, as well as other budgetary and financial measures in order to protect household incomes. Some local governments also implemented support programmes for vulnerable households, such as Bogotá, Bucaramanga or Medellín. Spending in social emergency programmes made through the emergency mitigation fund was stepped up by 0.8% of GDP in 2020 and 0.5% in 2021 (Ministry of Finance, 2021<sup>[79]</sup>).

**Figure 21. The COVID-19 pandemic induced a comprehensive social response to protect the most in need**

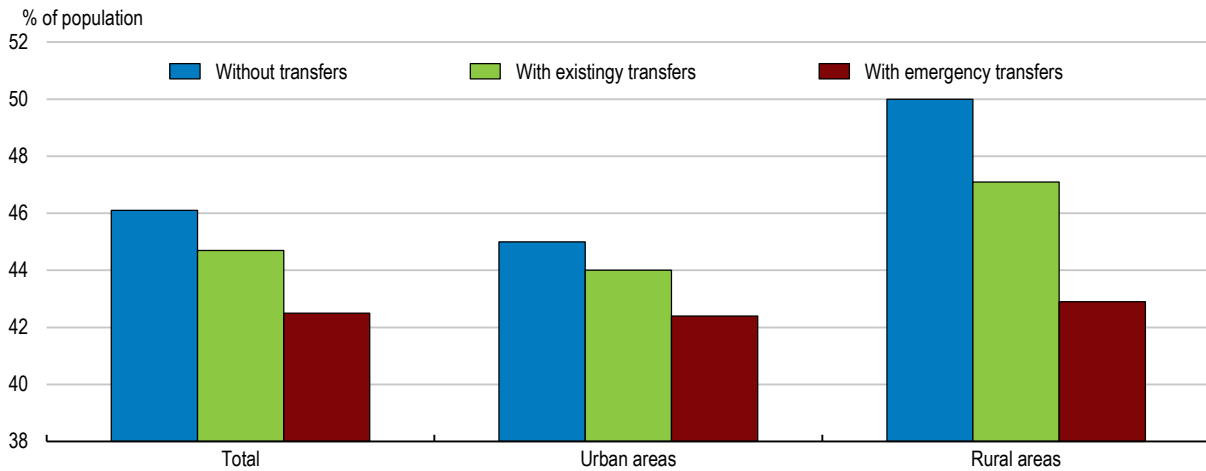


Note: Extremely poor households are households with per capita household income below the extreme poverty line; poor are households with per capita household income between the extreme poverty and the poverty line; the low-income class comprises households with per capita household income between the poverty line and 2 poverty lines; the middle-income class comprises households with per capita household income between 2 and 10 poverty lines, and the upper-income are households with per capita income of more 10 poverty lines.

Source: OECD calculations using GEIH 2019 and 2020, DANE data.

The social response was key to mitigate the impact of the COVID-19 pandemic on household incomes and poverty (Figure 22). By expanding the number of beneficiaries and increasing the level of benefits, social programmes supported household incomes, including for some well-off households. In particular, this support completely offset the effect of the crisis on households in rural areas, who saw their real income grow. The emergency transfers mitigated the increase in poverty nationally by 2.2 percentage points during 2020.

Figure 22. Emergency monetary transfers mitigated the COVID-19 impact on poverty



Note: Based on the national definition of poverty.  
Source: DANE

The main existing programmes saw benefits and coverage increase as households received extraordinary payments through existing programmes during 2020. The eligibility threshold for *Familias en Acción* was expanded, bringing in many households identified as economically vulnerable. Families previously excluded over failure to comply with the requirements were quickly re-enrolled. The programme also temporarily waived its usual conditionality, as the lockdown made these conditions far more difficult to meet. *Jóvenes en Acción* widened its age coverage to reach new beneficiaries (now between 14 and 28 years old). Though this move was planned prior to the pandemic, its implementation was fast-tracked, and officials plan a further expansion that will bring in an additional 200,000 young people.

A new cash transfer programme called *Ingreso Solidario* was designed and implemented in record time to support informal workers. The new programme provides a non-conditional cash transfer to poor and low-income households that are not beneficiaries of pre-existing social assistance programmes. The programme assisted up to 3 million households with COL 160 thousand (USD 40, around half of the poverty line in 2020) from March 2020. The programme was designed initially for three months but then was extended several times. In the fiscal reform of 2021, the authorities extended it further until end of 2022, increasing coverage to 3.6 million individuals in extreme poverty, reaching 4.1 million households. In 2022, *Ingreso Solidario* is expected to cost COP 7.2 trillion (around 0.6% of GDP) and to reduce poverty to pre-pandemic levels, according to Government estimates. From July 2022 onwards, eligibility criteria will be tightened, as the benefit needs to consider the size and the degree of vulnerability of the household.

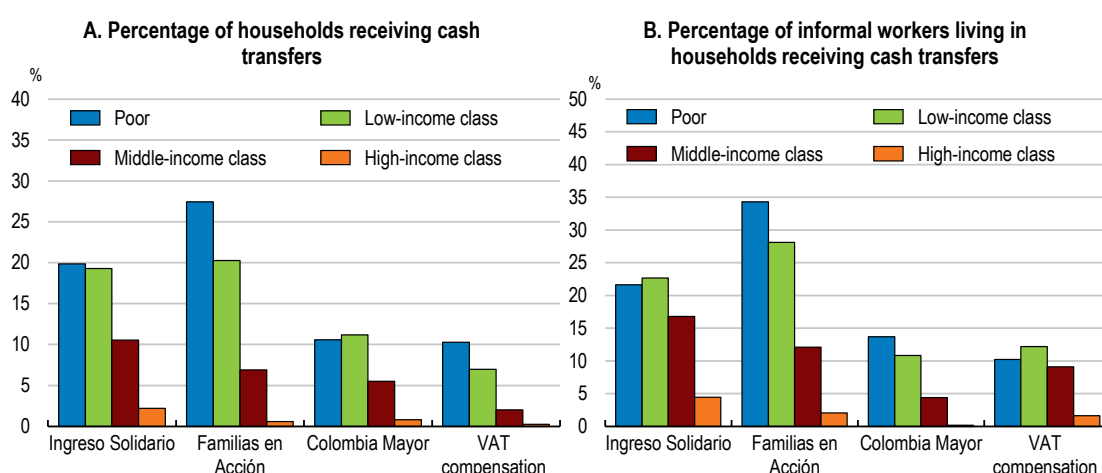
A key innovation of *Ingreso Solidario* is its use of bank accounts and mobile wallets for benefit disbursement, which helped to promote financial inclusion (Gallego et al., 2021<sup>[80]</sup>). The use of mobile wallets more than doubled during 2020 and 2.6 million beneficiaries of cash transfers received their payments through digital channels, 21% more than in 2019. Building on this progress can translate into increased opportunities for savings, access to affordable credit and other financial services for many households who, prior to the programme, were outside social safety nets and at the margins of the financial system. This would require providing access to financial education to ensure that access translates into an effective and safe usage of financial services.

