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## **THE POLITICAL ECONOMY OF LABOR REFORM IN COLOMBIA**

**JUAN CARLOS ECHEVERRY\***  
**MAURICIO SANTAMARÍA\*\***

### **Abstract**

This paper analyzes the entire reformist effort that spans from 1990 until 2002, emphasizing the second wave that ended with the issuing of a new labor code in 2002. A successful reform has to surpass a set of “deals” along the streamline of design, consensus building within civil society, submission to Congress and parliamentary debate, before it gets approved. The paper presents the story of two failed attempts for producing these “deals” within the government, along with labor unions and private sector firm confederations, before the 2002 labor reform was finally enacted. It shows what economic and social considerations created the need for reform, describes the actual policy changes implemented and evaluates their impact. The paper delves deep into the political aspects of the reform effort. Public officials of two governments pursued different lines of reform, discussion strategies and mechanisms for creating consensus, before the initiative gained momentum and circumvented key obstacles. The text of the 2002 reform proposal changed little during five years, but received important additions in the floor of Congress, with little technical support. Finally, an interesting dispute between lawyers and economists is presented regarding the role of the labor code for job creation and its function in the economic cycle. In the case of this reform, economists believed more on the computed elasticities, while lawyers believed more in the stability of established rules and in the limited role of norms. Economists should pay more attention to the workings of the political economy of reform and to the “life cycle of government”, both of them critical for success.

Key words: labor reform, unions, policy agenda, political economy, employment, informality.

JEL classification: J23, J32, J51, D72

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\* Universidad de Los Andes, Bogotá, [jechever@uniandes.edu.co](mailto:jechever@uniandes.edu.co).

\*\* World Bank, Washington, D.C. [msantamaria@worldbank.org](mailto:msantamaria@worldbank.org)

# LA ECONOMIA POLITICA DE LA REFORMA LABORAL EN COLOMBIA

## Resumen

Este trabajo analiza el esfuerzo reformista en el campo de la regulación laboral llevado a cabo desde 1990 hasta 2002, enfatizando la “segunda ola” que termina con la expedición de una nueva reglamentación laboral en 2002. Para que una iniciativa reformista sea exitosa debe sobrepasar un conjunto de negociaciones a lo largo de su período de diseño y aprobación, que pueden contemplar acuerdos con actores representativos de la sociedad civil y del parlamento. El documento presenta la historia de dos intentos de producir estas negociaciones al interior del ejecutivo, con los sindicatos y los gremios del sector privado, antes de que la reforma laboral fuera finalmente sancionada. Se muestra cuales consideraciones llevaron a pensar en la necesidad de una reforma, se describen los cambios de política implementados y se evalúa el impacto de los mismos. El documento analiza los aspectos políticos del esfuerzo reformista. El mismo fue adelantado por representantes de dos gobiernos, con diferentes estrategias de reforma y distintos mecanismos para crear consensos, hasta que la iniciativa ganó el ímpetu necesario para sobrepasar los obstáculos. El texto final de la reforma de 2002 cambió poco durante cinco años, pero recibió modificaciones considerables en pocas semanas por parte del Congreso, con poco de soporte técnico. Finalmente, se presenta una disputa interesante entre abogados y economistas respecto al papel del código de trabajo para la creación de empleos y en el ciclo económico. En el caso de esta reforma los economistas creyeron más en las elasticidades calculadas, mientras que los abogados dieron más crédito a la estabilidad de las reglas instauradas y al alcance limitado de reformar de las normas. Una lección es que los economistas deben prestar más atención a la economía política de las reformas y al “ciclo de vida del gobierno”, ya que estos dos elementos son claves para el éxito.

Palabras clave: reforma laboral, sindicatos, agenda de política económica, economía política, empleo, informalidad.

Clasificación JEL: J23, J32, J51, D72

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### **1. Motivation and Methodological Approach**

This paper focuses on a particular episode of policymaking, asks how such policy initiative came to live, what were its motivations, the policy changes introduced, and their impact. In the political economy realm, it inquires how the normal interplay of interests and incentives worked together to achieve intermediate agreements, “deals”, crucial for its approval. In every situation of “policy production” there are winners and losers, however slack their definition or identification might be. This implies, at least, two types of considerations: on the one hand, how to evaluate whether the end result is Pareto superior to the ex-ante one. And if it is not, as it is often the case, how to assess whether the gain from the winners is superior to the loss of the losers, an analysis that might involve value judgments or the possibility of computing gains and losses in comparable terms. Finally, the effects of a policy can be justified via social distributive considerations, which would imply a particular set of priorities and the allocation of costs and benefits.

