Available online at www.sciencedirect.com

ScienceDirect

Journal of Policy Modeling 36 (2014) 1118–1134

Journal of Policy Modeling

www.elsevier.com/locate/jpm

The impact of social security reform on the labor market: The case of Colombia

Jose Cuesta[a,b,*], Mauricio Olivera[a,b]

[a] *World Bank, Georgetown University, United States*
[b] *Fedesarrollo, Colombia*

Received 3 April 2014; received in revised form 4 June 2014; accepted 1 October 2014
Available online 22 October 2014

Abstract

This paper simulates the effects of three increasingly bolder reforms in the Colombian social protection system: the equalization of salaried and self-employed labor contributions; the removal of payroll taxes, *parafiscales*; and the complete delinking of social protection benefits from labor status. We collect nationally representative information concerning individual willingness to pay for several packages of social security benefits; identify and quantify – for the first time – three specific distortions caused by existing social security and social assistance systems; and simulate the gains that social protection reforms would bring about in terms of reduced labor distortions. We find that workers in Colombia, regardless of occupation, have a very similar willingness to pay for the full insurance package – below 20% of their labor earnings – and very similar valuation of social protection services – about 50% below par. Labor distortions are large, as expected from very high labor costs, but we quantify an implicit formality tax and informality subsidy ranging between 2 and 27 percent of different representative workers' earnings. Critically, the long-discussed reforms in Colombia – including the elimination of *parafiscales* – will not reduce substantially the multiple distortions in its labor market.

JEL classification: J32; J26; I38

Keywords: Distortions; Informality; Social protection; Willingness to pay; Colombia

* Corresponding author at: The World Bank, 1818 H Street NW, Washington, DC, 20477, United States. Tel.: +1 202 4737781.
E-mail address: jcuesta@worldbank.org (J. Cuesta).

http://dx.doi.org/10.1016/j.jpolmod.2014.10.002
0161-8938/

1. Introduction

Social protection systems in Latin America are typically truncated: a formal component of contributive or capitalized insurance covering multiple risks exists alongside a combination of assistance-based social programs that are frequently disarticulated or redundant (World Bank, 2007). In the last two decades, efforts to improve and rationalize social protection in the region have included revising the generosity of the benefits bestowed and evaluating the individual (or mixed) capitalization systems in the case of social security (see Cerda, 2008 for an analysis of the introduction of individual accounts in the Chilean pension system). Efforts also have focused on improving the targeting of social programs aimed at the poor, while also expanding them to cover the greatest possible number of poor people. More recently, there have been calls for a more integral vision for public policy on social protection. Levy (2008), the World Bank (2007), Cunningham (2007) and Bernal et al. (2009) argue that there are important interactions between social protection design and the structure of the labor market and, therefore, between social security and employment, productivity, and growth. Agénor, Nabli, Yousef, & Jensen (2007) find in a different region, the Middle East and North Africa, that "piecemeal" labor market interventions alone – such as reducing labor costs—are unlikely to bring substantial benefits in terms of growth and employment. With increasing informality, formal workers and public finances have mounting pressures to support the social assistance scheme at a time of declining formal contributions. In those contexts, the co-existence of contributive insurance programs and subsidized or assistance insurance programs creates a perverse subsidy to informality and a tax for formality. Although those perverse interactions have not yet been quantified in any country, some approximations in Mexico suggest that they could be considerable (Levy, 2008).

This paper adds to the understanding of the distortionary relationships of social security and social assistance in Colombia by explicitly quantifying a number of distortions and simulating the implications that often discussed reforms would have on such distortions. Colombia is an interesting case study for various reasons. Firstly, Colombia's public spending has increased rapidly—in fact, it is the country in the region that has seen the greatest growth since the 1990s—. Secondly, Colombia has experienced dramatic increases in the coverage of health care insurance while stagnation of pension coverage at low levels. This contrasts with experiences elsewhere in which changes in health benefits have not significantly changed the demand for public insurance (as it is the case in Germany: see Augurzky & Tauchmann, 2011). Thirdly, Colombia has large labor rigidities in the form of very high labor costs as a percentage of the payroll (76 percent of the basic minimum salary according to calculations made by Nuñez (2008)), the highest dismissal costs in Latin America (Cunningham, 2007) and a minimum salary that is also high according to regional standards (Maloney & Nuñez, 2004).

The paper is organized as follows. Section 2 reviews the Colombian system of social protection and its relationship with the labor market. Section 3 presents a methodological framework of labor relations and social protection analysis adapted from Levy (2008) and applied to the Colombian case. Section 4 calculates the distortions, which are separated into three categories: "social," "occupational" and "informal". Section 5 simulates the labor distortion effects that much debated social security reforms would have in Colombia. These reforms refer to the equalization of salaried and self-employed labor contributions; the removal of payroll taxes, *parafiscales*; and the elimination of noncontributory and noncontributory social protection benefits associated with labor status and occupation. Finally Section 6 presents the conclusions.