According to early evaluations, *Ingreso Solidario* had positive effects on household income, food consumption and education (Gallego et al., 2021<sup>[80]</sup>). The programme increased incomes for those most affected by the pandemic, without generating disincentives to labour market participation. It also increased households' expenditure on education and the time children dedicated to school activities.

Another new means-tested unconditional cash transfer programme, called the VAT compensation for vulnerable households, was introduced in March 2020 to make VAT less regressive. A pilot programme for 100,000 families was originally planned to be implemented during 2020, but with the pandemic, its rollout was accelerated and expanded to one million households. The transfer consists of COP 75 000 (USD 20 or 55% of the extreme poverty line in 2019) distributed every 5-8 weeks to beneficiaries of two existing social welfare programmes for low-income families and elderly: 700,000 households in *Familias en Acción* and 300,000 households enrolled in *Colombia Mayor*. Early evaluations suggest that the transfer has had positive (albeit modest) effects on household welfare measures such as financial health and access to food (Londoño-Vélez and Querubín, 2020<sup>[81]</sup>).

The COVID-19 response in Colombia marks an inflection point for Colombia and the future of cash benefits. The crisis response represents an opportunity to consolidate access and increase coverage of social programmes for the most vulnerable. However, despite the recent improvements, the coverage of households receiving cash transfers remains low (Figure 23), and *Ingreso Solidario* covers only around 20% of informal workers (Blofield, Lustig and Trasberg, 2021<sup>[82]</sup>), leaving many unprotected.

**Figure 23. The coverage of cash-transfers programmes remains low**



Note: Statistics cover months April to December 2020.

Source: OECD calculations using GEIH 2020 and microdata from administrative records from DANE.

### ***From emergency to permanent support: a single cash benefit programme for the poor***

Protection against poverty and income losses could be improved by unifying and integrating existing cash transfers into a single programme. One option would be to establish a guaranteed-minimum-income scheme for the population aged below 65, which would complement the incomes of those living in poverty. This programme could become the prime instrument for fighting poverty and provide a backstop to those who lose their livelihoods temporarily in the case of dismissal or income loss. Other social programmes that aim at improving household assets and human capital could complement it.

A guaranteed minimum income is a periodic cash transfer that supplements the income received by poor households to reach a certain minimum income level. Financed from general taxation revenues, such scheme could build on existing conditional and un-conditional cash transfers for the vulnerable and poor (*Familias en Acción* and *Ingreso Solidario*). The amount given to each household would be contingent on

the household's own income before the transfer (both from formal and informal jobs) and assets. If the household has no income, the transfer would be made for the entire minimum income. The cash transfer would decrease gradually as household income increases, until reaching the point in which the household does not receive any transfer. Changes in *Ingreso Solidario* expected from July 2022 go in this direction, as the amount of the benefit will consider the size and degree of vulnerability of the household. Such benefit is different from the existing cash transfers that provide a fixed level of cash transfer to poor households independent of the household or individual income (usually called basic income schemes). It is also different from the Universal Basic Income, which grants an identical amount to every citizen, regardless of his or her income (Box 6).

### Box 6. The pros and cons of a Universal Basic Income

A universal basic income (UBI) is an unconditional cash transfer granted at regular intervals to all residents, regardless of their wealth, earnings or employment status. The main advantage of such a programme is that it is simple to implement as no conditions or requirements are applied.

The main disadvantage of an UBI is that it could be extremely costly. An unconditional payment to everyone at meaningful but fiscally realistic levels would require strong tax rises and possibly reductions in existing benefits, and would not often be an effective tool for reducing income poverty (OECD, 2017<sup>[83]</sup>). Some disadvantaged groups would lose out when existing benefits (usually all other social programmes) are replaced by a universal basic income, illustrating the downsides of social protection without any form of targeting at all.

The Universal Basic Income is fiscally unviable in Colombia and can be controversial by guaranteeing transfers to high-income earners. Setting the monetary transfer to the extreme poverty line to every household member to assure that the most basic needs of all Colombians are satisfied even if no other income is available, would have a cost of 8.7% of GDP in 2020. This UBI level still would leave many households in poverty, especially those at old age not receiving any pensions or the unemployed or inactive. If the transfer were set to the poverty line, the cost would be 20% of GDP, almost equivalent to the tax revenues in Colombia (19.7% of GDP in 2019).

The programme would deliver unconditional cash transfers to every adult living in a poor household, in line with the *Ingreso Solidario* programme. When children are part of the household, the cash transfer can be conditional on human capital accumulation and desired health behaviours, as in the *Familias en Acción* programme, to generate incentives for investing in education and health. In line with the current *Familias en Acción* programme, benefit levels can take into account children's age and educational level.

A large body of evidence suggests that unconditional cash transfers can achieve significant reductions in poverty. These cash transfers can promote credit access, better eating habits, better school attendance, better academic results, better cognitive development, reduction of domestic violence, and female empowerment (Banerjee, Niehaus and Suri, 2019<sup>[84]</sup>). Evidence on the impact of cash transfers on labour participation and formal employment are mixed. While some evidence suggests that cash transfers do not discourage - and in some cases even encourage - labour participation by beneficiaries (Banerjee et al., 2017<sup>[85]</sup>), other evidence from the region suggests that cash transfers can decrease incentives to participate in formal employment (Bergolo and Cruces, 2021<sup>[86]</sup>). This is usually linked to abrupt benefit withdrawals for beneficiaries who find a job or earn more, which can imply high implicit tax rates for workers who lose the transfer if they earn additional income that lifts them above the threshold stipulated in the targeting mechanism to qualify.

To maintain the incentives to (formal) work, it is important that the programme be designed so that when a beneficiary moves into employment the value of the transfer forgone be smaller than the additional work income. This is important to strengthen work incentives and graduation from the programme, as otherwise

beneficiaries might be reluctant to take up work for fear of losing their benefit. The design could include a phase in which for every additional peso earned by the household or individual, only some part of the self-declared additional earnings, which includes both formal and informal earnings, are taken into account to calculate the cash benefit, until gradually reaching a point where no subsidy is available at all (Reyes, 2020<sup>[87]</sup>). Preliminary and ex-post impact assessments should be systematically conducted to evaluate the effects on (formal) labour force participation and adjust the design if necessary. Spain introduced a similar measure in 2020 with the new Minimum Subsistence Income, a guaranteed-minimum-income scheme. Adults without jobs should register with the public employment services to receive the Minimum Subsistence Income, and when they find a job, part of their wage will be temporarily exempted from the calculation of the benefit. For those adults already working, more hours worked and better jobs are encouraged, and for each extra income they earn the benefit is reduced by a smaller amount.

