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Foreword

This *Survey* is published on the responsibility of the Economic and Development Review Committee of the OECD, which is charged with the examination of the economic situation of member countries.

The economic situation and policies of Colombia were reviewed by the Committee on 6 December 2021. The draft report was then revised in the light of the discussions and given final approval as the agreed report of the whole Committee on 10 December 2021.

The Secretariat's draft report was prepared for the Committee by Jens Matthias Arnold and Paula Garda under the supervision of Aida Caldera Sanchez. Statistical research assistance was provided by Anne Legendre, and editorial assistance by Julie Arnal. The *Survey* also benefited from contributions from Lucila Bonilla.

The previous *Survey* of Colombia was issued in October 2019.

Information about the latest as well as previous *Surveys* and more information about how *Surveys* are prepared is available at https://www.oecd.org/eco/surveys/.

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Basic statistics of Colombia, 2019[1]

(Numbers in parentheses refer to the OECD average)[2]

LAND, PEOPLE AND ELECTORAL CYCLE					
Population (million)	50.3		Population density per km²	45.4	(38.4)
Under 15 (%)	22.6	(17.9)	Life expectancy at birth (years)	77.3	(80.2)
Over 65 (%)	8.8	(17.1)	Men	74.5	(77.6)
International migrant stock (% of population)	2.3	(13.2)	Women	80.0	(82.9)
Latest 5-year average growth (%)	1.4	(0.6)	Latest general election		June-2018
ECONOMY					
Gross domestic product (GDP)			Value added shares (%)		
In current prices (billion USD)	323.7		Agriculture, forestry and fishing	7.1	(2.6)
In current prices (billion COP)	1061 119.0		Industry including construction	28.8	(26.0)
Latest 5-year average real growth (%)	2.4	(2.2)	Services	64.2	(71.4)
Per capita (thousands USD PPP)	15.6	(47.6)			
GENERAL GOVERNMENT					
Per cent of GDP					
Expenditure	31.9	(40.6)	Gross financial debt	80.0	(97.2)
Revenue	29.4	(37.6)	Net financial debt (OECD: 2018)	36.5	(68.2)
EXTERNAL ACCOUNTS					
Exchange rate (COP per USD)	3277.83		Main exports (% of total merchandise exports)		
PPP exchange rate (USA = 1)	1349.41		Mineral fuels, lubricants and related materials	54.1	
In per cent of GDP			Food and live animals	13.2	
Exports of goods and services	15.9	(53.6)	Chemicals and related products, n.e.s.	7.8	
Imports of goods and services	21.7	(50.4)	Main imports (% of total merchandise imports)		
Current account balance	-4.6	(0.3)	Machinery and transport equipment	34.3	
Net international investment position	-48.8		Chemicals and related products, n.e.s.	19.9	
			Manufactured goods	14.3	
LABOUR MARKET, SKILLS AND INNOVATION					
Employment rate (aged 15 and over, %)	60.8	(57.5)	Unemployment rate, Labour Force Survey (aged 15 and over, %)	10.5	(5.4)
Men	73.4	(65.6)	Youth (aged 15-24, %)	20.8	(11.8)
Women	48.9	(49.9)	Long-term unemployed (1 year and over, %)	1.1	(1.3)
Participation rate (aged 15 and over, %)	67.9	(60.8)	Tertiary educational attainment (aged 25-64, %)	23.8	(37.9)
Average hours worked per year	2,172	(1,743)	Gross domestic expenditure on R&D (% of GDP, 2018)	0.2	(2.6)
ENVIRONMENT					
Total primary energy supply per capita (toe)	0.9	(3.9)	CO2 emissions from fuel combustion per capita (tonnes, 2018, OECD: 2019)	1.5	(8.3)
Renewables (%)	22.7	(10.9)	Water abstractions per capita (1 000 m³, 2016)	3.2	
Exposure to air pollution (more than 10 µg/m³ of PM 2.5, % of population)	99.3	(61.7)	Municipal waste per capita (tonnes, 2018, OECD: 2019)	0.2	(0.5)
SOCIETY					
Income inequality (Gini coefficient, OECD: latest available)	0.513	(0.318)	Education outcomes (PISA score, 2018)		
Relative poverty rate (%, OECD: 2017)	11.4	(11.7)	Reading	412	(485)
Median disposable household income (thousand USD PPP, OECD: 2017)	14.6	(24.2)	Mathematics	391	(487)
Public and private spending (% of GDP)			Science	413	(487)
Health care	7.7	(8.8)	Share of women in parliament (%)	18.7	(30.8)
Pensions (2018, OECD: 2017)	6.2	(8.6)			
Education (% of GNI)	4.0	(4.4)			

¹ The year is indicated in parenthesis if it deviates from the year in the main title of this table.

² Where the OECD aggregate is not provided in the source database, a simple OECD average of latest available data is calculated where data exist for at least 80% of member countries.

Source: Calculations based on data extracted from databases of the following organisations: OECD, International Energy Agency, International Labour Organisation, International Monetary Fund, United Nations, World Bank.

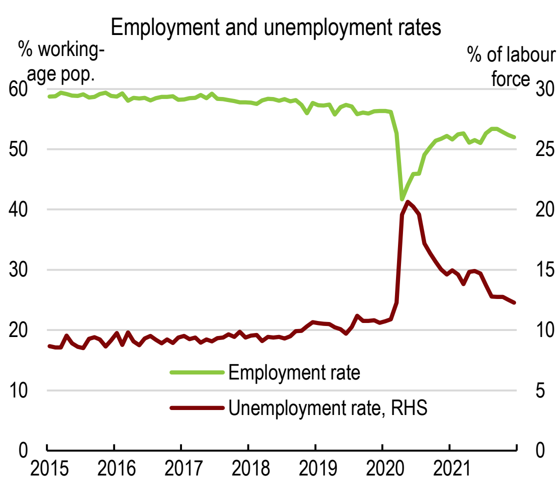
Executive summary

The economy has recovered well

Colombia's economy has recovered remarkably well from the COVID-19 crisis, as strong fiscal and monetary policy support have successfully averted a stronger contraction of incomes. New social programmes have saved millions from falling into poverty. Medium-term growth prospects hinge on reforms to expand social protection and boost productivity.

Over the last decades, Colombia enjoyed remarkable economic stability due to sound macroeconomic policies. A track record for prudent fiscal management, underpinned by a recently improved fiscal rule, a successful inflation targeting regime and a flexible exchange rate will lay the grounds for a continuous rebound of domestic demand. Unemployment has declined and now stands 1.5 percentage above the level of late 2019 (Figure 1). Still, deep structural challenges in the labour market remain, including high informality. Informal workers, women and youth were particularly hit during the pandemic, exacerbating long-standing inequalities.

Figure 1. The labour market has recovered



Source: DANE.

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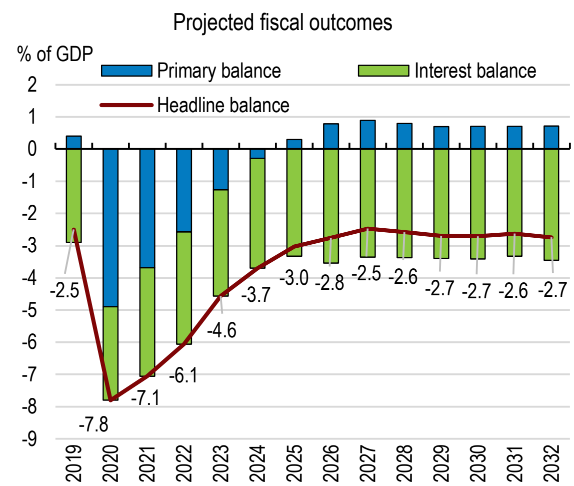
The fiscal rule was rightly suspended during 2020 and 2021 to provide exceptional fiscal support to the economy and vulnerable households in particular. Public debt has risen by 13.5 percentage points of GDP and financing costs have risen. A recent fiscal reform will pave the way for a gradual fiscal adjustment, but part of the adjustment planned for the next two years has not yet been implemented (Figure 2). Under current plans, debt is projected to stabilise at around 59% of GDP over the next ten years, 8.5 percentage points above pre-pandemic levels. This implies lower fiscal buffers than in the past and leaves less space to react to potential future adverse events.

Figure 2. A fiscal adjustment is planned



Source: OECD calculations based on Min Hacienda (2021).

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Tax revenues of only 20% of GDP are insufficient to meet rising social demands while preserving necessary public investment in infrastructure, education and health. Personal income taxes, which only 5% of Colombians pay, are the principal explanation behind this low tax collection (Figure 3), while widespread tax expenditures and tax evasion curtail revenues across all tax areas. High business taxes reduce investment incentives, particularly as the business sector will finance a significant part of the planned fiscal adjustment. However, the political economy of tax reform is complex, as previous plans to increase income and consumption taxes were widely opposed by social unrest in May 2021.

Looking ahead, enhanced social benefits will continue into 2022 and further underpin private consumption (Table 1). Infrastructure investment is buoying investment, while strong commodity prices and improving prospects in the main trading partners are supporting exports. Inflation has risen lately, but inflation expectations remain well-anchored. The Central Bank should continue the gradual withdrawal of monetary support to the extent that inflationary pressures intensify.

Table 1. A strong recovery is underway

	2021	2022	2023
Gross domestic product	9.5	5.5	3.1
Private consumption	13.6	5.6	3.8
Gross fixed capital formation	8.3	4.6	6.5
Exports	11.5	10.9	6.9
Imports	27.7	10.6	6.0
Unemployment rate	13.7	11.8	10.7
Consumer prices (end of period)	5.6	4.6	3.3
Headline fiscal balance (% of GDP)	-7.1	-6.1	-4.6
Primary fiscal balance (% of GDP)	-3.7	-2.6	-1.3
Public debt (gross, % of GDP)	63.8	62.5	62.4

Source: OECD Economic Outlook database.

In a longer view, however, both growth and social inclusion are trapped by weak policy settings that prevent firms from growing and becoming more productive while precluding more than half of Colombia's income earners from formal jobs and social protection. Productivity growth has been weak for two decades, including relative to regional peers and investment has weakened. Unless both can be raised, potential growth will be lower than in past decades, as support from commodity prices and demographics is vanishing.

Low and declining competitive pressures in a number of sectors are one reason behind weak productivity. Regulations hamper firm entry, while informality of firms and jobs creates both an uneven playing field and incentives for firms to remain small. Besides these domestic factors, tariff and non-tariff barriers, with high tariff dispersion and a rise in peak rates, stand in the way of stronger engagement in international trade and investment flows. Exports remain concentrated in a few commodity sectors and trading partners.

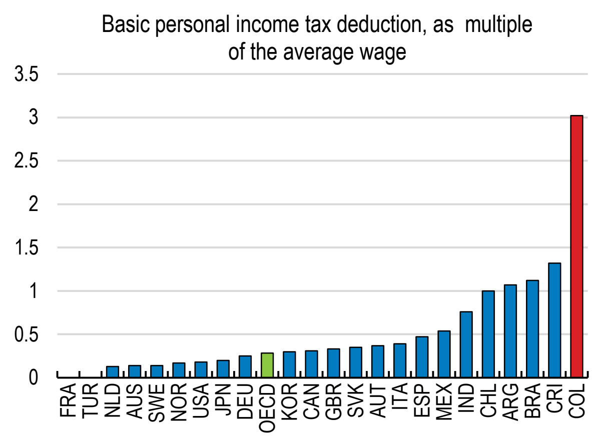
Expanding social protection and reducing informality are key priorities

Colombia has one of the highest levels of poverty, income inequality and labour market informality in Latin America. Despite a strong crisis response, social benefits do little to alleviate inequalities, and most social spending goes to the non-poor, particularly in the case of pensions.

Over 60% of workers have informal jobs and no access to social security benefits except health. A key factor behind labour informality are high non-wage costs that finance formal-sector social security benefits and a high minimum wage whose level is close to the median wage. These put a high price on formal jobs and generates a vicious circle that perpetuates informality and exclusion.

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. A basic and universal level of social protection should be made available to all Colombians by merging parallel schemes for cash transfers, pensions and health, combined with a more comprehensive set of benefits that can support those who can contribute more. These reforms will require shifting much of the financing of social protection gradually away from contributions on labour towards general taxation.

Figure 3. Few people pay income taxes



Note: The chart shows the income level as of which people start paying personal income taxes, relative to average wages.
Source: OECD Taxing Wages 2021.
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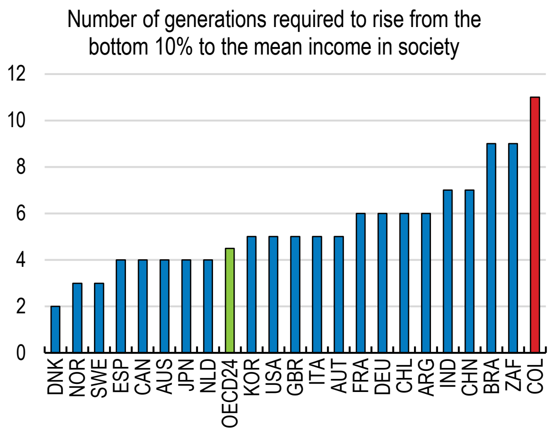
More equal opportunities in education are also key to raise formality and improve intergenerational mobility, which is particularly low in Colombia (Figure 4). After one of the longest schools closures in the region and in the OECD, the severe education inequalities that existed before the pandemic are likely to widen. For students from vulnerable households, virtual classrooms did little to compensate for the absence of physical classes, given stark differences in digitalisation. Early drop-out rates in secondary education, typically concentrated among students from disadvantaged socio-economic backgrounds, have risen in 2020, and are likely to rise further. Early childhood is when many of the basic skills for successful learning later in life are acquired, but pre-school education is available to only 50% of children between ages 3 and 5.

Figure 4. Intergenerational mobility is low



Source: OECD Income Distribution Database.

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Governance challenges persist

Colombia has made significant progress with recent anti-corruption efforts, but high corruption perceptions still point to significant governance challenges. Improvements in governance are key for raising public trust in institutions, which is low in Colombia (Figure 5).

Unlike many OECD countries, Colombia does not have a dedicated whistle-blower protection law. Typical high-risk areas for corruption include infrastructure projects and public procurement. A recently created centralised public purchasing body holds potential to reduce the scope for illicit behaviour, but direct purchases still represent around 70% of total public procurement transactions. Transparency in the interactions between interest groups and policymakers is not regulated by law.

Political campaigns are highly dependent on private funds in Colombia, given the limited scope of public campaign financing. This creates strong incentives for candidates to promise post-election favours and may affect spending efficiency.

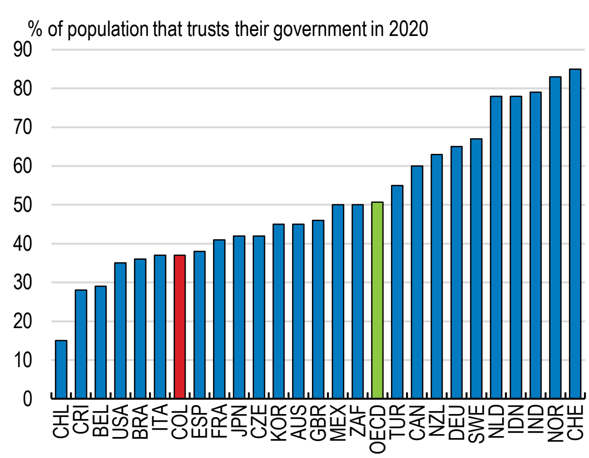
Fighting deforestation is key for sustainability

Greenhouse gas emissions are relatively low in per capita terms, but have been trending upward over the last decade. Reaching emission targets will depend crucially on advances in the fight against deforestation, a main source of emissions.

Colombia has committed to an ambitious target of zero net deforestation by 2030. Nonetheless, deforestation has risen in recent years, by as much as 8% in 2020. Remarkable institutional efforts to curb deforestation have included a satellite-based early detection system, but limited resources for enforcement action only allow following up on a minor fraction of detections.

Stronger incentives for the use of non-fossil sources of energy could reduce emissions. A recently introduced carbon tax is set at a comparatively low level and covers only 25% of domestic emissions. The revenues it raises only barely exceed spending on fossil fuel subsidies, which should be phased out. Electricity generation capacity is based to 70% on renewable sources, making Colombia one of the pioneers in this area.

Figure 5. Few people have trust in government



Source: World Gallup Poll.

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Main findings and key recommendations

MAIN FINDINGS	KEY RECOMMENDATIONS
Refining macroeconomic policies and reforming taxation	
Public debt will be permanently higher than before the pandemic, reducing the fiscal space to react to shocks. Although activity has seen a solid rebound, employment remains below pre-pandemic levels.	Reduce the expansionary fiscal stance gradually as of 2022 to rebuild fiscal buffers while continuing exceptional income support until the labour market recovers.
Tax revenues of only 20% of GDP, low even for regional standards, are insufficient to finance social demands and public investment. The tax system does little to reduce high income inequalities, with a minor role for personal income taxes and a strong reliance on corporate income taxes. The tax system is also excessively complex, with multiple special regimes and tax expenditures leading to significant revenue losses, while penalising growth and investment.	Raise more revenues from personal income taxes by lowering the income threshold where taxpayers start paying income taxes, eliminating exemptions and strengthening rate progressivity. Reduce corporate tax expenditures while reducing the tax burden and tax distortions for businesses. Reduce the scope of VAT tax expenditures while compensating low-income households through social benefits.
Corruption reduces public spending efficiency, creates an uneven playing field and exacerbates inequalities. Colombia has no dedicated whistle-blower protection law, in contrast to most OECD countries and political campaigns are highly dependent on private financing sources.	Continue the fight against corruption by establishing a dedicated whistle blower protection law and imposing stricter limits for private campaign contributions.
Inflation has begun to rise despite significant idle capacity and it is not clear to what extent these inflationary pressures are temporary.	Gradually increase interests rates if inflationary pressures intensify.
Progress in vaccination has been steady, but is lagging behind other countries in the region.	Accelerate the pace of vaccinations against COVID-19.
Fostering a more inclusive recovery	
Informal employment affects 60% of workers. This precludes them from access to social security, while reducing productivity and tax revenues.	Establish a comprehensive strategy to foster formalisation, including lower non-wage costs, stronger enforcement and improvements in tax administration.
High charges on formal labour hold back formal job creation and sustain high labour informality.	Reduce the tax burden on formal labour income by gradually shifting the financing burden of social protection towards general taxation.
The pandemic has exposed major gaps in social protection, particularly among informal workers. Different programmes are highly fragmented.	Merge existing cash transfer schemes into a single cash benefit for poor households while maintaining conditionalities for families.
Half the population above 65 is not covered by pension benefits of any kind. Contributory pension benefits are regressive, with competing schemes providing different benefits for the same career history and particularly low coverage among women.	Create a basic non-contributory universal pension benefit and merge existing contributory pension schemes into a single mandatory contributory scheme complementing the basic universal pension.
Formal workers pay contributions for public health insurance, while informal workers get almost the same benefit package for free.	Merge the two public healthcare systems into a single system, financed through general taxation revenues.
Early school drop-out has risen sharply due to the pandemic, particularly among children from disadvantaged socio-economic backgrounds.	Provide targeted support to those out of school and those at risk of falling behind, including through full-day schooling and school meals.
Strengthening productivity and competition	
Productivity growth has fallen behind regional peers and competition is weak. Regulations on product markets and administrative barriers restrict market entry and hamper competition.	Reduce domestic regulatory barriers to entrepreneurship and market entry.
Trade openness is low. Non-tariff barriers have risen sharply, while high peak tariffs afford high protection to some domestic producers, often characterised by low productivity.	Reduce tariff and non-tariff barriers to trade, starting with those items where current barriers are highest.
Making growth more sustainable and greener	
Deforestation has risen and reaching current objectives for reducing greenhouse gas emission will require stronger declines in deforestation.	Increase resources dedicated to anti-deforestation enforcement activities to follow up on more cases of detected deforestation.
A patchy land registry is one motive behind deforestation, often with the aim of obtaining a land title in the future.	Accelerate progress in expanding the land registry, especially into remote areas.

1 Key policy insights

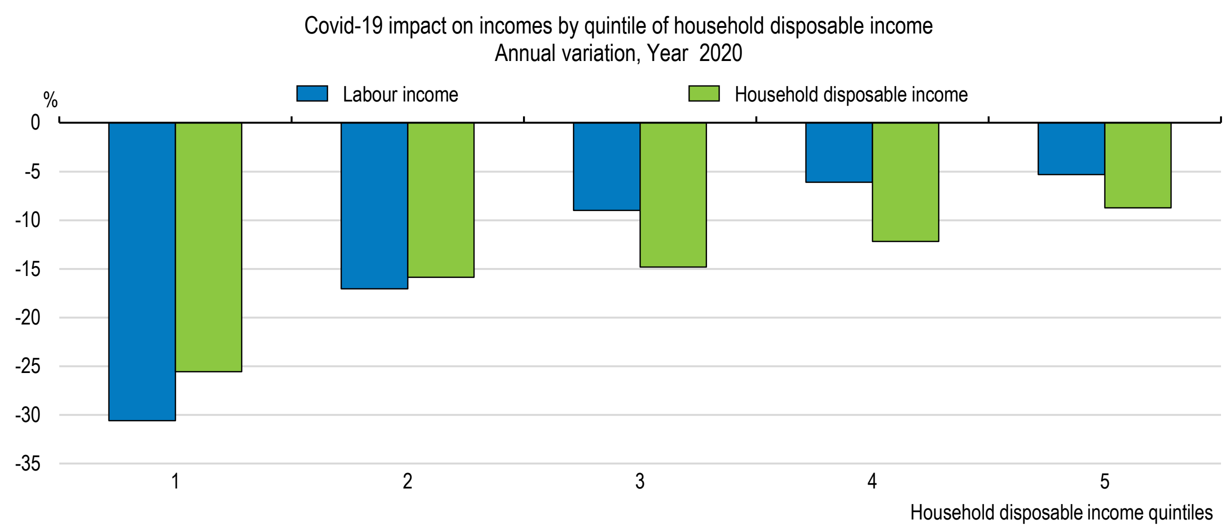
Colombia's economy has recovered remarkably well from the COVID-19 crisis, and strong fiscal and monetary policy support have averted a stronger contraction of incomes. Solid macroeconomic policy frameworks are laying the grounds for a continuous recovery of domestic demand, although the sustainability of fiscal accounts will require further action. In a longer view, however, both growth and social inclusion are trapped by weak structural policy settings that preclude more than half of income earners from formal jobs and social protection, while preventing firms from growing and becoming more productive. Solving this vicious circle through ambitious reforms would allow a significant leap forward for material well-being in Colombia.

The pandemic has highlighted and exacerbated long-standing challenges

The pandemic has hit Colombia hard and has left strong marks on its people. COVID-19 caused over 135,000 lost lives, set back income growth for years and destroyed over 6.2 million jobs. A significant policy response allowed cushioning the economic effects of the pandemic, through an expansion of existing as well as new social benefits, wage subsidies, tax deferrals and credit measures (Box 1.1). But healing the long-term scars of the pandemic will require even more ambitious policy responses and reforms.

As of mid-2020, the economy recovered more rapidly than regional peers, recovering pre-pandemic GDP levels by the third quarter of 2021. However, the pandemic has exacerbated many long-standing social challenges, including one of the world's most unequal income distributions. Employment and income losses were particularly concentrated among households with the lowest incomes, whose labour incomes declined by up to 30% (Figure 1.1). About 3.5 million people became poor and many families who had managed to escape poverty in the preceding years fell back into it. Informal workers, who account for more than 60% of all workers and have no access to social protection except healthcare, were the first to lose their livelihoods during the pandemic. Women have been disproportionately affected, amplifying pre-existing employment and wage gaps between men and women.

Figure 1.1. The pandemic hit hardest on households with low incomes



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

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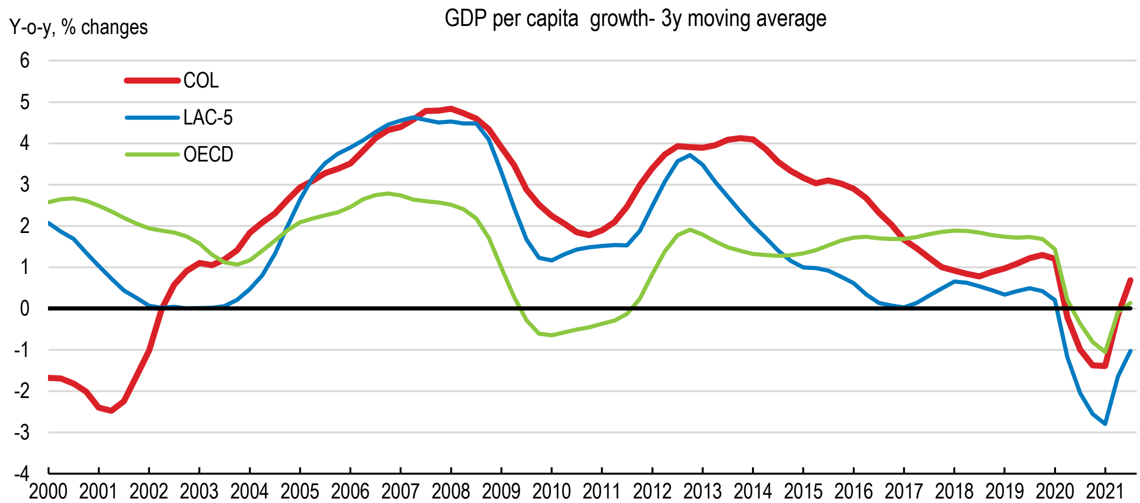
These setbacks have occurred in many areas where Colombia had previously made significant progress. In a region characterised by economic volatility, Colombia's sound macroeconomic policies, with a track record for prudent fiscal management underpinned by fiscal rules, a successful inflation targeting regime and a flexible exchange rate, have ensured economic stability and underpinned confidence. Poverty had fallen markedly over the past two decades, and access to education had improved. A violent internal conflict that haunted Colombia for decades has been set aside, and institutions have become stronger. Economic growth had been solid, buoyed by external demand for Colombia's commodity exports up until 2008, bearing some similarities to developments in other Latin American and Caribbean (LAC) economies (Figure 1.2).

Figure 1.2. Trend growth has slowed down



Note: LAC-5 is a simple average of Brazil, Argentina, Chile, Costa Rica and Mexico.
Source: OECD Economic Outlook database.

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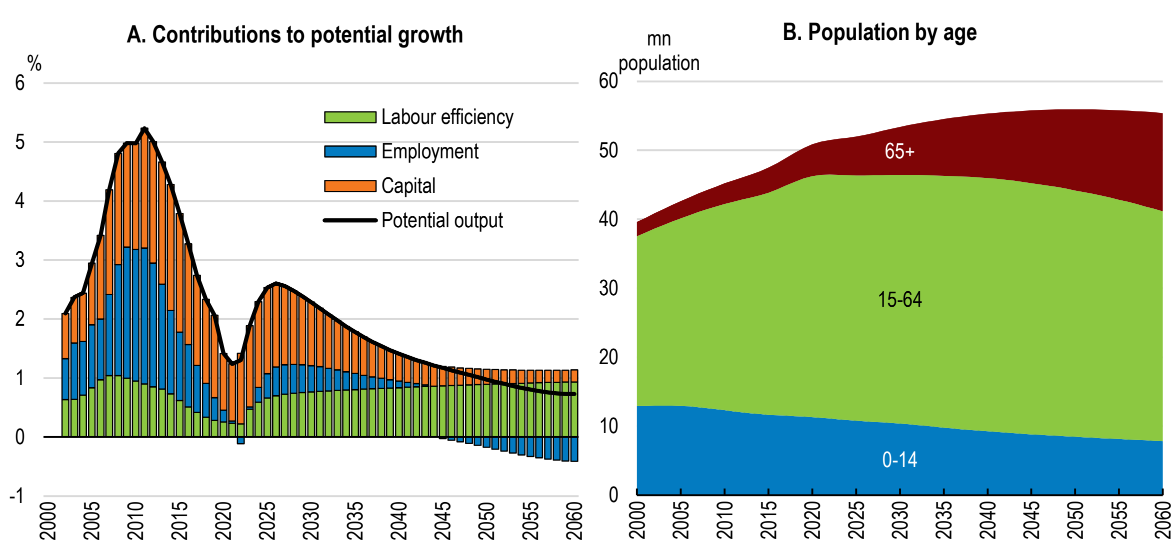
At the same time, trend growth was already declining before the pandemic, hinting at more structural obstacles to economic performance. Favourable demographics boosted employment and can explain much of Colombia's growth in the last two decades (Figure 1.3). But demographics and employment will cease to support growth in the future, except for the positive effect resulting from immigration from neighbouring Venezuela. At the same time, both investment and productivity, usually the key driver of long-term growth, have been on a declining trend, related to weak competition, low trade openness and a still largely commodity-dependent export base, which leaves it vulnerable to price shocks. The only way to counteract a growth slowdown is through reforms that accelerate productivity growth. Colombia's longer-term growth outlook will largely depend on its ability to address existing structural bottlenecks.

Figure 1.3. The economy's growth potential will fall as the demographic bonus fades



Source: OECD Long-term projections, based on (Guillemette and Turner, 2018[1]).

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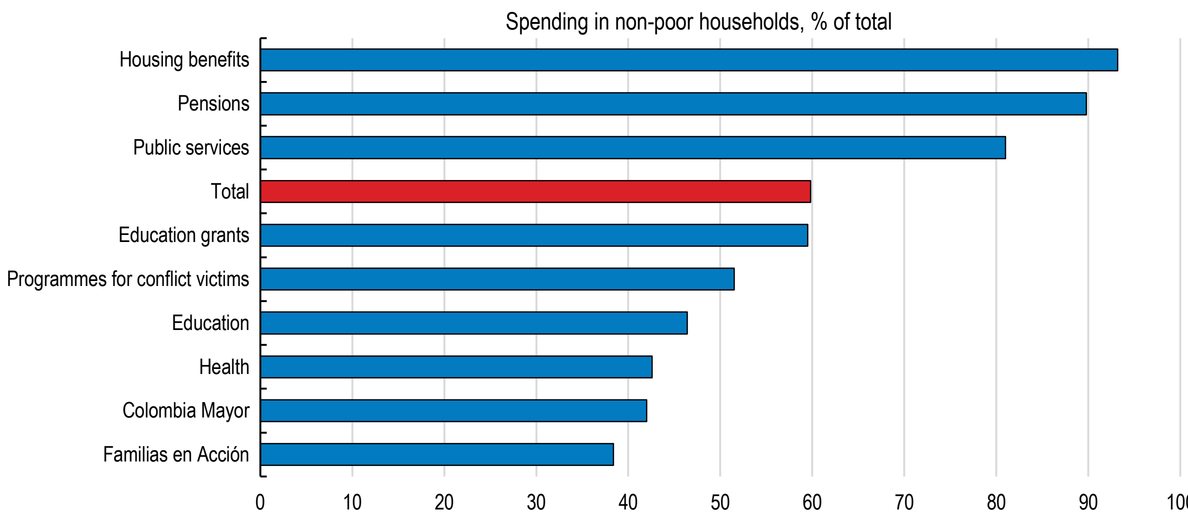
Colombia's growth and social challenges are intimately intertwined. Informality precludes workers from access to social security benefits like pensions or unemployment insurance. As a result, much of the spending on social benefits fails to reach those who need it most (Figure 1.4). For many firms, informality is a response to a difficult business environment, but it cuts them from access to credit and limits productivity and growth. By staying small and informal, firms can avoid high labour charges, taxes and cumbersome regulations. Widespread barriers to competition further add to the difficulties of formal market entry, while firms that are formal face unfair competition from low-performing but informal competitors.

Figure 1.4. Social benefits do not support those who are most in need



Source: Fedesarollo, 2021[3] based on ENPH-DANE.

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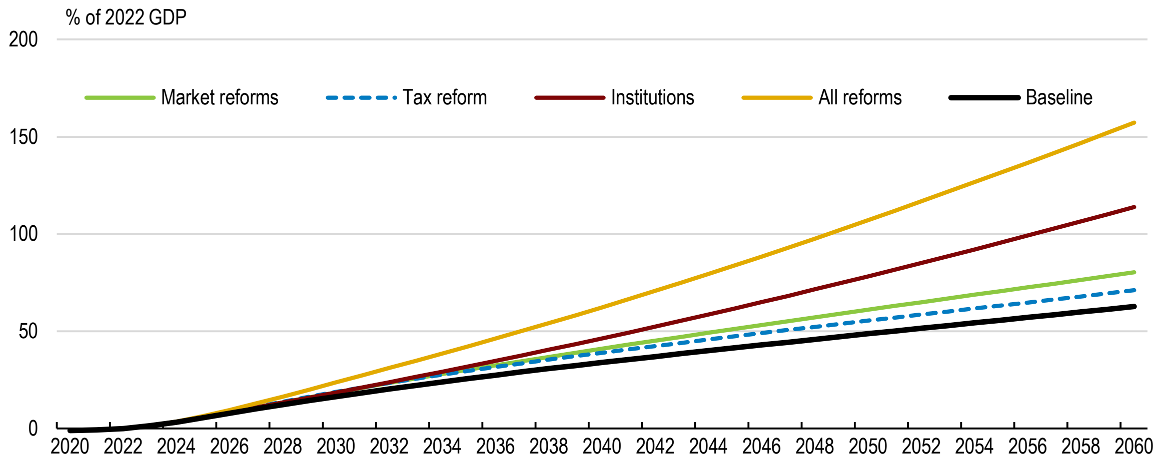
These challenges mutually reinforce each other and impede the flow of labour and capital to the most productive firms and activities, which would be essential for stronger growth and higher incomes. At the same time, they perpetuate the dual nature of the labour market and exclude a majority of income-earners from old-age pensions or unemployment insurance, which explains high and persistent income inequalities. Unleashing Colombia's potential to reach higher levels of prosperity for all will require deep and simultaneous reforms across several policy areas, rather than the small patches of the past. Country-wide social protests in 2021 have demonstrated that Colombians aspire to better economic opportunities.

Reforms would have substantial payoffs, as indicated by simulations based on the OECD long-term growth model (Guillemette and Turner, 2018[1]). An ambitious package that would improve domestic regulation and competition, reduce barriers to foreign trade, reform taxes and strengthen institutions, similar to current policies in Chile, would raise GDP per capita by an additional 24% over 15 years, equivalent to 1.6 percentage points of additional growth each year (Figure 1.5). While there is considerable uncertainty around such simulations, these are large effects, as they would allow Colombia to reach the approximate per-capita GDP levels that are currently enjoyed by countries like Costa Rica, Argentina and Uruguay within 15 years. By contrast, with no boost from reforms, demographic trends would diminish the economy's growth potential to 1.6% over 15 years, and to 0.9% over 30 years. This is significantly below the average GDP growth of 3.8% between 2000 and 2019.

Figure 1.5. Ambitious structural reforms are estimated to lift incomes significantly

Simulations using the OECD Long term growth model



Note: The “Baseline” projection depicts the increase of potential per-capita GDP in Colombia according to current estimations of potential growth, without any reform effects. The “Market reforms” scenario includes an improvement in product market regulations, as measured by the OECD PMR indicator, to the level of Chile, while also aligning tariff barriers and capital account openness with Chile’s current practice. As non-tariff barriers are not covered by any of the indicators in the model, this simulation is likely only a lower bound estimate for the effects of a comprehensive reduction of trade barriers in Colombia. The “Tax reform” scenario aligns business taxation with the OECD average and the labour tax wedge with the level of Chile, financed by a broadening of tax bases. Finally, the “Institutions reform” simulation reflects a gradual alignment of the Rule of Law index (Kaufmann, Kraay and Mastruzzi, 2015[2]) with the current OECD average by 2060.
Source: OECD calculations based on OECD Long-term growth model (Guillemette and Turner, 2018[1]).

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Growth-enhancing reforms could be implemented in several policy areas. Strengthening institutions by reducing corruption and improving economic governance and the rule of law would be one way forward. This could be complemented by market reforms that raise competition and improve the allocation of resources, for example through more competition-friendly regulation on product markets and lower barriers to international trade. Finally, a reform of taxes and social contributions could alleviate the burden on labour income and reduce distortive business taxes, in combination with a significant broadening of tax bases across income and consumption taxes.

Finding the necessary political consensus for further reforms will not be easy, and may require a gradual approach. Country-wide social protests paralysed much of the country during May 2021 after a tax reform proposal ignited significant discontent in the context of the pandemic and a severe recession. While the reform would have concentrated the additional tax burden on relatively high-income households and financed enhanced social benefits for those with low incomes, it was wrongly perceived as affecting middle class families. Political debate is crucial for building a consensus around reforms and it is essential that the debate is well-informed by facts and evidence, including on the economic incidence of reforms across different income groups. The set of reform recommendations contained in this Survey would not imply any additional financial burden for citizens in the bottom half of the income distribution; it would instead strengthen their incomes and improve their access to social protection benefits.

Against this background, the main messages of the Survey are:

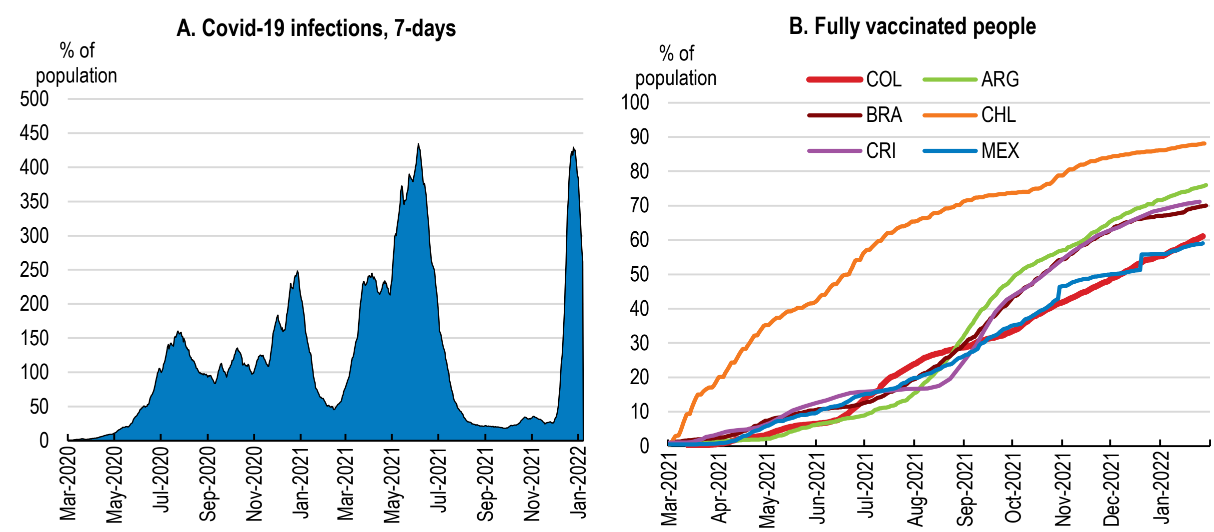
- Ensuring fiscal sustainability and protecting uncovered vulnerable groups will require both a revival of productivity growth and mobilising additional tax revenues, particularly by broadening narrow tax bases.
- Supporting vulnerable groups and reducing inequalities will require deep changes to social security benefits and their financing to strengthen incentives for formal job creation.