The second set of considerations refers to the political economy involved in the policy production process. In this approach, it is recognized that different actors with distinct sets of objectives interact pursuing their own rationale and, as a result, either they promote or oppose the production process. These interactions can be understood as a group of “deals”, indispensable for the enactment of the policy initiative. The deals might be between two actors that may potentially profit from the policy outcome, but that need to distribute its products. Or between actors that might win or lose, and their interaction is about compensating measures.

The policy production process follows a clear chain of events, contingent on every country’s institutional arrangements. This paper will be dealing with a modification of the labor code in Colombia, change that needs legislation. Hence, it is forced to pass through Congress. Since only government or Congress can propose this type of initiative, the first step is to identify the objective origins of the policy proposal from a socio economic point of view. Then, it is required to analyze its formation and passage through Congress. From a political economy perspective it will come out, though, that the richest part of the interaction and negotiation takes place before the project is actually presented to Congress (the “formation” process just referenced), since once it reaches the floor of Congress, success (e.g. approval) can only be achieved if the crucial agreements already took place. This is not

always the case, but it is a characteristic of successful projects, as this paper will illustrate.

The method then requires the identification of the relevant actors, their modes of interplay, the strategies they adopt, the way deals are reached or destroyed, and the institutional procedures throughout which those deals materialize in a new policy or regulation. In our case the actors are: (i) the different ministries involved in the reform of the labor code, basically, a) the Ministry of Labor and Social Security (ML- later the Ministry of Social Protection, MPS), b) the Ministry of Finance (MF), and c) the National Department of Planning (DNP); (ii) labor unions; (iii) private sector representatives, normally confederations of firms of different productive sectors (so called "gremios"); (iv) Congress; (v) the international financial community (either the capital markets that focus on Colombia or the multilaterals); and (vi) the press, including all other actors that make themselves heard via the media.

The data used throughout the paper are: (i) official presentations of the policy initiatives and drafts of reform bills; (ii) versions of those bills in their passage through Congress, product of parliamentary deliberation and voting; (iii) statements of purpose written by or for congressmen, where the initiative at hand is substantiated; (iv) interviews with the actors involved; (v) minutes of the meetings between the Colombian government and the representatives of the unions and the private sector; (vi) letters of intent with the IMF and matrices of conditionality for adjustment loans with the IADB and the World Bank; and (vii) technical literature and reports produced by the actors mentioned above, related to the situation of the labor market and the reform process.

The exposition will go through the analysis of the pre-reform situation that motivated the modifications, the actual policy changes proposed, their implementation and, finally, their impact. This analysis will cover two reform waves, the first one comprising the end of 1980s-1991 and the second one between 1998-2002. An important part of this succession is the political economy involved. To analyze this issue, the discussion will focus on the second wave and go, in a very detailed fashion, into three "deals" that took place before the final project got actually approved in 2002. The period in which these deals took place covers 5 years, 1998-2002, in which there were two governments in Colombia (1998-2002 and 2002- date).

The streamline followed in these deals is similar since it is set by the institutional procedure for a law approval. Of course, the first two deals discussed were unsuccessful for reasons interesting to understand. Indeed, along this chronological exposition of the consecutive "deals" the whole set of interests and the relative strength of the actors involved will become apparent, enriching our picture of what makes a policy initiative feasible or not. These three big "deals" mentioned are themselves composed of many small deals involving the different actors mentioned above. For a reform project to succeed, it is necessary to close all deals along the streamline of institutional decision-making. The failure of just

one of them can destroy the whole approval process. The goal then is to present the first two unsuccessful deals, trying to identify where exactly they broke the chain of decision making, and which interests and interactions were involved. This is our methodological approach to the political economy of labor reform in Colombia.

The paper is divided into four sections, after this introduction. The second one analyzes the initial reform period (1989-1991), trying to identify the socioeconomic factors that brought to the forefront of the policy agenda the need for a labor reform. Also, the impact of the reform is presented. The third section delves deep into the political economy of the second wave of the reform (1998-2002), with the objective of understanding the main causes of failure of the intermediate “deals”. The fourth section analyzes the reform implementation and the existing evidence on its impact. The last section concludes.