The level of the guaranteed minimum income should take into account at least the poverty line to ensure no household is left in poverty. By calculating the cash transfer as the difference between the per capita household income level and the poverty line, the programme would ensure that no household or individual is left in poverty. By choosing the national definition of the poverty line, the minimum income also adapts to the costs of living in the different territories and adjusts in time to changes in prices. Hence, the most efficient way to fight poverty would be to establish the minimum guaranteed income equivalent to at least the poverty line, while eliminating all other subsidies or tax exemptions. Unifying all income support in one programme would be more efficient and transparent, which could increase support for the reform.

The programme should be accompanied by strengthening state capacities to examine the veracity of the information and provide incentives for individuals to report their income and wealth truthfully. Local networks and social assistants can play a key role by checking the veracity of self-reported information. It is important to design incentives to encourage citizen responsibility, for example by implementing some kind of penalty for those who provide inaccurate or false information (Andes University, 2020<sup>[88]</sup>).

An almost equivalent alternative to this type of guaranteed minimum income would be a Negative Income Tax or Earned Income Tax Credit. In such a programme, the subsidy decreases gradually as the individual earns more from work, until the person eventually begins to be taxed on his or her earned income. Evidence shows that the Earned Income Tax Credit in the United States has raised labour force participation, particularly for single mothers, a group that previously faced the greatest disincentive to work (Hoynes and Patel, 2017<sup>[89]</sup>). There are also positive effects on poverty reduction, as the programme rewards work and supplements the income of low-wage workers. These programmes have also decreased informal employment in developing countries (Gunter, 2013<sup>[90]</sup>). The salient distinction between a guaranteed-minimum-income and the negative income tax is that the latter is financed directly through a progressive income tax. Another important difference is that some part of the cash transfers can be conditional on educational and health behaviours, as proposed here. Finally, in the case of cash transfers, a network of social workers is in charge of verifying and constantly improving the database of poor households while raising awareness of available benefits. Under a negative income tax, tax inspectors do this work instead, which might make their work more difficult.

### ***The targeting of the main social programmes can be further improved***

Colombia has different targeting instruments for social policy. On the one hand, the Identification System of Potential Beneficiaries (*Sistema de Identificación de Potenciales Beneficiarios de Programas Sociales - Sisbén*) is the main targeting instrument for social programmes. *Sisbén* is a multi-dimensional proxy means test, implemented through a national survey of income and assets that determines if one household qualifies for most social support programmes, including anti-poverty programmes and the non-contributory health regime. On the other hand, some subsidies are currently targeted according to an older instrument called the “socio-economic stratification”. This is a classification of residential properties, which aims to mimic economic vulnerability based on the dwellings’ characteristics and their urban/rural settings.

However, this classification is out to date and more than 90% of dwellings are classified as vulnerable, thus failing to target poor or vulnerable households. This is the case of public services subsidies (energy, housing, telecommunication and water and basic sanitation), for which in 2017, 81% of the residential public services subsidies and 93% of the housing subsidies went to two highest income quintiles (Table 1).

To improve the targeting of social spending, a single targeting mechanism would be essential. Using *Sisbén* as the single targeting mechanism, merging it with updated information from the socio-economic stratification, would help to improve targeting of social policy. For example, in a welcome move, recently the authorities moved away from socio-economic stratification to *Sisbén* to select the beneficiaries of the new programme of free tuition for tertiary education (*Matrícula Cero*), planned for 2023.

*Sisbén* has recently undergone a deep transformation that improved the targeting of social policy. In 2017, the Government initiated a comprehensive census (*Sisbén IV*), aiming to improve the quality and timeliness of the information in the registry while making it less vulnerable to manipulation and fraud (Conpes, 2016<sup>[91]</sup>). Additionally, in 2020, the authorities implemented an ambitious process to consolidate and expand a social registry to integrate previous versions of *Sisbén* with the new one and other administrative databases, including the civil registry, social security, and financial sector supervisor, thus increasing interoperability. The social registry is geo-referenced and aims at a more frequent updating of information and a shorter response time for citizens by moving to a regularly updated social registry (Conpes, 2016<sup>[91]</sup>). The fast deployment of *Ingreso Solidario* was made possible thanks to the development of this social registry, which allowed, for the first time, low-income and vulnerable households not receiving benefits from any social programme to be identified together with their contact details and bank accounts. Individuals did not need to apply for the benefits as public agencies contacted them individually, mainly through SMS messages. This new social registry is expected to deliver significant benefits in terms of the impact on social spending, including better targeting the poorest and a faster response time particularly in the event of shocks.

Sustained progress on this social registry could be achieved by merging additional administrative databases and increasing further interoperability among them, and would benefit the design and implementation of social policy. Ideally, the social information system would incorporate information on the entire life cycle of individuals from birth (with information from the civil registry), following their life path and that of their household (health, work, education and other characteristics), thereby incorporating social registries, as well as other information, such as all public-sector provision of social entitlements.

The *Sisbén* registry has expanded its coverage and contains information on 43 million individuals, covering 80% of all poor (Table 5). Efforts to expand coverage further aim at achieving a 90% coverage of all poor by the end of 2021. These efforts should continue to cover the whole population as it is key for providing better socioeconomic information for designing and implementing new social programmes and entitlements as well as for monitoring existing ones (Berner and Van Hemelryck, 2021<sup>[92]</sup>).

**Table 5. *Sisbén* coverage has improved**

		People (millions)	
		<i>Sisbén</i> III	<i>Sisbén</i> IV (December-2021)
Covered by <i>Sisbén</i> IV	Extreme poverty	4.6	7.7
	Moderate poverty	7.0	10.0
In poverty (2021)		19.7	19.7
<b><i>Sisbén</i> coverage of people in poverty (%)</b>		<b>58.7</b>	<b>89.2</b>
Vulnerable people			7.7
Not poor nor vulnerable			2.4
<b><i>Sisbén</i> coverage of total population (%)</b>			<b>55</b>

Note: Poverty for 2021 is estimated by DNP.