- Continuing the fight against corruption will require changes in the areas of public procurement, whistle-blower protection and the financing of political parties.
- Raising productivity to boost growth through the recovery and over the longer run will hinge on more competition-friendly regulations, a fairer tax system and lower trade barriers.

The economy is recovering from the pandemic, but there are significant risks

The Covid-19 pandemic took a strong toll on economic activity in the second quarter of 2020. GDP declined by -6.8% in 2020, slightly deeper than the regional average and unprecedented in Colombia's economic history. Lockdowns and social distancing measures have been implemented on several occasions since March 2020. Four infectious waves led to temporary infection peaks in August 2020, in January 2021, June 2021 and January 2022 (Figure 1.6). Progress in vaccination has been steady, but is lagging behind other countries in the region, and should be accelerated.

Figure 1.6. Covid-19 infections have peaked and vaccinations are making progress



Source: Center for Systems Science and Engineering at Johns Hopkins University, Our World in Data.

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The authorities have rolled out a wide set of relief measures aimed at cushioning the economic fallout from the pandemic. Policies have aimed at preventing the most vulnerable groups from falling into poverty, to support firms and to provide sufficient liquidity to the economy (Box 1.1). These measures help to preserve jobs, firms and capital. According to IMF estimates, the 2020 recession would have been around 1.5 percentage points deeper without this policy support (IMF, 2021[3]). In the same vein, the increase in poverty and inequality could have been more than twice as high without exceptional policy support (UNDP, 2021[4]).

Box 1.1. Policy responses to the COVID-19 pandemic and recent reform progress

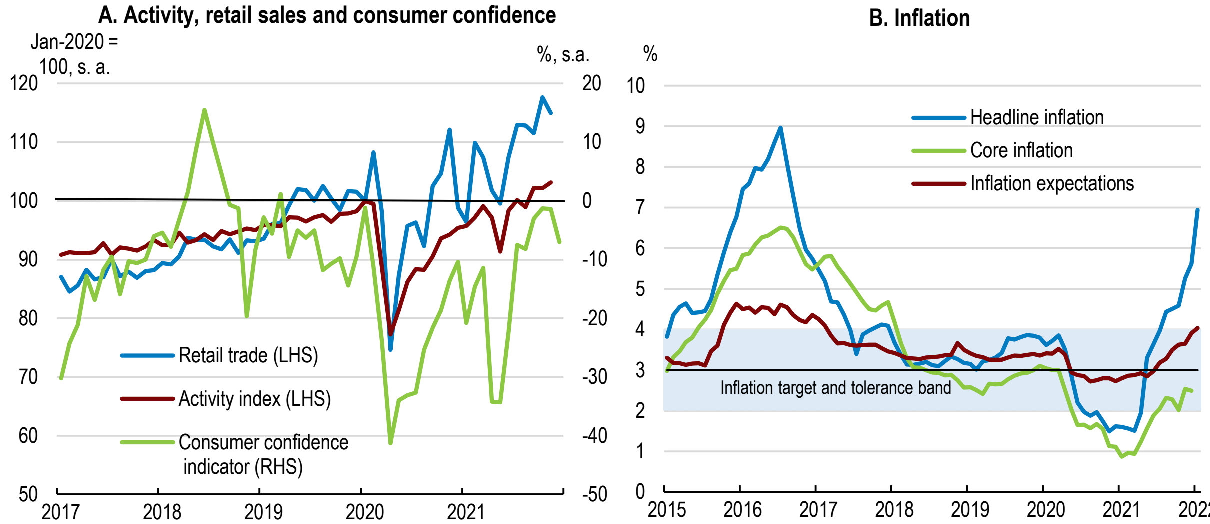
The pandemic response included a temporary suspension of the fiscal rule for 2020 and 2021 to allow for a fiscal stimulus of 4.1% of GDP during 2020 and 2021. Many of the main policy measures resemble support measures adopted across a wide range of OECD countries (OECD, 2021[5]):

- Income support measures to low-income workers, particularly those with informal jobs. Besides expansions in existing cash-transfers, a new unconditional cash transfer (*Ingreso Solidario*) was created for low-income households, especially informal workers not covered by other social protection programmes.
- Incentives for hiring young and female workers have been strengthened by a fiscal reform of September 2021.
- Temporary payroll subsidies have been put in place for more than 4 million formal workers, up to half a minimum wage (*Programa de Apoyo al Empleo Formal-PAEF*).
- The health system has been strengthened, including through additional resources. Intensive care capacity was significantly expanded.
- Monetary authorities cut rates by 250 basis points between March and September 2020 and temporarily provided extra liquidity in the first half of 2020 to protect payment systems and stabilise foreign exchange and asset markets. Bank lending benefited from an easing of reserve requirements and other prudential rules, complementing extraordinary credit lines and guarantees for particularly affected sectors. Grace period arrangements reduced credit defaults.
- A tax reform approved in September 2021 is expected to increase net public revenues by an average of 0.9% of GDP over the next decade, largely from higher corporate taxes, improvements in tax administration and expenditure restraint.

Activity has rebounded strongly, but the labour market remains weak

GDP has recovered strongly since the second half of 2020, driven by a solid rebound in private consumption (Table 1.1). Despite mobility restrictions, GDP continued its solid expansion in the first quarter of 2021. Widespread social protests which included road blocks and caused significant disruptions to local supply chains have dented the recovery in the second quarter of 2021 as consumer confidence and retail sales plunged (Figure 1.7). This pushed a more durable recovery of private consumption and investment into the second half of 2021. Annual GDP growth is projected at 9.5% for 2021, although heavily influenced by statistical carry-over effects from 2020. At the end of the last quarter of 2021, GDP is projected to stand 4% above the last quarter of 2019. Inflation has risen since April 2021, was 5.6% in 2021 and stood at 6.9% in January 2022, exceeding the tolerance band around the 3% inflation target. Core inflation, by contrast, is below target and inflation expectations remain well-anchored. Growth is projected at 5.5% for 2022 and 3.1% for 2023, while inflation is projected to return close to the target by late 2023.

Figure 1.7. Short-term indicators have been volatile and inflation has ticked up lately



Source: DANE, Fedesarrollo.

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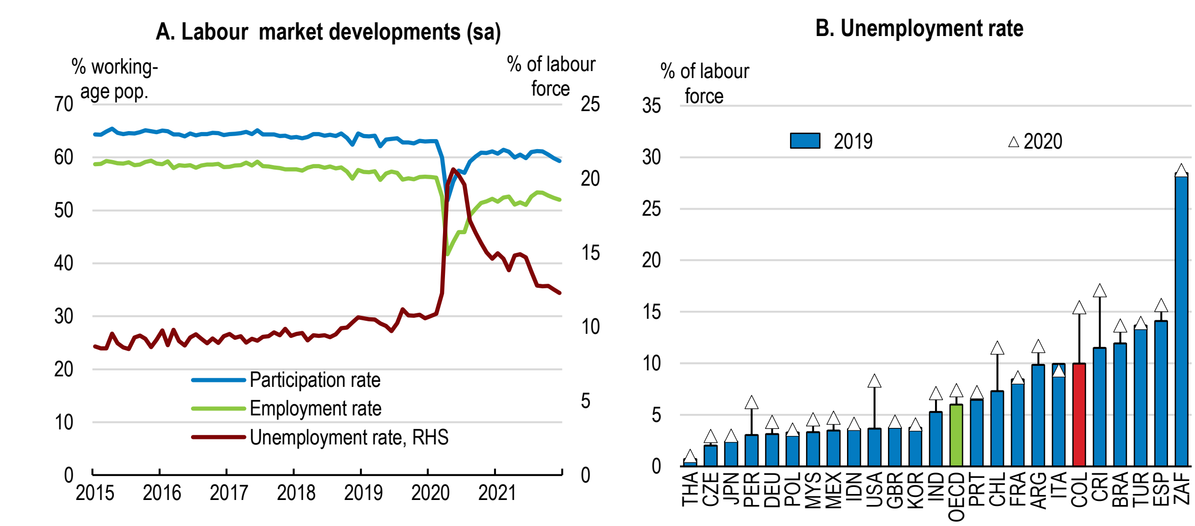
In contrast to GDP, the labour market is taking longer to recover (Figure 1.8, Panel A). The unemployment rate, which was already relatively high before the pandemic (Figure 1.8, Panel B), remains some 1.5 percentage points above the level of late 2019. By end-2021, some 95% of jobs lost during the pandemic had been recovered. As discouraged job seekers abandoned their efforts during the lockdowns in 2020, labour market participation declined substantially. At present, labour participation is around 3.8 percentage points below December 2019 levels, while the employment rate is 4.3 percentage points below. Job losses affected particularly informal workers and women, exacerbating pre-existing inequalities. Among women, unemployment is 15.1%, compared to 8.4% for men. Women's labour participation rate is recovering slower than men's. Real wages in the manufacturing and retail sectors now exceed pre-pandemic levels.

Figure 1.8. The labour market is recovering gradually



Source: DANE, CEIC, World Bank World Development Indicators.

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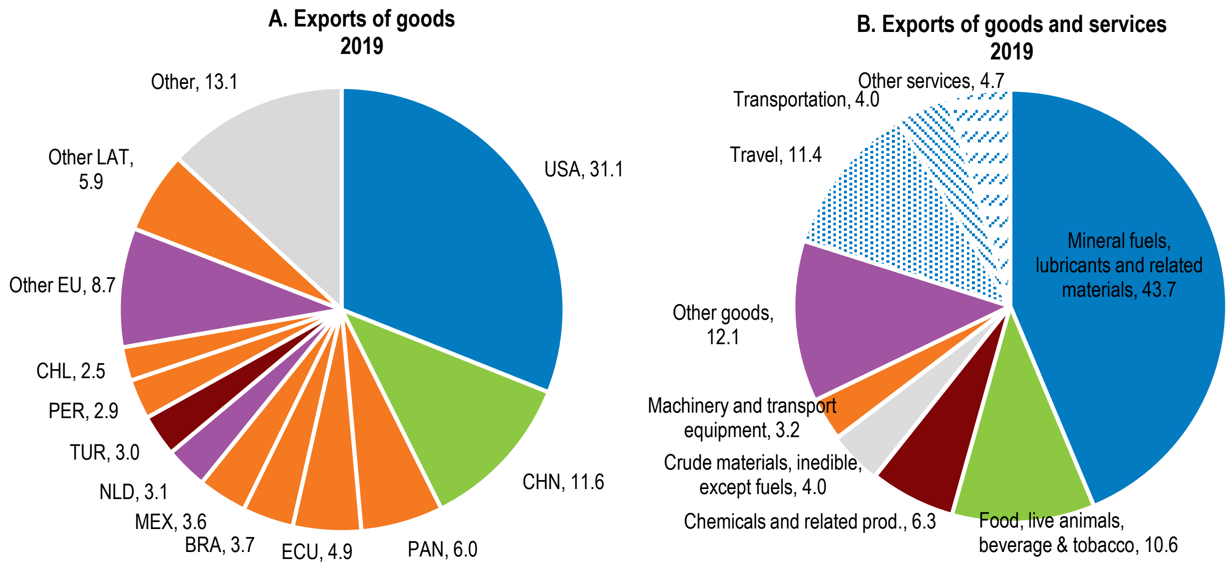
Table 1.1. Macroeconomic indicators and projections

	2017	2018	2019	2020	2021	2022	2023
National accounts	Percentage changes, volume (2015 prices)						
GDP at market prices	1.4	2.6	3.3	-6.8	9.5	5.5	3.1
Private consumption	2.1	3.2	3.9	-5.6	13.6	5.6	3.8
Government consumption	3.6	7.4	5.3	3.7	13.2	6.2	-1.4
Gross fixed capital formation	1.9	1.0	3.1	-20.6	8.3	4.6	6.5
Total domestic demand	1.1	3.5	4.1	-7.2	13.0	6.6	3.3
Stockbuilding[1]	-1.2	0.1	0.2	0.0	0.6	0.3	0.0
Exports	2.6	0.6	3.1	-18.3	11.5	10.9	6.9
Imports	1.0	5.8	7.3	-17.3	27.7	10.6	6.0
Net exports[1]	0.2	-1.1	-1.0	0.8	-4.0	-0.8	-0.3
Other indicators							
CPI inflation[2]	4.3	3.2	3.5	2.5	5.6	4.6	3.3
Core inflation (excluding food and regulated prices)[3]	5.3	3.9	3.3	2.0	2.5	3.7	3.1
Unemployment rate	9.4	9.7	10.5	15.9	13.7	11.8	10.8
Fiscal balance (central government, percent of GDP)	-3.6	-3.1	-2.5	-7.8	-7.1	-6.1	-4.6
Primary balance (central government, percent of GDP)	-0.8	-0.3	0.4	-4.9	-3.7	-2.6	-1.3
Gross public debt (central government, percent of GDP)	46.6	49.3	50.3	64.7	63.8	62.5	62.4
Current account balance (per cent of GDP)	-3.2	-4.2	-4.6	-3.5	-5.0	-4.6	-4.7

1. Contribution to changes in real GDP.
2. End-of-period, December-on-December changes.
3. End-of-period, December-on-December changes.
Source: OECD projections, OECD Economic Outlook Database, DANE, Central Bank, Minhacienda.

Looking ahead, continuous fiscal support to households through recently legislated enhanced social benefits will underpin further marginal improvements in consumption, but a stronger rebound in private consumption will hinge on improvements in the labour market. Significant infrastructure investment and strong demand in the housing construction sector will continue to support investment. Strong commodity prices and improving prospects in the main trading partners, in particular the United States and China, are expected to buoy external demand and reinforce the recovery of exports (Figure 1.9). As the vaccination campaign makes further inroads, 63% of the population were fully vaccinated in early February 2022. In year-on-year terms at the end of the last quarter of the year, GDP is expected to grow by 3.9% in 2022 and by 2.8% in 2023.

Figure 1.9. Principal export markets and exports



Source: UN Comtrade database.

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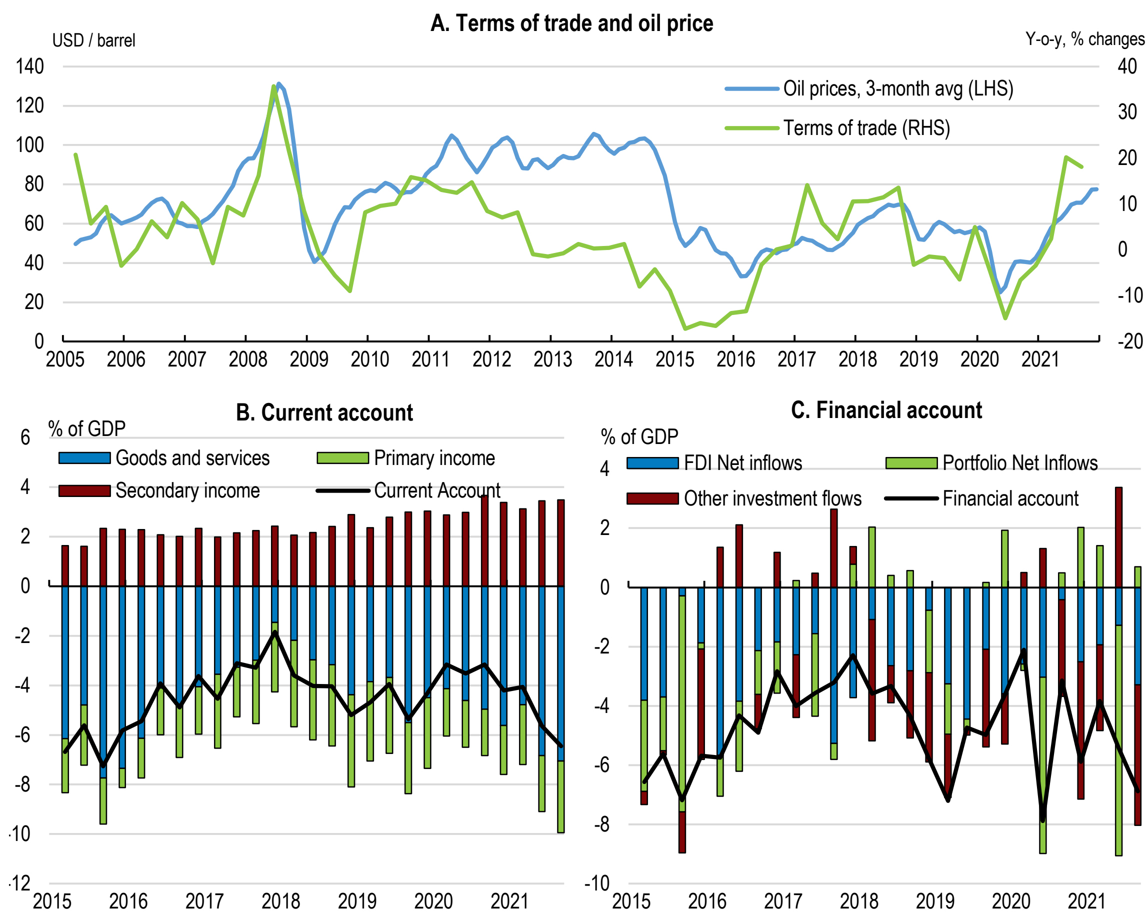
Risks around the recovery remain substantial

Overall, Colombia weathered the pandemic-related turbulences well and the flexible exchange rate acted as successful shock absorber. However, elevated financing needs and twin deficits on fiscal and external accounts imply vulnerabilities to external shocks and turbulences on global financial markets. Potential triggers could include a sudden drop in demand for emerging market financial assets, possibly in the context of monetary policy normalisation in advanced economies.

While direct investment inflows have been the main source of financing for the current account deficit, portfolio flows have been highly volatile, with significant outflows in early 2020 as global investors fled towards safe assets, and then again in 2021 during the social protests. As a major exporter of primary products including crude oil, Colombia remains exposed to changes in commodity prices. Exports saw a steep drop at the outset of the pandemic in 2020, amid global declines in commodity demand and prices which triggered a deterioration in Colombia's terms of trade. In 2021, the picture reversed and Colombia's export performance regained steam, including beyond mining and energy, which is particularly promising (Figure 1.10). The current account deficit narrowed in 2020 on account of lower investment income outflows, reflecting lower returns on foreign investments in Colombia. As the domestic demand recovers, the current account deficit is widening again. Fiscal adjustment, the dissipation of supply shocks and solid export performance, including in services, are likely to attenuate this widening over the next years.

Figure 1.10. External accounts have been marked by global volatility



Source: BRC; OECD Economic Outlook database.

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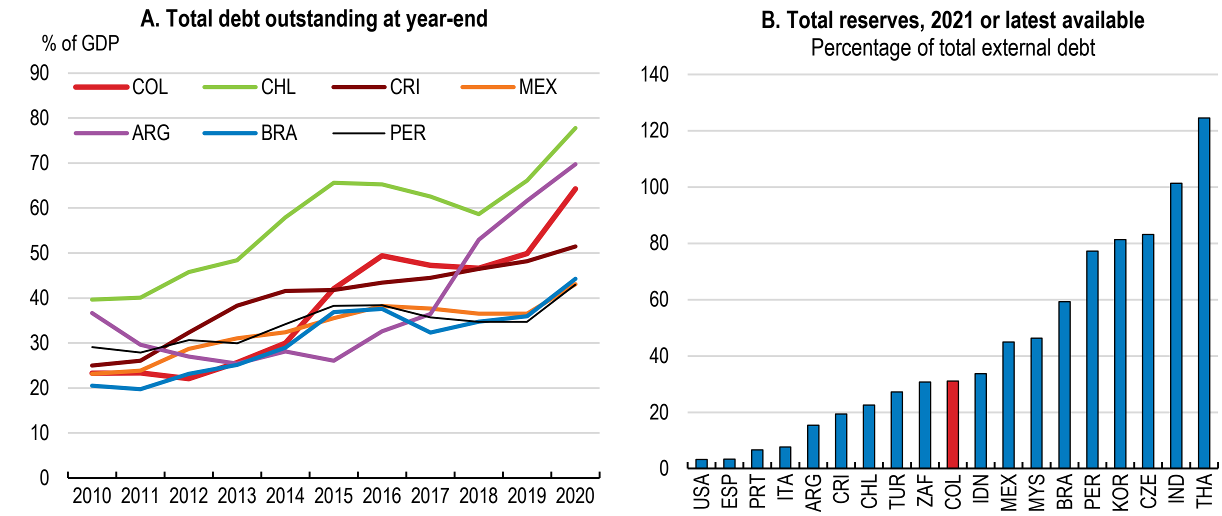
External debt amounts to 62% of GDP according to the definition applied by the IMF, which is higher than in other countries in the region and carries considerable risks (Figure 1.11). Exposure to global financial conditions has increased, in line with developments in other countries in the region. Currency reserves of 33% of external debt (or 22% of GDP) have increased, including through currency purchases by the central government, and are mid-range in international comparison, covering almost 12 months of imports (IMF, 2021[3]). Additional external buffers come from a two-year flexible credit line arrangement with the IMF until May 2022, of which only around a third has been drawn so far, with the remaining access of USD 12.2 billion (4.5% of 2020 GDP) being treated as precautionary. In the context of the August 2021 general allocation of Special Drawing Rights, Colombia received additional SDRs worth 1% of GDP.

Figure 1.11. External debt has risen and foreign exchange reserves are moderate



Source: IMF IFS and WEO databases.

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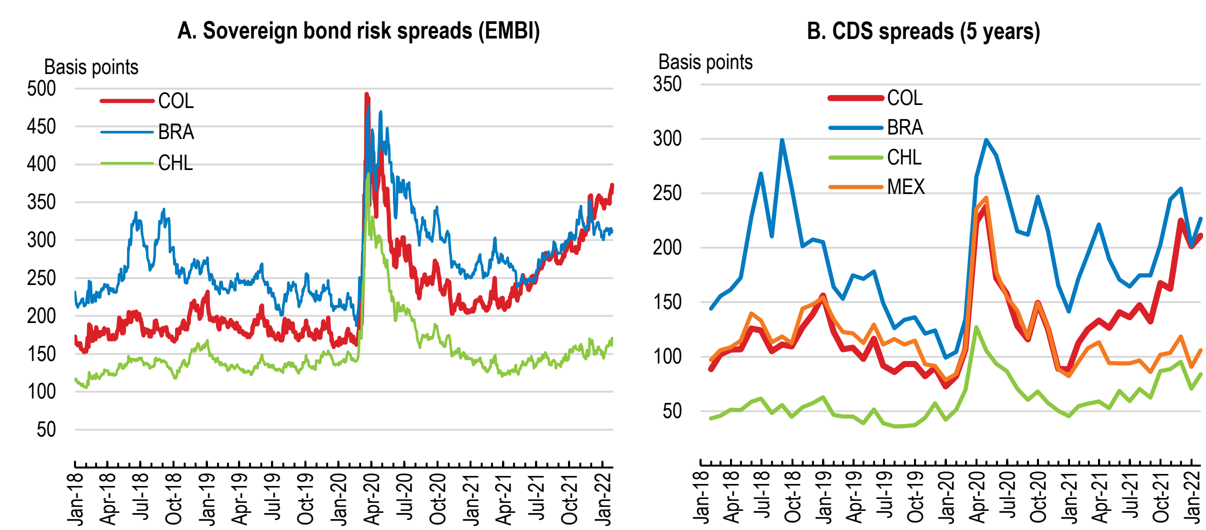
In mid-2021, external financial conditions tightened as risk perceptions about Colombia's public debt were affected by the decision of two major rating agencies to downgrade Colombian public bonds below investment grade. This occurred in a context of social unrest that eventually led to the withdrawal of an ambitious fiscal reform proposal, highlighting the political challenge of building a consensus for fiscal adjustment. Sovereign bond risk spreads edged up (Figure 1.12). The value of the currency, which tends to move in line with terms of trade, lost value at the same time as the latter continued improving. Fiscal uncertainties remain a significant medium term risk that could result in higher financing costs. With 40% of public debt denominated in foreign currency, tighter global financial conditions could exacerbate this and potentially increase rollover risks.

Figure 1.12. Colombia has weathered financial turbulences well, but risk perceptions have risen



Note: EMBI = JP Morgan EMBI spreads.
Source: Refinitiv.

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Future developments of the Covid-19 pandemic remain another potential downside risk, given previous swings in the trajectory of infections and the potential emergence of vaccine-resistant variants. Accelerating progress in vaccine rollouts would help to mitigate this risk. Moreover, a number of medium-term vulnerabilities could affect growth outcomes (Table 1.2).

Table 1.2. Potential major medium-term vulnerabilities

Vulnerability	Possible economic outcomes
COVID-19 and vaccines: Emergence of new virus variants and a potentially limited efficacy of vaccines.	Renewed lock-downs, significantly lower growth, deterioration of fiscal and social outcomes.
Fiscal risks: Future administrations could struggle to put the public finances on a solid footing in the context of a polarised political environment.	Further increases in public financing costs, potentially affecting public debt sustainability.
With 5% of public revenues coming from fossil fuel extraction, long-term fiscal sustainability challenges may arise from a global transition towards alternative energy sources.	Deterioration of fiscal outcomes
Additional social tensions. Even after the 2021 wave of protests has subsided, the risk of civil unrest remains high.	Lower prospects for the implementation of reforms, weaker policies and hence lower growth.
Climate-related risks: More frequent adverse climate events, such as the major hurricane that struck Colombian islands in 2020, could reduce economic activity in some sectors and areas, while requiring stronger fiscal efforts for disaster relief.	Lower growth, deterioration of fiscal outcomes
Environmental risks: Deforestation or an increase in extractive activities could lead to increased greenhouse gas emissions.	Meeting greenhouse gas emission targets may become out of reach.

Financial stability risks seem contained

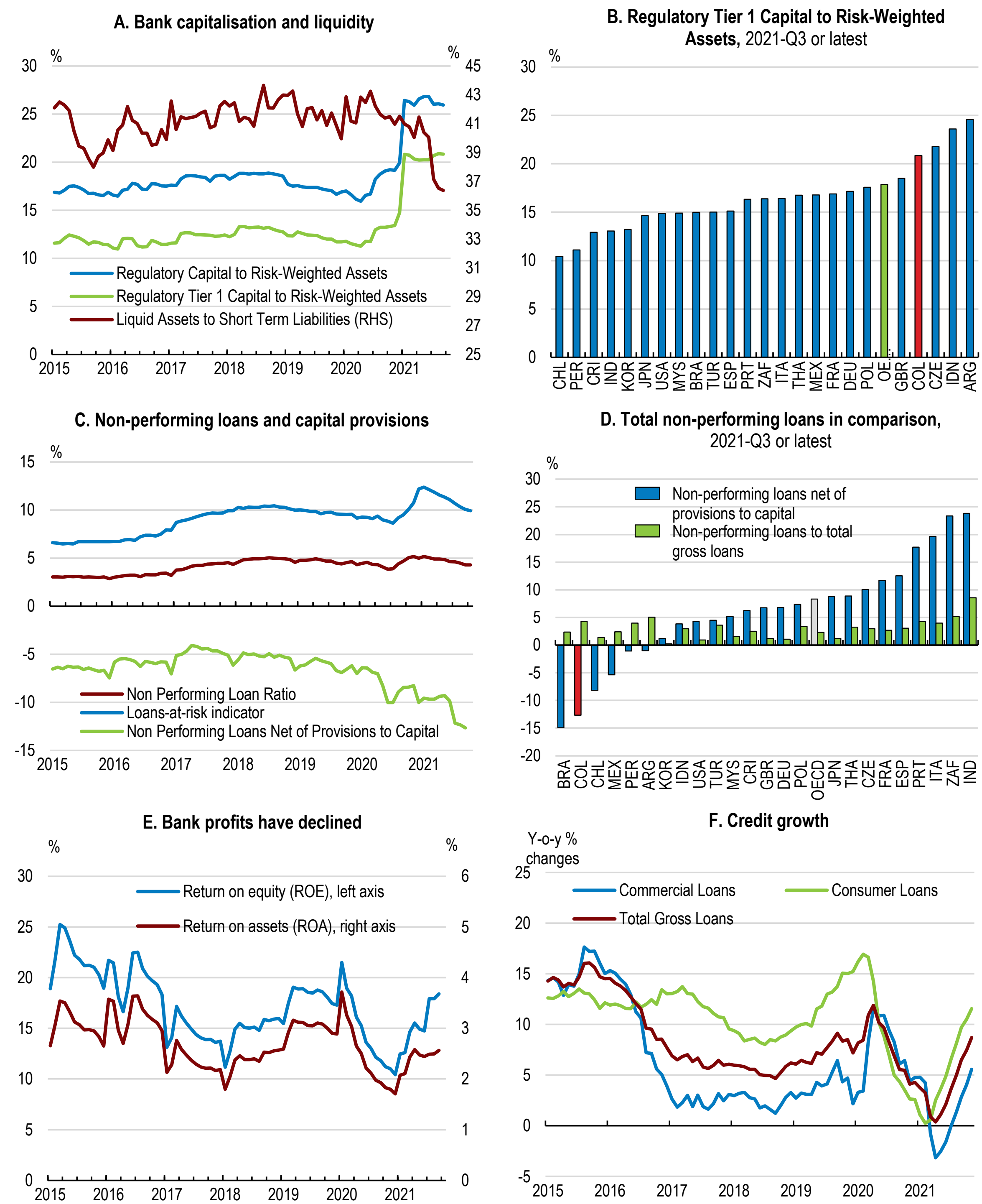
Significant uncertainties affect the future developments of asset quality in the financial sector, as the full effects of the crisis on default rates and credit portfolios remain yet to be seen. This could present risks for financial institutions, who entered the pandemic from a strong starting position. Capitalisation and liquidity indicators have improved, exceeding regulatory requirements, and compare well against other emerging economies (Figure 1.13). Mandatory compliance with Basel III rules was phased in as of 2021, which explains an increase in measured capitalisation, although some institutions have started this process earlier. Stress tests undertaken by the Central Bank suggest that in the case of a growth shock during 2021 and 2022, bank capitalisation would not fall below regulatory limits (Banco de la República, 2021[6]).

As the pandemic struck, credit quality initially deteriorated between July 2020 and January 2021. Since then, both the non-performing loan ratio and a more stringent loans-at-risk indicator have declined (Superintendencia Financiera de Colombia, 2021[7]). A first wave of exceptional grace period arrangements and enhanced flexibility in loan classifications came to an end in July 2020 and a second wave of measures in August 2021. Credit institutions have raised provisions to pre-empt a potential deterioration of their credit portfolio, with provisions currently covering 150% of overdue credit. These provisions dented bank profits in late 2020, shown by a decline in their returns on assets and equity, but much of that has been recovered since. Banks have tightened their credit standards, which may help to explain why overall credit growth came to a temporary halt in early 2021 (Banco de la República, 2021[8]). Since then, it has picked up again, and overall credit now stands at 52% of GDP.

Corporate sector liabilities have risen to 64% of GDP in 2020, 7.5 percentage points above 2019 (Banco de la República, 2021[6]). This is related to lower GDP, but it also suggests that corporates have been able to obtain financing to cover a period of contracting demand and mobility restrictions, both from domestic banks and foreign parent companies, in the case of foreign subsidiaries. Small and medium enterprises in particular were able to benefit from public loan guarantees and related schemes, but around 500,000 of them closed during 2020. Exchange rate risks can affect private corporate liabilities denominated in foreign currency, equivalent to 19% of GDP and of which around 6% of GDP are neither hedged, nor owed by exporting or foreign-owned companies. The recent decline in operating revenues experienced by many corporates could also present lingering risks for this credit segment, as around 21% of firms lacked after-tax incomes sufficient to cover their interest expenses in late 2020 (Banco de la República, 2021[9]). This percentage increased 200 basis points.

Household credit came to a temporary halt in early 2021, but its growth has since resumed, reaching 26% of GDP. One of the legacies of the pandemic may be a significant improvement in financial inclusion propelled by the electronic payment of emergency benefit programmes. The share of people with at least one financial product has risen to 88% in 2020, at a pace 10 times historical trends.

Figure 1.13. Financial stability indicators have deteriorated at the margin during the pandemic



Source: CEIC, Superintendencia Financiera de Colombia, BIS , BRC.

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Monetary policy support should be withdrawn gradually

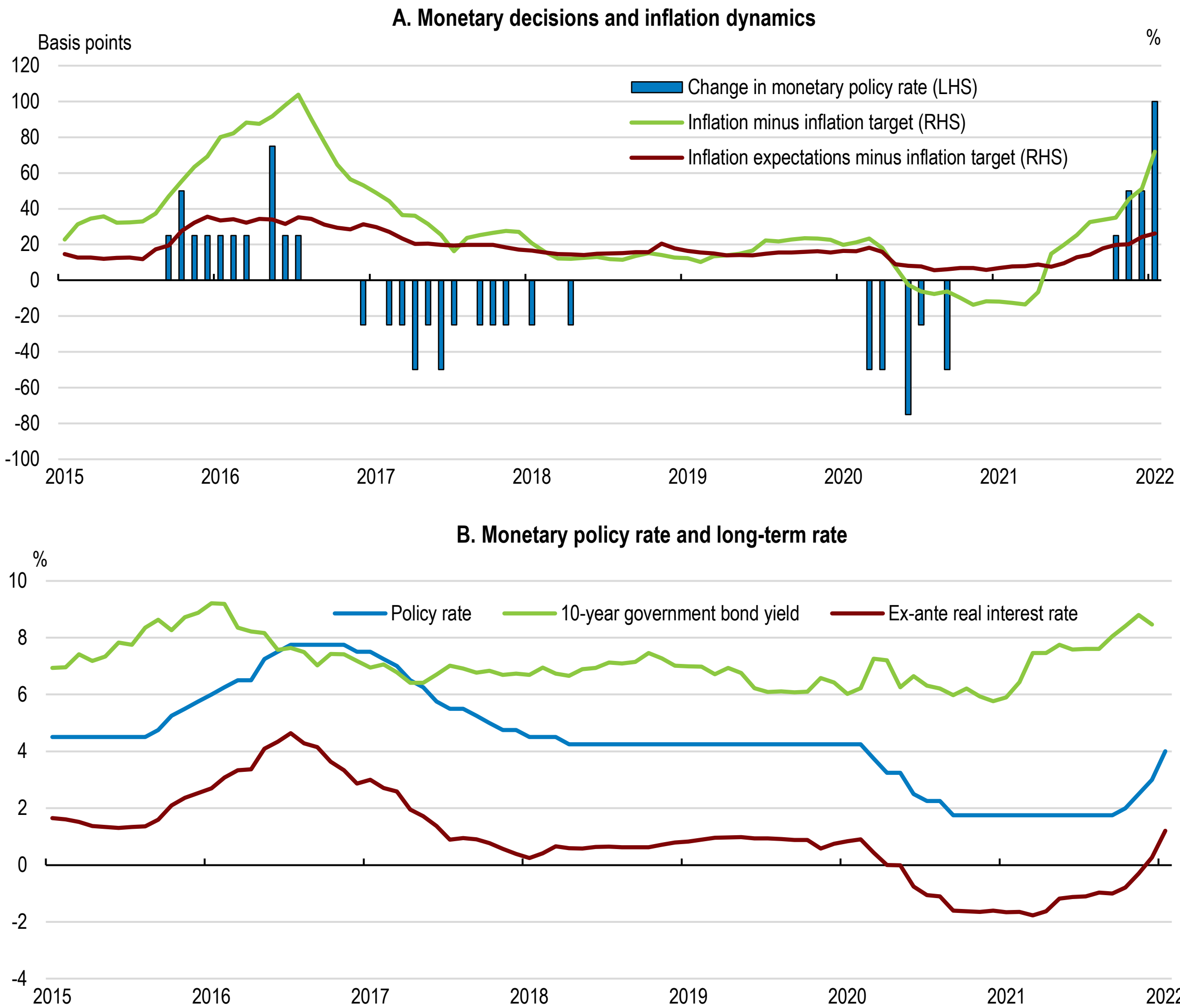
Monetary policy has built up strong credibility within Colombia's inflation-targeting regime, by correctly anticipating increases in inflation above the 3% target in 2016, and easing financial conditions as inflation declined (Figure 1.14). This allowed a decline in the policy rate by 250 basis points as of March 2020 to a historic low of 1.75%, anticipating a steep drop in inflation to 1.6% as output and credit demand plummeted. In this context, real rates dropped below zero. Enhanced liquidity operations in domestic and foreign currency provided additional support through a more generous definition of admissible collateral and counterparts in 2020, in addition to a reduction of reserve requirements and temporary direct asset purchases aimed at stabilising markets. These measures reduced volatility, supported credit supply and ensured a swift transmission of monetary policy easing.

Inflation rose above the 3% target in May 2021 after 12 months well below it, and has accelerated to 6.9% in January 2022. Core inflation measures, however, have been significantly lower, with the main measure that excludes food items and administrated prices at 2.5% in December 2021. Rising energy and oil prices are one source of inflationary pressures, but some of the recent factors could well be temporary, such as supply chain disruptions related to global supply bottlenecks and local social protests. By contrast, prices for telecommunications services eased in the advent of a new market entrant. Inflation expectations remain well-anchored around the target over a two-year horizon.

Monetary policy has started to withdraw some of the previous stimulus with 225 basis points of rate increases since September 2021, in line with developments in other Latin American economies. The policy rate now stands at a still accommodative 4.00%. Against the background of a slow labour market recovery, the economy still has significant idle capacity and core inflation and wages will remain muted for now.

The gradual normalisation towards a neutral policy stance should continue in a context of pronounced uncertainty. As inflationary pressures intensify, monetary policy should gradually return towards a broadly neutral stance, with neutral policy rates estimated to be in the 4.5 to 5% range (Banco de la República, 2021[10]). The pace of rate increases will depend on whether additional price pressures emerge, on developments in inflation expectations and on the speed of recovery. Rising uncertainty, including about the currently planned fiscal adjustment, could be one reason to accelerate this pace, should it occur. The flexible exchange rate should continue to act as a shock absorber, as it did during the significant depreciation in 2020. Continuing a prudent accumulation of foreign currency reserves, to the extent that financial conditions allow, would provide additional insurance against a potential unexpected tightening of global financial conditions.

Figure 1.14. Monetary policy has reacted strongly and anticipated inflation developments



Source: CEIC; BCR; OECD calculations.