## **2. The 1990 Labor Reform and its Impact**

Labor reforms in Colombia began to be undertaken seriously in 1990. Until then, policies related to the labor market (pre-reform policies) were, as it was the case in much of Latin American, based on the protection and stability of employment. That is, labor regulations sought to (i) make it very hard for employers to fire workers; (ii) protect and increase workers’ labor income (especially for those perceived as being poor or more vulnerable to economic shocks); (iii) improve working conditions; and (iv) discourage “excessive” job turnover. These objectives tried to be accomplished by putting in place a set of “traditional” instruments, namely: strong hiring and firing regulations, provisions that obliged to pay extra charges to all workers for a variety of reasons (overtime and work on holidays, for example) and some regulations aimed directly at improving the quality of working conditions (vacations and codes of conduct, for example).

Among these instruments, the first type (hiring/firing regulations) was perceived as critical in determining labor market outcomes at the end of the 1980s. Indeed, firing related provisions made it very difficult to fire any worker. First, as it was common in Latin America, for a worker to be fired there had to be a “just cause” on which to base such decision. Second, the worker had to be notified in written form of the decision at least one month before the actual dismissal occurred. Third and most importantly, the severance payments included in the Law were the highest non-wage labor cost under the pre-1990 regime. Employees were entitled to one month worth of salary per year of work (based on the last salary). Partial withdrawals of such funds were allowed and deducted in nominal terms from the final payment, implying a form of “double retroactivity” (with an estimated cost of 4.2% of the total wage bill). Additionally, workers with more than ten years of tenure were able to contest the decision in courts if they deemed the firing as being “unjust”. Under this scenario, successful plaintiffs could oblige firms to rehire workers with back pay (foregone wages).

As mentioned, these restrictions were believed to negatively influence a number of key labor market outcomes such as employment creation (i.e. to create unemployment), formality and labor productivity. Regarding these, the most noticeable effects of hard firing regulations are relatively well documented in the literature and are closely linked to the business cycle. Costs of dismissals cause firms to not shed labor during the lower part of the cycle because it is costly, even if necessary due to a lower marginal value of labor. On the other hand, in the upper part of the cycle, firms may want to hire more workers, but if they take into account the expected cost of each new worker, they will not necessarily hire all the required labor. This is reinforced by the fact that workers with ten or more years of tenure had a strong incentive to sue even if their firing was “fair”, because the expected payoff from this action was always positive. Workers might also avoid looking for (or accepting) more productive jobs due to the loss of accumulated severance payments. The identified results are an inefficient allocation of labor that negatively affects productivity growth and a lower level of “equilibrium” employment, which may be translated into unemployment or a higher informality rate. In addition, they imply lower turnover rates, which discourage training and hinder productivity growth. Thus, it seemed to be a fact that the labor system in place was not compatible with the simultaneous processes of internationalization and technological progress, which constituted the main goals that the new government (headed by President Gaviria) had in mind when entering office in 1990.

Additionally, under the existing Law it was quite difficult to hire for a temporary job, even if the task to be performed was indeed temporary. That is, under the Law, all labor contracts were to be considered as open-ended positions. In any case, the minimum allowable duration of a “justified” temporary contract was one year. Additionally, only in very specific situations could the labor relationship be considered fixed term or for a specific assignment. This hiring inflexibility was believed to impair an efficient allocation of labor and hinder formal employment creation along the business cycle. This perceived difficulty arises because, among other reasons, the employer will have to prove that the work was indeed over when the contract was over.

If working relationships are always considered permanent, there is no incentive for the employee to demonstrate his or her skills, even at the beginning of the working relationship. This ends up being reflected in either increased transaction costs in the hiring process (more thorough screening), or in hiring within a closed circle of individuals whose demonstrated skills are known to the employer or to his or her advisors. For these reasons, in practice, the only noticeable effect of these restrictions was employers trying to circumvent them. Employers always found ways, many times illegally, of hiring workers through informal contracts. So, in the end, a well-intended regulation ended up generating higher informality levels. In this sense, this specific set of regulations was believed to provide a poor service to both workers (by encouraging more informality and unemployment), and employers (by impairing their ability to adjust and use inputs efficiently).

Finally, it seemed to be an accepted fact (both in theory and empirically) that strict firing and hiring regulations were very effective in protecting the employment level and stability for certain groups of workers (formal workers, and even more for those unionized), while negatively affecting other labor market groups (mainly informal and some non-unionized salaried workers). These facts reflected what is known in the specialized literature as the “insider-outsider” model.