Source: OECD Tax Expenditures Report of Colombia (2021) and DNP

The targeting method has also been updated and now takes into account the income generating capacity of households based on their socio-economic conditions and considering regional and local specificities. The current targeting method measures the structural situation of households, that is, the household long-term income level. However, to enhance the capacity of social programmes to respond to crisis, it would be important to continue improving the real-time nature of the database and to develop a targeting instrument that captures short-term or sudden changes in individuals and households' income status (Berner and Van Hemelryck, 2021<sup>[92]</sup>). For example, Brazil uses self-declared per capita household income to deliver *Bolsa Família* benefits, its main cash transfer programme, and this has shown to be a good targeting instrument (WWP, 2017<sup>[93]</sup>). Another example is Chile, which developed a targeting instrument for the delivery of pandemic-related emergency measures, even if not finally implemented, based on the household income in the last month before applying to the emergency benefit. This requires fast crosschecks of income data with other data sources and a high interoperability between registries to reflect immediately changes in labour market status or household income. However, it would enable social policy to protect those facing income shocks even if not living in structural poverty.

Strengthening local networks and social assistants' networks could be beneficial to make updates, search for other potential beneficiaries not yet included and check on self-reported entries in a more timely and accurate manner. Territorial entities are in charge of updating the information feeding *Sisbén*. However, response times, even if they have improved, are long. In other countries, means-testing mechanisms rely on granular local networks of social assistants or civil servants, for example Brazil's CRAS. These local contact points collect timely information through regular visits and/or checks upon self-reported entries. In Costa Rica, the programme Bridge to Development (*Puente al Desarrollo*) involves an active participation of social workers and satellite images to increase the take-up of social assistance programmes.

Implementing a universal income tax declaration and merging it with the social registry would make available a more reliable information on income and allow for better crosschecking of income data. Tax declarations are typically used in advanced OECD countries for the targeting of social benefits. Although many Colombians do not pay taxes, filling a tax declaration could increase awareness and help strengthen a culture of tax compliance. An example of such a system in the region is the National Tax and Social Identification System in Argentina that coordinates tax, social, wealth and consumption data thus contributing to an efficient targeting and monitoring of social benefits (OECD, 2019<sup>[94]</sup>). The main function of this system is to achieve the identification of people, through the co-ordination of the exchange of the numerous databases that exist at the national, provincial and municipal levels.

This improved *Sisbén* could be an efficient instrument to implement the new single cash benefit programme proposed in the previous subsection by helping define the amount needed to supplement each household's income up to the guaranteed-minimum-income. All the information from *Sisbén*, including self-declared income, money in the financial system, household characteristics, and all available validity and cross checks of information done under this social registry would be used to determine the transfers to be done at the household level.

## Protection against the risk of job loss is patchy

Risks arising from the loss of employment are covered through different instruments for formal workers in Colombia. The first is the severance pay, consisting of a fixed one-off payment paid by the employer to the worker at dismissal. The amount depends on the worker' salary, ranging between a month and a year. The second instrument is an unemployment protection scheme based on individual accounts, financed from individual savings accumulated by formal workers. The last instrument is an unemployment insurance benefit granted to formal workers who lose their job to partially replace the lost wages.

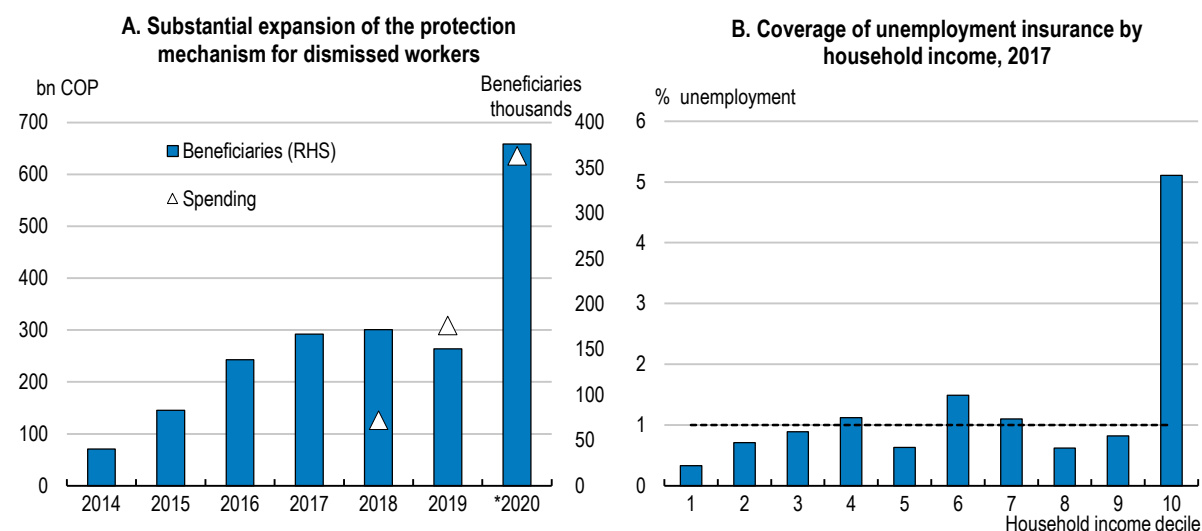
The individual unemployment savings account system fails to provide proper income protection to unemployed workers. Over the years, the system has lost its purpose of income protection in the event of

unemployment as workers can withdraw the savings before job loss for a variety of reasons – for instance, to finance education, purchase a home or renovate their dwelling. In 2017, two thirds of the funds were withdrawn for reasons other than unemployment (ACRIP and Fedesarrollo, 2018<sup>[95]</sup>). In March 2021, there were around 9 million people affiliated to individual severance accounts (*cesantías*), corresponding to 95% of all formal salaried workers. Only 8% of all self-employed workers, however, contribute to this system. To redirect the system of individual severance accounts towards income support provision in the case of unemployment, in 2013 the government introduced a bonus proportional to the savings amount for those who keep at least 10% of their savings in the fund, 25% for those who earn more than twice the minimum wage (OECD, 2016<sup>[38]</sup>).

As a complement to the individual savings accounts, an unemployment insurance (*Mecanismo de protección al cesante*) was established in 2013, financed through the Family Compensation Funds. This unemployment insurance is privately funded, decentralised, and has limited resources. The system ensures the continuation of health and pension contributions for six months, income-support for families with children, and provides access to public employment services and vocational training and employment offers.

Although the unemployment insurance mechanism has substantially expanded since its introduction (Figure 24, Panel A), most unemployed people do not qualify, either because they were informal workers or because their employer did not contribute long enough. It only covers formal workers whose employer contributed 4% of the payroll to a family compensation fund for at least 12 months in the three years before the job loss (24 months for self-employed workers). This explains the poor targeting of this protection mechanism (Figure 24, Panel B): 82% of resources go to non-poor households and 53% to the two highest income quintiles (Fedesarrollo, 2021<sup>[26]</sup>).