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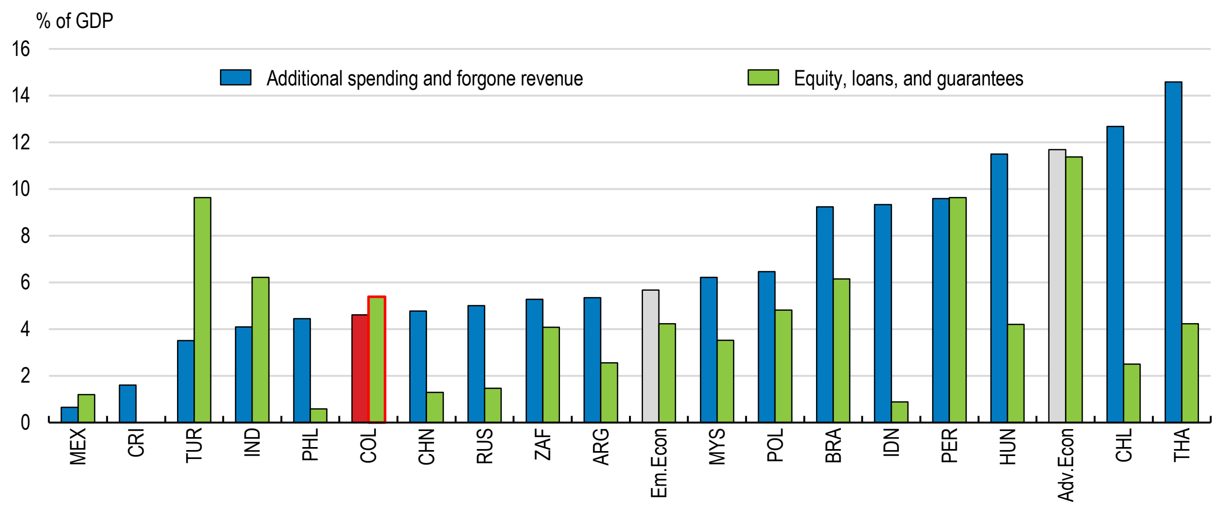
Public finances will need reforms to boost sustainability and equity

A significant fiscal response of around 4.6% of GDP in discretionary spending helped to protect millions of households, firms and jobs from an even more adverse impact of COVID-19. This policy response was close to the average for emerging economies, but somewhat below the response of Brazil, Chile and Peru (Figure 1.15). The fiscal rule has been appropriately suspended for both 2020 and 2021 (Minhacienda, 2021[11]). The headline fiscal balance declined to -7.8% of GDP in 2020, before improving to -7.1% in 2021. Continuous stimulus in 2021 was warranted in light of the weak labour market recovery and the resulting need to support poor and vulnerable households.

Figure 1.15. Colombia's fiscal response to Covid-19 has been substantial

Cumulative discretionary fiscal response



Note: Estimates as of September 27, 2021. Em Econ = simple average of emerging economies shown in chart. Adv Econ = simple average of AUS, BEL, CAN, CHE, CZE, DEU, DNK, ESP, FIN, FRA, GBR, ITA, JPN, KOR, NLD, NOR, NZL, SGP, SWE, USA.
Source: IMF Database of Country Fiscal Measures in Response to the COVID-19 Pandemic, available at https://www.imf.org/en/Topics/imf-and-covid19/Fiscal-Policies-Database-in-Response-to-COVID-19.

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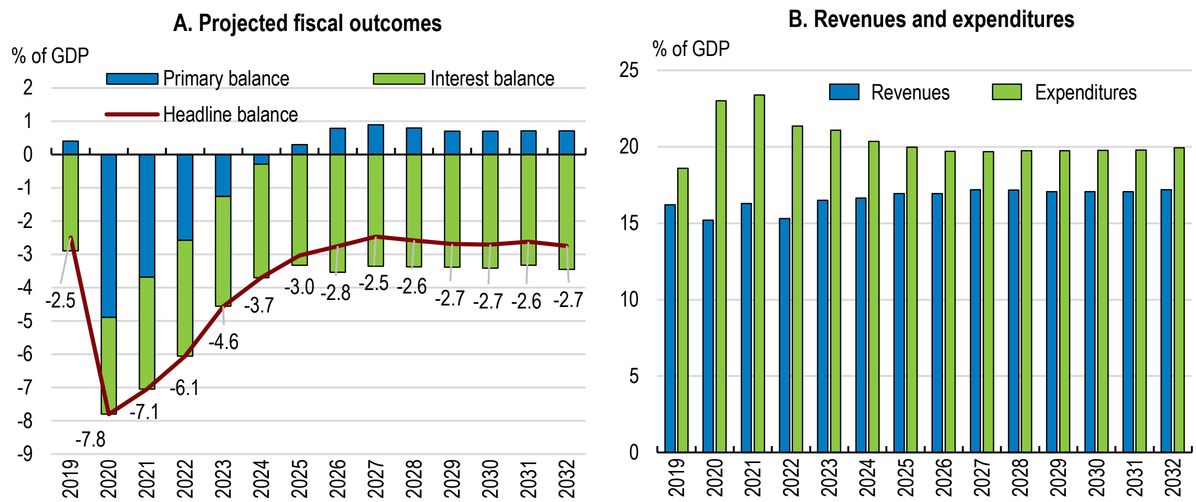
Looking ahead, fiscal policy will require a gradual adjustment once the recovery strengthens in 2022, while maintaining exceptional income support measures for vulnerable households and the most affected sectors until the labour market recovers. A fiscal reform legislated in September 2021 is an important step into this direction. The reform is expected to lead to permanent improvements of the fiscal balance of around 0.9% of GDP as of 2023, as part of an adjustment plan to bring the headline deficit below 3% of GDP over a period of 5 years (Figure 1.16). Over the period 2022-2032, central government revenues are meant to increase by 0.7 percentage points of GDP while expenditures are expected to decline by 5.2 percentage points, including the phase-out of pandemic-related extraordinary expenses (Minhacienda, 2021, p. 242[11]). The legislated reform, however, will only lead part of the way to this planned adjustment, as the frontloaded fiscal adjustment foresees an improvement in the fiscal balance of 1.0 percentage points in GDP in 2022 and 1.5 percentage points in 2023. Over a longer horizon, OECD estimates point to adjustment needs of approximately 1.5% of GDP, if public investment is to be maintained at its long-term average of 1.5%-2% of GDP.

Figure 1.16. The planned fiscal adjustment is centred on expenditure restraint



Note: Numbers reflect central government fiscal plans from the Medium Term Fiscal Framework, adjusted for the fiscal plan of February 4, 2022 and OECD GDP projections.
Source: Ministerio de Hacienda (Minhacienda, 2021[11]).

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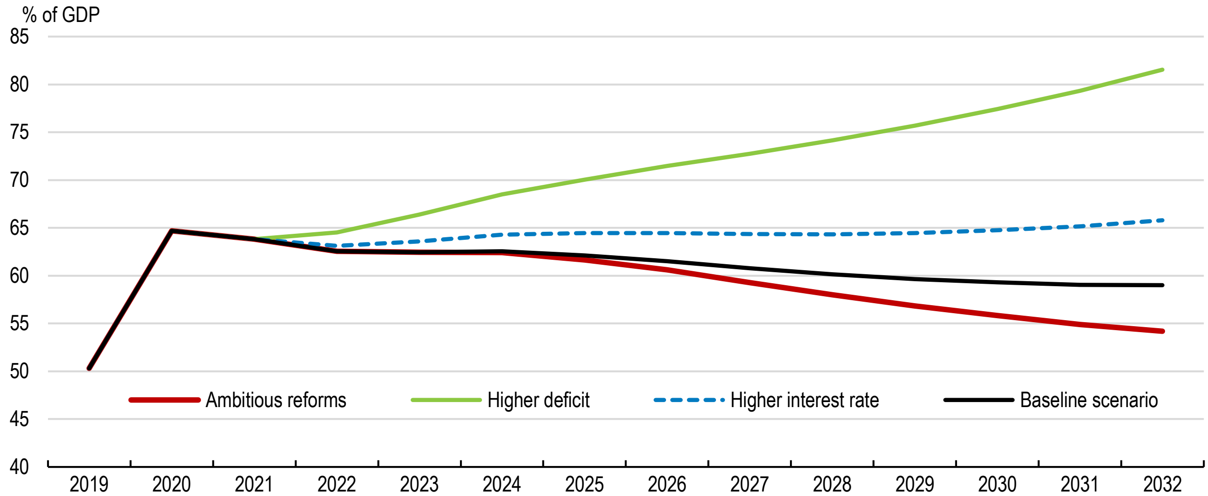
With the currently planned fiscal adjustment, OECD projections suggest that gross public debt will stabilise at around 59% of GDP by 2030 (Figure 1.17). This is slightly below current debt levels, but 8.5 percentage points higher than in 2019. This level is below the average gross public debt of 65% of GDP for emerging market economies today, and also below today's Latin American average of 75% (IMF, 2021[12]). At the same time, this level leaves much less space to address unforeseen spending needs or risks and it would be prudent to rebuild stronger fiscal buffers. Fiscal costs related to population ageing will be small compared to other OECD countries, given that less than 25% of those in old age have access to contributory pensions and that the cost of non-contributory pensions is only 0.1% of GDP due to low benefits and coverage.

The 2021 fiscal reform has significantly reduced fiscal risks. Still, with around half of the planned fiscal adjustment due in 2023 left for the next administration to achieve, implementation risks around the current debt projections remain in place. A lower commitment to fiscal consolidation in the future could easily derail debt stabilisation, as could a small rise in interest rates (Figure 1.17). The latter could potentially result from changing international investor sentiment toward Colombia or emerging market assets more broadly, as well as stronger domestic monetary policy tightening. In May 2021, public debt yields rose visibly after two major rating agencies withdrew Colombia's investment grade rating, following social protests and the withdrawal of a much more comprehensive fiscal reform proposal. Permanently higher debt levels could make it more difficult to regain investment grade rating and the financing conditions enjoyed in the past. On the upside, an ambitious structural reform package along the lines of the policy recommendations in this Survey would strengthen growth (see Figure 1.5) and improve the sustainability of public debt. Colombia's long-standing and solid track record for fiscal prudence will also support investor confidence in its fiscal accounts.

Figure 1.17. Public debt has risen sharply

Scenarios for the trajectory of gross public debt



Note: The chart depicts gross public debt of the central government. The baseline scenario assumes GDP growth as in table 1.1 until 2023, with a gradual transition to OECD long-term model estimates of potential output thereafter. Inflation is projected at an average of 3.1%, and baseline fiscal assumptions are those outlined in Minhacienda (2021), adjusted for the fiscal plan of February 4, 2022 and OECD GDP projections. The ambitious reform scenario assumes all the implementation of all reforms described in Figure 1.4. The higher deficit scenario implies higher primary expenditures of 2% of GDP per year. The higher interest rate scenario considers a 1 percentage point increase in the implicit interest rate paid on public debt.
Source: OECD projections based on OECD analysis and Minhacienda (2021).

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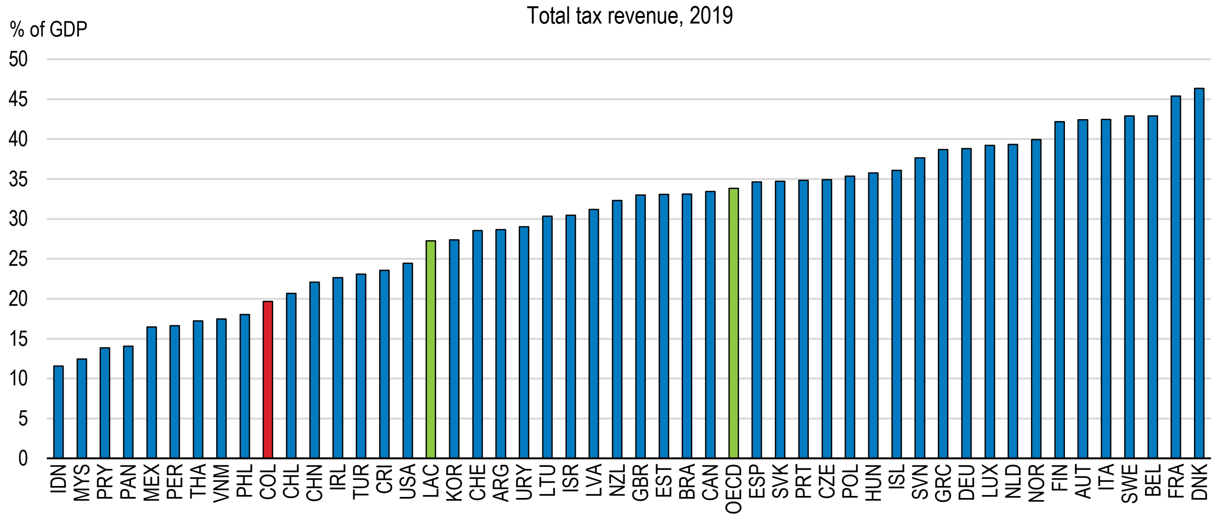
While the fiscal reform legislated in September 2021 will help to stabilise public debt, it will not entail a deeper overhaul of public spending and revenues. Current adjustment plans are largely based on expenditure cuts (Figure 1.16), involving a retrenchment of investment, a fade-out of pandemic-related social spending by end-2022 and significant expenditure restraints for the public administration including a general hiring freeze (Minhacienda, 2021[11]), some of which may be hard to uphold over the years. The only sources of additional revenues are higher taxes on corporations, which are already high in comparison to OECD economies, and welcome improvements in tax collection, which have been recommended in previous OECD work (OECD, 2019[13]).

The reform reflects a broad political compromise in the aftermath of the social protests in May, but is far from optimal in light of Colombia's long-standing need to raise more public revenues and the exacerbation of persistent social challenges in the aftermath of the COVID pandemic. Colombia's public sector is small in international comparison, including in the region (Figure 1.18). At only 20% of GDP, public revenues are insufficient to meet rising social demands, heal the wounds of the pandemic and preserve essential public investment. The need to raise more public revenues and address long-standing challenges in the tax system has been discussed in several previous Economic Surveys (OECD, 2019[13]; OECD, 2017[14]; OECD, 2015[15]; OECD, 2013[16]).

Figure 1.18. Colombia's public sector revenues are small in international comparison



Note: LAC is a simple average of ARG, BRA, CHL, COL, CRI, MEX, PER.
Source: OECD, Global tax revenue database.

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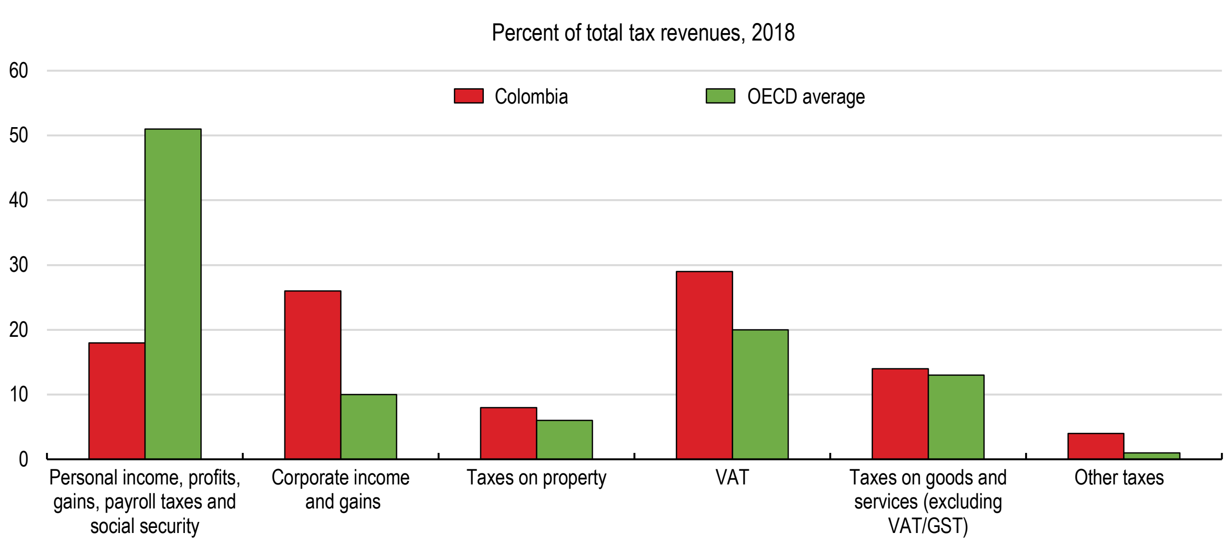
An ambitious tax reform is needed to address long-standing challenges

Colombia's low tax revenues reflect essentially very low revenues from personal income taxes compared to other OECD economies (Figure 1.19). In turn, corporate income tax revenues are more than 2.5 times higher than the OECD average. Previous OECD tax recommendations included rebalancing the tax burden from corporate to personal incomes, simplifying the tax system, reducing tax expenditures and more ambition to reduce tax evasion, as outlined in the 2019 OECD Economic Survey of Colombia (OECD, 2019[13]) or the 2021 Tax Expenditure Report (OECD, Dian and Ministerio de Hacienda, 2021[17]).

Figure 1.19. Colombia's tax structure is distant from the OECD average

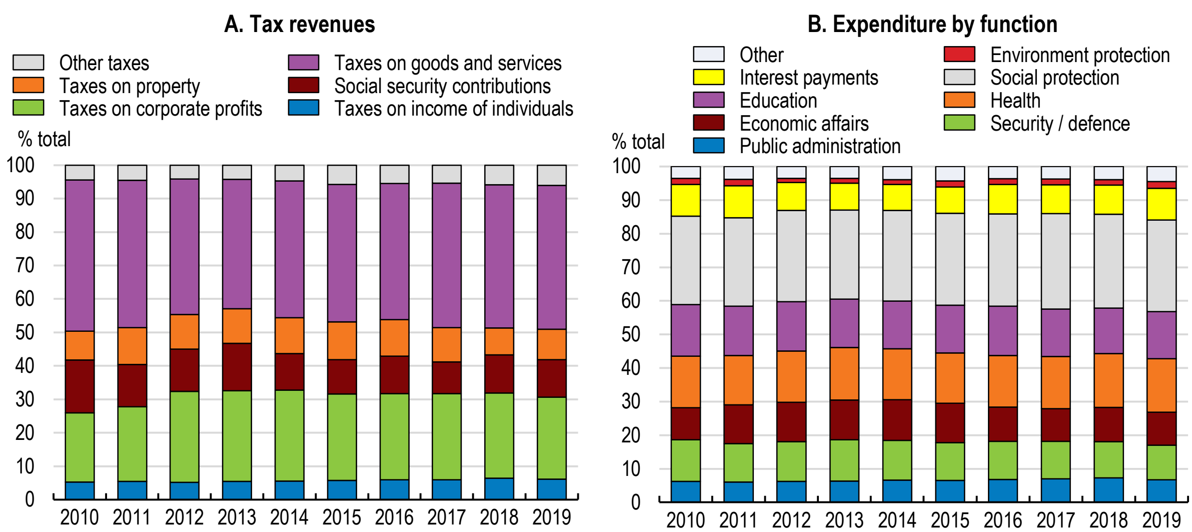


Note: Tax revenue includes net receipts for all levels of government.
Source: OECD Revenue Statistics.

StatLink https://stat.link/kpdz9c

Despite 20 tax reforms in the last 20 years, the structural shortcomings of Colombia's tax system have not been effectively addressed and tax structures have remained fairly stable (Figure 1.20). Most of the past reforms were small and piecemeal, providing small patches to existing shortcomings, while creating others along the way.

Figure 1.20. The composition of public revenues and expenditure has been stable



Source: OECD Revenue Statistics; DANE.

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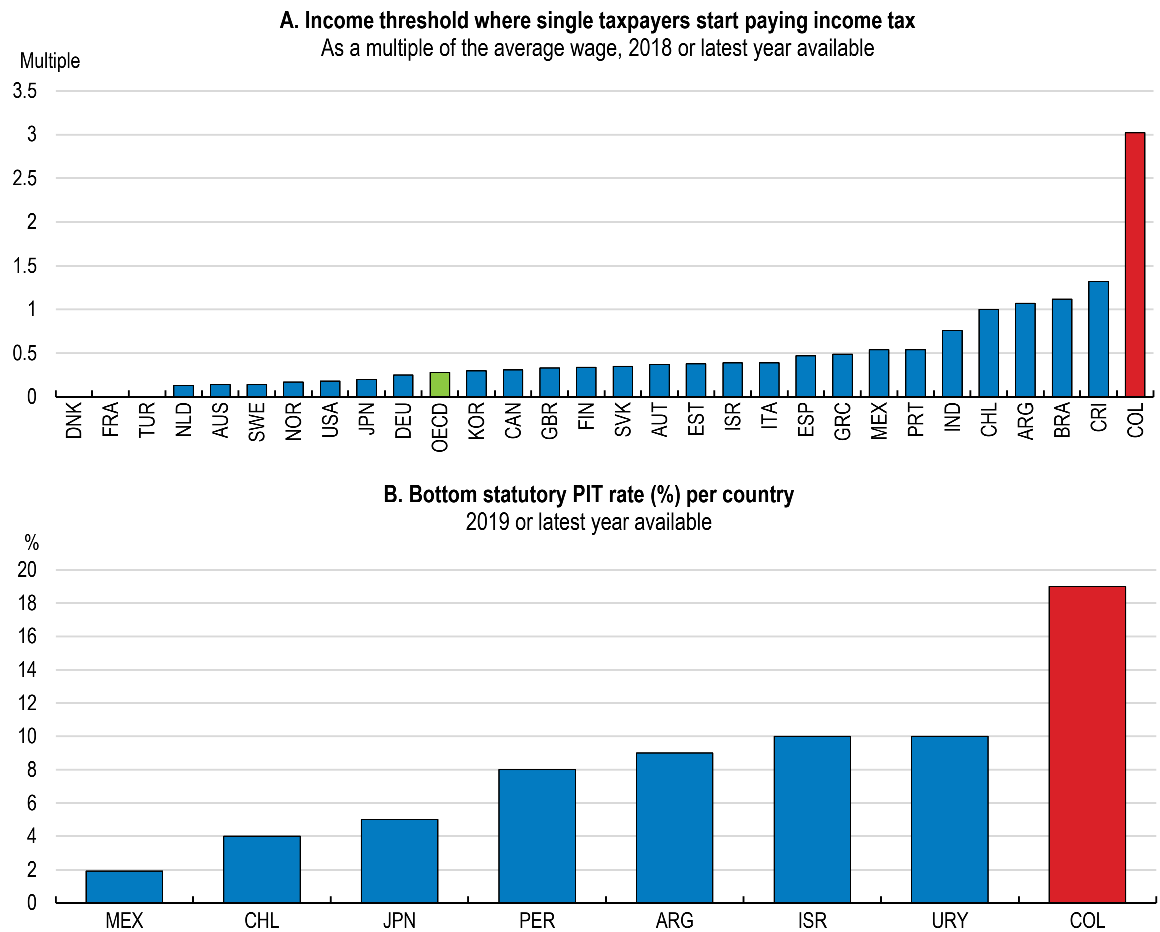
Only around 5% of income earners (1.6 million individuals) pay personal income taxes, due to a basic exemption of around 3 times the average wage. This leaves not only the entire middle class out of personal income taxation, but also many high-income earners, and reduces the scope for progressive taxation (Figure 1.21). Colombia has substantial scope to bring more people into the personal income tax system without affecting the bottom half of the income distribution. Moreover, the current situation implies that most people do not file income tax returns, which deprives the state of an important potential targeting mechanism for redistribution through taxes and transfers (see Chapter 2). This explains the traditionally low impact of Colombia's tax and benefit system on income inequalities, compared to other OECD countries. Lowering the basic personal income tax exemption should proceed gradually over time, in line with a reduction of the entry tax rate (currently at 19%), which is high in international comparison, and in line with the reductions in social security contributions discussed in Chapter 2. Such a reform would reduce rates simultaneously with broadening the tax base and setting a more progressive rate schedule, while strengthening the incentives for formal job creation.

An immediate priority and appropriate first step in reforming personal income taxes would be to reduce tax expenditures, as discussed in the 2021 OECD Tax Expenditure Report (OECD, Dian and Ministerio de Hacienda, 2021[17]). Exemptions of certain incomes and tax deductions, some of which increase with income, cause revenue losses of around 0.7% of GDP and significantly diminish tax progressivity (Minhacienda, 2021[11]). Most of the benefits accrue to high-income households. Mortgage interest payments, contributions to private healthcare schemes, voluntary retirement savings and severance payments can all be deducted from the tax base. Pension contributions, including to voluntary schemes, can be deducted almost without limits and most pension benefits are not taxed either, despite their highly regressive nature under the current pension system (Chapter 2). The case for taxing high pensions is strong, given the regressive nature of the implicit public subsidies. This would allow to frontload some of the savings from a pension reform. Overall income tax exemptions are currently capped at 40% of taxable income, but that number could be reduced significantly.

Dividend incomes are currently only taxed at 10% at the personal level, with a 0% tax rate on the first 3000 USD, equivalent to around one yearly minimum wage. A higher dividend tax rate and no exemption would be possible, as part of a partial shift of the tax burden on capital income from the corporate level towards the shareholder level.

Figure 1.21. Only few people pay personal income taxes



Source: OECD Taxing Wages 2021, available at https://doi.org/10.1787/83a87978-en.

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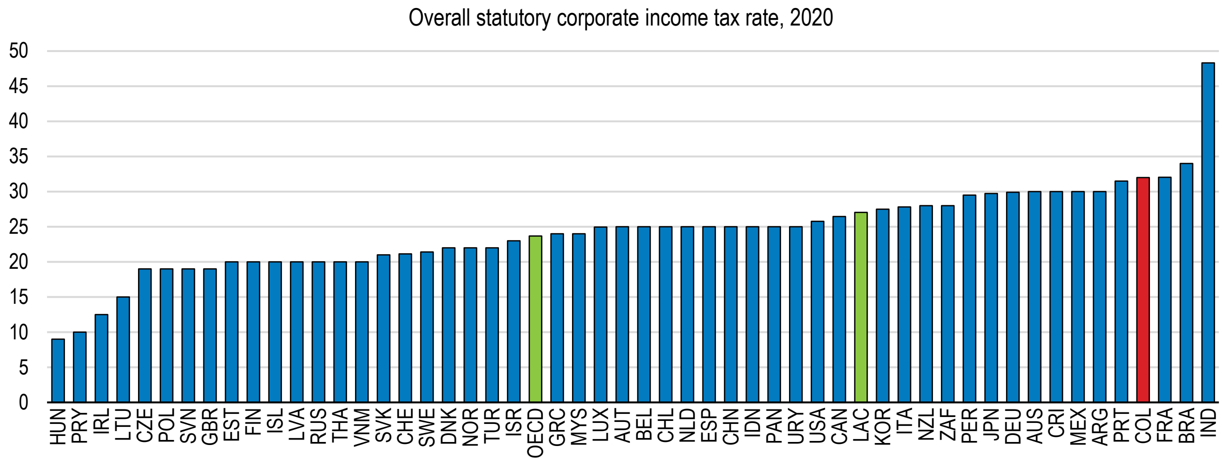
A statutory corporate tax rate of 35% in 2022 is high relative to the OECD average of 24% (Figure 1.22). Gradual rate reductions as of 2021 had been legislated, before the 2021 fiscal reform implemented a 35% rate. This high corporate tax rate adds to other highly distortive taxes on businesses like the local business turnover tax ICA, all of which weaken investment incentives and are likely to have negative growth effects (OECD, Dian and Ministerio de Hacienda, 2021[17]; Arnold et al., 2011[18]). Moreover, many of the current exemptions and tax benefits could be reconsidered as a first priority, potentially raising revenues by as much as 1% of GDP while levelling the currently uneven playing field (Minhacienda, 2021[11]). For example, the lower rate and simultaneous VAT exemptions for so-called “Free Zones”, some of which consist of single enterprises, have never been subject to a systematic cost-benefit evaluation and probably generate more distortions than benefits. It is predominantly used by domestically-oriented firms. The distortive design of the business tax regime for corporations is also one factor behind the large number of unincorporated firms and should be addressed with a broad business tax reform that creates a simpler system for all firms rather than adding additional exemptions.

Figure 1.22. The corporate tax rate is high



Source: OECD Tax Revenue Database.

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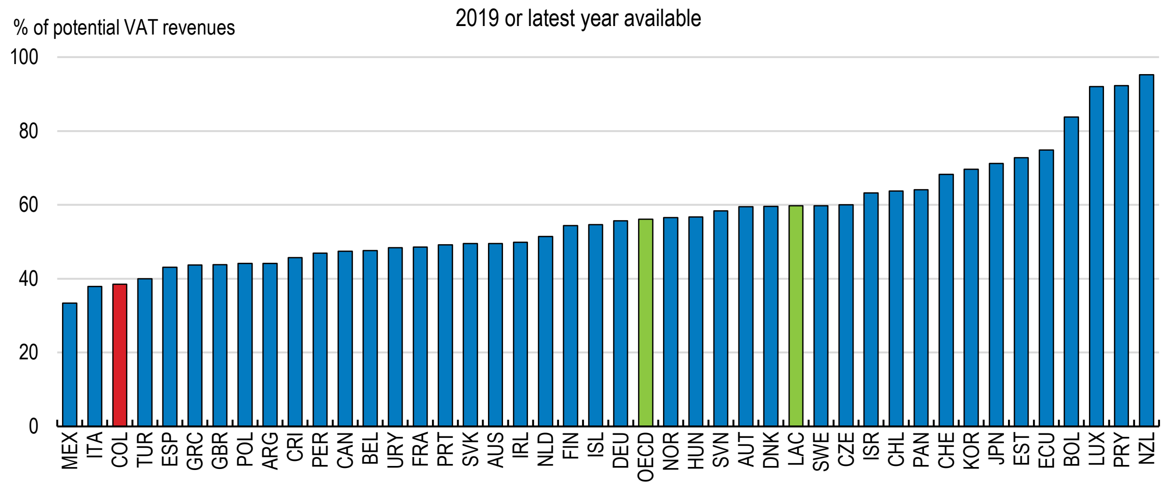
VAT revenues could be raised significantly by limiting the scope for exemptions and reduced rates and raising compliance (Figure 1.23), with compensation mechanisms to protect the poorest households. The overall fiscal impact of exemptions and reduced rates in VAT amounts to 4.9% of GDP (Minhacienda, 2021[11]). Zero and reduced rates and exemptions affect not only basic consumption items, but a wide range of goods and services across health, education, food, medicines and transportation, in addition to computers, tablets and mobile phones up to a price cap. The lion's share of the foregone revenues ends up with higher income households. Instead, poor households could be compensated through means-tested benefits to improve targeting. The authorities started to roll out such a compensation benefit in 2020 (*Compensación del IVA*). This benefit could be better integrated with existing benefits to the poor, but once this reaches all low-income households, authorities can progressively eliminate VAT exclusions and exemptions while raising compensation benefits. The practice of declaring specific days as VAT holidays should be discontinued, as this fails to promote any legitimate policy objective.

Making these tax reforms politically viable may require a gradual implementation, and requires a clear identification of winners and losers. In combination with a benefit reform as discussed in Chapter 2, all those in the bottom half of the income distribution, and those with incomes not far above the minimum wage, would reap strong net benefits from deep tax reform. The sequencing of these reforms could be more gradual for lowering the income threshold for paying personal income taxes, which would go hand-in-hand with lower social security contributions, and more immediate for the removal of largely regressive tax expenditures. For low-income households, potential effects on purchasing power from higher VAT on some consumption items would be compensated through benefits.

Figure 1.23. Exemptions and special rates erode VAT revenues



Note: The VAT revenue ratio (VRR) is defined as the ratio between the actual value-added tax (VAT) revenue collected and the revenue that would theoretically be raised if VAT was applied at the standard rate to all final consumption. The OECD and LAC (excluding Colombia) aggregates are unweighted averages of data shown and data for Canada cover federal VAT only.
Source: OECD Consumption Tax Trends 2018, OECD Revenue Statistics in Latin America and the Caribbean 2019.

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Improvements in tax administration could strengthen revenue collection

Colombia has made significant progress in improving tax administration and reducing tax evasion, including continued improvements in information systems, human resource management, governance of the tax authority and improved information exchange with other countries (OECD, 2019[19]; OECD, 2015[15]; IMF, 2021[3]). Tax collection has improved as a result of these efforts. The international tax agreement recently negotiated at the OECD and the recent information exchange agreement with Panama can provide further scope for international tax cooperation.

Nonetheless, there is significant scope to reduce tax evasion and strengthen tax administration, as estimates suggest that tax evasion currently leads to revenue losses exceeding 5% of GDP (Benítez et al., 2021[20]). Both the complexity of Colombia's tax system and the widespread informality of firms and workers are key factors reducing tax collection (Pinto López and Tibambre, 2019[21]; Benítez et al., 2021[20]). Improving trust in government would also help to strengthen tax discipline (OECD, 2019[22]). Enforcement efforts should also be scaled up, in tandem with better compliance incentives through tax reform.

One way ahead would be to build on past improvements and push for even stronger investment in databases and information technology to allow cross-checking of information across different sources. As a first step, customs and tax registries could be linked. The current taxpayer registry includes only 8% of the population, as opposed to 55% in Chile. Few of the large number of self-employed workers pay taxes at all. Bringing more people into the personal income tax system, as recommended above, would allow expanding current databases. Tax administration, including for property taxes, would also benefit from expanding the coverage of land registries, which would also help to in the implementation of the peace agreement and the fight against deforestation.

Electronic invoicing is making progress and has significant potential for raising tax collection, as shown in the case of Chile (Barreix and Zambrano, 2018[23]). The authorities could build on this progress by limiting the use of cash, which accounts for 90% of all private transactions, far above other emerging economies such as Brazil or Turkey (Pérez and Pacheco, 2016[24]). Prohibiting cash transactions above a certain threshold, or taxing the use of cash, is a measure employed in many economies to deal with tax evasion, including Mexico (Gobierno de México, 2021[25]). The current 0.4% tax on most financial transactions could be replaced by a tax on large cash withdrawals only, as recommended in past OECD Economic Surveys (OECD, 2019[19]; OECD, 2015[15]).

Public spending could be made more effective

There is significant scope for enhancing the effectiveness of public spending by improving targeting and by evaluating existing spending programmes and tax expenditures through a systematic spending review, retaining only those found to have a positive and cost-effective impact towards well-defined policy objectives while phasing out the rest. Ongoing efforts in this direction could be accelerated. Subsidies for electricity and gas, for example, are poorly targeted to the poor households they are meant to serve. 70% of implicit subsidies in the contributory public pension system, worth 3.4% of GDP, accrue to households in the three upper deciles of the income distribution (Levy and Cruces, 2021[26]). Even when programmes are retained, reducing fragmentation could avoid duplications and generate savings. In agriculture, input subsidies divert scarce resources from extension and technical assistance services, which would be more effective for developing an enabling environment for sustainable growth in the sector (OECD, 2021[27]). In social expenditures, for example, new benefits for informal workers who lost their incomes during the pandemic and the new VAT compensation mechanism for the poor are not integrated with existing programmes, exacerbating programme fragmentation and a lack of overall coordination. A summary of the fiscal impact of recommendations is presented in Table 1.3.

Table 1.3. Medium-term fiscal impact of recommendations

Recommendation	Estimated impact on fiscal balance
Reduce tax expenditures in VAT, corporate and personal income taxes	+3.9% of GDP
Bring more people into the personal income tax system, including by reducing the basic deduction	+1.9% of GDP
Reduce business taxes including the corporate tax rate and phase out the local turnover tax ICA	-1.2% of GDP
Social protection reform package as described in Chapter 2, including: - A single cash transfer programme for the poor to replace the current fragmented social benefits - A universal pension benefit to replace current pension system in the long run - Merging the two public healthcare systems - Eliminating social security contributions	-3.6% of GDP
Subject high pensions to income taxes to frontload some of the 2.6% of GDP long-run savings arising from phasing out the current pension system.	+0.5% of GDP
Provide targeted support to students who dropped out of school or are at risk of doing so	-0.1% of GDP
Expand early childhood education to achieve universal coverage	-0.3% of GDP
Increase resources dedicated to anti-deforestation enforcement	-0.1% of GDP
Resulting change in primary balance	+1.0% of GDP

Source: OECD estimates.

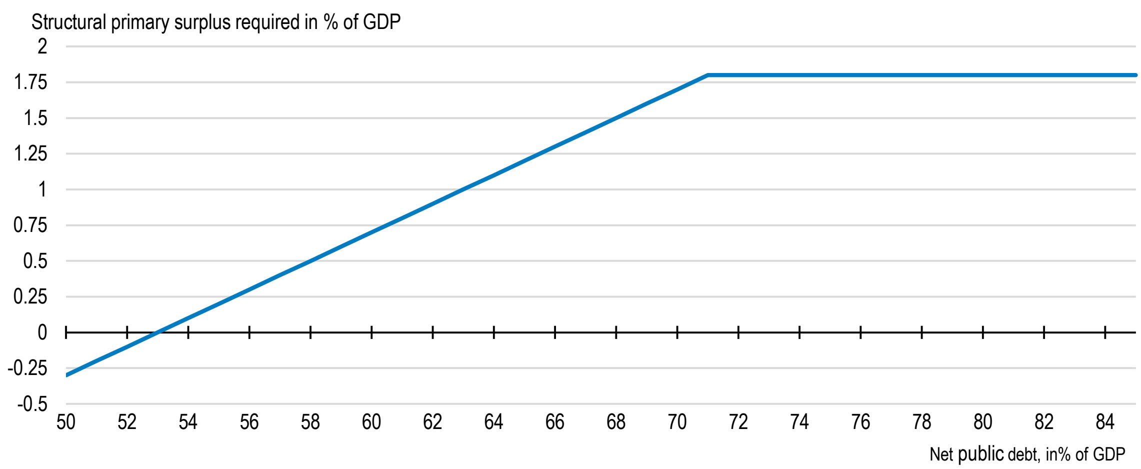
Strengthening the fiscal framework

A strong rule-based fiscal framework has provided macroeconomic stability and fiscal discipline over decades. Fiscal targets are established every year, with a view towards reducing the structural budget deficit gradually, while a comprehensive medium-term fiscal framework, published on an annual basis, provides consistent planning and transparency over a multi-year horizon (Minhacienda, 2021[11]). The fiscal rule in place between 2011 and 2019 put a limit on the structural deficit, but provided significant flexibility in the case of shocks to either oil prices or economic activity. This rule was suspended for 2020 and 2021 to address the COVID-19 pandemic. Despite full compliance with the fiscal rule, it has not been successful with respect to reining in the expansion of public debt, which has risen from 37% of GDP in 2011 to 50% in 2019. Negative macroeconomic shocks such as the sharp decline in oil prices in 2014 can explain part of this.

In order to address this shortcoming, the September 2021 fiscal reform establishes a new rule that includes an explicit debt anchor. More specifically, the new rule sets a floor for the structural net primary balance (SNPB, net of interest revenues) as a direct function of net public debt, defined as gross public debt net of short-term liquid financial assets (Figure 1.24).

The new rule requires primary surpluses for any debt level exceeding 53% of GDP. For the current level of net public debt, for example, the rule would require a SNPB of +1.2% of GDP. Under current parameters of the implicit interest rate and GDP growth, the fiscal outcomes mandated by the new rule will trigger a gradual conversion to a debt anchor of 55% of GDP. The required SNPB is capped at 1.8% of GDP for net debt levels exceeding 70% of GDP. At that level of debt, the required fiscal balance would still reduce debt even if the implicit interest rate on the whole debt stock were to exceed 2019 levels by 220 basis points. From today's point of view, it seems sufficiently likely that compliance with the new fiscal rule will impede future increases of public debt and instead usher in a gradual process of debt reduction. The new fiscal rule as described above is intended to come into force in 2026. For the near term, a transitional arrangement limits the SNPB at -4.7% of GDP in 2022, -1.4% of GDP for 2023, -0.2% of GDP for 2024 and +0.5% of GDP in 2025.

Figure 1.24. The new fiscal rule links the primary deficit to debt levels



Source: OECD calculations based on Ley 1473 of 2011, as modified by the 2021 Ley de Inversión Social.