Casual observation of some labor market outcomes before 1990 provided empirical support to the conjectures mentioned in the previous paragraphs. In particular, urban unemployment (especially its long term component or “natural rate”), increased steadily during the second half of the seventies and eighties, stabilizing at a high level. After reaching a peak in March 1986 (14.6%), associated with a recession, unemployment rates declined somewhat and stabilized until 1989 around 12%. Bernal and Cárdenas (2003) attribute a significant share of this persistent high level of unemployment to significant labor costs, including large dismissal costs, combined with a relatively high own wage elasticity. Informality also grew steadily in the eighties, while overall labor productivity (and Total Factor Productivity-TFP) declined since the end of the 1970s (see for example Loayza, Fajnzylber and Calderón, 2002). For example, while TFP yearly growth was 1.8% in average during the sixties, it fell practically to zero during the eighties.

Of course, it is difficult to directly attribute these outcomes to the existing labor regulations. Some (scarce) evidence, however, leads to fairly robust conclusions. In particular, Kugler and Cárdenas (1999) show that before 1990 the presence of strict hiring and firing regulations reduced formal employment among hard-to-hire groups (mainly the young and individuals with intermediate levels of skill, the so-called “outsiders”) and increased the duration of unemployment for informal workers. They estimated that the hiring and firing regulations in force at that time increased the overall unemployment rate by at least 10%. Additionally, those regulations kept turnover rates artificially low in the formal sector, a fact that lends support to the belief that the negative evolution of productivity in Colombia in the 1980s was partially explained by stringent hiring and firing regulations in the labor market.

Summarizing, the main findings of these and other authors (Tockman and Martínez, 1999, for example) are that the hiring/firing regulations reduced the dynamism of the Colombian labor market during the 1980s, by decreasing the exit rates into and out of unemployment. Moreover, they also contributed to decrease compliance with labor legislation by increasing the costs of formal hiring (i.e. promoted informality). As a result, the equilibrium unemployment rate was higher than it would otherwise be, while productivity growth was negatively affected due to the fact that the ability of firms to use and combine inputs efficiently along the business cycle was seriously impaired.

As a result, and taking into account the internationalization of the economy that occurred in 1990-91 and the overarching goal of increasing economic growth through higher productivity, in 1990 the government introduced a labor market

reform that substantially reduced the costs of dismissing workers and widened the hiring modalities available for employers. That is, the main thrust of that reform was to substantially change hiring and firing regulations (i.e. affect the contracting stage), rather than modify other provisions, such as non-wage costs. Indeed, the reform reduced severance payments, broadened the definition of 'just' dismissals, extended the use of temporary contracts, and speeded up the process of mass dismissals. These changes reduced the costs of firing workers covered by the legislation (reduced firing costs for formal firms but not for informal firms).

Although the reform simultaneously introduced various legislative changes, the one major policy change that decreased dismissal's costs was the reduction of severance payments. This was achieved in two ways: first, prior to the reform, employers were mandated to pay severance of one month per year worked based on the salary at the time of separation. After the reform, employers were required to deposit a monthly contribution equivalent to one month of the yearly salary to an individual severance payments savings account ("Fondo de Cesantías"), which would be accessible to workers in the event of separation. Total severance payments were reduced because the payment per year worked was no longer based on the higher salary at the time of separation, and yearly nominal increases were not multiplied by the whole employee's tenure.

Also, prior to the reform, workers could obtain advance payments from their severance to use for investments in education and housing, which would only be credited to the employer in nominal terms in the event of separation. After the reform, although the withdrawal of funds was still permitted, these 'loans' were now credited to the employer in real terms. According to Ocampo (1987), the fact that withdrawals were credited to the employer in nominal terms before the reform implied, on average, a cost of 35% of the total severance payments in the manufacturing sector prior to 1990 (this is what became known as "retroactividad de las cesantías").

A second important modification introduced was related to indemnities for "unjust" dismissals. First, the definition of 'unjust' changed. Prior to the reform, "just" causes included fraud, violence, undue care, sabotage, discipline problems, deficient performance, and release of proprietary information. After the reform, the definition of "just" cause dismissals was extended to include any dismissal for failure to comply with firm regulations and instructions from supervisors. Second, the reform eliminated the ability of workers with more than ten years of tenure to sue for back pay and reinstatement. At the same time, however, the reform increased the cost of "unjust" dismissals for workers with more than ten years of tenure, which may have increased the incentives for firms to dismiss workers just before reaching 10 years of seniority (see below). Thus, these changes in the "unjust" dismissal legislation can be expected to have the greatest impact on formal workers with intermediate levels of seniority. An additional change introduced by the reform was

a reduction in the advance notice for mass dismissals<sup>1</sup>. While advance notice requirements for mass layoffs existed prior to the reform, the reform introduced penalties to bureaucrats who did not process requests for mass layoffs quickly (the effectiveness of this change depends critically on whether the bureaucrats believed the threats or not).