**Figure 24. Coverage of unemployment insurance is low and those that need it the most have no access**



Note: The year 2020 was an atypical year due to the pandemic and given that the resources of the 4% of the family subsidy system were exhausted, the National Government did transfers from the general budget.

Source: (Fedesarrollo, 2021<sup>[26]</sup>)

The unemployment insurance proved to be insufficient for compensating formal workers for income losses during the pandemic. During the lockdowns, the government implemented a transfer equivalent to two minimum wages over a period of three months for those earning less than four minimum wages. By late June 2020, nearly 800,000 applications for unemployment insurance had been received, but only 109,000

people had actually been granted insurance. By December 2020, slightly over 400,000 unemployment subsidies were approved. Given the high number of newly unemployed workers on the waiting list, the government injected the unemployment protection mechanism with resources from the general budget and in early June authorised some of these individuals to be included in a new cash transfer programme designed for vulnerable workers, *Ingreso Solidario* (Blofield, Lustig and Trasberg, 2021<sup>[82]</sup>).

### ***Improving unemployment insurance***

The implementation of the single cash benefit programme to the poor, discussed above, could provide a backstop for those losing their job or income and could serve as a universal pillar of the unemployment insurance system. For workers earning the minimum wage, a cash benefit equivalent to the poverty line would imply a 40% replacement rate. The implementation can only be possible if the targeting system and *Sisbén* are made more agile and able to detect or at least verify changes in workers' labour market status and income without long delays.

Beneficiaries would be automatically registered with the labour market intermediation services to receive support for the search for employment and training. As part of the strategy to increase formalisation and productivity, and as recommended in previous Economic Surveys of Colombia (OCDE, 2019<sup>[34]</sup>), strengthening the institutional capacity of the Public Employment Service to improve the quality of services provided and matches between job seekers and vacancies will be key. Improving quality and relevance of job training will also be essential. In Colombia, the skills gap is wide and weaknesses of the job training system affect its effectiveness to bridge this gap. Around 50% of firms consider inadequate training as a very serious constraint to their operations (Andrián and Hirs, 2020<sup>[96]</sup>). Moving towards an effective governance of the training system with a clear national regulatory framework and a clear national plan while reducing the fragmentation in the course offering would help. A national system of quality assurance using unified criteria for all suppliers would help increase transparency and quality of the system, and a first step in this direction has been taken through the National Qualifications System (OECD, 2019<sup>[7]</sup>).

The cash benefit programme designed in this way would have several benefits. Most importantly, it would allow reducing social contributions while increasing the incentives for formality and guaranteeing coverage of social insurance, mostly during unemployment, disability or maternity. It would also allow job seekers to look for jobs without the immediate concern for minimum survival. Doing so, the programme would increase workers' bargaining power and the probability of obtaining a fair wages without relying on the minimum wage, which generates distortions against the generation of formal work.

As this pillar is designed to avoid poverty, a second contributory pillar could exist to provide consumption smoothing and maintain living standards for workers above the minimum wage. This second pillar would provide top-up benefits and be based on existing individual unemployment accounts financed from individual savings accumulated by workers, as to achieve a replacement rate more in line with other OECD countries (60% on average).

One advantage of individual unemployment savings accounts over other unemployment insurance systems is that they significantly limit the risk of moral hazard (ILO, 2019<sup>[97]</sup>). By allowing workers to run down their personal savings during periods of unemployment, workers internalise the cost of unemployment benefits, thus strengthening the incentives for the employed to prevent job loss and for the unemployed to return to work quickly. Individual unemployment savings accounts can also strengthen incentives for formal work since social security contributions are perceived less as a tax on labour and more as a delayed payment (OECD, 2018<sup>[98]</sup>). The disadvantage of individual unemployment savings account system is that individuals with lower contributory capacity, who also tend to have a higher risk of unemployment, generally tend to receive insufficient protection. This is why these systems are often supplemented to support individuals with lower contributory capacity. The guaranteed-minimum-income programme discussed above would act as the minimum protection floor when unemployed.

The current unemployment individual accounts system would need improvements to regain its income protection role during periods of unemployment. An important first step is to restrict withdrawals to dismissals. If the worker does not entirely draw the contributions accumulated during the employment career, any surplus could be credited in the form of pension entitlements upon retirement, mimicking the current practice in Chile. In the Chilean system, workers need to fulfil certain requirements to withdraw money from the unemployment individual savings accounts system related to number of months that they have been contributing (Sehnbruch, Carranza and Prieto, 2018<sup>[99]</sup>). The contributions to the severance accounts can be limited to a maximum number of years to allow for a sufficient accumulation of resources to cover the eventuality of unemployment. In Chile, this maximum is 11 years.

As the benefits received from the severance accounts provide top-ups to the guaranteed-minimum-income programme, contributions to the individual accounts could be substantially reduced. Employers are currently mandated to contribute to the employee's severance account with around 8.5% of the payroll and 12% of interest on the annual amount of the severance pay. These contribution rates are high even compared to advanced countries (ILO, 2019<sup>[97]</sup>). In Chile, contribution rates for a similar scheme are of 3% of wages (financed by the employer in case of a fixed term contract or 0.6% by employees and 2.4% by employers in case of a permanent contract).

## Expanding social protection carries wide benefits at an affordable cost

### ***An estimation of the fiscal costs and the impact on poverty and inequality***

Illustrative simulations based on microdata from the Colombian household survey (GEIH) allow for comparing different reforms of the social protection in Colombia, through estimates of likely fiscal costs and the impact on poverty and inequality. The cost estimates can only provide an upper bound in the short run, as they are based on the current status quo and do not account for the medium-term benefits from improvements in labour incomes, inequality and productivity. The latter are notoriously hard to estimate in a reliable way, but they are the ultimate reason why such a reform should be undertaken.

A basic, non-contributory, universal pension for all those aged 65 and above would cost 1.6% of GDP in 2020 (Table 6). The corresponding benefit would amount to a 4-fold increase vis-à-vis the current non-contributory Colombia Mayor programme and imply a replacement rate of around 50% for a minimum-wage earner. Taking into account demographics, and maintaining the benefit at this level, the cost of the universal basic pension would peak at 2.6% of GDP in 2030, fall to about 1.8% of GDP in 2060 and 0.7% of GDP by the end of the century (Fedesarrollo, 2021<sup>[26]</sup>).