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Creating an independent fiscal council has been recommended by earlier OECD work and a 2017 Commission on Public Spending (Table 1.4) (Bernal et al., 2018[28]; OECD, 2019[13]). The 2021 fiscal reform sets the legal basis for the creation of an Autonomous Fiscal Rule Committee, consisting of 5 salaried external members and 2 members of congress. While this is an improvement over the unpaid experts with part-time dedication that formed the previous fiscal council, the new body's budget and financial independence are not defined by law, which means that it is still distant from the role of a truly independent fiscal institution. In Latin America, Brazil, Chile and Costa Rica have been successful with the creation of such institutions, which typically produce regular forward-looking reports on fiscal developments and debt sustainability and estimate the fiscal costs of legislative proposals. Mimicking the success of other countries would imply creating a reasonable and stable budget, guaranteed by law, to hire qualified full-time analysts, and insulating the selection of council members from the political process.

Table 1.4. Past OECD recommendations on macroeconomic policies

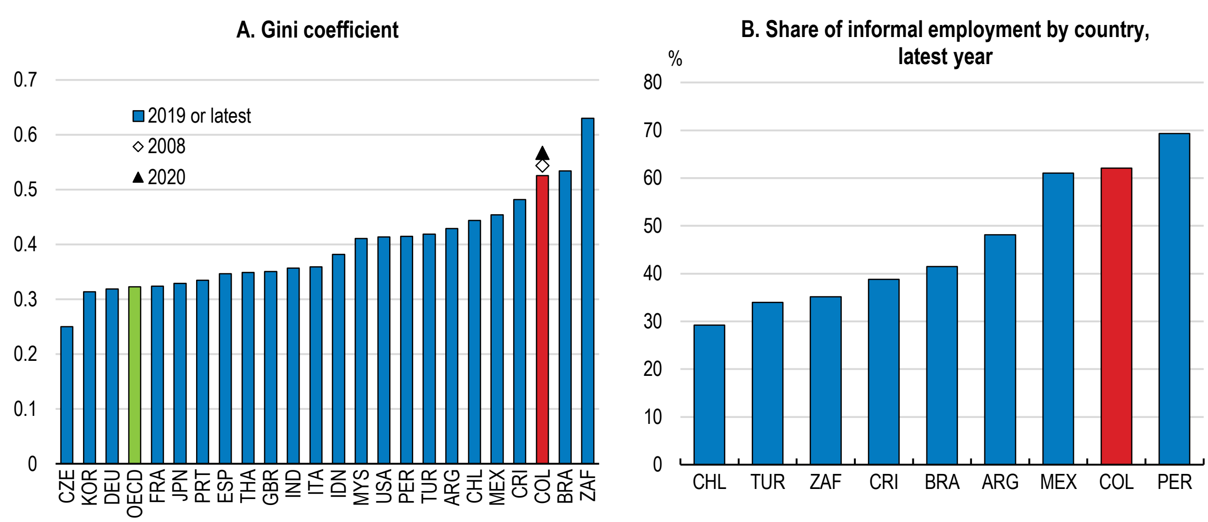
Recommendations	Actions taken since the 2019 Survey
Establish an independent fiscal council to monitor fiscal risks and provide additional technical analysis on fiscal targets and its revisions.	A new fiscal council has been created in September 2021, but its budget autonomy is not guaranteed by law.
Reduce budget rigidities by cutting mandated spending and revenue earmarking.	No progress made.
Evaluate social programmes and tax exemptions and retain only those with a positive impact on productivity or equity.	Social programmes remain fragmented and their effectiveness limited, despite improvements. Frequent tax exemptions persist.
Broaden the base of the personal income tax by lowering the income threshold where taxpayers start paying income taxes and eliminating exemptions.	No progress made.
Replace VAT reduced rates with cash transfers to low-income families.	Compensating cash transfers have been established without progress on reduced VAT rates.
Lower the rate and broaden the base of corporate taxes.	The corporate tax rate has been raised and there have been only modest increases in the tax base. However, since 2019, part of local tax liabilities can be deduced from corporate tax liabilities.
Reinforce tax administration and establish a limit for large cash transactions.	In 2020, Colombia secured a loan from the Inter-American Development Bank (IDB) to improve the effectiveness and efficiency of its tax and customs administration. The September 2021 fiscal reform plans revenue increases from better tax administration. No progress on cash limits.

Source: OECD, 2019[14]

Fostering an inclusive recovery

Poverty and inequality remain severe challenges in Colombia and will require strong and sustained growth as well as deep reforms of social, labour market and education policies. Colombia is one of the countries with the highest income inequality and labour market informality in Latin America and globally (Figure 1.25). After years of decline, income inequality has been on the rise since 2017, and is now being exacerbated by the Covid-19 pandemic. The pandemic has also exacerbated inequalities of opportunity, with disproportionate effects on less privileged groups, particularly in education.

Figure 1.25. Inequality and labour market informality are high



Note: GINI coefficients are estimated on the basis of disposable incomes, after taxes and transfers. For informal employment, the latest year of available data is 2019 except for Argentina, Brazil and Peru (2018), Mexico (2017) and Turkey (2015).
Source: World Bank, WDI; DANE; OECD poverty database, ILOSTAT database on informality.

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Ambitious reforms are needed to tackle long-standing social challenges

The pandemic has highlighted significant gaps in social protection, in particularly among informal workers. Informality is a complex phenomenon and must be addressed with a multi-pronged strategy, of which a deep reform of social protection systems would be a key element. Colombia has an extensive social security system for those who participate in the formal labour market. However, around 60% of informal workers have no access to these benefits, with the exception of near-universal healthcare benefits (OECD, 2019[13]; OECD, 2015[15]). On the whole, large parts of social spending are poorly targeted and give out scarce public resources to the non-poor. In the case of pensions, transitions between formal and informal work imply that more than 65% of workers who contribute to a pension will not get one (Levy and Cruces, 2021[26]). Almost 20% of public revenues is used to subsidise the pensions of only 4% of the population. Non-contributory benefits reach some informal workers, but despite a significant expansion in response to COVID-19, access is patchy and benefits are very low. Non-contributory pensions for example, are only one-tenth of a minimum wage (Levy and Cruces, 2021[26]).

As discussed in detail in Chapter 2 of this Economic Survey, Colombia's social protection system generates a vicious circle where informal workers are excluded from most benefits, while informality is perpetuated by high non-wage costs that finance formal-sector benefits (Levy and Cruces, 2021[26]; Meléndez, Alvarado and Pantoja, 2021[29]; IMF, 2021[3]; OECD, 2019[13]). Social benefits for formal workers are largely financed through contributions and non-wage labour costs that can reach 55% for minimum wage earners and are high in international comparison (IMF, 2021[3]). Together with a high minimum wage whose level is close to the median wage, this puts a high price on formal jobs and encourages informality.

One way to break this vicious circle would be to establish single and universal non-contributory benefits for each of the three main policy objectives of eradicating poverty, providing old-age pensions for all, and supplying basic healthcare services. These single benefits would replace the current fragmented, poorly targeted and contribution-financed social benefits. The financing burden should be gradually shifted away from contributions on formal labour through a substantial reduction in social security contributions (Levy and Cruces, 2021[26]). OECD calculations suggest that in the long run, such a reform would require raising additional resources of about 1% of GDP, to be financed from general taxation (see Chapter 2). As social security contributions are reduced, personal income taxes could be expanded and the VAT base broadened. It is important to note that personal income taxes 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.

For current formal workers, part of social security contributions would be replaced with income taxes. Reducing tax expenditures and lowering the basic deduction of personal income taxes into the vicinity of the minimum wage, which is currently more than what 50% of workers earn, provides ample scope for this. Subjecting somewhat less than half of income earners to income taxes, instead of the current 5%, would also solve a long-standing challenge in revenue collection. For formal workers with relatively higher incomes, a more progressive tax schedule would imply a higher tax burden than at present.

By contrast, informal workers and those with incomes below or around the minimum wage would benefit from better formal-sector job opportunities and take-home pay. Reductions in non-wage costs have proven an effective catalyst of formalisation in a 2012 tax reform (Morales and Medina, 2017[30]; Fernandez and Villar, 2017[31]; Bernal et al., 2017[32]; Kugler, Kugler and Herrera-Prada, 2017[33]).

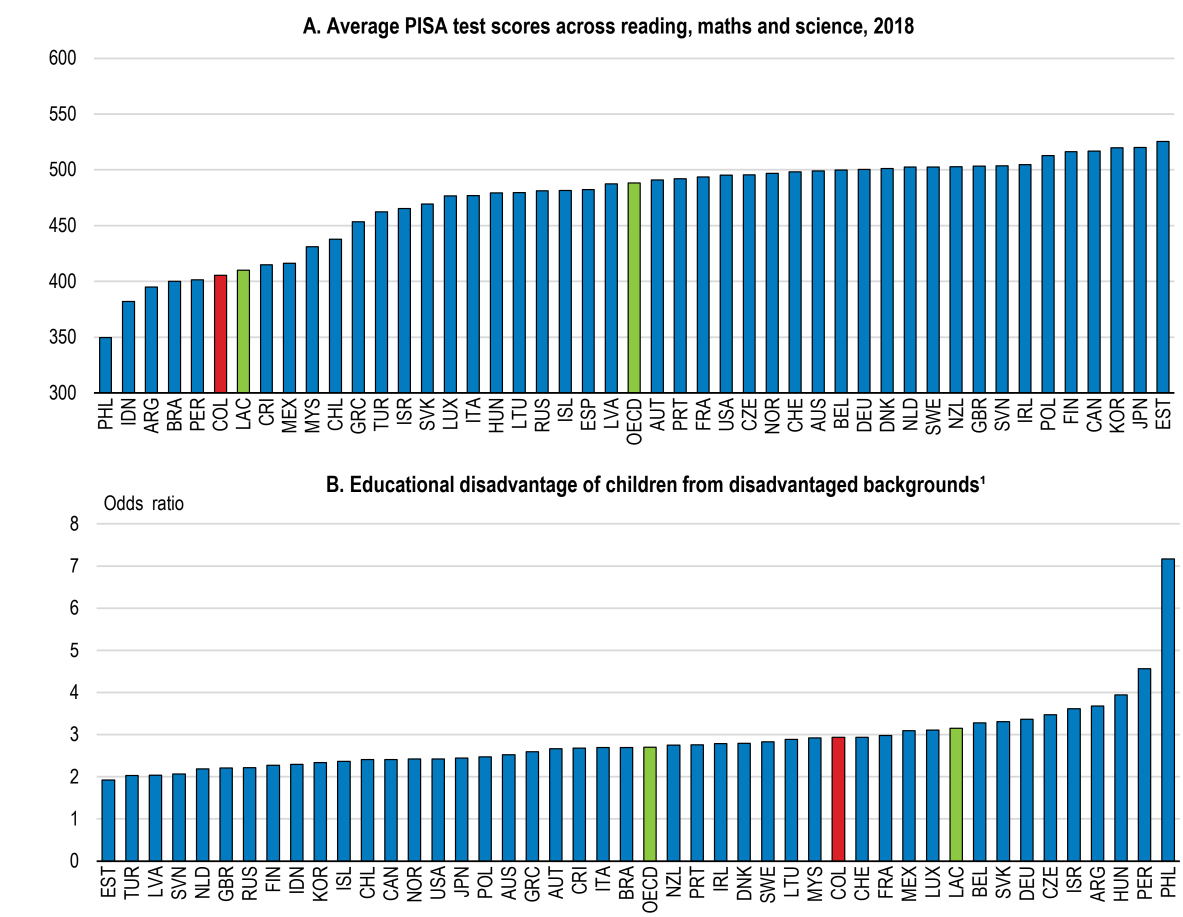
A combined tax and benefit reform would have a highly progressive impact, and would undoubtedly leave the bottom half of the income distribution financially better off. Poverty would essentially be eliminated as cash benefits raise all incomes to the poverty line, provided that a strong benefit pickup can be ensured. Income inequalities as measured by the GINI coefficient would fall by 13 percentage points, equivalent to a 25% lower level of inequalities. With this reduction, Colombia's GINI coefficient would be left around 7 percentage points above the OECD average, compared to 20 at present. This would only be the immediate effect, not accounting for long-term benefits arising from a substantial reduction of informality. In light of social unrest in 2021, enhancing the scope of personal income taxes should proceed with care and in a gradual manner, and should include strong communication efforts on which parts of Colombia's income distribution would stand to gain and which would stand to lose for a combined tax and benefit reform. Enforcement efforts against informal employment would be an important complement to such an improvement in formalisation incentives, and should be enhanced simultaneously.

Addressing severe challenges in education

The education system was highly affected by the pandemic, exacerbating longstanding challenges. Before the pandemic hit, Colombia was grappling with low learning outcomes in secondary education compared to the OECD average (Figure 1.26, Panel A.), and a high correlation between outcomes and students' socioeconomic backgrounds (Figure 1.26, Panel B). After one of the longest schools closures in the region and in the OECD, these inequalities are likely to widen even further.

By October 2021, around 22% of students had not returned to the classroom (Fundación Empresarios por la Educación, 2021[34]). For students from vulnerable households and rural areas, virtual classrooms did little to compensate the absence of in-person learning, given stark differences in access to digital resources and digital literacy. Only 32% of disadvantaged students have Internet access at home, compared to 93% among students from more advantaged backgrounds (OECD, 2020[35]). This supports the case for a more rapid nationwide roll-out of internet connectivity.

Figure 1.26. Colombia lags behind in student performance



1. Panel B shows the increased likelihood of students in the bottom quarter of the economic, social and cultural status (ESCS) scoring below minimum proficiency in reading, relative to non-disadvantaged students (the 3 remaining quarters of the ESCS distribution).
Source: OECD, PISA 2018 Database.

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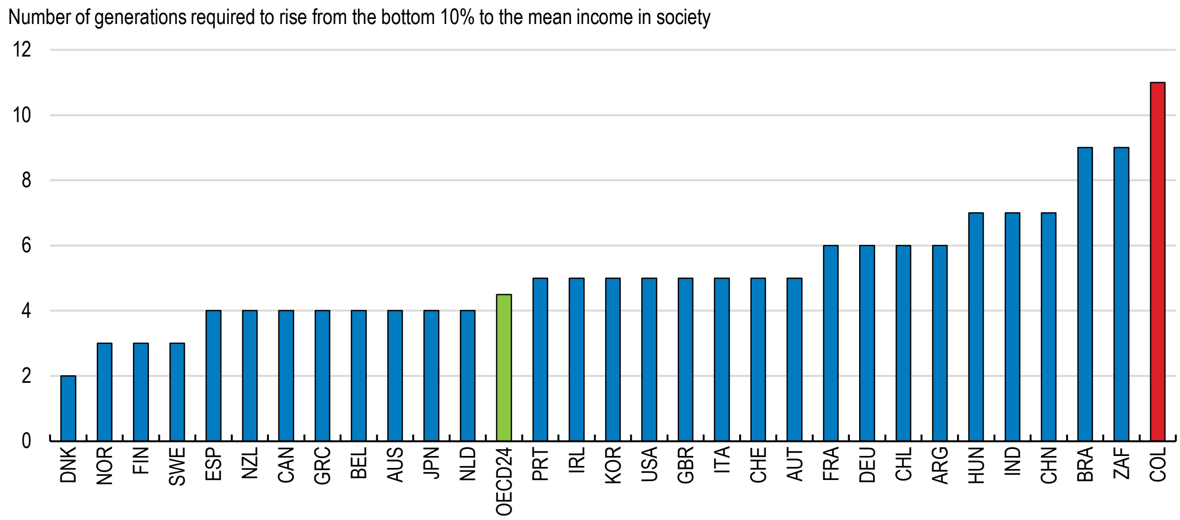
Addressing the unequal legacy of the pandemic will require a stronger focus on disadvantaged children. Early drop-outs in secondary education have risen by 25% between 2019 and 2020, according to preliminary data, particularly among children from public schools and vulnerable households in rural areas (Ministerio de Educación, 2021[36]). Putting in place targeted programmes will be essential to reverse the negative impact of school closures, in particular for re-engaging youth and children who dropped out during the pandemic and helping students catch up with learning loss from school closures (OECD, 2018[37]; Kraft and Falken, 2021[38]). A recent programme financed by the World Bank is a step in the right direction. Evidence suggests that targeted programmes to attract those out of school and those lagging behind in school, expanding school meals and full-day schooling programmes can reduce early drop-out, teenage pregnancy, drug use and crime and strengthen socio-emotional competencies (Llach et al., 2009[39]; Berthelon and Kruger, 2011[40]).

Allocating more resources towards the earlier stages of education should be prioritised not only to mitigate the effects of the pandemic, but also to make the education system more equitable. In 2019, slightly more than 50% of children between 3 and 5 years old were in education (Fedesarrollo, 2021[41]), compared to between 90 and 100 % for most OECD countries, reinforcing inequalities from the start. Early childhood education and care (ECEC) significantly decreases the likelihood of disadvantaged students dropping out from the education system later on (OECD, 2016[42]). High-quality ECEC services also help support children's outcomes later in life, including in labour market participation, reduction of poverty, increased intergenerational social mobility and social integration (OECD, 2018[43]). Estimates put the cost of universal coverage for children aged 3-5 at 0.3% of GDP (Forero and Saavedra, 2019[44]).

More equal opportunities in education are key for raising intergenerational mobility, which has been particularly low (Figure 1.27). A recent decision to provide free tertiary tuition for 700,000 vulnerable students (Matrícula Cero) will enable more students from low-income backgrounds to access higher education. The benefits of this costly measure, however, will depend crucially on more equal learning opportunities from early childhood to the end of secondary education. For children from disadvantaged backgrounds, a lack of preparation and low aspirations are often just as much of an impediment for pursuing higher education as tuition fees.

As more disadvantaged schools and areas often lack high-quality teachers, improving the incentives for high-quality teachers to relocate at least temporarily can help to reduce inequalities, as the example of Chile has shown (Bertoni et al., 2018[45]; Elacqua et al., 2019[46]). However, the current 15% salary bonus offered in Colombia has proven insufficient for this. Depending on the school and the degree of remoteness, salary bonuses could be raised and combined with accelerated career progression and automatic grade increases for teachers who complete at least a 3-year assignment in disadvantaged areas (Forero and Saavedra, 2019[44]). This could be complemented by facilitating professional exchange and learning for teachers through networks, digital tools and resources, and improving contract conditions (Radinger et al., 2018[47]).

Figure 1.27. Social mobility across generations is the lowest among OECD members



Note: These estimates are simulation-based and intended to be illustrative. They should not be interpreted as giving the precise time that a person from a low-income household will need to reach the average income. They are based on earnings persistence (elasticities) between fathers and sons and the current level of household incomes of the bottom decile and the mean, assuming constant elasticities, following Bowles and Gintis (2002). Low-income family is defined as the first income decile, i.e. the bottom 10% of the population.
Source: OECD Income Distribution Database.

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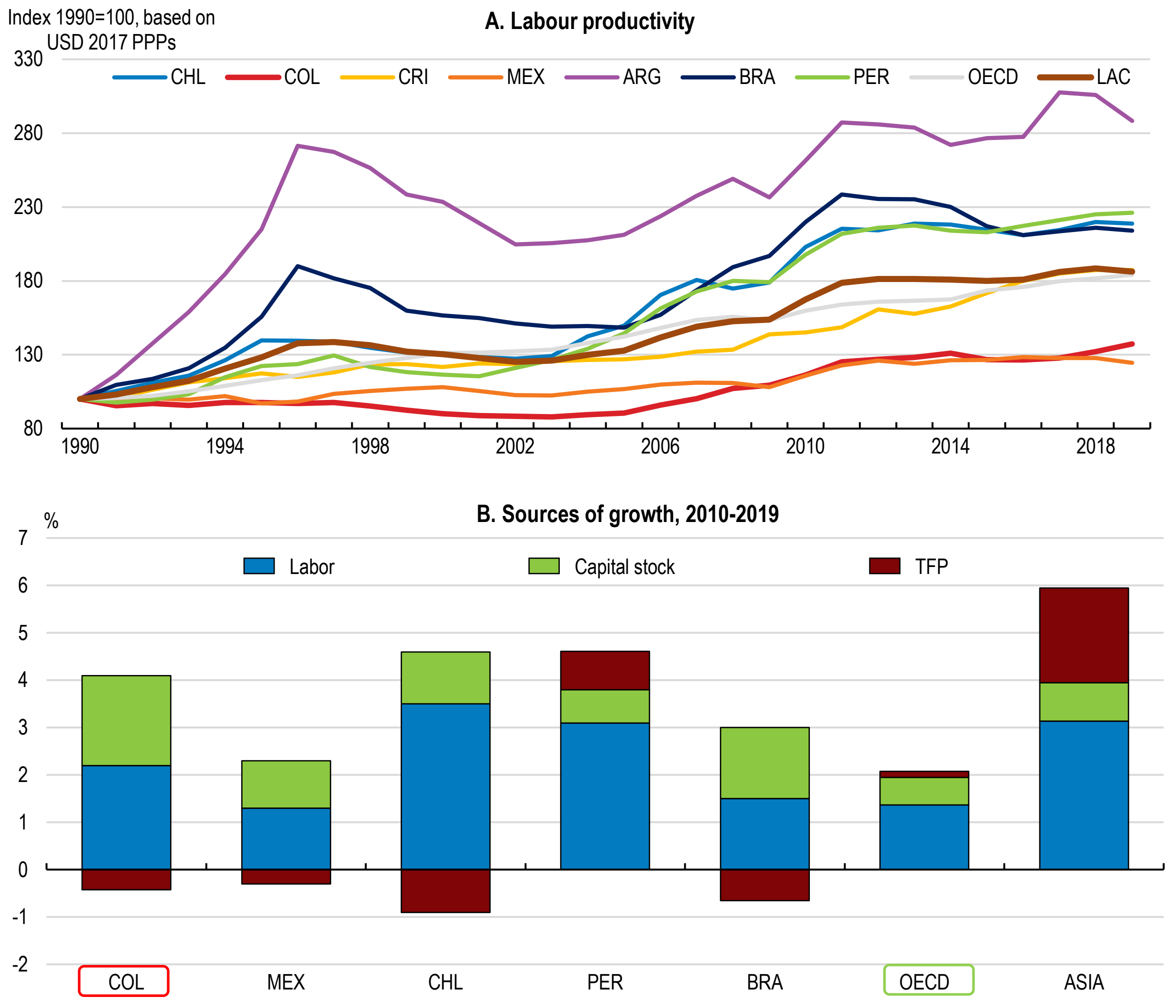
Strengthening productivity, competition and internationalisation

Productivity growth has been weak for two decades and Colombia has fallen behind regional peers in terms of labour productivity (Figure 1.28, Panel A). Over the last decade, growth has been entirely accounted for by the accumulation of labour and capital, while total factor productivity has actually subtracted from economic growth (Figure 1.28, Panel B) (Rivera and Robledo, 2021[48]). This mirrors developments in other Latin American economies, but stands in sharp contrast to high-growth economies in Asia. Immigration, and in particular a welcome 2021 decree that grants legal residence status to immigrants from neighbouring Venezuela, will have a positive effect on the labour force and growth, raising GDP levels by up to 0.4% (Pulido and Varón, 2020[49]). Still, population ageing will withdraw the previous boost to growth from an expanding labour force over the next years, and unless productivity and investment make up for that loss, potential growth is set to decline sharply (Figure 1.3).

Figure 1.28. Productivity has fallen behind regional peers and has not contributed to GDP growth



Note: ASIA, LAC and OECD are GDP-weighted averages for countries with available data.
Source: Conference Board; Feenstra, Robert C., Robert Inklaar and Marcel P. Timmer (2015), "The Next Generation of the Penn World Table" American Economic Review, 105(10), 3150-3182, available for download at www.ggdc.net/pwt.

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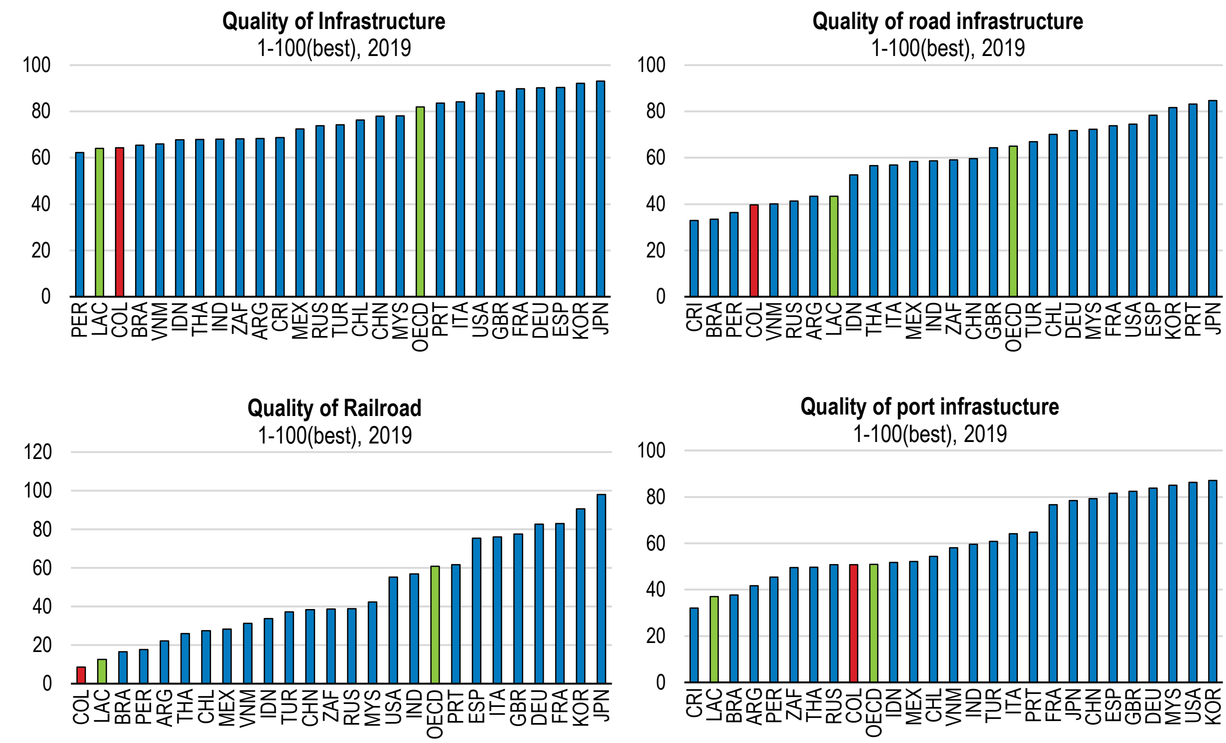
More investment in infrastructure can boost productivity

One way for policies to bolster productivity is to alleviate common production cost drivers, such as infrastructure bottlenecks. Colombia has narrowed the gap to regional peers over the last decade (Misión de Internacionalización, 2021[50]). Still, further improvements in infrastructure could have significant growth payoffs (Ramírez-Giraldo et al., 2021[51]). Significant challenges remain in many areas, including ports, airports, communication infrastructure, roads and railroads (Figure 1.29). Only 25,000 km of the 213,000 km of roads are paved, and often in poor condition (Misión de Internacionalización, 2021[52]). This hurts both exports and the development of lagging regions, with less employment opportunities, especially in the formal sector. A sizeable infrastructure package designed in response to the pandemic, worth 1.4% of GDP, and a new national logistics policy will alleviate some bottlenecks, besides supporting the recovery, and build on Colombia's extensive experience with public-private partnerships in the road sector (Misión de Internacionalización, 2021[50]). These actions will also contribute to reducing the times and costs of logistics operations. Further progress could be made in the development of intermodal transport facilities, such as rail-road connections, and reducing the handling times in ports, including those caused by customs and other agencies.

Figure 1.29. Significant infrastructure gaps persist in many areas



Note: LAC refers to the unweighted average of ARG, BOL, BRA, CHL, COL, CRI, ECU, GTM, HND, MEX, PAN, PER, PRY, URY, VEN.
Source: World Economic Forum, The Global Competitiveness Index dataset, Geneva.

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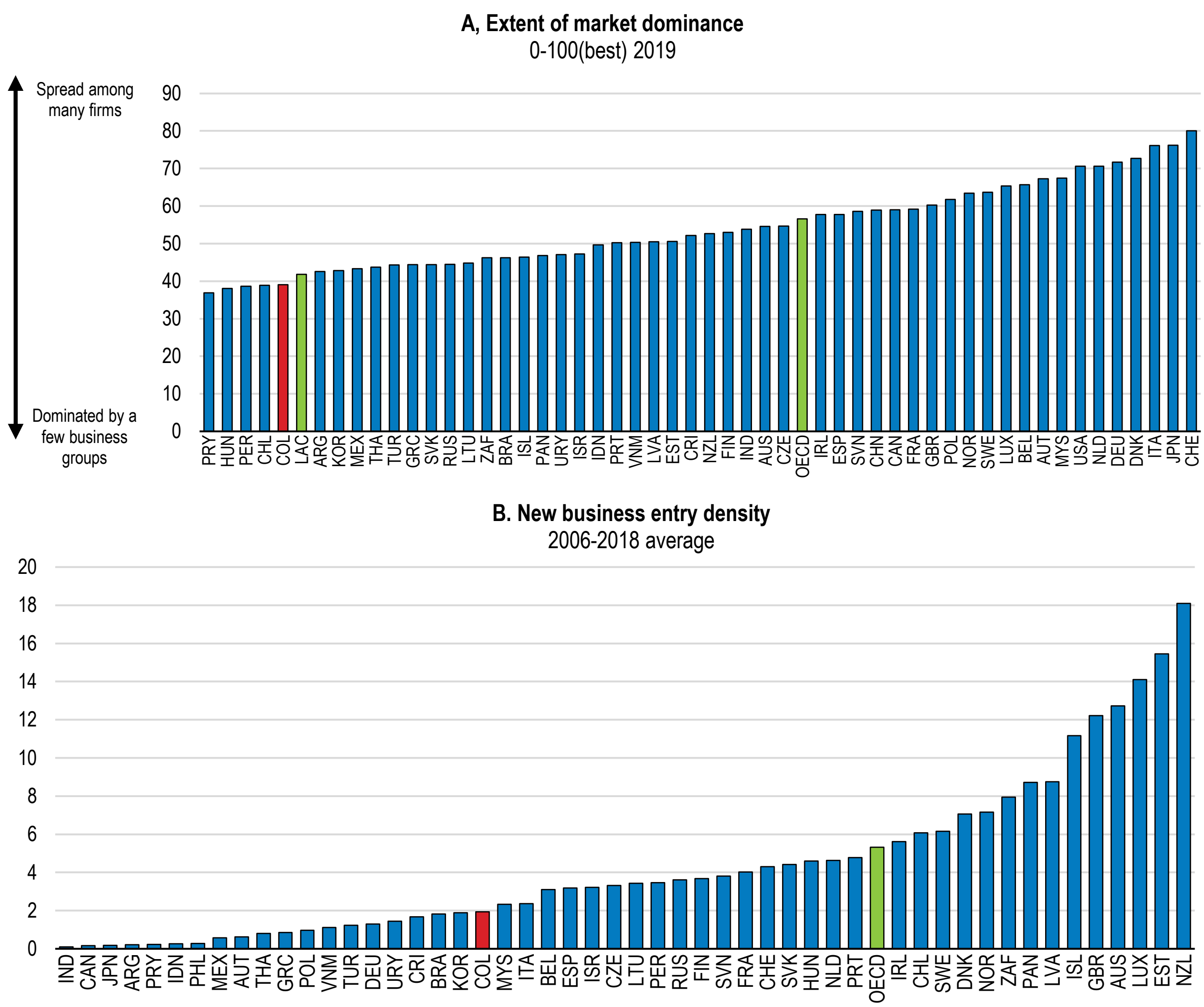
Weak productivity growth is related to low levels of competition

Improving incentives for businesses is another, equally important, policy agenda to strengthen productivity. Many current policies and institutional settings hamper competition, both among existing firms and from new market entrants (Jaramillo Londoño, Gómez Márquez and Rodríguez Reyes, 2021[53]; CONPES, 2020[54]). This curtails the incentives both for existing firms to innovate and adopt better technologies, and for resources to move towards more productive firms, including new market entrants. In the current situation with limited fiscal resources, moving ahead on this agenda is more relevant than ever, as reforms to strengthen competition can have strong growth pay-offs without requiring much additional public resources.

Several indicators point to weak and declining competitive pressures on Colombian firms. Perceptions of business executives suggest that many markets in Colombia are dominated by relatively few players, placing Colombia at rank 102 out of 141 countries surveyed (WEF, 2019[55]) (Figure 1.30, Panel A). When markets are dominated by a few firms, this also leaves limited space for new entrants, and indeed new market entry occurs less frequently than in other economies, according to indicators based on firm-level data (Figure 1.30, Panel B).

Figure 1.30. Competition is relatively weak



Source: World Economic Forum. The Global Competitiveness Index 4.0 2019 dataset, available at https://www.weforum.org/reports/how-to-end-a-decade-of-lost-productivity-growth (Panel A); World Bank Entrepreneurship Survey and database, available at https://data.worldbank.org/indicator/IC.BUS.NDNS.ZS (Panel B).

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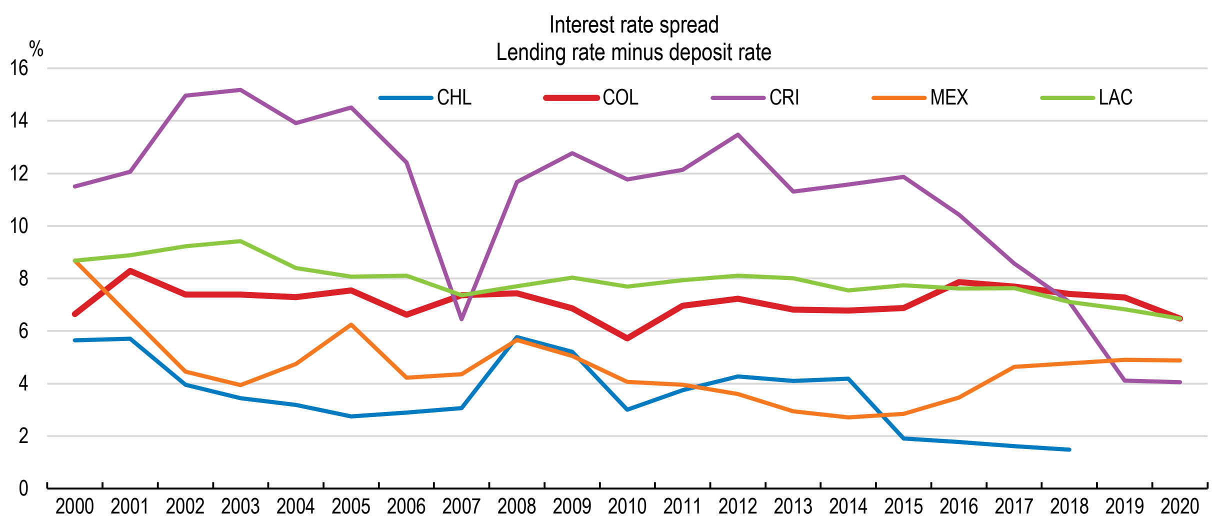
New market entrants in advanced economies typically face “up or out” dynamics in their first years of existence, but in Colombia, these dynamics are weakened by significant barriers to entrepreneurship and the survival of small unproductive plants (Eslava, Haltiwanger and Pinzón, 2019[56]). This may be traced back to the widespread informality of firms and jobs, which can provide a competitive edge and generates an uneven playing field for competition. Informality also holds back firm growth, as informal firms attempt to remain below the radar of enforcement agencies. This further strengthens the case for improving formalisation incentives, aside from the social considerations elaborated in Chapter 2. Early evidence suggests that the pandemic may have triggered the exit of small and less productive firms, and promoted automation (Flórez et al., 2020[57]; Bonilla et al., 2021[58]).

Firm-level data from the manufacturing census suggest that competition has weakened further between 2008 and 2018, as mark-ups, which reflect the difference between prices and costs, and operational profitability have increased by 37% and 11%, respectively. The resulting economic rents have regressive income distribution effects and may translate into political power that, in turn, reinforces monopoly power, creating a vicious circle (UNDP, 2021[59]). Firms with higher mark-ups have tended to gain market share despite being less productive and less willing to invest in information technology (Iootty et al., 2021[60]). These firms tend to be overrepresented in sectors with high trade protection (García et al., 2019[61]). Evidence of weakening competition also extends to the services sector (Iootty et al., 2021[60]), with one example being persistently high interest spreads in financial services (Figure 1.31). Empirical analysis suggests that reducing mark-ups in manufacturing and services –as a result of stronger competition- would be associated with stronger productivity growth (Iootty et al., 2021[60]).

Figure 1.31. Financial intermediation spreads are high in a regional comparison



Source: World Bank, WDI.

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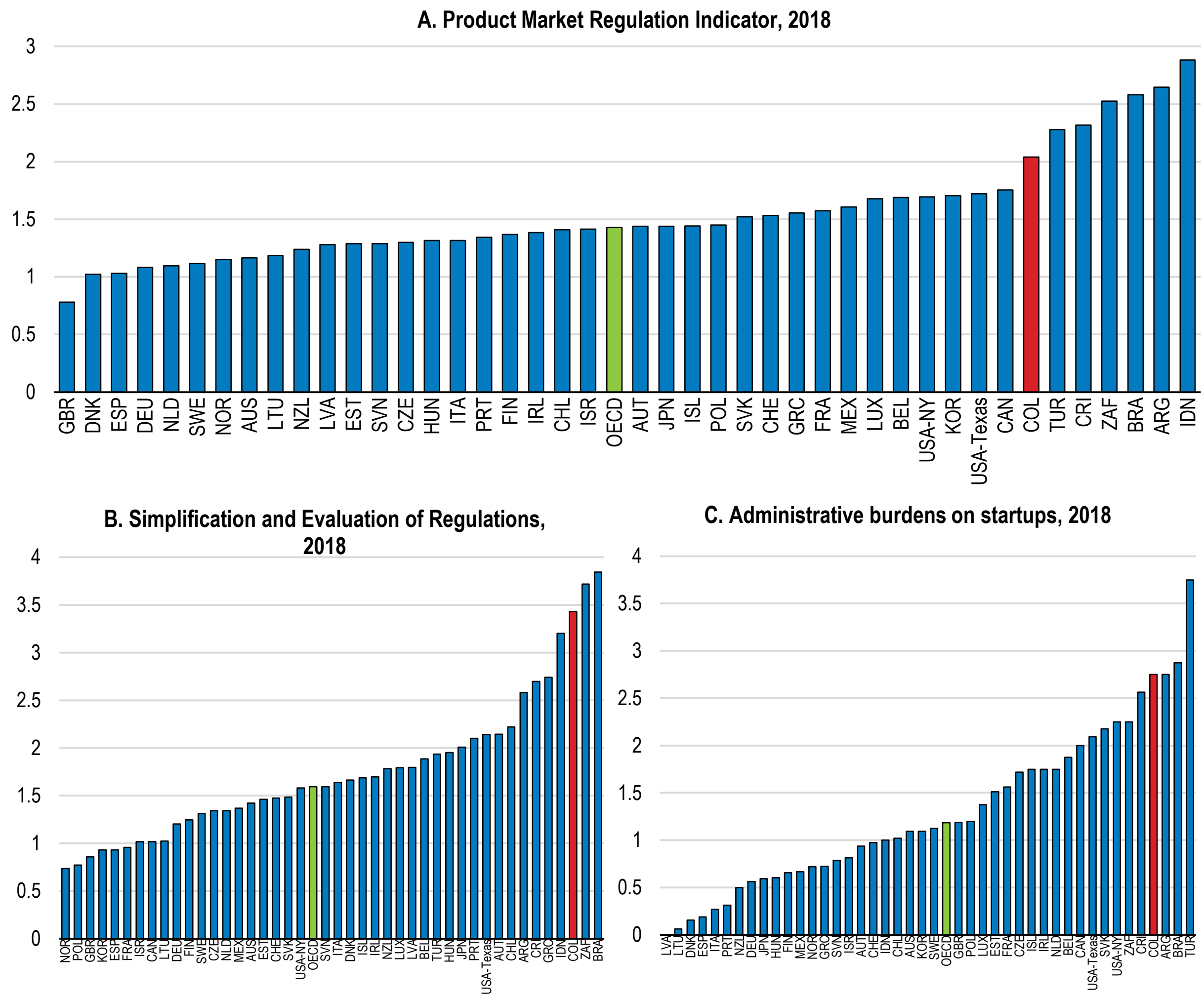
Making domestic regulations more conducive to competition

Regulations can restrict competition, often as collateral damage in the pursuit of other policy objectives. Colombia's regulatory policies are less competition-friendly than in most of the 46 economies covered by the OECD Product Market indicators (Figure 1.32). Specific sub-indicators suggest that Colombia is significantly more restrictive in the complexity of regulatory procedures (Figure 1.32, Panel B.). Understanding current rules is complicated by the lack of an online register of secondary legislation, and the regulatory agenda of planned approvals or modifications is not regularly published online (OECD, 2018[62]). Unlike all other OECD countries, Colombia does not grant the right to appeal against regulatory decisions.