In terms of hiring regulations, the two most important changes were the extension of fixed-term contracts and the introduction of the so-called “salario integral” (all-including monthly payments, including all non-salary outlays). The reform introduced the possibility of using fixed-term contracts for durations below one year (renewable up to three times). The “salario integral” eliminated severance payments altogether and broadened the alternatives in terms of hiring modalities. This type of contract allowed formal workers who earned more than ten times the minimum wage to opt out of severance payments, indemnities for unjust dismissals, benefits (except paid vacations), social security contributions, and payroll taxes in exchange for a higher salary. The introduction of this type of contract effectively allowed firms to eliminate the cost of dismissing highly paid workers who opted for the “salario integral”.

In sum, these changes were aimed at reducing dismissals costs for formal firms, giving them more alternatives for hiring and allowing higher turnover in the formal sector. The final goals were to remove incentives for informal labor relations, to increase employment and the pace of productivity growth.

In a clear attempt to “compensate” the groups that were perceived as the losers from this reform, government and Congress introduced a special provision regarding severance payments. As it was clear from the discussion above, the main losers from the changes introduced were workers employed in the formal sector, especially those working in large firms complying with labor regulations. Their loss came from both the forgone severance payments and the reduced difficulty to separate workers from the firm. The main “beneficiaries” from the reform were the active individuals (i.e. being part of the labor force) not covered by the regulations. Workers in the informal sector and, most importantly, the unemployed were thought to benefit the most from the reform, due to the new opportunities of formal employment allegedly generated by the reform.

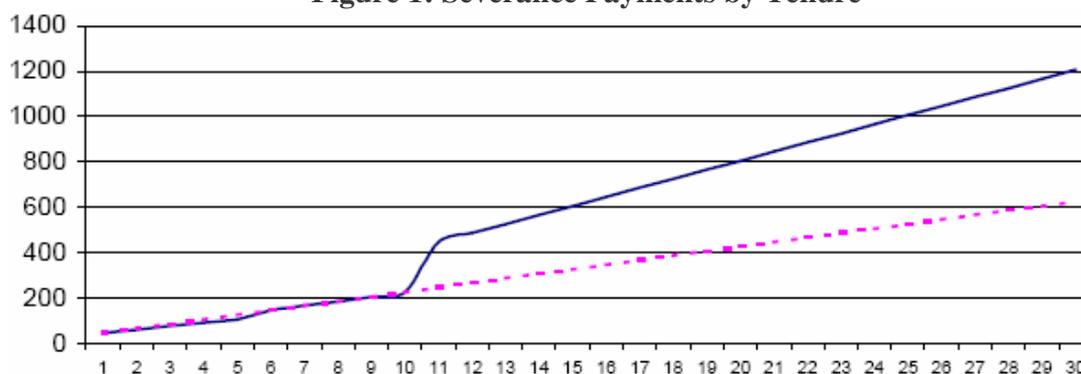
The measure taken to partially compensate the losing group, which, by the way, was instrumental in allowing the bill to be approved in Congress, consisted of increasing the severance payment due to “unjust” separations for workers with more than ten years of tenure. Workers with less than a year of tenure on the job were to receive 45 days worth of wages. In the event of separation, a worker with more than 10 years of tenure on the job used to receive 30 days for each extra year after the first. The new legislation increased the indemnity to the equivalent of 40 days of wages per additional year. Figure 1, below, shows the steep increase of

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<sup>1</sup> Mass dismissals are those that occur due to bankruptcy or technological adoption, among others, which often imply the firing of a sizeable percentage of the staff in the firm (sometimes the entire 100%).

severance payments after the 10<sup>th</sup> year of tenure. The cost of this compensation was to be paid by employers directly, and indirectly by workers with less than 10 years of tenure at the time of the reform, who were confronted to a decreasing likelihood of remaining in their jobs ten or more years (that is, the expected cost of maintaining a worker for more than ten years became too high for employers). In fact, Rojas and Santamaría (2001) showed that, after the reform, the conditional probability of reaching 10 years of tenure (conditional on having reached nine years and on some set of personal attributes) decreased from around 35% to just 5%.