A guaranteed-minimum-income programme as described above, topping up to the poverty line all incomes of those below 65, net of current government transfers, would cost 4% of GDP in 2020. This number is clearly higher than the expected cost in the future, given the extraordinary increase in poverty rates during 2020. Once poverty rates return to 2019 pre-pandemic levels, the estimated cost would be around 2.5% of GDP. A reasonable conservative medium-run cost estimate may be around 3% of GDP for the guaranteed-minimum-income programme (Table 6). An alternative option, with similar fiscal cost but lower impact on social outcomes, would be a basic income programme, similar to the current social programme, delivering a fix benefit to all households in poverty regardless of their income or wealth (Box 7).

The impact of the universal basic pension and the guaranteed-minimum-income on poverty and inequality are large (Figure 25, Panels A and B). By construction, these two programmes together would lift everyone out of poverty in the case of full benefit take-up. Benefits are clearly concentrated at the bottom of the income distribution (Figure 25, Panel C). This does not take into account possible inclusion errors, which in 2017 where 38% of beneficiaries (Table 1). Given that *Sisbén* is undergoing significant improvements, the inclusion errors would be substantially lower, even if probably not zero. Inequality, measured by the Gini coefficient, would be reduced by 13 percentage points, which would leave Colombia around 7

percentage points above the OECD average of 2019. The true decline in inequality will be probability stronger as the feedback effect on labour formality is not taken into account, which would likely lead to a convergence of incomes between formal and informal workers. Furthermore, a reform would present significant scope to make the tax system more progressive, which is not yet accounted for in these estimates.

Finding alternative financing mechanisms to employee contributions for the contributory health scheme and employer's contributions to the Family Compensation Funds would imply funding needs equivalent to 2.2% of GDP, based on 2019 household data. Social contributions of workers with higher incomes, i.e. above 1.5 minimum wages, which accounted for 1.4% of GDP, could be simply replaced by personal income taxes of the same amount. That would leave a remainder of around 0.8% of GDP to be financed from general taxation revenues instead of social security contributions, as workers with incomes close to the minimum wage are unlikely to become subject to personal income taxation in the near future.

These reforms together would initially cost 5.4% of GDP, but the net cost, after phasing out existing cash transfer programmes and subsidies on public services, would fall to 3.7% of GDP (Table 6). This takes into account the expected savings in spending on current social assistance programmes, such as *Familias en Acción*, *Ingreso Solidario* and *Colombia Mayor*, whose transfers to the poor are worth 1.2% of GDP in 2020, in addition to public subsidies of around 0.5% of GDP. In the longer run, as the current pension system is replaced by a new one, current subsidies to high-income pensioners worth 2.6% of GDP would gradually converge towards zero, depending on the exact details of organising the transition in the pension reform. That would reduce the long-run net cost of a deep social protection reform to around 1% of GDP. Even in the short run, a smaller part of the pension savings could be frontloaded by subjecting high pensions from the current system to income taxes. All the calculations in this section are an illustrative exercise, with the final cost depending on many minor details of the reform and its implementation.

**Table 6. Illustrative fiscal costs of achieving universal social protection**

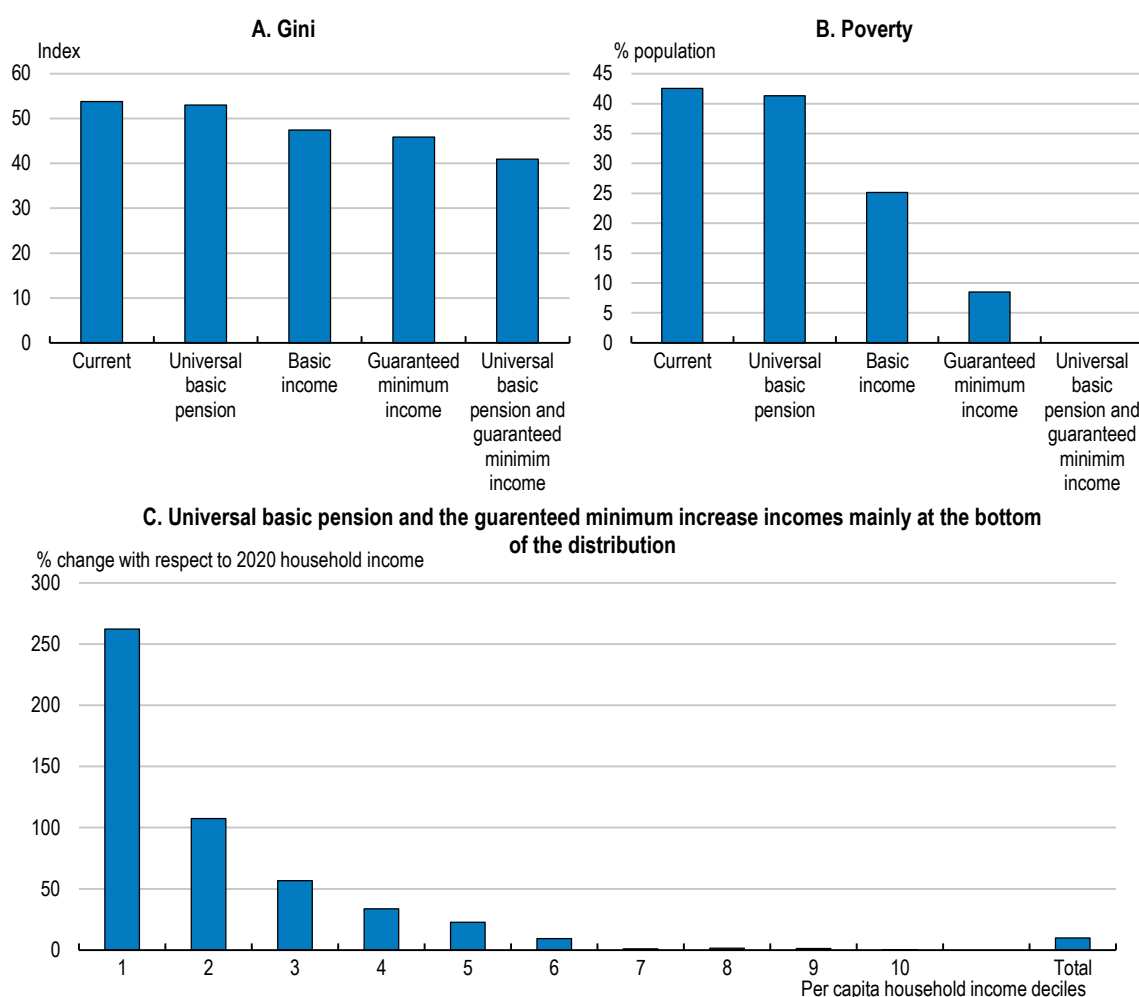
New programme	Cost (% GDP)	Current cost of programmes to be phased out (% GDP)	Assumptions
A universal basic pension	1.6		Cash transfer equivalent to 1.3 poverty lines, covering 75% of those aged more than 65 in 2020 (the remaining 25% are the current beneficiaries of the contributory pension system)
A guaranteed minimum income equivalent to the poverty line	3.0		Cash transfer to supplement income up to the poverty line for the population under the age of 65 living in poor households
Phasing out health contributions and Family Compensation Funds for low-income workers	0.8		For workers with higher incomes, i.e. above 1.5 minimum wages, the current health contributions and to the Family Compensation Funds are replaced by personal income taxes of the same amount
<b>Short-term net cost</b>	<b>3.6</b>	Existing cash transfer programmes: 1.2; Colombia Mayor: 0.1; Subsidies on public utilities: 0.5	The short-term net costs include the replacement of existing social cash transfers programmes by the new ones and the elimination of subsidies on public services. The pension reform would be implemented only gradually without affecting acquired pension rights.
<b>Long-term net cost</b>	<b>1.0</b>	Subsidies on pensions: 2.6	In the long-term, the impact of the pension reform is fully materialized having eliminated pension subsidies. The growth and formalisation effect of the reforms is not taken into account.