An ongoing review by the government of the stock of existing regulations and their competition impact is a useful first step, which should be expanded and accelerated. Besides, evaluating the competition impact of new draft laws and regulations should become a systematic requirement, as it currently only applies to some secondary legislation (Jaramillo Londoño, Gómez Márquez and Rodríguez Reyes, 2021[53]). The competition authority should be given a stronger role in competition advocacy and its prowess could be strengthened by aligning its current low penalties with international practice (CPC, 2020[63]).

Entry barriers and administrative burdens on start-ups are high, reflecting Colombia's exceptionally cumbersome license and permit requirements (Figure 1.32, Panel C). Full information on license requirements is not available online, and there is no single one-stop shop where all licenses and authorisations can be issued. Progress has been made in reducing business registration renewal fees, but these may still be one factor behind widespread informality among small firms (Salazar et al., 2017[64]). A 2018 programme has started to simplify some administrative procedures across the domains of different ministries, with likely positive effects on productivity and the scope for corruption. In addition to the progressive roll-out of one-stop shops, this is an important step in the right direction. A national entrepreneurship policy of 2020 and a new entrepreneurship law aim to overcome existing barriers to entrepreneurship (CONPES, 2020[54]).

Figure 1.32. Competition is hampered by domestic regulations



Source: OECD Product Market Regulation database, available at http://oe.cd/pmr.

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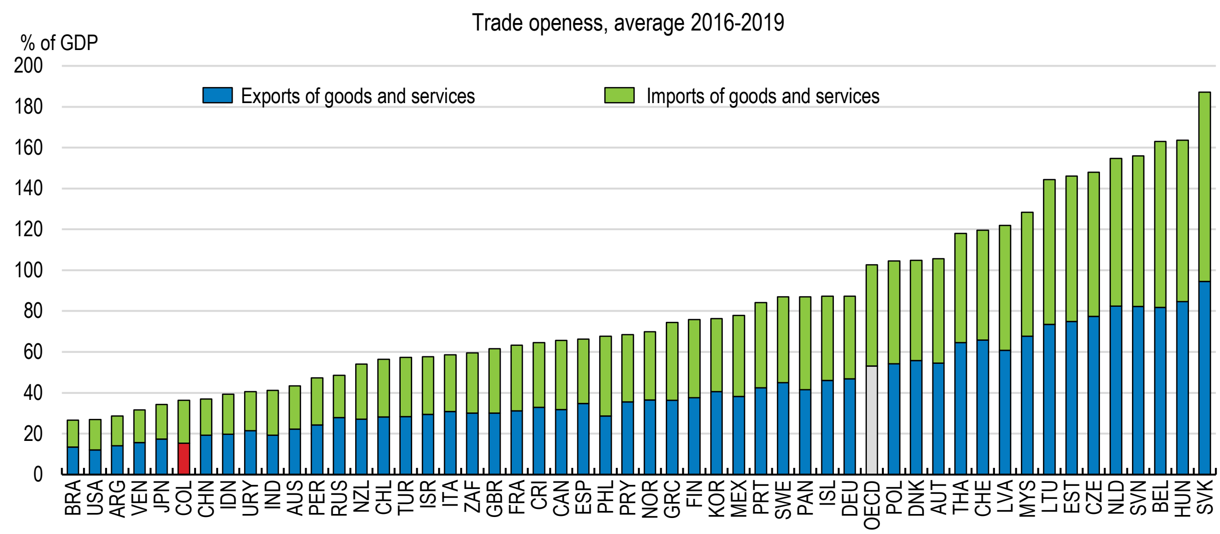
Boosting participation in international trade and investment flows

Strong engagement in international trade and investment flows also plays a key role for productivity. Trade is another source of disciplining competitive pressures, promoting the adoption of internationally competitive production techniques, and provides opportunities for exploiting economies of scale through exports. Investment inflows are not only an important source of external financing, but they often bring in new technologies and generate significant spill-over benefits (Javorcik, 2004[65]; Arnold et al., 2016[66]), not least because foreign affiliates are generally more productive than domestic firms (Arnold and Javorcik, 2009[67]). As discussed in the 2019 Economic Survey (OECD, 2019[13]), Colombia has not fully reaped these benefits, as it participates little in international trade (Figure 1.33). Exports represent 15% of GDP, slightly below the level 50 years ago, and -despite recent improvements- remain highly concentrated in a few products and markets, with a strong natural resource content.

Colombia's integration into global value chains is minimal (García Guzman, Rivera and Robledo, 2021[68]). Investment inflows can be key to increasing the integration of the economy into global value chains. In many emerging markets, supplying the domestic subsidiaries of foreign multi-national enterprises is one of the most promising ways for many small and medium size enterprises to increase their forward integration into global value chains (López González, 2017[69]). Although Colombia imposes relatively few restrictions on inward FDI, inflows have been stagnant since the 2014 commodity price crisis (Li and Aranda Larrey, 2021[70]; OECD, 2018[71]). Moreover, they are heavily concentrated in extractive industries, where foreign subsidiaries in Colombia are less productive, less engaged in international value chains and less more prone to generate positive spill-overs to domestic firms than in manufacturing (Li and Aranda Larrey, 2021[70]). The main challenges reported by foreign subsidiaries in Colombia include tax rates and tax administration, corruption, electricity, transport, workforce skills, licenses, courts, and competition from informal firms (Li and Aranda Larrey, 2021[70]). Analysis based on several Latin American countries suggests that key factors that influence the stock of foreign direct investment are labour costs, corruption and the rule of law and skills (Cadestin, Gourdon and Kowalski, 2016[72]). In other words, the same policy improvements that can advance productivity growth among domestic firms would also allow Colombia to reap greater benefits from FDI.

Figure 1.33. Colombia participates little in international trade



Source: World Development Indicators, World Bank, OECD Economic Outlook database.

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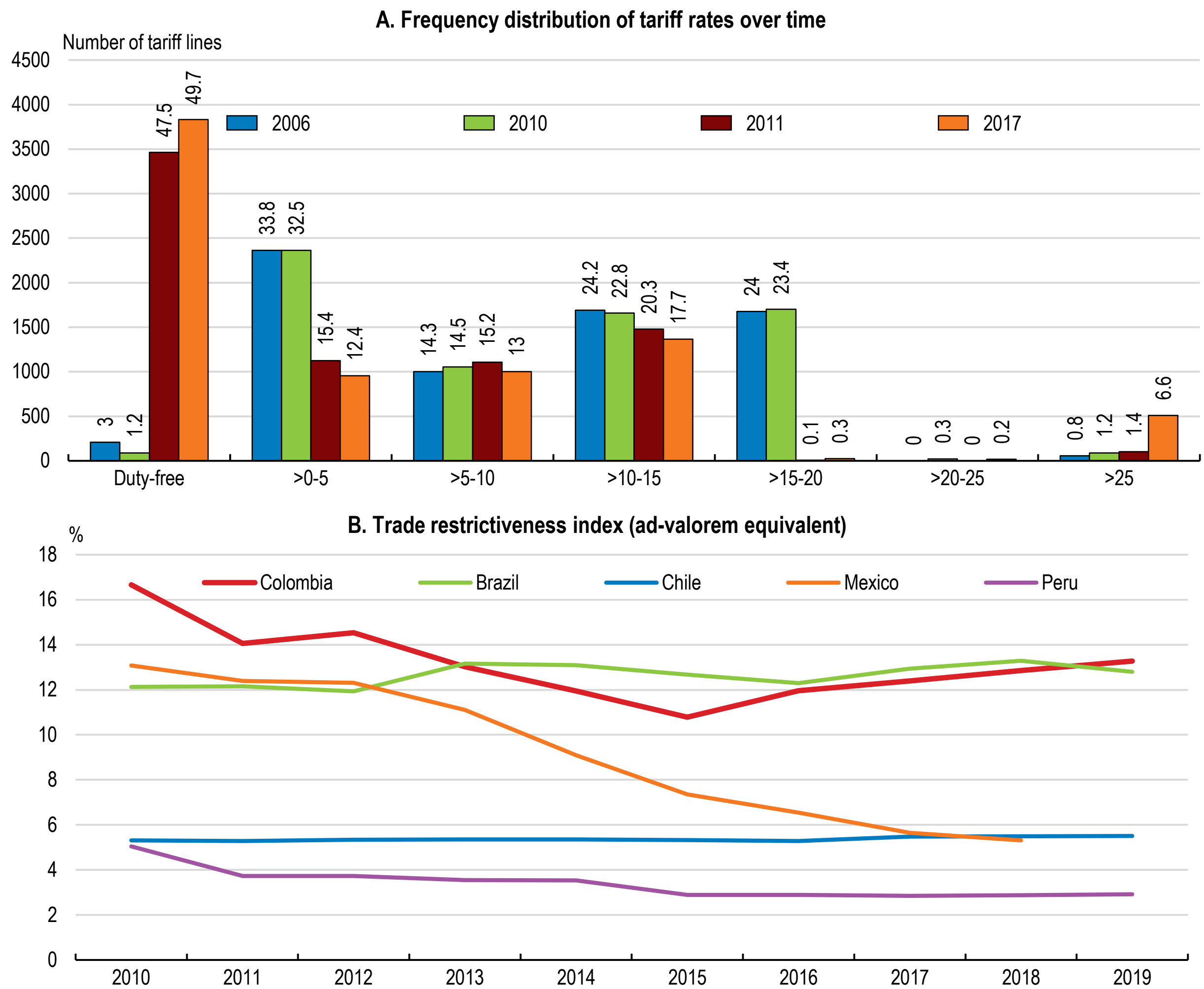
Significant trade barriers are one explanation behind Colombia's tepid embrace of internationalisation, as successful exporting requires exposure to global competition and access to inputs, especially within value chains. Tariff barriers exceed those of regional peers. Although they have come down on average and the number of zero-ratings has increased, tariff dispersion has risen (Rivera et al., 2021[73]; García Guzman, Rivera and Robledo, 2021[68]). As a result, average tariffs mask high tariff rates in key sectors with significant domestic production. Peak tariff rates above 25% have become more common in recent years (Figure 1.34, Panel A). Concentrated in textiles, apparel, footwear, agriculture and the automotive sector, they are often applied only to narrow tariff lines relevant for specific domestic producers (Echavarría, Giraldo and Jaramillo, 2019[74]; García Guzman, Rivera and Robledo, 2021[68]), which suggests scope for a better insulation of trade policy making from domestic special interest groups (see next section).

With such dispersed tariffs, simple or weighted tariff averages do not have an easy interpretation. A more illustrative way to compare with other countries and across time is the Trade Restrictiveness Index (TRI), which measures the uniform tariff that is welfare-equivalent to a given protective structure (Anderson and

Neary, 1996[75]). This index shows Colombia's protection level closer to that of Brazil than to Chile, Mexico or Peru, with a visible increase since 2015 (Figure 1.34, Panel B). Sectors with particularly high protection include food, beverages, natural oils and the automotive sector (Rivera et al., 2021[73]).

Figure 1.34. Despite an overall downward tendency, the frequency of peak tariffs has increased



Note: A. Figures indicate the percentage of most favoured nation tariff lines in a given range. Total tariff lines amounted to 6993 in 2006, 7273 in 2010, 7292 in 2011 and 7708 in 2017. B. The Trade restrictiveness index represents the uniform tariff that would maintain welfare at its current level given the existing tariff structure (Anderson & Neary, 1996).
Source: (WTO, 2018[76]; Rivera et al., 2021[73]).

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Tariff protection is exacerbated by non-tariff barriers, which have mushroomed from 300 in the 1990s to 5120 in 2014. 61% of products and 64% of trade volumes are currently subject to non-tariff barriers (Kee and Forero, 2021[77]). These can reach ad-valorem equivalents of 20% in vehicles, 40% in footwear and up to 89% for processed rice, well above what is common in regional peers (García Guzman, Rivera and Robledo, 2021[68]; Cadot, Gourdon and van Tongeren, 2018[78]). Non-tariff barriers applied by Colombia include requiring pre-shipment inspection formalities for 1811 products, while Chile requires these only on 720 products (Kee and Forero, 2021[77]). Non-automatic import licenses apply to 1890 products in Colombia, compared to 136 in Chile. These products include cars, rice or powdered milk. Finally, one measure that is highly uncommon in the region are the authorised ports of entry requirements that Colombia applies on more than 1700 products. One example is a rule that requires all sugar imports to enter through one pacific port, although many potential suppliers could more readily access Colombia through a port on the Caribbean coast. Streamlining these requirements and eliminating those that have no technical justification such as public health or safety considerations has significant potential for reducing trade costs (Kee and Forero, 2021[77]).

Trade could also be boosted by addressing gaps in infrastructure, logistics and customs procedures. A digital single window for foreign trade has been rolled out progressively since 2004 and an increasing number of the 21 public sector entities involved in clearing foreign trade transactions now allow accomplishing procedures online through this mechanism. The programme aims at reducing import and export delays and fostering coordination between different agencies, including through joint inspections. With the ratification of the WTO Trade Facilitation Agreement in 2020, Colombia has committed to reducing the time for clearance of imports, exports and transit to 48 hours. These are all important steps that future efforts can build on. However, Colombia still has some way to go to achieve best practice (CPC, 2020[63]; Misión de Internacionalización, 2021[50]). The Single Window project could be developed further by enhancing the cooperation and information exchange between entities, for example by ensuring the interoperability of management systems between the single window and existing customs and border agencies, or the application of common risk profiles to guide inspections. The authorities have recently commissioned detailed analysis in the context of an “Internationalisation Mission”, which provides useful recommendations to follow up on (DNP, 2021[79]).

Embracing internationalisation more thoroughly would promote productivity, technology adoption and social inclusion simultaneously. Empirical evidence suggests that earlier tariff reductions have boosted productivity growth in Colombia (Eslava et al., 2013[80]). At the same time, exporting firms tend to pay higher wages and hire more workers than non-exporters (Brambilla, Depetris Chauvin and Porto, 2017[81]). Previous OECD analysis suggests that halving tariffs would boost the purchasing power of the poorest households, i.e. those in the lowest income decile, by more than 10%, while overall, average household income would increase by 3.5% (OECD, 2019[13]). The marked pro-poor feature of the tariff reduction is explained by the fact that lower income households spend more on traded goods as a share of their income.

Reforms could start with a thorough review of tariff and non-tariff barriers, beginning with the higher ones in a quest to reduce dispersion. This could be supported by further improvements in trade facilitation, including better customs logistics and coordination among different agencies, building on past progress with the Single Window. Colombia can also build on recent success with policies to overcome coordination and information failures, such as export promotion and industry roundtables, as well as technology extension services through a programme called “Productivity Factories”. A pro-active trade agenda, participating actively in plurilateral and bilateral trade negotiations could strengthen the political momentum for lower domestic trade barriers and allow improvements in market access for Colombian firms. For example, while Chile has bilateral agreements with 32 trading partners, Colombia has only 22.

Lowering trade barriers typically combines the medium-term benefits of more and better jobs with short-run adjustment costs for workers, which occur while jobs disappear in some firms and emerge in others. Policies can go a long way to reduce the burden of adjustment for poor and vulnerable households. Strong social protection networks are a key buffer in the short term, to help displaced workers across temporary spells of unemployment. Expanding the coverage of social protection, as discussed in Chapter 2 of this Survey, is therefore a key priority. The adjustment will be more rapid, and the costs will be lower, the more product and labour markets accommodate reallocations without strong frictions that impede new firm entry or new job creation (Winters, McCulloch and McKay, 2004[82]). Reducing regulatory burdens on product markets, as discussed earlier in this section, and the cost of formal employment, as discussed in Chapter 2, can help for this.

Last but not least, job movements often require new skills. Scaling up training opportunities can help workers to get ready for new jobs in expanding firms, and facilitate the transition into better paying jobs. Evidence from Brazil suggests strong benefits for the employability of displaced workers, especially when training courses are well-aligned with labour market needs (Grundke et al., 2021[83]). Evidence from Colombia also points to strong potential payoffs from training programmes (Attanasio, Kugler and Meghir, 2011[84]; Attanasio et al., 2017[85]). The recent establishment of a National Qualifications System is likely to improve the alignment of training programmes with skill needs.

Strengthening institutions and fighting corruption

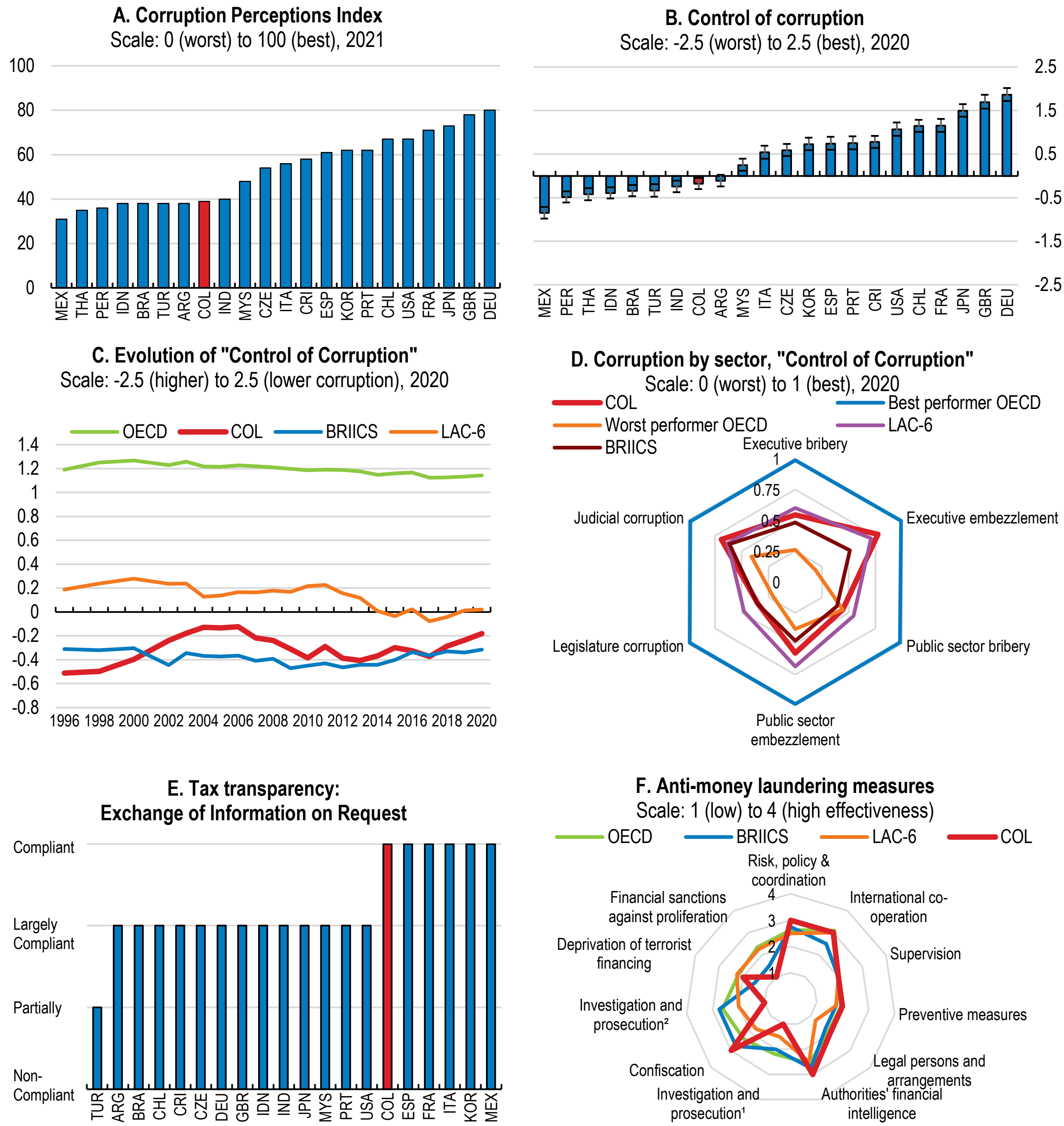
Strong institutions are crucial for raising productivity and competition, but also for making growth more inclusive (Acemoglu, Johnson and Robinson, 2005[86]). Weak governance and corruption hamper growth and opportunities for ordinary Colombians by affecting the quality and coverage of public goods and services, siphoning off scarce public resources, distorting labour and capital allocations, eroding trust in public institutions and weakening governance, and maintaining excessive bureaucracy and arbitrariness (Perry and Saavedra, 2019[87]). For example, rewards for productive and innovative firms can be jeopardised when access to resources and markets depends on relationships and individual arrangements that circumvent the rule of law, rather than on strong performance. Excessively strong vested interests may also render pro-competitive reforms, including lower trade barriers, politically unviable.

Colombia has made significant progress with recent anti-corruption efforts and initiatives to foster integrity and combat corruption in the public sector (OECD, 2017[88]). However, corruption perceptions point to significant governance challenges, exceeding those of other countries in the region, such as Argentina and Costa Rica. Moreover, these perceptions suggest that the situation has deteriorated over the years (Figure 1.35). 48% of Colombians consider that corruption poses the greatest challenge for Colombia (CID Gallup, 2021[89]). Particular challenges affect the subnational level, where corruption indicators tend to be higher in local jurisdictions that receive higher transfers and royalties from central sources (Alvarez Villa et al., 2019[90]). Scope for improvement exists across a wide range of issues, including public procurement, whistle-blower protection, the regulation of campaign financing, lobbying, and law enforcement, which encompasses the functioning of the judicial system.

Public procurement and infrastructure projects are typical high-risk areas for corruption. Harnessing competition among potential providers is crucial, and requires an even playing field and full transparency. Evidence suggest that public purchases in Colombia are often characterised by a lack of competition, significant concentration among contractors, frequent contract renewals and amendments without new tenders, and unclear rules regarding conflicts of interest (Zuleta, Saavedra and Medellín, 2018[91]; Zuleta, Ospina and Caro, 2018[92]; Palacios Lleras, 2019[93]). There are more than 800 unfinished infrastructure projects, often the result of irregularities uncovered before completion, representing a sunk cost of around 2.2% of GDP (Contraloría General de la República, 2021[94]).

Streamlining bureaucratic procedures and enhancing transparency can help to insulate institutions against interest groups, as can systematic training of procurement officials on effective tender design and effective detection of collusive practices (OECD, 2012[95]). Colombia has no regulation requiring transparency in the interactions between interest groups and policymakers, as reflected in the low performance on the OECD PMR indicator on interactions with interest groups (Figure 1.36).

Figure 1.35. Corruption indicators



Note: Panel B shows the point estimate and the margin of error. Panel C: LAC6=average CHL,CRI,MEX,BRA,ARG,PER. Panel D shows sector-based subcomponents of the "Control of Corruption" indicator by the Varieties of Democracy Project. Panel E summarises the overall assessment on the exchange of information in practice from peer reviews by the Global Forum on Transparency and Exchange of Information for Tax Purposes. Peer reviews assess member jurisdictions' ability to ensure the transparency of their legal entities and arrangements and to co-operate with other tax administrations in accordance with the internationally agreed standard. The figure shows first round results; a second round is ongoing. Panel F shows ratings from the FATF peer reviews of each member to assess levels of implementation of the FATF Recommendations. The ratings reflect the extent to which a country's measures are effective against 11 immediate outcomes. "Investigation and prosecution¹" refers to money laundering. "Investigation and prosecution²" refers to terrorist financing.
Source: Panel A: Transparency International; Panels B & C: World Bank, Worldwide Governance Indicators; Panel D: Varieties of Democracy Project, V-Dem Dataset v11. Panels E&F: OECD Secretariat's own calculation based on the materials from the Global Forum on Transparency and Exchange of Information for Tax Purposes; and OECD, Financial Action Task Force (FATF).

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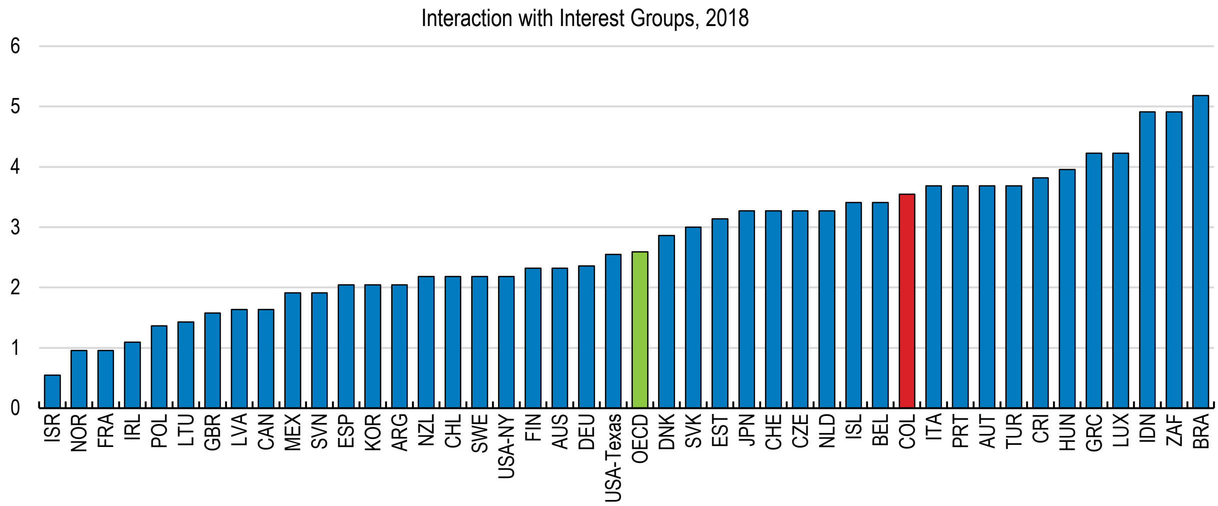
Figure 1.36. Lobbying and interest groups hamper competition



Source: OECD Product Market Regulation indicators, available at http://oe.cd/pmr.

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Centralised purchasing bodies and electronic procurement are an effective way to reduce the scope for side-payments and collusion. Colombia has made important progress in this regard by establishing a central procurement entity (*Colombia Compra Eficiente*), as discussed in the previous Economic Survey (OECD, 2019[13]). Still, direct purchases represented around 70% of total public procurement transactions in 2019 and 2020 (Agencia Nacional de Contratación Pública, 2021[96]). The largest component is personal services provision and management support, which tend to be correlated with the electoral cycle (Zuleta, Saavedra and Medellín, 2018[91]). Direct purchasing and the scope for illicit behaviour could be restricted through a clearer definition of instances where centralised purchasing is mandatory, including at the subnational level.

Further improvements could also stem from a thorough assessment of the laws and regulations affecting public procurement. One way ahead would be to lower the cost of participating in tenders. At present, only companies who pay an annual fee for listing on a public registry (*Registro Único de Proponentes*) can compete in public tenders, which unduly limits the participation of smaller enterprises in government purchases, as well as the use of centralised purchases for smaller contracts, in light of the annual listing fee of approximately USD 150. The competition authority (*Superintendencia de Industria y Comercio*) has taken a leading role in uncovering procurement cartels ex-post, but its action is often hampered by the limits of its statutes and of competition law (Palacios Lleras, 2019[93]). The competition authority's fines are low and it lacks the power to disqualify those involved in bid-rigging from participating in future procurement processes (Jaramillo Londoño, Gómez Márquez and Rodríguez Reyes, 2021[53]).

Whistle-blowers are one common way to detect cartels and bid-rigging in procurement cases, but also corruption cases more widely. Brazil's recent prosecution of large-scale corruption cases, with ramifications across Latin America, can be directly related to improvements in incentives for whistle-blowers to come forward, as discussed in OECD Economic Surveys of Brazil (OECD, 2020[97]; OECD, 2018[98]) Most OECD countries have dedicated whistle blower protection laws, like the one implemented by Australia in 2019, while Colombia does not (Sanclemente Arciniegas, 2020[99]; OECD, 2019[100]; OECD, 2016[101]). Individuals sanctioned for bid-rigging in public procurement can be criminally prosecuted according to the penal code, which is a significant disincentive. Attempts to remedy this shortcoming were not approved by Congress during the 2020-21 legislature. In one such attempt, relevant sections were excluded from a draft proposal before approval by Congress (Law 341/2020). Other similar projects that would have provided whistle-blower protection were archived (Transparencia por Colombia, 2021[102]; Transparencia por Colombia, 2021[103]; OECD, 2019[100]). This lack of ambition represents a missed opportunity in the fight against corruption.

Regulating the financing of political parties can prevent powerful special interests from capturing policy design, which makes growth less inclusive and decreases trust in government (OECD, 2016[104]). Given the limited public financing, campaigns are highly dependent on private funds in Colombia, for which there is no limit (Pachón Buitrago, 2018[105]). Private financing is particularly predominant in regional and local elections. This creates incentives for candidates to pay back campaign contributions with political favours once in office, affecting spending efficiency or the quality of politically-appointed officials (Perry and Saavedra, 2019[87]; Fedesarrollo, 2021[41]). Allegations of several large-scale cases stretching across political parties and sectors have been investigated by the judiciary (Escallón Arango, 2014[106]; Garay, Salcedo-Albarán and Álvarez, 2020[107]). The accountability of campaign financing is particularly limited for independent candidates, whose electoral campaigns are subject to weaker rules regarding registration and campaign financing and exempt are from the usual time limits for electoral campaigns (Pachón Buitrago, 2018[105]; Fedesarrollo, 2021[41]). Stricter limits and transparency requirements for private campaign contributions, for both political parties and independent candidates alike, would lessen corruption incentives, including through a full replacement of private campaign funding by public funds, allocated in a transparent manner and with strict accountability rules (Fedesarrollo, 2021[41]).

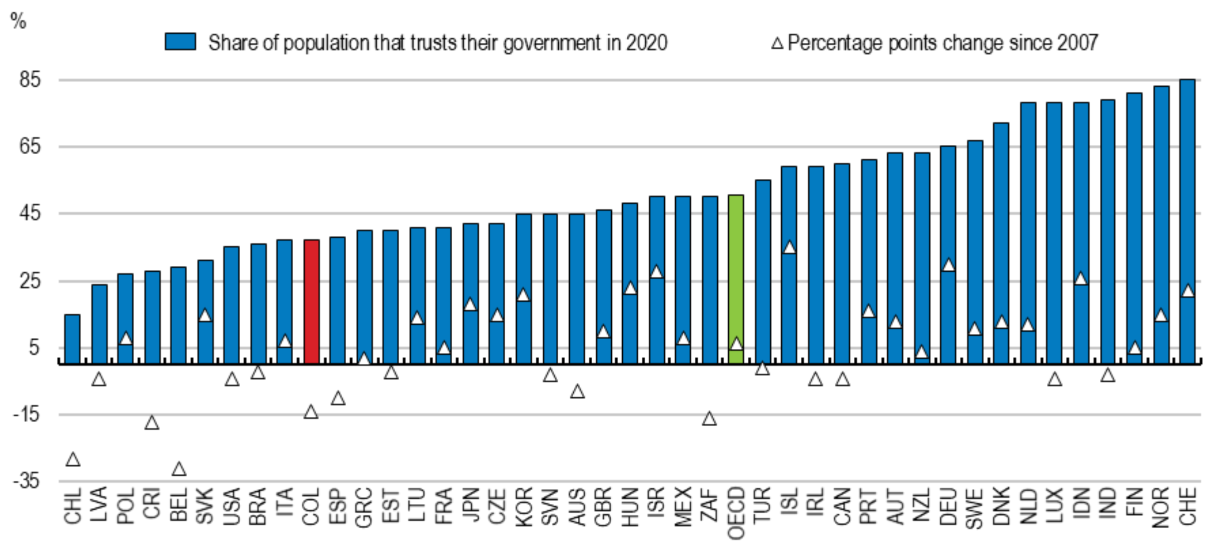
Enforcing laws and private contracts also hinges on effective institutions, especially the performance of the judicial system (Perry and Saavedra, 2019[87]). Colombia's weak performance is related to cumbersome procedural requirements, low court automation, unlimited adjournments and little recourse to electronic case management tools. There is also scope to improve governance within the judicial system, strengthen performance incentives for judges, and improve the training of investigators, lawyers, prosecutors and judges, including in economic matters and white-collar crimes, in addition to establishing clear safeguards against political interference to protect investigations and prosecutions (Fedesarrollo, 2021[41]; OECD, 2019[100]). Finally, the low trust of Colombians in the integrity of judges in surveys suggests the need for more transparency regarding conflicts of interest (Villadiego and Hernández, 2018[108]; Pring and Vrushi, 2019[109]).

Colombia made tangible progress in the fight against impunity in the past couple of years. The Prosecutor General's Office has been prioritising the investigation of violence against trade unionists and has introduced a dedicated investigation strategy and specialised teams. These efforts resulted in the clarification of 43% of homicides of trade unionist between 2017 and 2020. For comparison, only 30% of intentional homicides were clarified during the same period. Despite these advances, the country continues to suffer from violence against trade unionists, with 22 homicides of trade unionists reported between April 2020 and March 2021.

Improvements in governance are key for raising public trust in institutions, which is low in Colombia (Figure 1.37). For instance, trust leads to greater compliance with regulations and the tax system (OECD, 2017[110]; Batrancea et al., 2019[111]). More trust in the good use of public resources would strengthen the political support for raising additional public resources. Low trust in public institutions may also deter whistle-blowers from reporting corruption cases. 58% of Colombians consider it is unlikely that complaints generate any consequences, while 78% indicate that they would suffer retaliation if they report (Pring and Vrushi, 2019[109]). Trust in institutions may also have been negatively affected by alleged police violence during recent social protests (OAS/ CIDH, 2021[112]). In May 2021, 56% of survey respondents disapproved of police behaviour (Portafolio, 2021[113]). Colombia is one of the few countries where the police is subordinated to the Ministry of Defence, making apparent the need to adapt police forces to a post-conflict context. Integrating the police into the Ministry of the Interior, more emphasis on Human Rights training, and judging police agents in ordinary courts as opposed to a military one are useful proposals that are currently being discussed.

Figure 1.37. Public trust in government is low and has declined over time

Confidence in national government in 2020 and its change since 2007



Source: World Gallup Poll.

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The implementation of the 2016 peace agreement is also key for strengthening Colombia's institutions and has shown steady progress (see Box 1.2). Over the next decade, its completion will require substantial fiscal efforts. Total implementation costs between 2017 and 2031 are expected to reach 12.9% of GDP (Contraloría, 2021[114]).

After five years of implementation of the peace agreement, the latest report by independent observers indicates that 30% of the stipulations are fully implemented (Instituto Kroc, 2021[115]). Provisions related to land titles, supporting victims of conflict and reducing illicit drugs have shown significant progress in the past year. Many of the low-hanging fruits of the agreement have now been picked, and more ambition will likely be needed for future progress, particularly with respect to land access and use (Procuraduría Nacional de la Nación, 2021[116]). A land reform intended to facilitate land access for Colombians who need it, like former combatants, those displaced by internal conflict and poor farmers without access to land has seen relatively little progress, not least because it requires significant resources. Similarly, some commitments within the National Comprehensive Program for the Substitution of Crops Used for Illicit Purposes have not yet been initiated or show a minimal level of implementation. However, the programme covers 56 municipalities and supports close to 100,000 families that participate in the voluntary crop substitution process, 70% of which have received emergency food assistance. These areas will require constant and long-term efforts in order to achieve substantive changes that address the structural causes of violence. A nationwide rollout of the multipurpose land registry would promote a better land use, reduce legal uncertainties, foster investment and facilitate transactions (OECD, 2019[13]). This would make peace more sustainable by providing a boost to rural development, in addition to supporting the fight against illegal deforestation (see next section). At the same time, it may face opposition from powerful vested interests. As of January 2021, only 15.4% of land had updated cadastral information, up from 6% in 2018 (Procuraduría Nacional de la Nación, 2021[116]). Reaching 60% by 2022, one of the agreement's goals, will require stepping up efforts significantly, especially in municipalities affected by conflict. In addition, more could be done to deliver on the agreement's promise of actually distributing land to landless victims of conflict. Colombia's arable land is not only highly concentrated in a few hands, but also under-exploited.

Corruption in the implementation of the agreement could foster distrust and a loss of legitimacy in the transition process towards a sustainable peace (Transparencia por Colombia, 2020[117]). Recent corruption scandals in which local officials undertook changes in urban and territorial planning for private gain underline the relevance of this threat. Strengthening local citizens' oversight committees could increase transparency and enhance the legitimacy of the process.

Table 1.5. Past OECD recommendations on structural policies

Recommendations	Actions taken since the 2019 Survey
Establish a comprehensive strategy to reduce the cost of formalisation, including reducing non-wage costs, reviewing the minimum wage to achieve a more job-friendly level, reducing firms' registration costs and simplifying the registration of workers.	Recurrent firm registration costs have been lowered but continue to hamper firm formalisation. No progress made on reducing non-wage labour costs.
Improve targeting and focus spending on social programmes targeted at low-income individuals. Target higher cash transfers towards the most vulnerable, especially those in rural areas.	Poor and vulnerable households have benefitted from additional Covid-related transfer benefits, but targeting remains weak overall.
Prioritise spending on education that increases coverage in early education. Reallocate more resources to the most vulnerable territories.	No progress made.
Make teaching in rural areas more attractive by shaping the working conditions and professional opportunities in these areas.	No progress made.
Introduce whistle-blower protection procedures.	Attempts for Congress to approve dedicated whistle-blower protection regulations failed in 2021.
Bring all purchases by subnational governments into the central procurement entity (Colombia Compra Eficiente).	Direct purchases still represent around 70% of total public procurement transactions.
Regulate the financing of political parties and campaigns.	Political campaign remain highly dependent on private financing, leading to conflicts of interest.
Grant the competition authority the ability to impose higher and more dissuasive sanctions.	No progress made.
Widen the scope of regulatory impact assessments, including also the stock of regulations.	No progress made.
Make a greater use of one-stop shops and online tools for administrative procedures.	One-stop shops for domestic businesses and foreign trade transactions are continuously being expanded and improved and the 2018 ESCA programme started has successfully reduced some administrative burdens.
Phase out import restrictions and review other non-tariff barriers with a view to reducing them.	No progress made.
Reduce tariff dispersion.	No progress made.
Prioritise improving multi-modal transport connectivity of ports and customs, and reduce barriers to entry and competition in transport.	Infrastructure investment includes multi-modal transport, but scope for further progress remains.
Improve customs logistics, including by increasing inter-agency cooperation and making further use of paperless online solutions for permissions and payments.	No progress made.

Source: OECD, 2019[14]

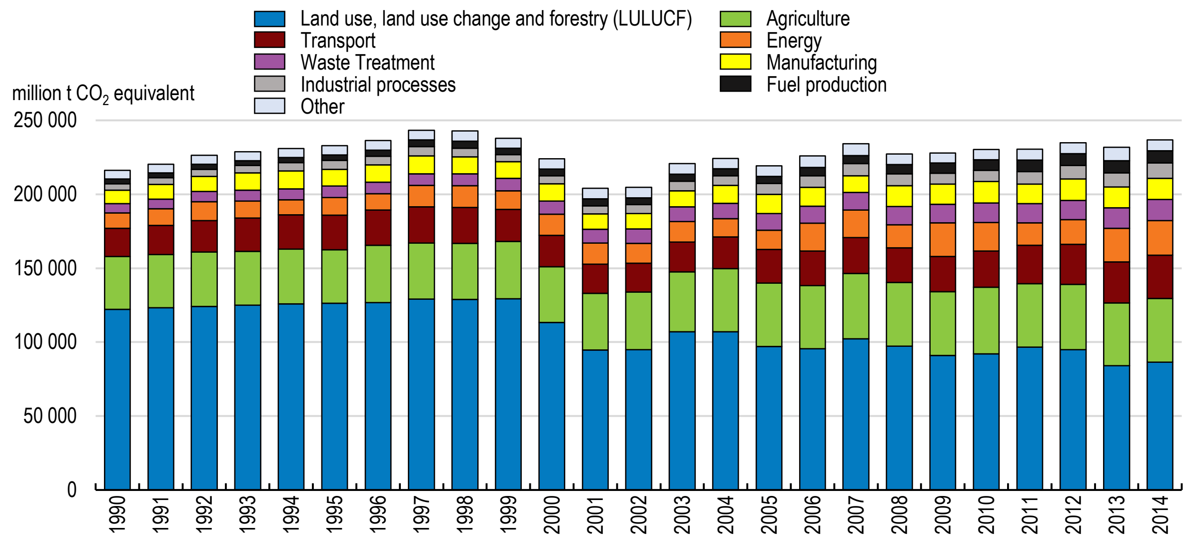
Fostering sustainable and green growth

Ambitious objectives aim at reducing greenhouse gas emissions

Greenhouse gas (GHG) emissions are relatively low in per capita terms. However, net emissions have been trending upward over the last decade (Figure 1.38). GHG emission reduction goals have recently been made more ambitious, aiming at a 51% reduction with respect to the baseline scenario by 2030 (CAT, 2021[118]; UNEP, 2019[119]). This is meant to pave the way for reaching carbon neutrality by 2050, although it may not be enough to reach that goal (CAT, 2021[118]).

Historically, the largest emitting sectors have been land use and forestry, agriculture, transport and the energy sector. Emissions from land use, the largest component, have decreased significantly since the 90s, with ups and downs associated with changes in deforestation, in contrast to the generalised upward trend in the other three sectors.

Figure 1.38. GHG emissions are no longer declining



Note: Official data have only been published up until 2014.
Source: Instituto de Hidrología, Meteorología y Estudios Ambientales (IDEAM), available at https://www.datos.gov.co/Ambiente-y-Desarrollo-Sostenible/Reporte-emisiones-y-absorciones-estimadas-para-el-/8u6k-4wrz.

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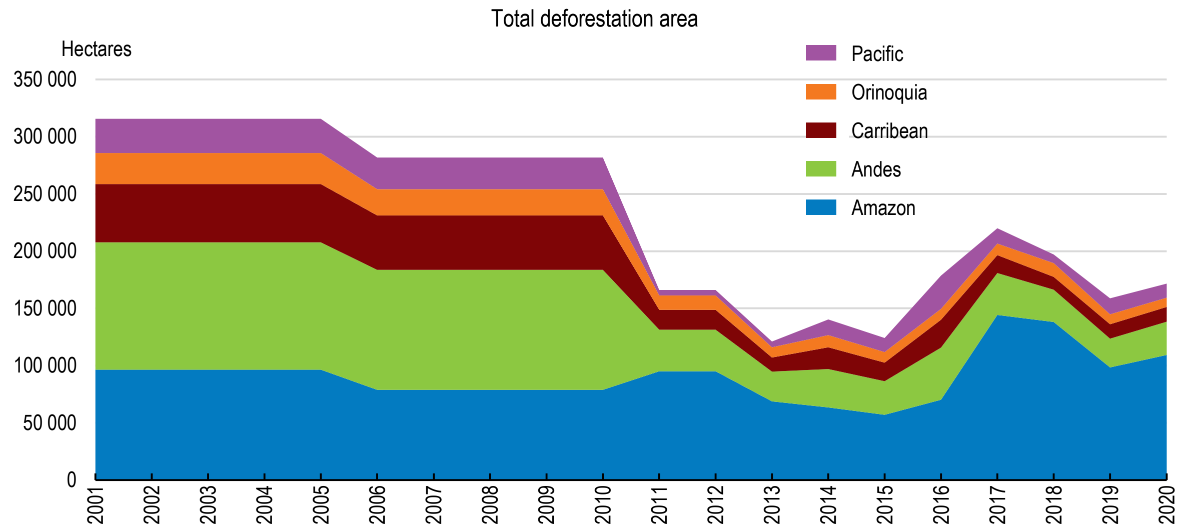
Stepping up efforts to rein in deforestation

Achieving emission goals will depend crucially on advances in the fight against deforestation, which is the major activity behind GHG emissions. According to government plans, deforestation is meant to decrease to 50,000 hectares per year by 2030, compared to 172,000 in 2020 (IDEAM, 2018[120]). In late 2021, a more ambitious goal of zero net deforestation by 2030 was formulated at the Glasgow summit. Colombia's forests are an invaluable natural asset, not only due to their significant role in absorbing CO_2 but also for their biodiversity and the central role they play as livelihoods for local communities. They encompass diverse ecosystems, from the Andean woods to the Amazon rainforest. Today's deforestation generates short-term private gains that are far below its social value. Deforestation declined sharply between 2011 and 2015, before a new surge in 2016-2017 (Figure 1.39). The year 2020 saw an 8% increase in deforestation, concentrated in the Amazon region. These developments are compromising Colombia's forest protection goals.

Causes of deforestation include the expansion of the agricultural frontier, often for extensive, low-productivity cattle breeding or simple land appropriation in the hope of a future land title, but also illicit crops. Extensive cattle breeding, based on converting forests into grassland, is one of the main causes of deforestation in the Amazon region (Murcia García et al., 2015[121]). Both in the Andean and Amazon region, much of the total deforestation is related to coca cultivation, which also drains land and water resources through excessive fertiliser use (UNODC, 2018[122]). At the same time, coca eradication attempts based on fumigation can harm not only human health and ecosystems, but might push cultivators into more remote areas, thus contributing further to deforestation. A tax on non-organic pesticides, which was recently proposed at a rate of 8% but not implemented, could help to internalise the associated external effects of pesticide use more widely and raise additional revenues (OECD, Dian and Ministerio de Hacienda, 2021[17]).

Carbon and ore extraction, part of which is illegal, has also propelled deforestation and is responsible for large releases of hazardous chemicals. Moreover, a rapid expansion of secondary and tertiary infrastructure has improved access to remote areas and thereby facilitated deforestation (IDEAM, 2018[120]).

Figure 1.39. Deforestation has picked up and the Amazon is the most affected region



Note: Data from 1990 to 2012 correspond to yearly average in that period. After 2012 data is reported every year.
Source: Instituto de Hidrología, Meteorología y Estudios Ambientales (IDEAM), available at http://smbyc.ideam.gov.co/MonitoreoBC-WEB/.

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A dramatic and highly significant increase in deforestation has occurred since 2015 in the context of the peace agreement, affecting 80% of protected areas and their buffer zones following the end of armed conflict (Clerici et al., 2020[123]). This is likely related to several reasons including the sudden retreat of guerilla forces, weaknesses in territorial control by the central government, the interest of some armed groups of dissident ex-guerillas to strengthen their position in some territories, the illicit extraction of forest resources, the expansion of the agricultural frontier, land grabbing, extensive cattle ranching, and the growing international demand for cocaine (González et al., 2018[124]).

Colombia's institutional efforts to curb deforestation have included an early detection system based on satellite imagery and the establishment of an inter-institutional national council to combat deforestation. A new Environmental Crimes law defines deforestation, its financing, and illegal land appropriations as crimes and raises the penalties for environmental damage. A new policy document for combating deforestation and sustainable forest management has been issued to coordinate actions by 40 national entities. Based on this sound framework, additional resources for enforcement action should be deployed permanently to accelerate the fight against deforestation, as recommended in the 2019 Economic Survey of Colombia (Table 1.6, OECD, 2019[14]). At present, enforcement action only follows a minor fraction of detections. In light of the global externalities, the case for international financial support for such action is strong. Additionally, uncertainties about land ownership related to the patchy coverage of land registries in remote regions need to be resolved to avoid opportunistic deforestation, especially around natural parks.

Table 1.6. Past OECD recommendations on green growth

Recommendations	Actions taken since the 2019 Survey
Ensure technical capacity and resources to allow for proper enforcement and management of forests.	In 2019, additional military and police forces were mobilised temporarily to fight deforestation in what was called "Operación Artemisa".
Grant the status of protected areas to a greater proportion of the forestland.	Three new protected areas totalling 26180 hectares were created in the Boyacá, Norte de Santander and Antioquia departments.

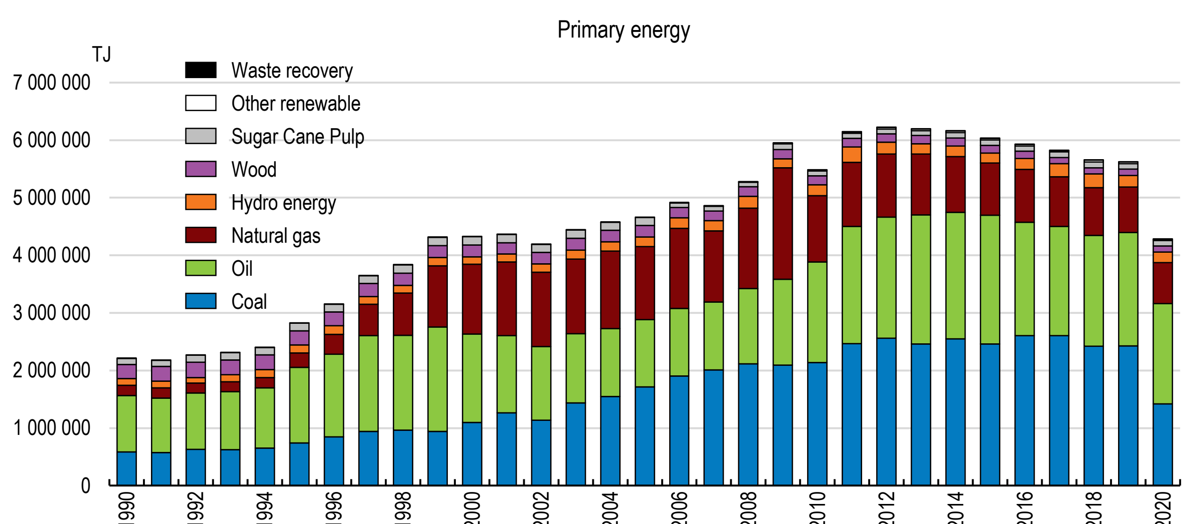
Source: OECD, 2019[14]

Rising agriculture emissions are mainly related to growing livestock herds (IDEAM, 2017[125]), which is one of the causes of deforestation. Deforestation for extensive cattle breeding is not only harmful to ecosystems, but also inefficient, as it is carried out on low-productivity land that is not suitable for this activity. Redirecting part of this activity to higher-productivity land and implementing modern production techniques could leave millions of hectares for reforestation and sustainable forestry, recuperating the land and acting as a carbon sink. Zero-deforestation agreements originating from the private sector, notably the beef, dairy, palm oil and cocoa supply chains, may be part of the strategy to rein in deforestation related to agriculture.

Reducing emissions from energy and transport

Energy-related emissions have increased by around 73% since 1990, although this trend has started to revert more recently (Figure 1.38). These emissions originate from rising combustion of fossil fuels such as coal and oil (Figure 1.40), mostly from transport, energy production and manufacturing. Surface transport is a strong emitter and transitioning to electric vehicles and other sustainable modes of transport would help cut emissions substantially, particularly as electricity generation in Colombia is to a significant extent clean and from renewable sources. Registrations of electric and hybrid vehicles are growing at a fast pace, supported by tax benefits.

Figure 1.40. Fossil fuel consumption has seen sharp increases



Source: Unidad de Planeación Minero Energética, available at https://www1.upme.gov.co/DemandayEficiencia/Paginas/Petroleo.aspx.

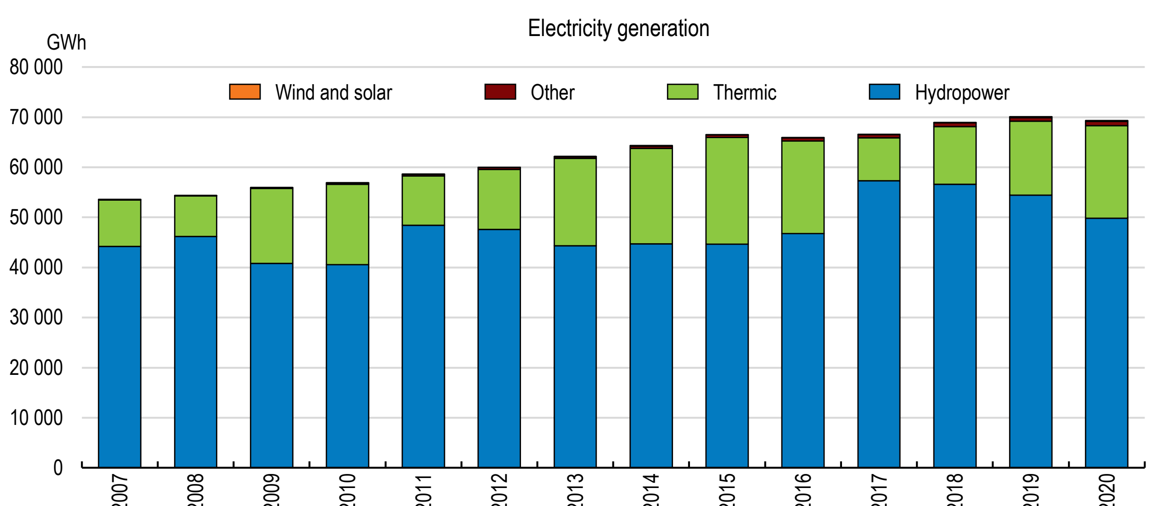
StatLink https://stat.link/bcowx7

In 2019, almost 80% of electricity came from hydroelectric sources (Figure 1.41), above the OECD average in renewable generation of electricity. Non-traditional renewables such as solar energy, where Colombia has significant potential (Suri et al., 2020[126]) and wind generation, with high potential in the Guajira department (Carvajal-Romo et al., 2019[127]), are less developed than in other OECD countries, although the recent trajectory is promising. Advancing them would also decrease the exposure to droughts and support energy security.

Shifting some fossil energy consumption, especially coal, towards cleaner energy holds significant potential for emission reductions. Industrial users have room to replace coal (30% of total consumption) by natural gas, although that would require additional investment in regasification plants. Furthermore, households source 38% of their energy consumption from wood, part of which could be substituted by electricity, natural gas or liquefied petroleum gas (LPG) for rural areas.

Colombia's fossil fuel prices fail to internalise the associated environmental and social impacts by a wide margin (Fedesarrollo, 2021[41]). A first important step be to eliminate all fossil fuel subsidies, which currently amount to 0.4% of GDP, while implementing measures to protect low-income households against real income losses. Making wider use of the carbon tax could also be part of a strategy towards shifting production and consumption patterns. Colombia was the third Latin American country to introduce a carbon tax in 2016, which has potential for significant CO2 reductions in Colombia (Calderón et al., 2016[128]). The tax currently covers around 25% of domestic emissions. The most important items not covered are coal, including in thermal power plants, natural gas and LPG for non-industrial uses (MADS, 2017[129]).

Figure 1.41. Electricity generation is mostly from renewable sources



Source: Unidad de Planeación Minero Energética, available at https://www1.upme.gov.co/DemandayEficiencia/Paginas/Petroleo.aspx.

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Expanding the carbon tax to coal and natural gas could help to reduce emissions and air pollution, and contribute to further shifts towards renewable energy use in electricity generation. At USD 5 per ton of CO_2 equivalent the carbon tax is also significantly lower than in other countries with similar income levels (Federsarrollo, 2021[130]). This explains why environmentally-related taxes, which in Colombia also include taxes on vehicle sales, represent only 0.6% of GDP, well below the 1.6% OECD average. Aligning the tax rate with current OECD average levels over several years could lead to additional revenues on the order of 0.2% of GDP, part of which could be used to compensate low-income households for the associated price increases. (Carbon Pricing Leadership Coalition, 2019[131])An emission trading scheme does currently not exist, although the legal basis for this was created in 2018 (Sousa et al., 2020[132]).

Table 1.7. Policy recommendations from this chapter (Key recommendations in bold)

MAIN FINDINGS	RECOMMENDATIONS
Refining macroeconomic policies and reforming taxation	
Public debt will be permanently higher than before the pandemic, reducing fiscal buffers. Although activity has seen a solid rebound, employment remains well below pre-pandemic levels.	**Reduce the expansionary fiscal stance gradually as of 2022 to rebuild fiscal buffers while continuing exceptional income support until the labour market recovers.**
Tax revenues of only 20% of GDP, low even for regional standards, are insufficient to finance social demands and public investment. The tax system does little to reduce high income inequalities, with a minor role for personal income taxes and a strong reliance on corporate income taxes. The tax system is also excessively complex, with multiple special regimes and tax expenditures leading to significant revenue losses, while penalising growth and investment.	**Raise more revenues from personal income taxes by lowering the income threshold where taxpayers start paying income taxes, eliminating exemptions and strengthening rate progressivity.** **Reduce corporate tax expenditures while reducing the tax burden and tax distortions for businesses.** **Reduce the scope of VAT tax expenditures while compensating low-income households through social benefits.**
Dividend incomes are currently taxed at 10% at the personal level, with a 0% rate on the first USD 3000, equivalent to one yearly minimum wage.	Raise the tax on dividends and eliminate the basic exemption, shifting some capital income taxation from the corporate towards the shareholder level.
A financial transactions tax hampers revenue collection and financial inclusion.	Convert the financial transaction tax into a tax on cash withdrawals only.
Settling large transactions in cash enhances opportunities for tax evasion.	Consider imposing limits on cash transactions.
Weaknesses in tax collection lead to yearly revenue losses exceeding 5% of GDP.	Strengthen tax administration and reduce tax evasion through stronger use of information technology and cross-checking of information across different sources.
The efficiency of public spending is low and a number of public expenditures do little to advance policy objectives.	Undertake regular and systematic public spending reviews, including for tax expenditures.
Subsidies for electricity and gas are poorly targeted and reduce incentives for energy saving.	Eliminate subsidies on electricity and gas while protecting low-income households through social benefits.
The new autonomous fiscal council lacks budget independence and is understaffed.	Enhance the budget and the financial independence of the newly created autonomous fiscal council.
Inflation has begun to rise despite significant idle capacity and it is not clear to what extent these inflationary pressures are temporary.	**Gradually increase interest rates if inflationary pressures intensify.**
Progress in vaccination has been steady, but is lagging behind other countries in the region.	**Accelerate the pace of vaccinations against COVID-19.**
Fostering a more inclusive recovery	
Informal employment affects 60% of workers. This precludes them from access to social security, while reducing productivity and tax revenues.	**Establish a comprehensive strategy to foster formalisation, including lower non-wage costs, stronger enforcement and improvements in tax administration.**
High charges on formal labour hold back formal job creation and sustain high labour informality.	**Reduce the tax burden on labour income by shifting the financing burden of social protection towards general taxation.**
The pandemic has exposed major gaps in social protection, particularly among informal workers. Different programmes are highly fragmented.	**Merge existing cash transfer schemes into a single cash benefit for poor households while maintaining conditionalities for families.**
Half the population above 65 is not covered by pension benefits of any kind. Contributory pension benefits are regressive, with competing schemes providing different benefits for the same career history and particularly low coverage among women.	**Create a basic non-contributory universal pension benefit and merge existing contributory pension schemes into a single mandatory contributory scheme complementing the basic universal pension.**
Formal workers pay contributions for public health insurance, while informal workers get almost the same benefit package for free.	**Merge the two public healthcare systems into a single system, financed through general taxation revenues.**
Early school drop-out has risen sharply due to the pandemic, particularly among children from disadvantaged socio-economic backgrounds.	**Provide targeted support to those out of school and those at risk of falling behind, including through full-day schooling and school meals.**
Early education and care significantly decreases the likelihood of disadvantaged students dropping out from the education system later on, but in Colombia, only around half of children aged 3-5 have access to it.	Expand access to quality early childhood education to all children aged 3 and above.
Disadvantaged schools and areas often lack high-quality teachers.	Improve the incentives for high-quality teachers to relocate at least temporarily through higher salary bonuses and better contract conditions for teachers who relocate to disadvantaged schools.
Strengthening productivity and competition	
Productivity growth has fallen behind regional peers and competition is weak. Regulations on product markets and administrative barriers restrict market entry and hamper competition.	**Reduce domestic regulatory barriers to entrepreneurship and market entry.**

Infrastructure bottlenecks continue to hamper logistics and act as a cost driver, reducing firm productivity.	Continue investing in infrastructure improvements, including intermodal transport facilities such as rail-road connections.
Port logistics are often slow and the coordination between procedures and inspections by different public agencies is not assured.	Reduce the handling times in ports, including those caused by customs and other agencies.
Business registration renewal fees are unusually high and add to widespread informality among firms, particularly smaller ones.	Eliminate recurring business registration fees.
Trade openness is low. Non-tariff barriers have risen sharply, while high peak tariffs afford high protection to some domestic producers, often characterised by low productivity.	**Reduce tariff and non-tariff barriers to trade, starting with those items where current barriers are highest.**
Lowering trade barriers can generate adjustment costs as it may cause jobs to disappear in some firms and emerge in others.	Scale up professional training programmes to help workers acquire the skills needed to move into new jobs.
Colombia has signed a number of bilateral free-trade agreements, but less so than other countries in Latin America.	Actively engage in signing additional bilateral trade agreements to obtain better market access.
Strengthening economic governance and the fight against corruption	
Corruption reduces public spending efficiency, creates an uneven playing field and exacerbates inequalities. Colombia has no dedicated whistle-blower protection law, in contrast to most OECD countries and political campaigns are highly dependent on private financing sources.	**Continue the fight against corruption by establishing a dedicated whistle blower protection law and imposing stricter limits for private campaign contributions.**
Strong reliance on private campaign contributions creates incentives for candidates to pay back contributions with political favours once in office.	Set stricter limits and transparency requirements for private campaign contributions, for both political parties and independent candidates.
A central procurement entity has been created, but direct purchases still represent around 70% of total public procurement transactions.	Better define the scope for mandatory recourse to centralised purchasing, including at the subnational level.
Only companies who pay an annual fee for listing on a public registry can compete in public tenders and few smaller enterprises participate in government purchases.	Eliminate fixed annual fees for participating in public tenders.
Colombia has no regulation requiring transparency in the interactions between interest groups and policymakers	Legislate provisions to frame the activities of lobbyist.
Courts are slow to resolve civil disputes and enforce contracts, and procedural requirements are cumbersome.	Strengthen the performance of the judicial system by enhancing court automation and electronic case management tools and reducing adjournments.
Making growth more sustainable and greener	
Deforestation has risen and reaching current objectives for reducing greenhouse gas emission will require stronger declines in deforestation.	**Increase resources dedicated to anti-deforestation enforcement activities to follow up on more cases of detected deforestation.**
A patchy land registry is one motive behind deforestation, often with the aim of obtaining a land title in the future.	**Accelerate progress in expanding the land registry, especially into remote areas.**
Fossil fuel subsidies currently amount to 0.4% of GDP.	Phase out fossil fuel subsidies while supporting vulnerable household in coping with the resulting price changes.
The 2017 carbon tax leaves out important emission sources and is levied at a relatively low rate.	Expand the carbon tax to cover all uses of coal, natural gas and LPG and consider aligning its rate with OECD averages.

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2 Filling in the gaps: expanding social protection in Colombia

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The pandemic has highlighted significant gaps in social protection, in particularly 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. By contrast, formal workers have access to a full range of social protection benefits, involving large-scale public subsidies to the better-off. Labour informality and social protection coverage are interlinked, as high social contributions are one of the main barriers to formal job creation. Ensuring some basic social protection coverage for all, while simultaneously reducing the cost of formal employment, would reduce labour informality, raise productivity, and decrease poverty and inequality, all of which are long-standing challenges in Colombia.

Introduction

The COVID-19 pandemic has highlighted long-standing gaps in the social protection system and is reversing decades of progress made in eradicating poverty and reducing inequality. Major structural problems, including a high share of informal workers with no social insurance and a low coverage of social assistance programmes, have worsened and become more visible with the pandemic when incomes of those at the bottom of the income distribution fell three times more than for those with higher incomes. 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 included both an expansion of existing benefits and the establishment of new ones, including an unconditional cash transfer programme and wage subsidies. These social 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, unfortunatedly 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 impact of the pandemic on social outcomes. 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 more 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[1]). With less access to digital solutions, informal firms have struggled to access the policy support put in place during the pandemic, such as wage subsidies and state-guaranteed loans. 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.

Among the many roots of informality, including low access to high-quality education and training and a weak institutional framework and enforcement, the design of the social protection system is a key factor. 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[2]; Meléndez et al., 2021[3]; Levy and Cruces, 2021[4]; Loyaza, 2018[1]). The sum of employers' obligations can reach 53% of the wage for earners on the minimum wage. Because regulations are imperfectly enforced, firms regularly 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, leaves many workers in informal jobs.

To address the lack of coverage in social protection of informal workers, non-contributory pillars in pensions and health have been established over the years. These pillars are financed through the budget with general tax revenues, i.e. non-earmarked resources proceding from different taxes, sometimes, 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. But these non-contributory pension and cash transfers programmes share two common features: 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 regime has reduced the stark gap between the 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 and their families 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[5]).

The long-term goal of achieving 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. 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 and 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 productive inclusion. 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 permanent additional resources by about 1% of GDP. This estimate is an upper bound, as the increased formalisation and growth, and consequent revenue collection 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) and expenditure 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.

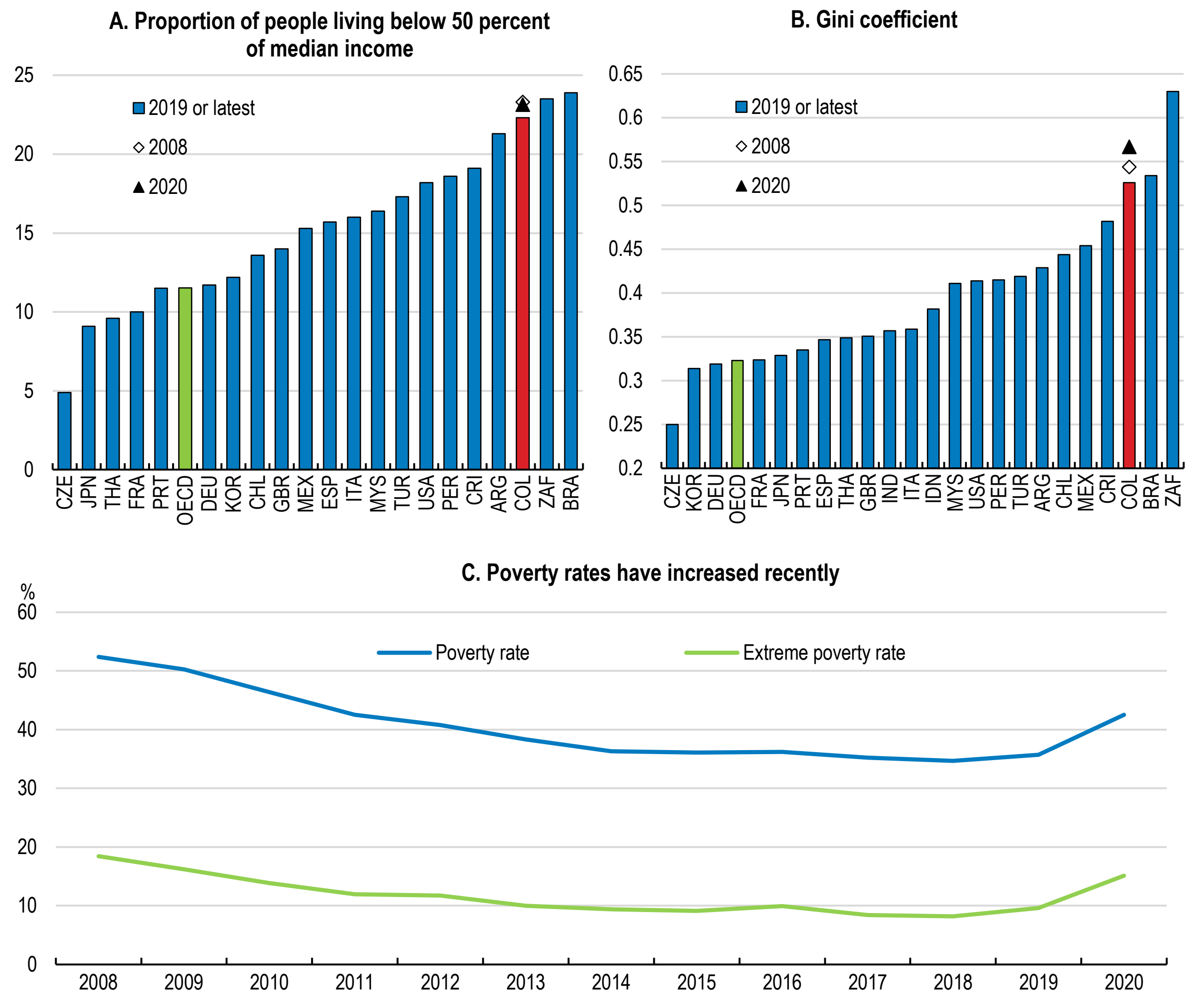
Finding the appropriate sequencing and prioritisation is essential for a politically viable reform agenda. Moving forward in a gradual manner could help to improve political acceptance. In this regard, a first priority should be to strengthen social assistance programmes and consolidate them into a single programme to tackle poverty. This should be financed by additional tax revenues, with changes to the basic deduction 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 and in previous Economic Surveys (OECD, 2019[6]; OECD, 2017[7]).

COVID-19 is reversing progress in poverty and inequality reduction

Poverty and inequality declined significantly in the last two decades in Colombia, but remain the highest among OECD countries (Figure 2.1). 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[8]). The decline in poverty decelerated and poverty eventually started increasing again as of 2017, partly explained by 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[9]), and the increase 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[10]). 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[11]; Lustig, 2016[12]). However, the redistributive impact of taxes and transfers remains relatively low compared to advanced and even other developing countries (Lustig, 2016[12]).

Figure 2.1. 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, which is used in Panel C. Gini index measures the extent to which the distribution of income (or, in some cases, consumption expenditure) among individuals or households within an economy deviates from a perfectly equal distribution. Panel C shows povety using the national defition based on the calculation of the basic food consumption basket.
Source: World Bank, WDI; DANE.

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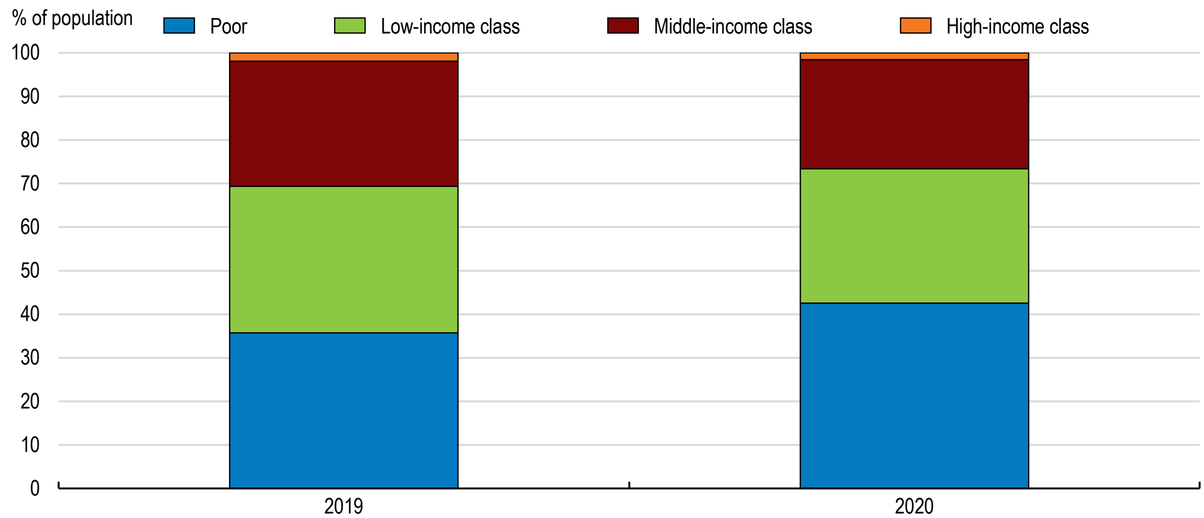
The Covid-19 pandemic had a profound impact on lives and livelihoods, increasing poverty from 36% to 42.5% in 2020 (Figure 2.1, Panel C). Many of these newly poor households suffered steep income declines and 1.7 million people fell out of the middle-class (Figure 2.2). At the end of 2020, more than 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 2.2. 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.

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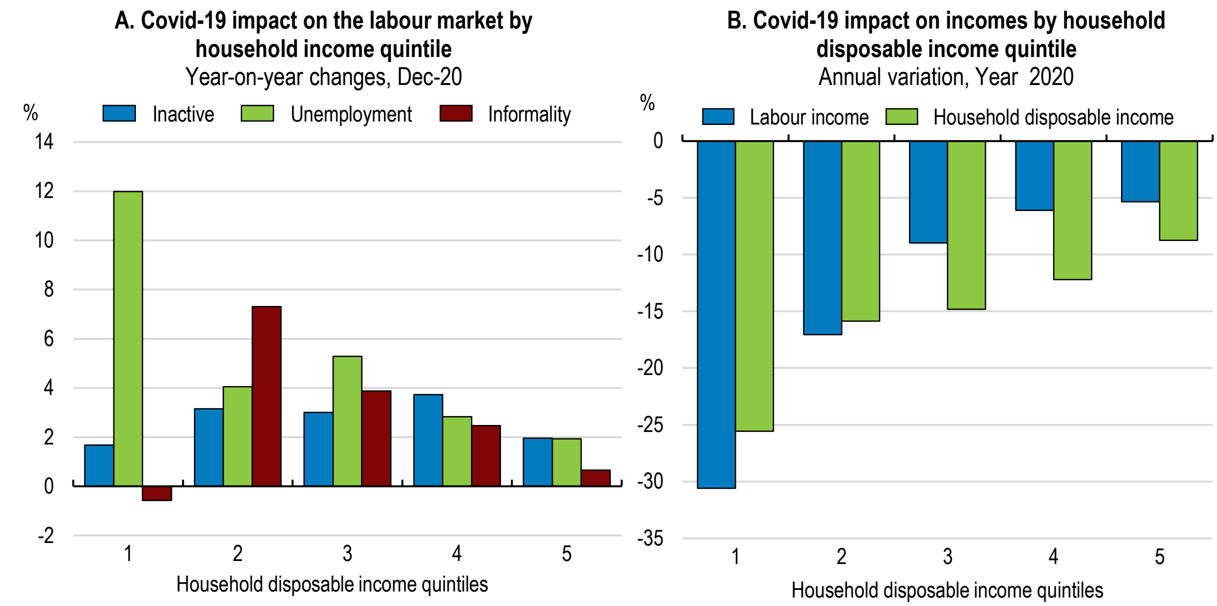
Massive losses of jobs and livelihoods have been the main drivers of the increase in poverty and inequality following the COVID-19 pandemic (Figure 2.3). This strong impact has its roots in already existing inequalities driven by a high share of informal jobs (Box 2.1), the resulting low social protection coverage and high unemployment, both concentrated in the lowest part of the income distribution (Figure 2.4). This has been coupled with a traditionally patchy coverage of cash transfers benefits that miss out many households in need, despite a significant benefit expansion of existing programmes and 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 provides useful diagnosis and recommendations to follow up on (Levy and Maldonado, 2021[13]). In addition, a temporary reduction in non-wage labour costs targeted on youths and women is meant to support these groups, which were particularly affected by the pandemic.

Figure 2.3. 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.