Note: The calculations imply subtracting from households' income all transfers based on existing programmes, such as Colombia Mayor, Familias en Acción and Ingreso Solidario, and replacing them by transfers based on the new proposed programmes.

Source: OECD Secretariat calculations based on DANE-GEIH data.

The implementation of such reforms can be gradual and should be accompanied by a comprehensive fiscal reform to achieve higher tax collection and redistribution (see Chapter 1 of the Economic Survey of Colombia (OECD, 2022<sup>[6]</sup>)). This would require a combination of reducing the many existing exemptions that dampen tax collection and the progressivity of the tax system; higher tax rates on high incomes; and broadening the tax bases for corporate and personal income taxes. For comparison, Colombia currently raises around 1.9% of GDP lower general government revenues than the average economy in Latin America, and 12.4% of GDP lower than the average OECD economy (see Chapter 1 of the Economic Survey of Colombia (OECD, 2022<sup>[6]</sup>)). The higher employment formalisation and growth that would be driven by these reforms would also increase tax collection. Boosting the recovery with structural reforms, as discussed in Chapter 1 of the Economic Survey of Colombia (OECD, 2022<sup>[6]</sup>), would result in higher employment and higher incomes for individuals and, in that way, increase tax collection.

**Figure 25. Estimated impact on poverty and inequality of proposed social protection programmes**



Note: The current situation includes existing programmes, such as Colombia Mayor, Familias en Acción and Ingreso Solidario. Calculations assume that when a new programme is introduced and replaces the old one. *Colombia mayor* is replaced by the universal basic pension programme and the rest of cash transfers programmes by the new social programme (GMI or basic income).

Source: OECD secretariat calculations based on DANE-GEIH data.

### Box 7. A guaranteed minimum income or a basic income programme

An alternative to a guaranteed minimum income programme is a basic income programme, similar to *Ingreso Solidario* and *Familias en Acción*. A basic income programme would deliver a cash transfer of a fixed amount for all those living in poverty. To increase coverage and benefit levels of the existing cash transfers programmes, the basic income would provide a benefit equivalent to the extreme poverty line to every household member below 65 years living in poor households. The fiscal cost would be of 3.9% of GDP in 2020, similar to the guaranteed-minimum-income. For a similar cost, the guaranteed-minimum-income provides a higher minimum income floor, assuring no one is left in poverty. The advantage of the basic income is that it is simpler to implement needing less information and less prone to errors in the amount to be delivered. However, given that *Sisbén* is undergoing significant improvements and could easily be transformed in a real-time information database, the guaranteed-minimum-income may be preferable due to its larger effects on poverty and inequality (Figure ).

### A discussion on the impact on formal employment and growth

The proposed reforms to social contributions and payroll taxes would boost formal employment permanently, due to the lower cost of formal employment relative to informal employment and capital. These reforms would induce firms of all sizes to hire more formal workers and the self-employed to become formal.

Employers' contributions to the social security system would be significantly reduced for low earning workers and, especially, for the self-employed. To gauge the magnitude of the impact on formal employment, it is interesting to make a comparison to the 2012 reform that reduced non-wage labour costs by about 13 percentage points for workers with wages up to 10 minimum wages. The reform increased by 3.5 percentage points the probability of unemployed or informal workers below 10 minimum wages of moving into formality (Kugler, Kugler and Prada, 2017<sup>[53]</sup>). Hence, the semi-elasticity of formal employment with respect to each point of reduction in non-labour costs would be 0.26. Using this semi-elasticity, the estimated impact of a reduction of labour charges on formal employment would be an increase of 303,000 low-income formal workers that represents a 5.5% increase in workers earning less than 1.5 minimum wages.

However, these simple calculations are likely to be a lower bound, as the expected impact on formalisation may be much larger for a number of reasons. First, after the 2012 reform, other factors, such a fast increase of the minimum wage, counteracted the impact on formality, and the individual effects are difficult to disentangle. Second, in the 2012 reform contributions of self-employed workers were not modified and estimates for this population are not available. Additionally, the reduction of non-wage labour costs, especially for the self-employed, would be much larger than in the 2012 reform, probably invalidating the use of the elasticity. Under these reforms, self-employed would only need to contribute to professional risks, making highly probable a universal formalisation, particularly for those earning less than 1.5 minimum wages. Third, contributions made by salaried workers would also be reduced (the 4% they pay to the pension system and the 4% to the health system), which would also induce formalisation, though the impact is difficult to measure. Finally, the high labour cost is only one important factor inducing informality, as there are other determinants such as the low access to quality education and training, the low productivity of firms and the low quality of management. Reforms in these areas would also help reduce informality and self-employment while boosting productivity.

In addition to the impact on formalisation, the reforms discussed in this chapter would increase real wages, disposable income of households and overall economic growth. First, the real disposable wage of formal employees would increase, because of the reduction in the fiscal wedge due (social contributions paid by the workers for pensions and health). Second, all elderly, except those in the transition regime, would

receive the universal basic income, which will increase their disposable income. It is reasonable to assume that the increase in real disposable income would be entirely consumed, thus increasing aggregate demand. Finally, disposable income for poor households would increase as the guaranteed-minimum income implies an increase in coverage and level of benefits with respect to current cash transfers.