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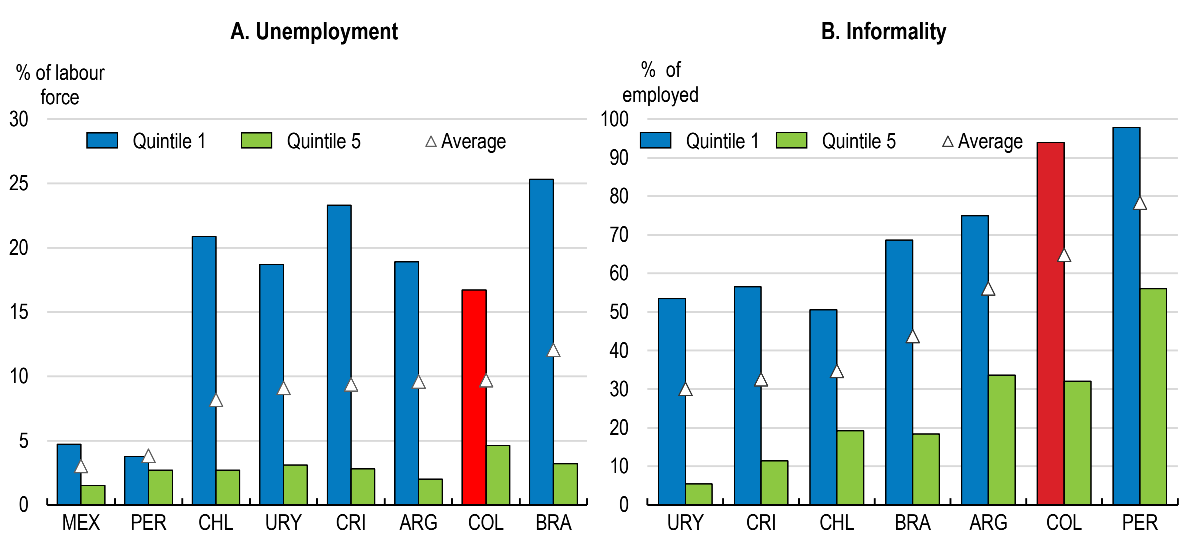
Figure 2.4. Informality and unemployment are high and concentrated among the vulnerable



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

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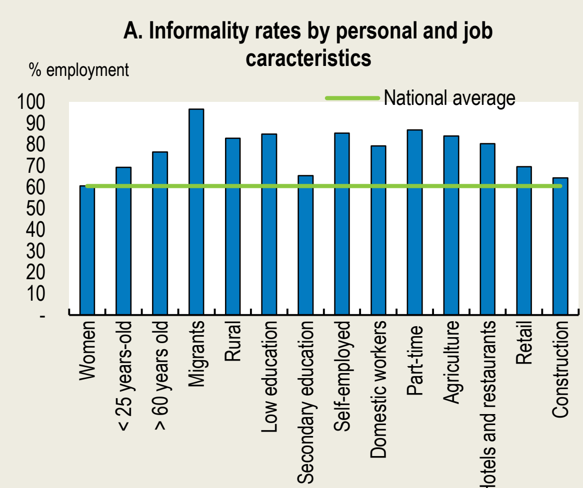
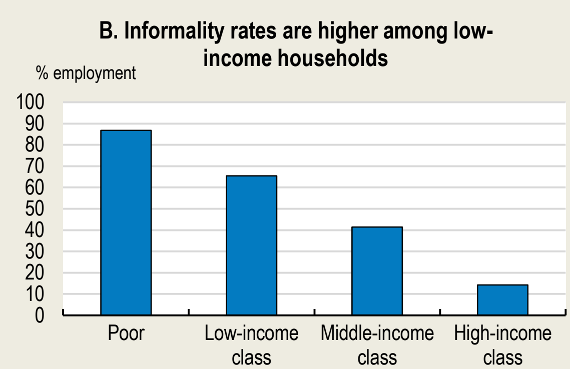
Box 2.1. Who are the informal workers?

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 informality for salaried workers as those whose employers do not contribute to social protection systems. 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 2.5, 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 decreasing informality as workers attain higher education levels. The agricultural sector, retail, hotels and restaurants and the construction sectors concentrate many informal workers. Poverty rates are higher among workers in informal employment and there is a strong correlation between household income and informality (Figure 2.5, panel B). Furthermore, informal workers tend to have lower (Figure 2.6) 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[3]). 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 2.5. 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.

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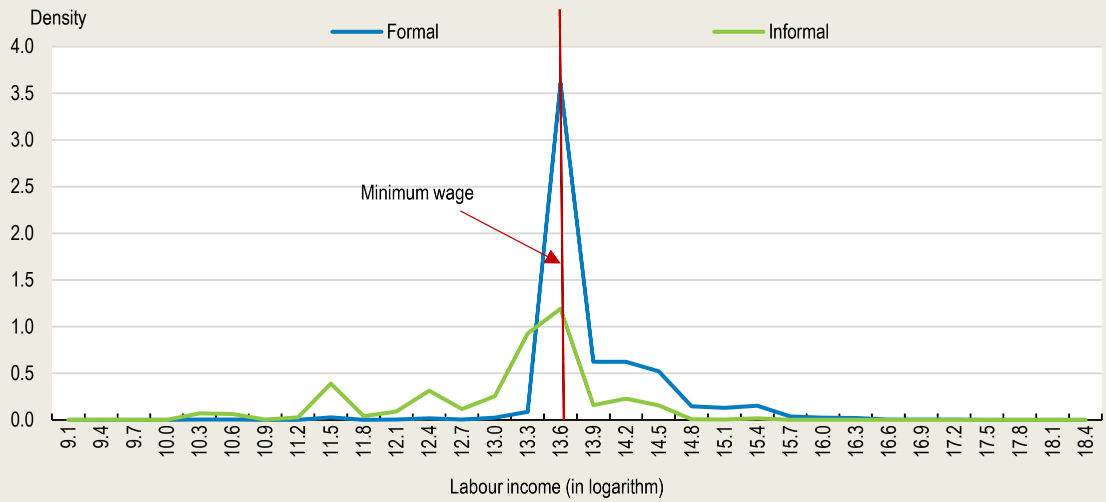
Figure 2.6. Informal workers earn less than their formal peers



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.

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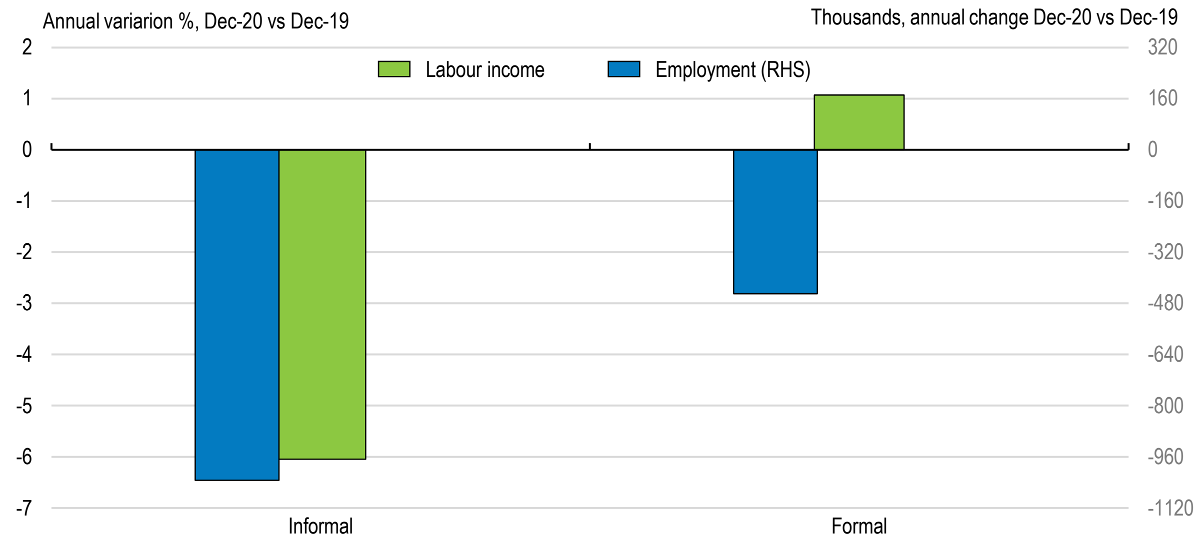
Colombia has also high levels of business informality. Around 76% of microenterprises were not registered with the tax administration and 89% were not registered in the chamber of commerce in 2020, according to the microenterprises survey of the national statistical institute. This is highly correlated with low compliance for hiring formal workers, sanitary standards, low implementation of formal accounting and tax declaration and payment (DNP, 2019[14]). Indeed, 88% of microenterprises did not contribute to health or to pension and 95% did not contribute for 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[15]).

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 2.7). 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 2.7). The latter is explained by composition effects as the adjustment in formal employment was mainly done at the expense of temporary workers (ILO, 2021[16]). 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[17]). 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[18]).

Large firms, with a high incidence of formal jobs, were able to cope 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[19]).

Figure 2.7. Informal workers suffered large jobs and incomes losses during the pandemic



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

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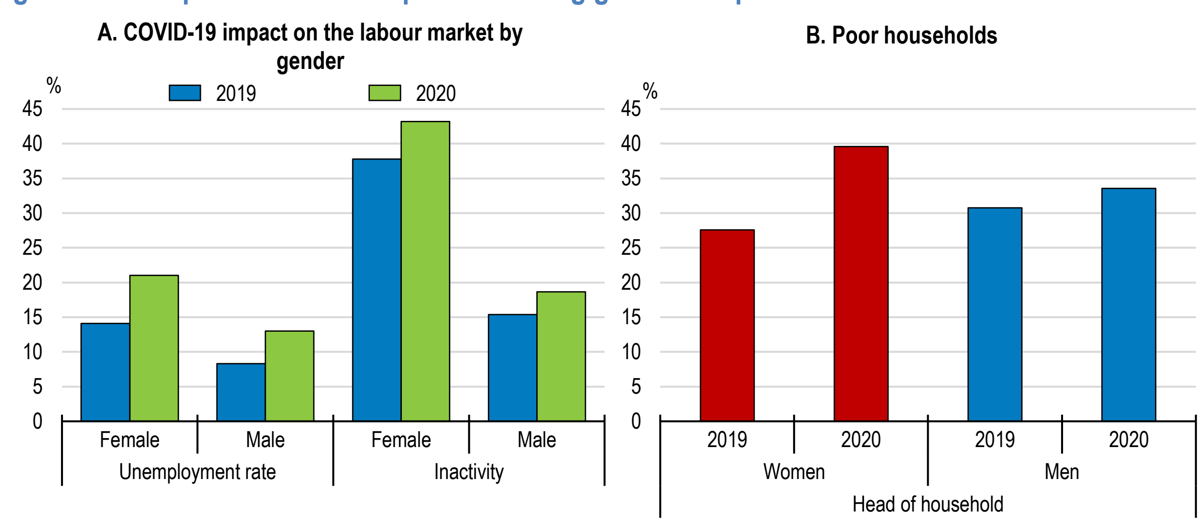
Women were also more affected by COVID-19, partly because of pre-existing large employment and wage gaps, which were amplified in 2020 (Figure 2.8, Panel A). Female labour force participation has seen an unprecented reduction during 2020, and as the economy rebounds, the recovery has been slower than 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 disproportionally affected by increases in poverty in 2020 (Figure 2.8, Panel B). The impact of the crisis also varied greatly across cities and regions, reflecting significant discrepancies in informality, availability and quality of public services.

Figure 2.8. The pandemic has amplified existing gender inequalities



Source: OECD calculations based on GEIH 2019 and 2020.

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The migrant population has also been strongly hit by the COVID-19 pandemic as they face various vulnerabilities. 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[20]). 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.

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[21]). 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.

Ethnical minorities have also been strongly affected by the pandemic. Poverty rates were higher among those groups before the pandemic and access to social protection very low (ANDI, 2019[22]). The Government increased cash transfer support for ethnical 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

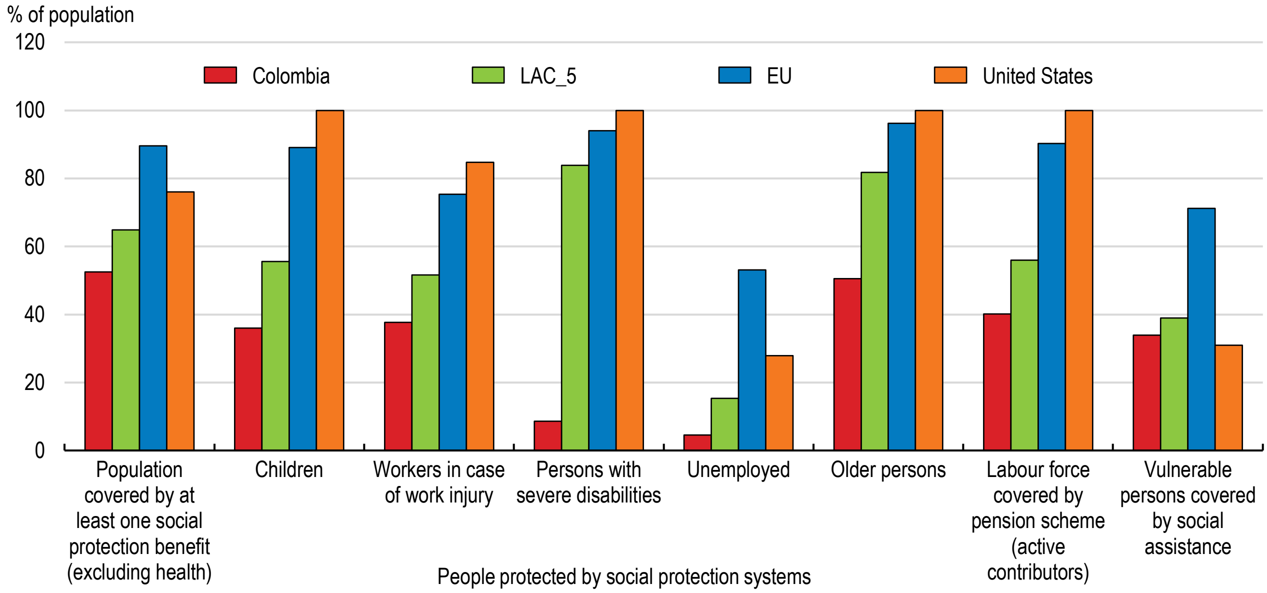
The social protection system in Colombia is fragmented with entitlements mostly determined by the labour market status (Box 2.2). On the one hand, "social security" benefits are associated with formal work, and, on the other hand, "social assistance policies" directed towards the poor constitute a parallel non-contributory system.

The result of this set-up 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, some of which have access to non-contributory social assistance programmes. Informal workers have lower average incomes than formal workers, however, some informal workers have incomes above the poverty line, which generally precludes them from access to 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 even if they earn less than the minimum wage, but their social contributions need to be based on a monthly minimum wage. This duality has led to a low coverage of social protection (Figure 2.9).

This fragmentation is not only a source of inequality, but also one important factor contributing to low productivity growth (Levy and Schady, 2013[23]; Levy and Maldonado, 2021[13]). When contributory benefits from the social security system are not fully valued by workers, they tend to act as an implicit tax for formal employment. At the same time, non-contributory benefits can act as a subsidy to informality when they are perceived as similar as 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 2.9. 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.

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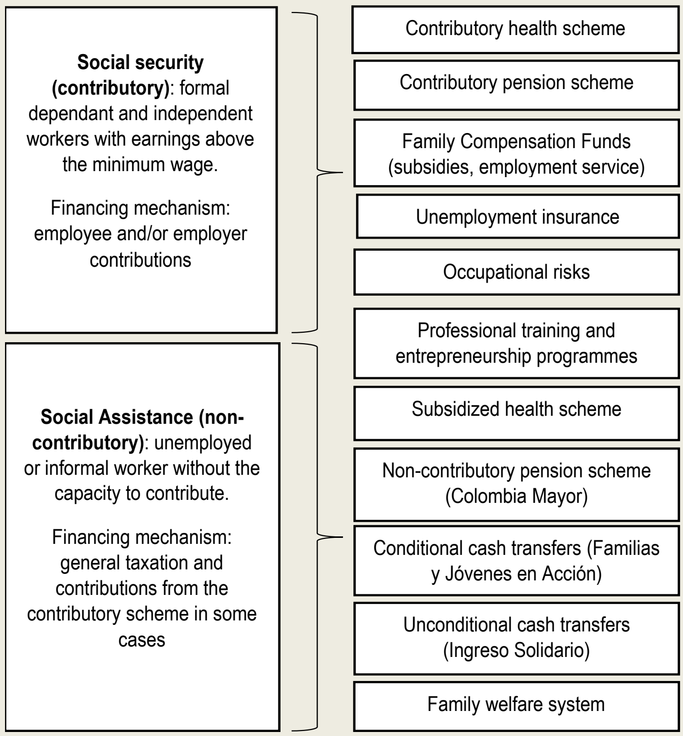
Box 2.2. The social protection system in Colombia

The social security system comprises health, pension, and unemployment insurance and occupational risk coverage (Figure 2.10). The system is financed through contributions made by employers and/or employees which are proportional to the worker' salaries or wages, hence the label of "contributory social security scheme". Workers covered by this system are also subject to regulations on employment protection and minimum wages.

The social assistance system was created to provide insurance to those left out from 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 (subsided) 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 (*"Estategia 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 help 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 2.10. The social protection system in Colombia



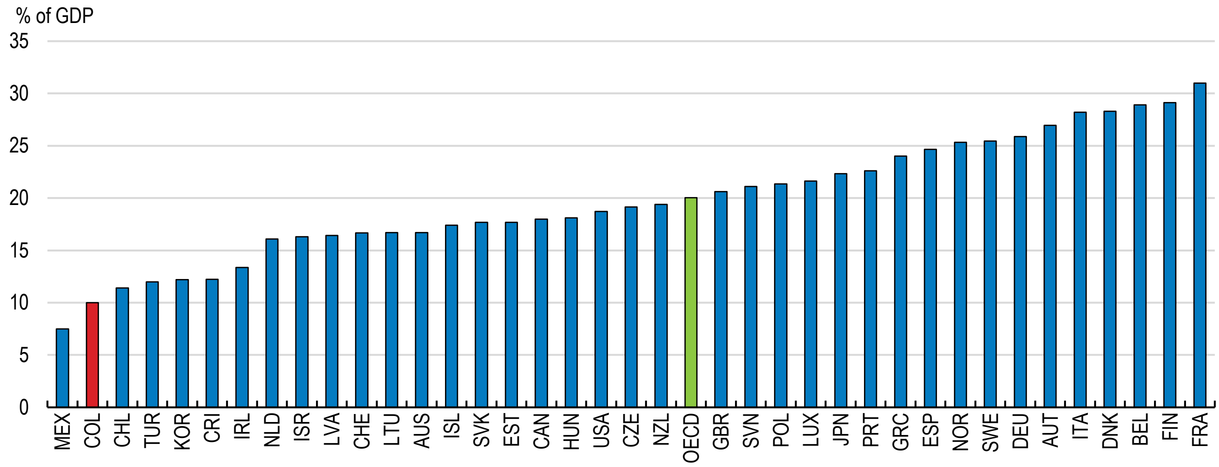
Source: OECD Secretariat.

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[24]) to 10% of GDP in 2019, it remains low in international perspective (Figure 2.11). 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, targeting is poor, with a significant part of social public spending benefiting non-poor households (Table 2.1). 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[12]). This is driven by the high share of informal jobs 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[9]). The best-targeted items are social assistance programmes, such as *Familias en Acción*, and although almost 40% of spending went to non-poor households in 2016 (Fedesarollo, 2021[25]), targeting has improved recently.

Subsidies for public utilities are the second most ill-targeted item, as 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 lower 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 subsidies for electricity and 60% for gas (Eslava, Revolo and Ortiz, 2020[26]).

Figure 2.11. 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.

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Table 2.1. 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	
Total without pensions	**39.6**	**24.3**	**16.6**	**12.1**	**7.4**	**50**	
Total	**31.1**	**20.6**	**15.6**	**13.7**	**18.8**	**59.8**	**11.1**

Note: Year 2017. Poor is 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: (Fedesarollo, 2021[25]) based on ENPH-DANE.

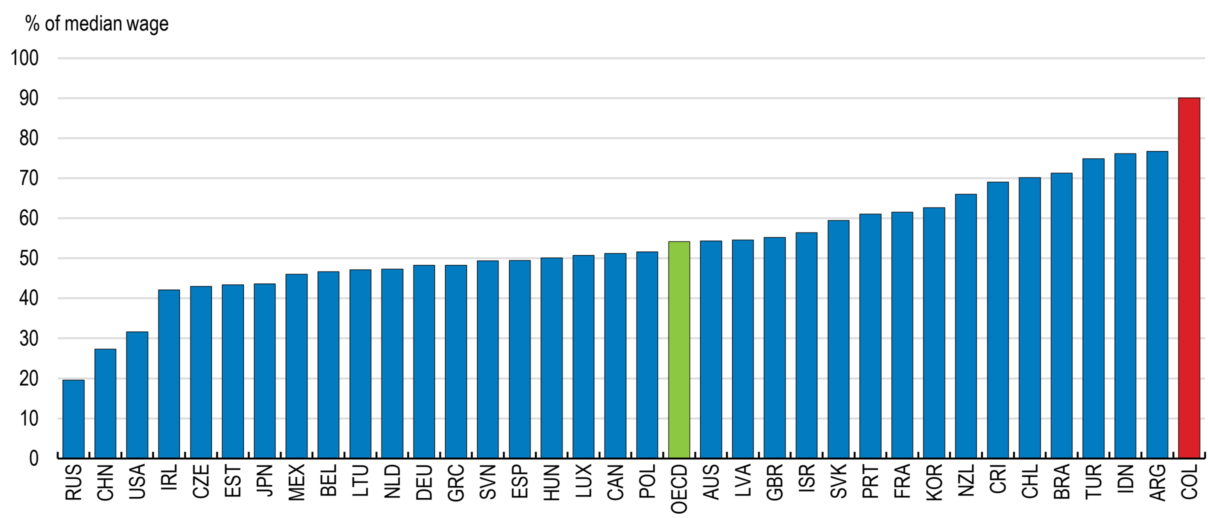
High formal labour costs explain large social insurance coverage gaps

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 2.12). International evidence on the impact of minimum wages on employment is not conclusive (Broecke, Forti and Vandeweyer, 2017[27]). 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[28]; Pérez Pérez, 2020[29]; Mora and Muro, 2019[30]), and induces informality (Arango, Flórez and Guerrero, 2020[31]; Mondragón-Vélez et al., 2010[32]; OCDE, 2019[33]; Arango and Flórez, 2017[34]; Olarte Delgado, 2018[35]). 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 2.12. 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.

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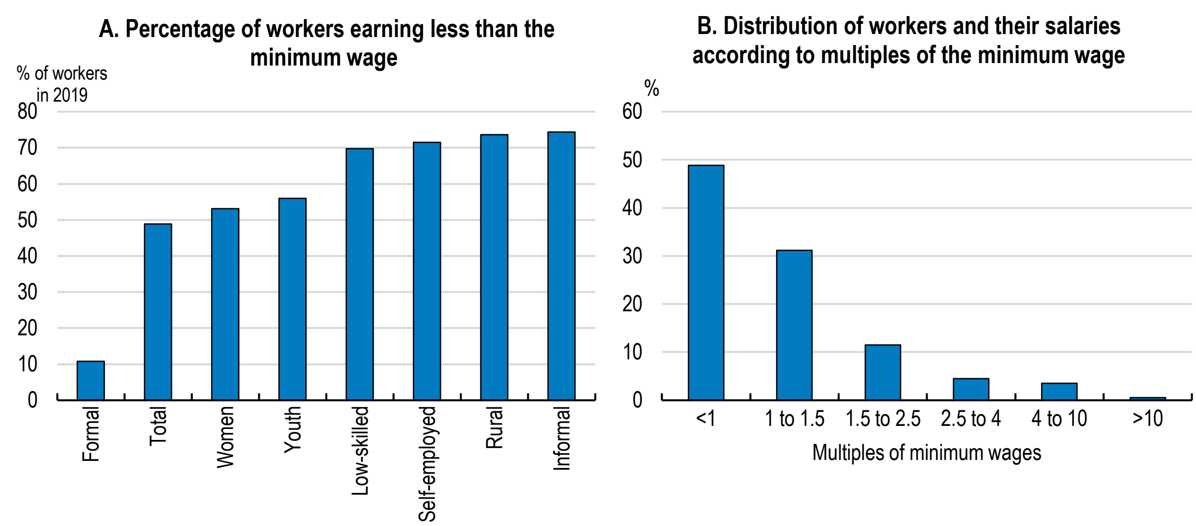
This high minimum wage has likely left many workers in informal jobs, self-employment and unemployment. Almost half of the total workforce earns less than the minimum wage, and this number is higher for self-employed, women, informal, young, low-skilled and rural workers (Figure 2.13), whose labour productivity is likely lower. As argued in OECD (2016[36]), 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[37]).

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. Labour productivity grew by an annual average of 0.3% during the same period. 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 remuneration for those earning below the minimum wage than for other workers, which adds to the regressive nature of current arrangements. Allowing workers with incomes below the minimum wage to participate in social security, and calculating 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[37]; OECD, 2019[38]). 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[39]).

Figure 2.13. 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.

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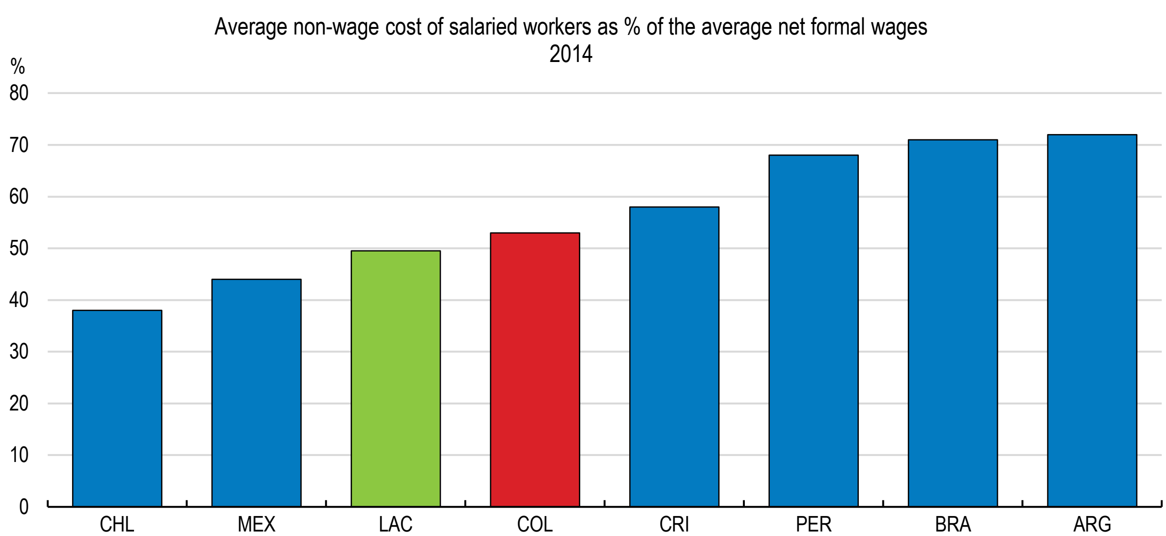
In the medium term, a permanent and independent commission could provide recommendations on setting minimum wage increases, as in other OECD countries. For example, the process of setting minimum wages in Germany and the United Kingdom includes a systematic monitoring of its potential impact by specific independent bodies mandated to evaluate and provide recommendations (Low Pay Commission UK, 2018[40]; Eurofound, 2018[41]; Vacas-Soriano, 2019[42]). 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 of 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[37]) or by region (OECD, 2017[7]), 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 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 add 50% the labour costs of an average-wage worker (Figure 2.14). However, for informal workers, non-wage labour costs usually add up to 120% to their average wages (Alaimo et al., 2017[43]). Such high costs perpetuate a high incidence of informality, self-employment and unemployment.

Figure 2.14. 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.

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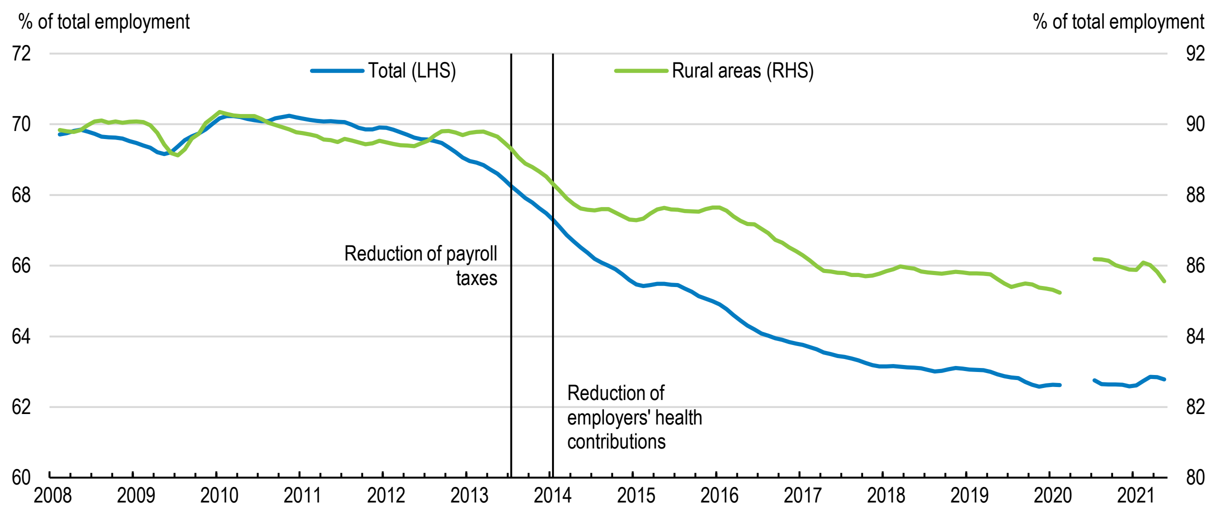
The 2012 tax reform that reduced payroll taxes and employer's health contributions (Box 2.3) shows that reducing non-wage labour costs helps to reduce informality. In the aftermath of the reform, labour informality declined visibly (Figure 2.15). Available impact evaluations suggest that the reform led to a 2 to 4 percentage-point reduction in the informality rate (Kugler et al., 2017[44]; Morales and Medina, 2017[45]; Fernández and Villar, 2017[46]; Bernal et al., 2017[47]). For self-employed workers, the reform implied no changes in social contributions, explaining why the effect on increased formality was stronger among employees than self-employed workers (Figure 2.16). 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[47]). Estimates of wage effects vary, ranging from only a small effect (Morales and Medina, 2017[45]), to a positive effect of 2.7% on average wages (Bernal et al., 2017[47]). 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[48]).

Figure 2.15. 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.

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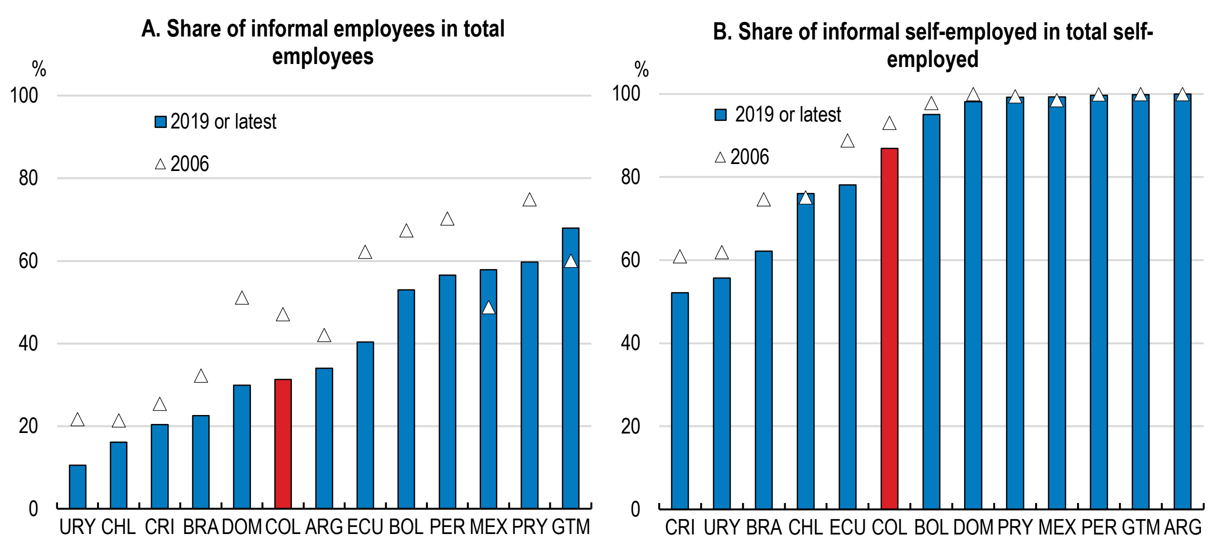
Figure 2.16. The decrease in informality has been much stronger among employees than among self-employed



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

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Despite the 2012 tax reform, social contributions remain high (Box 2.3) 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% for an employer. Among the most costly 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 2.3. 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 set at 8.5% of the payroll. These payroll 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 e firms in the special tax regime, in particular, non-for-profit organizations, 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 2.2. Non-wage labour costs in detail

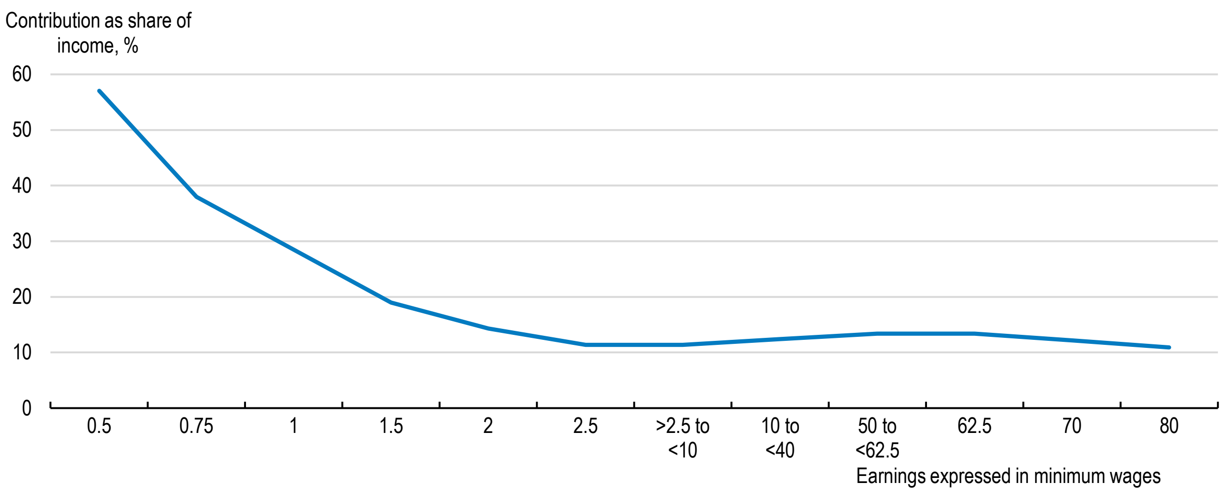
% of wage	Employer		Employee	Self-employed
Pensions	12%		4%	16%
Health insurance	0% for employees earning less than ten minimum wages	8.5% only for employees who earn more than 10 times the minimum wage or for firms in the special tax regime	4%	12.5%
Contributions for professional risks	From 0.522% to 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[49]; Cuesta and Olivera, 2014[50]; Kugler, Kugler and Prada, 2017[51]; Kugler and Kugler, 2008[52]). 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[53]). 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 2.17). This acts as a particularly strong impediment to becoming formal (Meléndez et al., 2021[3]).

Figure 2.17. High social contributions leave many self-employed with no other choice than being informal

Pension and health contributions relative to the self-employed worker's income



Source: (Meléndez et al., 2021[3])

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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 formal workers (see Chapter 1). 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 simplication 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 facilitates 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.

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 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 2.3). 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 2.3. 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 earning above 4 minimum wages.		
If requirements are not met	Get their balances book adjusted for inflation without interest accrued on the savings (*indemnización sustitutiva*)	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 (*Colpensiones*)	Private pension funds	The Government (*Colpensiones)*	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 2.18, 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[54]).There are marked differences across populations groups. Women have a coverage of 21%, while for men the coverage 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 high commissions in the private funds and the fact that returned savings are only adjusted for inflation in the public system.

The non-contributory scheme *Colombia Mayor* has expanded in recent years, helping to reduce old-age poverty (DNP, 2016[55]; Econometria, 2017[56]). However, this scheme covers only 39% of those older than 65 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[57]). *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 2.18, 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%.

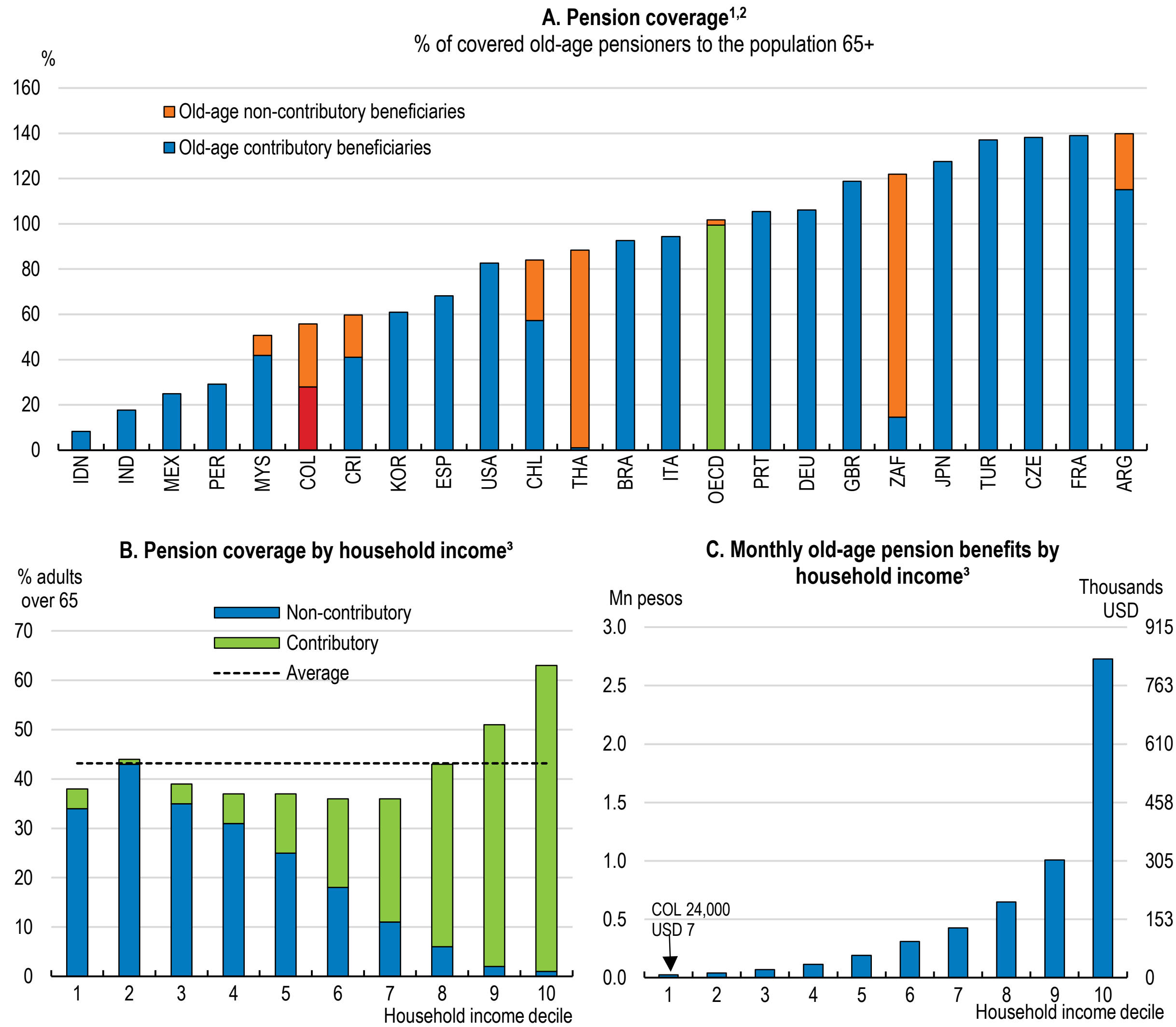
Inequities in the pension system are also driven by significant subsidies for high-income earners. In the public regime, the government fills the gap when contributions fall short of outlays, which gives rise to high implicit subsidies towards relatively high-income beneficiaries. Indeed, 51% of those with contributory pensions belongs to the 20% of the richest population (Fedesarollo, 2021[25]).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[58]), compared to an average 58% in the OECD. The fiscal cost of the pension system, which includes several special regimes for the public sector, military forces and teachers, is also high in relation to its coverage: 3.9% of GDP in 2019, nearly 30% of the government tax revenues, and nearly three quarters of this subsidises the public scheme.

A third pillar that encourages voluntary savings for low-income Colombians is the so-called Periodic Economic Benefits Scheme (BEPS). However, design problems and the fact that the programme relies on voluntary savings by a low-income population, who have little spare income, have limited its impact and development. Although the programme's coverage has grown, the number of people who save (around 1.6% of the old aged in 2020) and the amounts saved 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 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 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.

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. After one year of implementation, only 7000 out of 9 million potential workers have started contributing through this system (El Tiempo, 2021[59]). Adding this third element as a contributory scheme with different contribution rates and rules adds to the complexity of the pension system. It also potentially creates awkward incentives, as formal workers also 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 inadequate pension benefits and low coverage.

Figure 2.18. 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).

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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 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 2.4).

The need to strengthen the incentives for formal job creation calls for shifting the financing burden of pensions away from (formal) labour towards broader sources. Essentially, this implies financing the universal pension from general taxation revenues, as opposed to labour charges. 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, where revenue collection is undermined by exemptions and reduced rates (see Chapter 1).

Box 2.4. 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[60]). 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[61]).

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. But that would require a deep reform of the current contributory pension system, which is excessively complex, as analysed in a thematic chapter in the 2015 OECD Economic Assessment of Colombia (OECD, 2015[37]). 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[62]). 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 switching opportunities. If the public defined-benefit scheme continues to exist, phasing out ill-targeted subsidies and eliminating competition between the private and public schemes would be key for equity and fiscal sustainability. This would benefit from a parametric reform that links the retirement age to life expectancy and determines benefits on the basis of life-time 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[63]). 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 resistancein the more traditional terms of parametric reform of defined benefit formulas. These reform results include the use of lifetime wages for determining benefits, adjustments to reflect growing longevity and declining fertility, and incentives for older workers to remain in the labour force and pay contributions.

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 to diversify funding sources, which is generally considered an advantage (OECD, 2016[64]). 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 2.5), as it is efficient in redistributing resources to the most vulnerable while minimising distortions on the labour market (Morales and Olate, 2021[65]). Colombia could consider a reform in which the first universal basic pension could be integrated with the individual accounts, while having public subsidies 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 with a compulsory employer contribution to private superannuation savings; and a voluntary superannuation contributions and other private savings (OECD, 2021[66]). 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 2.5. 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 are 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[5]). Workers never lose their contributions, and pensions increase with individual savings. The system also provides women with children with a one-time monetary transfer at retirement age.

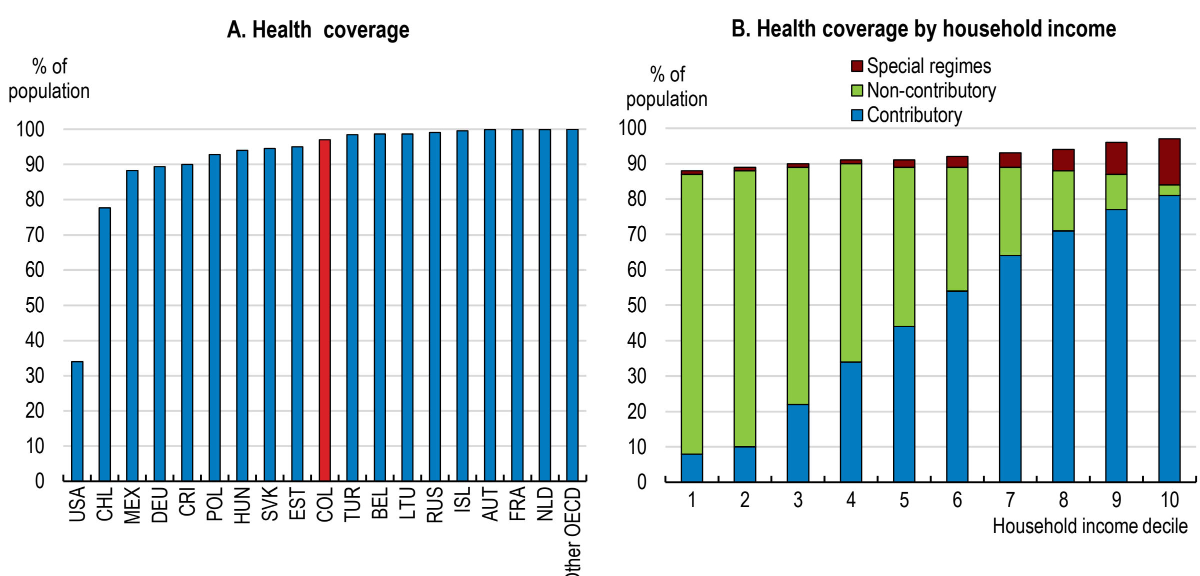
The Chilean system suffers from low replacement rates of around 52% for men and 29% for women when including the solidarity pillar (Morales and Olate, 2021[65]). This is partly related to the relatively low total contributions during working years. The government allocated 0.7% of GDP to subsidise pensions 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[67]).

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

Colombia has achieved almost universal healthcare coverage, with 97% of 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 2.19).

However, the public health system consists of two parallel schemes, a contributory scheme for formal workers and a non-contributory scheme, incentivising 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 effectively taxed away. Finally, workers face a temporary discontinuity in healthcare coverage when an individual switches between systems as a result 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 2.19. The health coverage is almost universal but its financing generates incentives for informality



Source: OECD Health at a Glance, 2020 and (Fedesarollo, 2021[25])

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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 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 workers, would allow reducing by 4 percentage points the cost differential between formal and informal employment, all of which is currently paid by the employee. For self-employed workers, this would reduce the cost of formal labour by 12.5 percentage points, or even more for those earning less than a minimum wage. By not discriminating between formal and informal workers, contributing or non-contributing workers, this type of financing of the health system would boost formality (Levy, 2019[53]).

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 shift more of the burden of contributions into higher income ranges, away from the vicinity of the minimum wage. One recent proposal is to set an initial contribution rate for salaried or self-employed workers at zero if they earn up to one minimum wage or less, and increase the rate gradually up to a maximum for workers earning 25 minimum wages (Fedesarollo, 2021[25]). This would leave the average contribution rate in the contributory scheme at around 4% of wages, implying no fiscal cost, but more progressive contributions.

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 in these firms, which account for 16% of all formal employment, mainly in the sectors of education and health. As these sectors provide work for 26% of female workers, reforming them would help to improve gender equality.

Family compensation funds could be reorganised

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 for affiliates. 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[36]). Moreover, many of the funds’ services are located in the regional capitals and are unavailable to formal employees in smaller cities or those living in the periphery. As a result, an increasing part of the contribution is in reality a tax on formal labour, 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 of the contributions, thus incentivising informality (Levy, 2019[53]).

Services currently provided by Family Compensation Funds could be subjected to a comprehensive cost-benefit and impact evaluation 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 regardless of labour status and equally across the country, as the substantial variation in the quality of services offered by the different 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 maintainint through general tax revenues can subtract 4 percentage points from labour charges and significantly strengthen the incentives for formal job creation.

If this proves 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 a zero contribution around the minimum wage that rises with income, but remains low below two minimum wages (Fedesarollo, 2021[25]). 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 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% had all their employed members working informally in 2019. The main programmes (Table 2.4) are *Familias en Acción* (Families in Action), a conditional cash transfer programme to fight poverty; *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 2.4. Main pre-COVID conditional cash transfer programmes in Colombia

	Familias en Acción	Jóvenes en Acción
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).

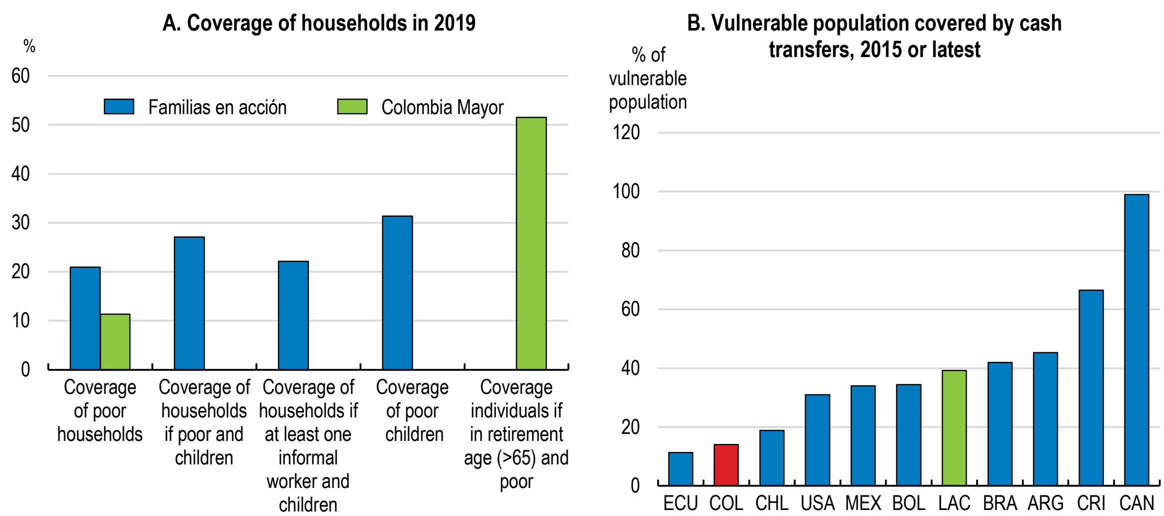
Evaluations suggests that these social programmes have contributed to reducing poverty and raising well-being of households. *Familias en Acción* has significant impacts on dimensions such as educational attainment, nutrition and other dimensions of life quality (Angulo, 2016[68]), in addition to reducing extreme poverty, poverty and multidimensional poverty (DNP, 2008[69]; DPS, 2020[70]). On the other hand, some evidence suggests that being a beneficiary from *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[71]). *Jovenes en Acción* has had positive effects on earnings and employment prospects, including formality, in the short and in the long run, and increased education for participants and their relatives (Attanasio, Kugler and Meghir, 2011[72]; Attanasio et al., 2017[73]; Kugler et al., 2020[74]).

The coverage of cash transfers programmes is low, leaving many poor households without any support (Figure 2.20). 52% of poor households do not receive any support from the state. Only 13% of households with all members working informally received *Familias en Acción* in 2019. Insufficient programme resources are the main reason for this low coverage. In 2019, only 2.7 million families were targeted, out of 4.3 million households in poverty. 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[75]), where on average is 15% (Gentilini et al., 2021[76]).

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 of 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 2.20. 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.

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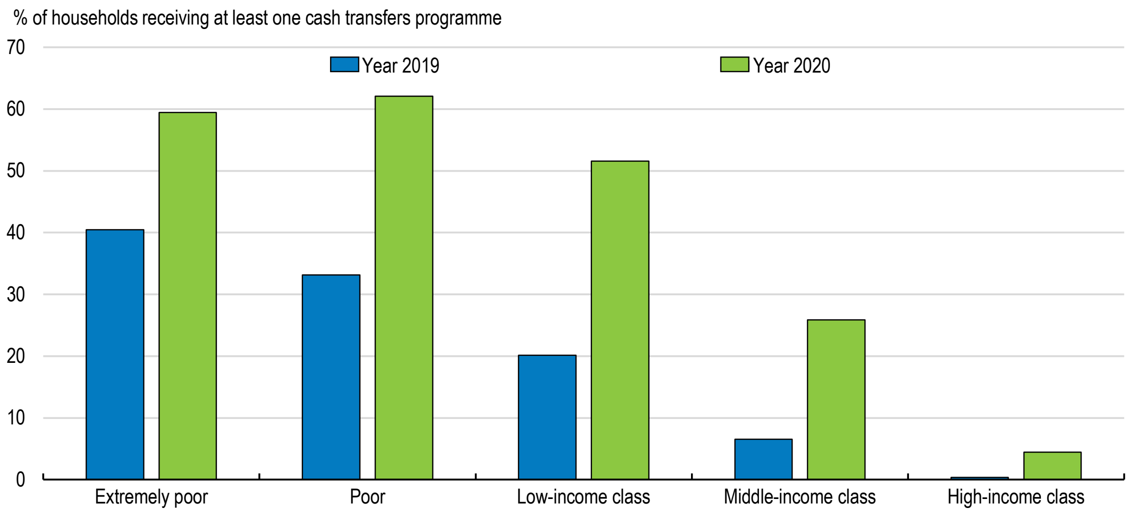
The COVID-19 pandemic accelerated some important changes in social policy

In response to the pandemic, the authorities launched a comprehensive social response to protect the poor and vulnerable (Figure 2.21). 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 the 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[77]).

Figure 2.21. 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 income of more 10 poverty lines.
Source: OECD calculations using GEIH 2019 and 2020, DANE data.

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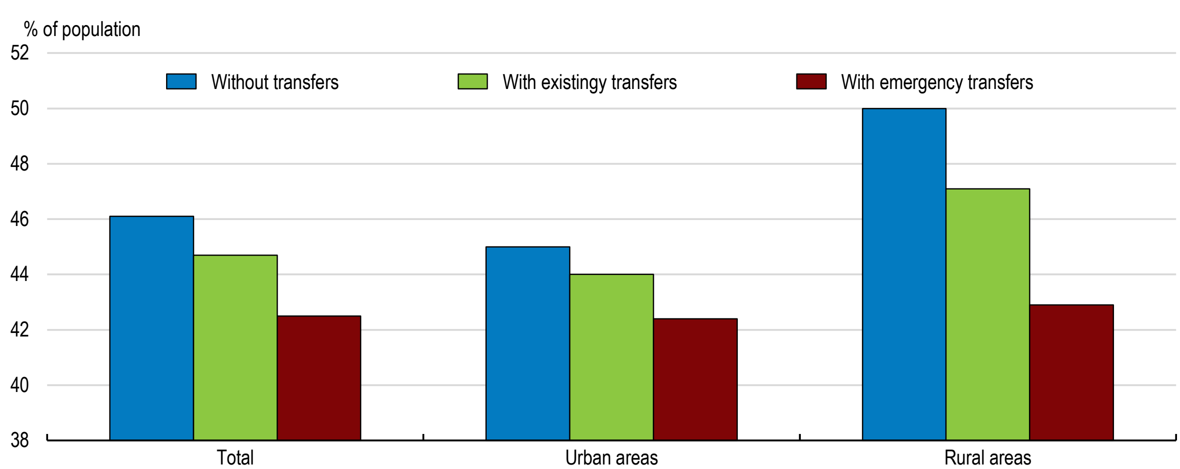
The social response was key to mitigate the impact of the COVID-19 pandemic on household incomes and poverty (Figure 2.22). By expanding the number of beneficiaries and increasing the level of benefits, social programmes supported household incomes, including for some well-off households. In particular, 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 2.22. Emergency monetary transfers mitigated the COVID-19 impact on poverty



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

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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 conditions 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 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 vulnerability of the household.

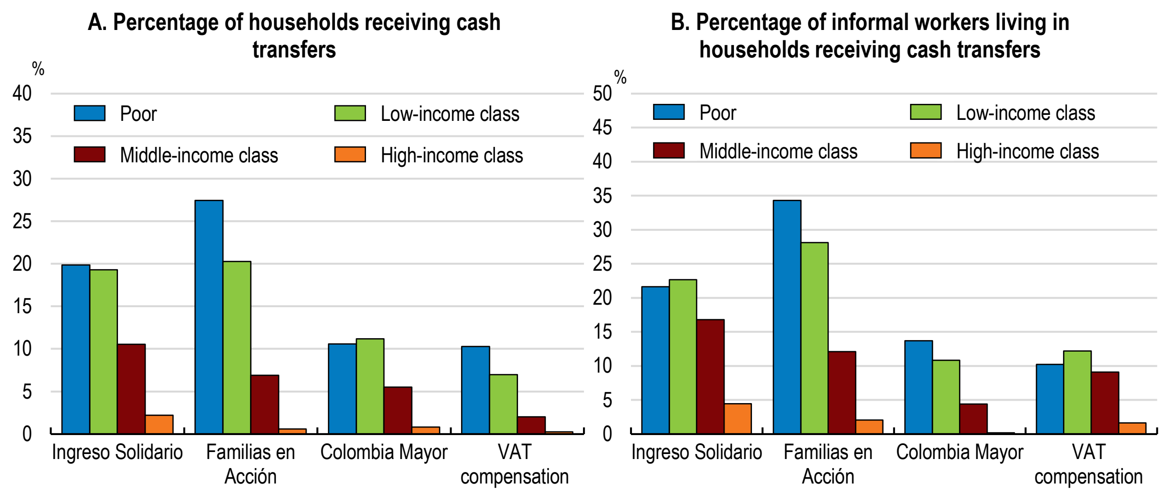
A key innovation of *Ingreso Solidario* is its use of bank accounts and mobile wallets for benefit disbursement, which helped to promote financial inclusion (Gallego et al., 2021[78]). The use of mobile wallets more than doubled during 2020 and 2.6 million beneficiaries of cash transfers received their 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 effectively providing access to financial education to ensure that access translates into effective and safe usage.

According to early evaluations*, Ingreso Solidario* had positive effects on household income, food consumption and education (Gallego et al., 2021[78]). The programme increased incomes for those most affected by the pandemic, while not 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. The programme was originally planned to be implemented during 2020 as a pilot for 100,000 families 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 programs benefitting 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[79]).

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, even now the coverage of households receiving cash transfers remains low (Figure 2.23) and *Ingreso Solidario* covers only around 20% of informal workers (Blofield, Lustig and Trasberg, 2021[80]), leaving many unprotected.

Figure 2.23. 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.

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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. It could be complemented by other social programmes that aim at improving household assets and human capital.

A guaranteed minimum income is a periodic cash transfer to supplement 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 (both from formal and informal jobs) and assets before the transfer. 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 expected in Ingreso Solidario from July 2022 go in this direction as the amount of the benefit will consider the size and 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 income (Box 2.6).

Box 2.6. 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 simply 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[81]). 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 levels still would leave many households in poverty, especially those at old-age not receiving any pensions or the unemployed or inactive. If the transfer is 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 for 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[82]). 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[83]), other evidence from the region suggests that transfers can decrease incentives to participate in formal employment (Bergolo and Cruces, 2021[84]). 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 for (formal) work, it is important that the programme has a graduation phase, in which the value of the transfer forgone is smaller than the additional 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[85]). 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 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 from the per capita household income level and its distance from 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 more 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 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[86]).

An almost equivalent alternative to this type of guaranteed minimum income would be a Negative Income Tax or Earned Income Tax Credit. In such as 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 disincentives to work (Hoynes and Patel, 2017[87]). There are also positive effects on poverty reduction, as the programme rewards work and supplements the incomes of low-wage workers. These programmes have also decreased informal employment in developing countries (Gunter, 2013[88]). The salient distinction between a guaranteed-minimum-income and the negative income tax is that in the case of the latter, its financing is done 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 building on recent progress

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 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 based on an older instrument called the "socio-economic stratification". This is a classification of residential properties, with the aim to mimic economic vulnerability based on the dwellings' characteristics and their urban/rural settings, but is out to date and more than 90% of dwellings are classified as vulnerable. This is the case of the public services subsidies (energy, housing, telecommunication and water and basic sanitation), for which the targeting is poor. For example, in 2017, 81% of the residential public services subsidies and 93% of the housing subsidies went to two highest income quintiles (Table 2.1).

To improve the targeting of social spending, unifying targeting mechanisms into a single 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 and help those that need it the most. For example, in a welcome move, recently the authorities moved away from socio-economic stratification to *Sisbén* to select beneficiaries of the new programme of free tuition for tertiary education (*Matrículo Cero*), planned for 2023.

Sisbén has recently undergone a deep transformation improving 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[89]). 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, increasing interoperability. *The* social registry is geo-referenced and aims at more frequent updating of information and shorter response times for citizens by moving to a regularly-updated social registry (Conpes, 2016[89]). The fast deployment of *Ingreso Solidario* was made possible thanks to the development of this social registry, which allowed, for the first time, to identify low-income and vulnerable households not receiving benefits from any social programme and their contact details and bank accounts. Individuals did not need to apply for the benefits and the government contacted them individually, mainly through SMS messages. This new social registry is expected to deliver significant benefits in terms of the impact of social spending, including better targeting on the poorest and faster response times particularly in the event of shocks.

Sustained progress on this social registry, by merging additional administrative databases and increasing further interoperability among them 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 28 million individuals in 2021, covering almost 90% of all poor (Table 2.5). Efforts to expand coverage further aim at achieving a 98% coverage of all poor at the end of 2022. 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[90]).

Table 2.5. *Sisbén* coverage has improved

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

Note: Povery for 2021 is estimated by DNP.
Source: OECD Tax Expenditures Report of Colombia (2021) and DNP.

The targeting method has also been updated and takes now into account the income generating capacity of households based on their socio-economic conditions 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 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[90]). For example, Brazil uses self-declared per capita household income to deliver *Bolsa Familia* benefits, the main cash transfer programme, and this has shown to be a good targeting instrument (WWP, 2017[91]). Another example is Chile which developed a targeting instrument for the delivery of the 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 cross-checks of income data with other data sources and high interoperability between registries to reflect immediately changes in labour market status or household income. But 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 more active participation of social workers and satellite images to increase take-up of social assistance programmes.

Implementing a universal income tax declaration and merging it with the social registry would make more reliable information on income available and allow better cross-checking 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, which coordinates tax, social, wealth and consumption data contributing to an efficient targeting for implementation and monitoring of social benefits (OECD, 2019[92]). 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 define the amount needed to supplement each household's income up to the guaranteed-minimum-income, the new single cash benefit programme proposed in the previous subsection. 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

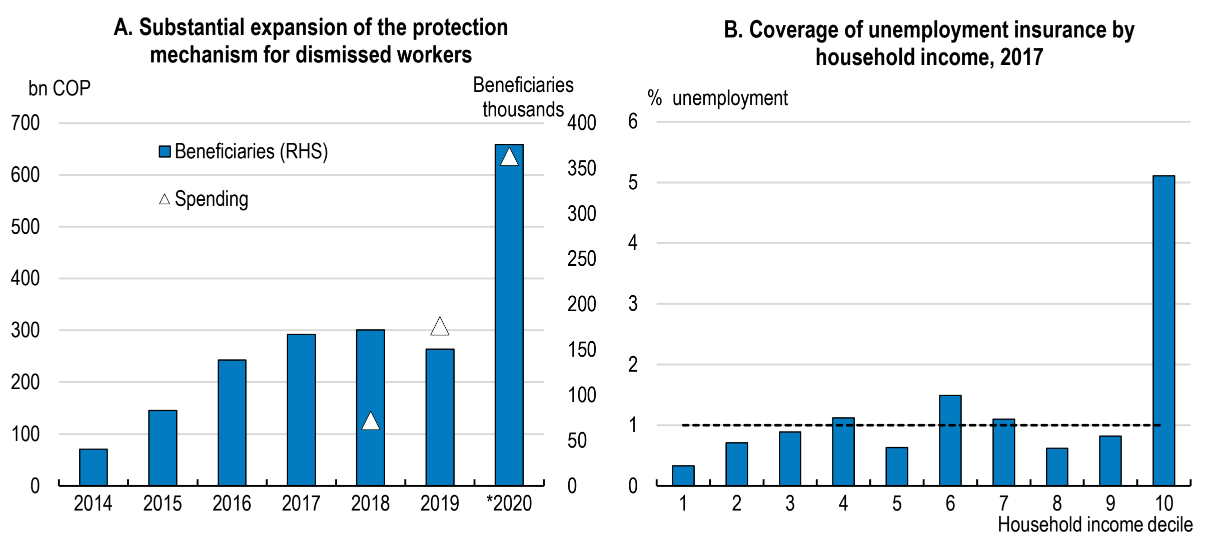
Risks arising from the loss of employment are covered through different instruments for formal workers in Colombia. The first is severance pay, consisting of a fixed one-off payment paid by the employer to the worker at dismissal. The amount depends on the worker' salary, ranging between a month and a year. The second instrument is an unemployment protection scheme based on individual accounts, financed from individual savings accumulated by formal workers. Third, 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. 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 contribute to this system. 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[93]). 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[36]).

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 2.24, Panel A), most unemployed people do not qualify, as they have been informal workers or their employer did not contribute long enough. It only covers formal workers whose employer has contributed 4% of their 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 2.24, Panel B): 82% of resources go to non-poor households and 53% to the two highest income quintiles of households (Fedesarollo, 2021[25]).

Figure 2.24. 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: (Fedesarollo, 2021[25])

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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 authorised in early June some of these individuals to be included in a new cash transfer programme designed for vulnerable workers, *Ingreso Solidario* (Blofield, Lustig and Trasberg, 2021[80]).

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 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 support 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[33]), 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[94]). 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 and relevance 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[6]).

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 leave. It would also allow job seekers to look for jobs without the immediate concern for minimum survival. Doing so, the programme would increase the bargaining power of workers to obtain 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 the existing individual unemployment accounts, financed from individual savings accumulated by workers, 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[95]). By allowing workers to run down their personal savings during periods of unemployment, workers internalise the cost of unemployment benefits, thus strengthening the incentives of the employed to prevent job loss and of the unemployed to return to work quickly. Individual unemployment savings accounts can also strengthen incentives for working formally since social security contributions are less perceived as a tax on labour and more as a delayed payment (OECD, 2018[96]). The disadvantage of individual unemployment savings account system is that generally individuals with lower contributory capacity, who also tend to have a higher risk of unemployment, 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 work properly and 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[97]). The contributions to the severance accounts can be limited to a certain maximum of years that would 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 act providing top-ups to the guaranteed-minimum-income programme, contributions to the individual accounts can be substantially reduced. Employers are currently mandated to contribute around 8.5% of wages and 12% of interest on the annual amount of the severance pay into the employee's severance account. These contribution rates are high even compared to advanced countries (ILO, 2019[95]). 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 a Colombian household survey (GEIH) for 2020, allow comparing costs and benefits of reforming social protection in Colombia, by estimating the likely fiscal cost of different reforms and gauging the impact on poverty and inequality. The cost estimates can only provide an upper bound for 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 2.6). The 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 and fall to about 1.8% of GDP in 2060 and 0.7% of GDP by the end of the century (Fedesarollo, 2021[25]).

A guaranteed-minimum-income programme as described above, topping up all incomes of those below 65, net of current government transfers, to the poverty line would cost 4% of GDP in 2020. This number is clearly higher than the expected costs in the future, given the extraordinary increase in poverty rates during 2020. When poverty rates return to pre-pandemic levels of 2019, estimated the 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 2.6). An alternative option with similar fiscal cost but lower impact on social outcomes would be a basic income programme, similar to the current social programmes, delivering a fix benefit to all households in poverty regardless of their income or wealth (Box 2.7).

Box 2.7. 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 old 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 is simpler to implement needing less information and less prone to errors in the amount to be delivered. However, given that *Sisbén* is undergoing great improvements and could easily be transformed in a real-time information database, the guaranteed-minimum-income should not be ruled out and be preferred as the impact on poverty and inequality are larger (Figure 2.25***).***

The impact of the universal basic pension and the guaranteed-minimum-income on poverty and inequality are large (Figure 2.25, Panels A and B). By construction, these two programmes together are lifting everyone out of poverty in the case of full benefit take-up. Benefits are clearly concentrated at the bottom of the income distribution (Figure 2.25, Panel C). This does not take into account possible inclusion errors, which in 2017 where 38% (Table 2.1). 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 for employee contributions to 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. Workers with higher incomes, i.e. above 1.5 minimum wages, accounted for 1.4% of GDP, and for these workers, the current social contributions 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 be lower at 3.7% of GDP (Table 2.6). 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 2.6. Illustrative fiscal costs of achieving universal social protection

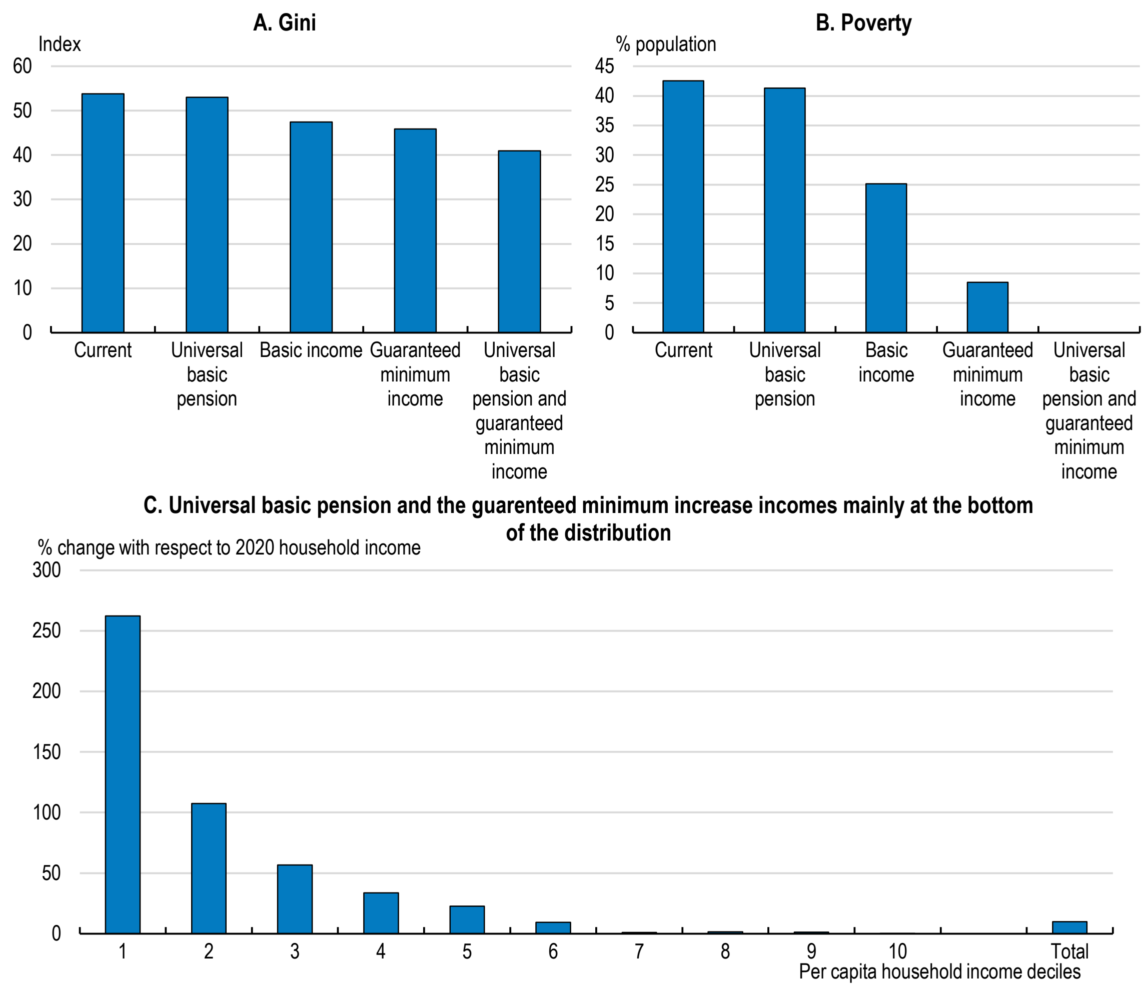
New programme	Cost (% GDP)	Current cost of programmes to be phased out (% GDP)	Assumptions
A universal basic pension	1.6		Cash transfer equivalent to 1.3 poverty lines, covering 75% of those aged more than 65 in 2020 (the remaining 25% are the current beneficiaries of the contributory pension system)
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
Short-term net cost	**3.6**	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 implement only gradually without affecting acquired pension rights.

Long-term net cost	**1.0**	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 household income the existing programmes, such as Colombia Mayor, Familias en Acción and Ingreso Solidario, and replacing them by 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). This would require a combination of reducing the many existing exemptions that dampen collection of revenues 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). The higher employment formalisation and growth driven by these reforms would also increase tax collection. Boosting the recovery with structural reforms, discussed in Chapter 1, would result in higher employment and higher incomes for individuals and, in that way, increase tax collection.

Figure 2.25. Estimated impact on poverty and inequality of proposed social protection programmes



Note: The current situation includes the existing programmes, such as Colombia Mayor, Familias en Acción and Ingreso Solidario. Calculations then assume that when a new programme is introduced replaces the old existing programme. *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.

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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 those with low earnings, 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 for about 13 percentage points for workers with wages up to 10 minimum wages. The reform increased by 3.5 percentage points the probability of informal or unemployed workers below 10 minimum wages moving into formality (Kugler, Kugler and Prada, 2017[51]). 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 would be an increase of 303,000 low-income formal workers, that is 5.5% increase of all those earning less than 1.5 minimum wages.

However, these simple calculations are a lower bound, as the expected impact on formalisation is 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 distangle. 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) inducing to formality, but the impact is difficult to measure. Finally, the high labour costs are one important factor inducing informality, but there are other determinants such as the low access to quality education and training and the low productivity of firms and quality of management. Reforms on 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 growth. First, the real disposable wage of formal employees would increase; as workers would receive part of the reduction in social contributions, at least those payed by the workers to pensions and health. Second, all elderly, except those in the transition regime, would receive the universal basic income, increasing disposable income. It is reasonable to assume that it would be entirely consumed, increasing aggregate demand. Finally, disposable income for poor households would increase as the guaranteed-minimum income implies an increase in coverage and benefits with respect to current cash transfers.

Ensuring effective enforcement of labour and tax laws

Tackling informality also requires better enforcing 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 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 that workers, including the self-employed, and firms pay their taxes. Although Colombia has made significant efforts to reduce tax evasion, including continued improvements to the tax authority' 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[36]). The number of labour inspectors more than doubled between 2011 and 2019, the budget significantly increased and the fines 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 data, crossing different sources, such as social security, tax, healthcare, and its analysis is essential for the effective work of inspectors helping 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 and the 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 and 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[98]). However, recent information suggests that the collection of fines was already weakening before the pandemic and plummeted during 2020 (Ministerio del Trabajo, 2021[98]). There is also a need to enhance data collection for the inspectorate while assuring the skills to evaluate it in a timely manner (Levy and Maldonado, 2021[13]). 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, which purpose is to take the labour inspection system to all regions of the country. It has an emphasis on the rural areas and the 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 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, and 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 there are political reasons why structural reforms, including those related to social protection, may be more often undertaken in times of economic difficulties (Sturzenegger and Tommasi, 1998[99]; Drazen and Grilli, 1993[100]).

To boost feasibility of the proposed reforms, a policy debate is essential. This policy debate should be evidence-based with clear identification of the winners and losers of the reforms, quantification of 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[101]).

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 lead to 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[102]).

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[103]). This is especially the case for the pension reform. Changing dramatically the pension system requires a prolonged period of transition, in which those close to retirement and those already retired are not 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[104]). Reducing corruption and increasing transparency and government accountability, as chapter 1 in this survey highlights, would increase trust in goverment (Scartascini and Valle Luna, 2020[105]).

To optimise the implementation and ensure the fulfilment of the reform's objectives, regular monitoring and periodic evaluation of its impact and its evolution should be implemented. A robust monitoring and evaluation framework would increase trust in the reform 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 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, 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.

Table 2.7. Main findings and recommendations of this chapter

MAIN FINDINGS	RECOMMENDATIONS (Key recommendations are bolded)
Expanding social protection coverage	
The pandemic has highlighted major gaps in social protection, particularly for informal workers and income-support programmes are highly fragmented.	**Merge existing cash transfer schemes into a single cash benefit for poor households while maintaining conditionalities for households.**
Some social public spending is poorly targeted and the evaluation of public policies is sporadic and hindered by data gaps.	Enhance regular monitoring and evaluation of social programmes and phase out poorly targeted support, including subsidies for public utility services.
Lack of timely statistics on ethnical monitories labour market integration and access to social protection.	Collect systematically data on ethnical minorities, including on household and labour surveys.
The targeting system, Sisbén, has been improved, but should be updated more frequently to reflect changes in real time.	Continue improving *Sisbén* by merging in administrative databases and converting it in a real-time social registry and allocate all benefits on it.
Half the population above 65 is not covered by pension benefits of any kind. Contributory pension benefits are regressive, with competing schemes providing different benefits for the same career history and particularly low coverage among women.	**Create a basic non-contributory universal pension benefit and merge existing contributory pension schemes into a single mandatory contributory scheme complementing the basic universal pension.**
The contributory pension system is complex and unfair, with two competing schemes providing different benefits for workers with the same career history.	Eliminate pension subsidies.
Labour market reforms to boost formality	
Informal employment affects 60% of workers. This precludes them from access to social security, while reducing productivity and tax revenues.	**Establish a comprehensive strategy to foster formalisation, including lower non-wage costs and stronger enforcement and improvements in tax administration.**
High social contributions on labour hold back formal job creation and sustain high labour informality.	**Reduce the tax burden on labour income by shifting the financing burden of social protection towards general taxation.**
Formal workers pay contributions for public healthcare, while informal workers get almost the same benefit package for free.	**Merge the two public healthcare systems into a single system, financed through general taxation revenues.**
A mandatory employer contribution for family compensation funds raises labour costs and induces labour informality, especially for low-income workers.	Systematically evaluate costs and benefits of services provided by family compensation funds. Finance family compensation funds through general taxation revenues rather than charges on labour income.
A relatively high minimum wage reduces the prospects for low-income workers to obtain formal employment, particularly for women, young and rural workers.	Adjust the minimum wage level in line with price increases over the next years. Establish a permanent commission to evaluate the changes to the minimum wage regularly, in line with changing labour market conditions and productivity.
Ensuring adequate support for workers during unemployment	
Only few workers have unemployment insurance coverage.	Complement the new cash benefit programme for the poor with contributory unemployment individual accounts providing top-up benefits.
The individual unemployment savings system for formal workers does not provide proper income protection to unemployed workers.	Restrict withdrawals from individual severance accounts to the case of dismissal.

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COLOMBIA

Colombia's economy has recovered remarkably well from the COVID-19 crisis, and strong fiscal and monetary policy support have averted a stronger contraction of incomes. Solid macroeconomic policy frameworks are laying the grounds for a continuous recovery of domestic demand, although the sustainability of fiscal accounts will require further action. In a longer view, however, both growth and social inclusion are trapped by weak structural policy settings that preclude more than half of income earners from formal jobs and social protection, while preventing firms from growing and becoming more productive. Solving this vicious circle through ambitious reforms would allow a significant leap forward for material well-being in Colombia. Stronger productivity growth will also hinge on making regulations more transparent and more conducive to competition, while embracing internationalisation more thoroughly, including through significant reductions in trade barriers. Institutions could be strengthened further through more effective protection for whistle-blowers and better rules for financing political campaigns. Achieving ambitious climate-related objectives will require stepping up efforts to rein in deforestation.

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