## Ensuring effective enforcement of labour and tax laws

Tackling informality also requires better enforcement of labour laws and taxes, especially after the substantial reduction of labour costs. The challenge for the government is to ensure that all workers, regardless of their contract type, have access to adequate rights and protections, and that no abuses of the existing legislation are committed. For example, when companies falsely classify workers as self-employed or use service contracts in order to escape regulatory and tax commitments. Authorities should also step up enforcement efforts to make sure those workers, including self-employed, and firms pay their taxes. Although Colombia has made significant efforts to reduce tax evasion, including continuing improvements to the tax authority's digital system and electronic invoicing, there remains scope for further improvements in tax administration.

An effective judiciary and well-equipped labour inspectorate is essential to avoid labour informality and subcontracting. In the past decade, Colombia has taken an impressive amount of measures to improve the labour inspection system (OECD, 2016<sup>[38]</sup>). The number of labour inspectors more than doubled between 2011 and 2019, the budget significantly increased and the fine collection system has been revised and strengthened. The government also raised salaries for labour inspectors to attract better candidates and organised a civil career exam to improve job security and limit turnover. The training offer and qualification processes for inspectors were substantially strengthened to guarantee the rights of workers and conduct labour investigations properly. Well-trained labour inspectors are key for effective enforcement. In Spain, the Labour and Social Security Inspectorate School aims to strengthen the capabilities of the Spanish Labour Inspectorate by organising training programmes and activities for all staff. By conducting research about new undeclared work trends and by providing continuous training, the school enables labour inspectors to detect and prevent undeclared work more efficiently. Collecting and analysing data, crossing different sources, such as social security, tax, healthcare, is essential for inspectors to be effective, as it would help them understand which sectors or regions appear to be more problematic in terms of observance of a given law. Interventions should include not only inspection visits, but also preventive, awareness-raising and educational activities and campaigns.

Continued efforts to ensure sufficient resources to the labour inspectorate, which should count with well-trained inspectors, strengthen its capacity to collect and analyse relevant data and information, streamlining the fine collection, and improving its presence in rural areas are still needed. External oversight over labour inspectors is ensured by the public prosecutor's office (*Procuraduría*), but this role could be strengthened. There has been progress in the monitoring of labour formalisation agreements, increased effectiveness and progress in the collection of fines and the fight against forms of subcontracting that violate labour rights has continued (Ministerio del Trabajo, 2021<sup>[100]</sup>). However, recent information suggests that the collection of fines was already weakening before the pandemic and plummeted during 2020 (Ministerio del Trabajo, 2021<sup>[100]</sup>). There is also a need to enhance data collection for the inspectorate while assuring that its staff disposes of the adequate skills to evaluate data in a timely manner (Levy and Maldonado, 2021<sup>[14]</sup>). Increased actions are also necessary to inform employers and workers about the benefits of formalisation and stimulate formal employment, particularly in rural areas. Providing information and technical assistance during inspections would be especially important for small and medium-sized enterprises and help them comply with regulations. Authorities have recently developed the mobile labour inspection, whose purpose is to take the labour inspection system to all regions of the country, especially in rural areas and territories most affected by the armed conflict, poverty, illicit economies and institutional weakness.

## The necessary reforms and their political feasibility

Finding the necessary political consensus for the programme of very ambitious reforms discussed in this chapter will not be easy. These reforms imply overhauling the social protection system and labour market policies, accompanied by fiscal reforms to secure its financing. The political economy of such reforms is usually complicated. The benefits of these reforms tend to be seen only gradually and over the long term, while the potential political costs of making changes that cut into the generosity of the pension system or minimum wages are immediately felt by those affected. This is compounded by the fact that the main beneficiaries of these reforms are generally vulnerable workers, young people, children and the unborn generations, while those with higher incomes in the formal labour market are the ones most affected by these changes and therefore potentially opposed.

The strong negative impact of the COVID-19 pandemic on social inclusion and potential growth could generate momentum and lead to a necessary political debate. There is an extensive literature showing that there are political reasons why structural reforms, including those related to social protection, might be more often undertaken in times of economic difficulty (Sturzenegger and Tommasi, 1998<sup>[101]</sup>; Drazen and Grilli, 1993<sup>[102]</sup>).

To boost feasibility of the proposed reforms, a policy debate is essential. This policy debate should be evidence-based, clearly identify the winners and losers of the reforms and quantify the costs and possible impact on different population groups. An analysis of the sequence and timing of the reforms will also play a very important role. Having a clear mandate and political leadership from the government showing the will and commitment to act would also be important (Tompson, 2009<sup>[103]</sup>).

An effective communication strategy on the need for the reforms and their impact on different population groups and the society in general will be essential to increase acceptance by the population and avoid misperceptions on the impact of reforms. An effective communication strategy can include the provision of information, as well as consultation and dialogue with stakeholders. To reap its full potential, however, authorities can establish a two-way dialogue with the public (OECD, 2020<sup>[104]</sup>).

Another key aspect for the successful adoption and implementation of some of these reforms is to incorporate gradual transition mechanisms, which can reduce resistance to proposed changes (CAF, 2020<sup>[105]</sup>). This is especially the case of the pension reform. Changing dramatically the pension system requires a prolonged transition period in which those close to retirement and those already retired should not be affected. Such people would hardly be able to make decisions in the short term that could cushion the impact that such reforms would have on their incomes. The reform recommendations in this chapter can be implemented gradually, but in a coordinated manner, applying a whole of the government approach. In the past, small patches to punctual problems have often failed to take into account the broader picture, and often created as many new challenges.

Enhancing trust in the government will also be fundamental for successfully designing, approving and implementing reforms. Mistrust of government is high in Colombia, as in much of Latin America, reducing support for tax reforms to finance education, social protection, policing and redistribution (IADB, 2018<sup>[106]</sup>). Reducing corruption and increasing transparency and government accountability, as Chapter 1 of the Economic Survey of Colombia (OECD, 2022<sup>[6]</sup>) highlights, would increase trust in government (Scartascini and Valle Luna, 2020<sup>[107]</sup>).

To optimise the implementation and ensure the fulfilment of the reform's objectives, a regular monitoring and a periodic evaluation of its impact and its evolution should be implemented. A robust monitoring and evaluation framework would increase trust in the reforms and support the social protection system, while offering the most productive tool to simultaneously assess the programme's effectiveness and provide guidance for improvements. Colombia already has put in place an advanced monitoring and evaluation framework implemented by *Sinergia*, an agency within the National Planning Department. Continuous efforts to enhance this process, stronger links between planning, budgeting and evaluation, a more frequent and faster decision-making linked to results, and better quality of data from the beginning of the programme implementation would help improve social policy implementation and increase feasibility of reforms.

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