**Figure 1: Severance Payments by Tenure**



The solid line corresponds to the severance payment schedule after the 1990 reform

Source: Rojas and Santamaría (2001)

Within the broader package of reforms introduced in 1990-91, the labor reform appeared to have fulfilled its objectives, namely reduce unemployment and informality and increase the pace of productivity growth. Urban unemployment fell continuously from 12% to less than 8% between 1990 and 1994, informality dropped more than two percentage points in the same period (from around 47.5% to 45%) in the same period, and labor productivity growth picked up somewhat at the beginning of the decade, after the disappointing performance in the 1980s. The question here is how much, if any, of these positive developments can be attributed to the 1990 labor reform, given the fact that practically every major area of economic policy was reformed in those years<sup>2</sup>.

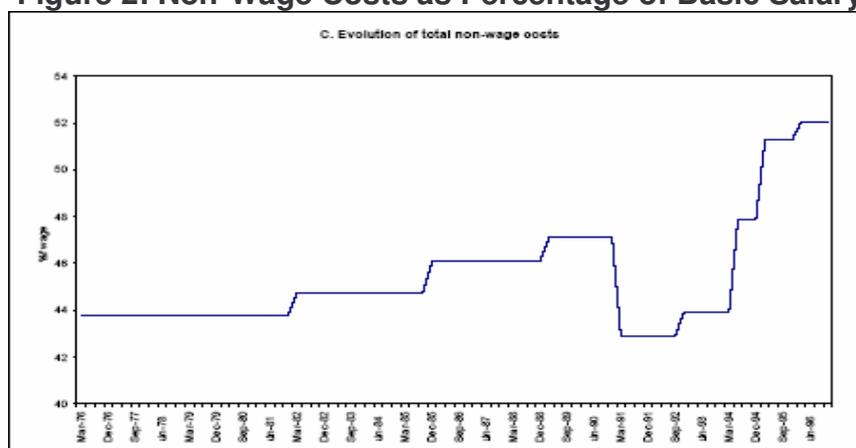
The available evidence on the impact of the labor reform indicates that indeed the changes introduced had a positive, though limited, impact. First, as Figure 2 illustrates, the modifications to the firing regulations produced a fall of about 4.5 percentage points in total non-wage costs, which fell from 47.2% to 42.9% of the basic salary between 1989 and 1992. On hiring regulations, the impact of the “salario integral” was rather low. On a recent survey, medium and large firms

<sup>2</sup> Foreign trade tariffs were reduced, the financial sector liberalized, the capital account opened, private participation in utilities and in infrastructure concessions for the first permitted and the Central Bank was turned independent in charge of controlling inflation and managing the exchange rate policy, to only mention the most important changes.

answered that about 5% of the potential beneficiaries (i.e. those workers earning more than 10 minimum wages) are working under this kind of contract. Kugler (2003) also notes that the reform resulted in increased separations and accessions for formal workers relative to informal workers. Moreover, the increase in worker turnover was greatest among younger, more educated, and larger firm workers, who are most likely to have been affected by the reform. In this sense, the reform is believed to have positively impacted the evolution of labor productivity. Also, her estimates suggest that the reform contributed to one tenth of the reduction in unemployment, which, taking into account that unemployment was reduced by about 4 percentage points (from 12% in 1989 to 7.8% in 1995), would mean that the reform was directly responsible for a reduction of 0.4 percentage points in the unemployment rate.

Also, Bernal and Cárdenas (2003) found that the labor reform did have a positive impact on labor demand, but only through its effect on relative prices. That is, they argue that the reform helped in augmenting labor demand because of the reduction of non-wage costs, but that it did not affect the dynamics of adjustment of employment to the economic cycle. Given their estimates of the elasticity of employment to own costs (wage and non-wage), the reduction of firing costs introduced by the reform would imply a higher effect on employment than the one estimated by Kugler, in the range of 1-1.5 percentage points.

**Figure 2: Non-Wage Costs as Percentage of Basic Salary**



Source: Bernal and Cárdenas, (2003)

Thus, in the first half of the 1990s there seemed to be positive evidence on the reforms' results. Of course, the labor unions did not agree with this line of reasoning. However, after 1995 three major events brought back the subject of labor market regulations to the forefront of the policy-making agenda. First, the social security and health reform of 1993 (Ley 100 de 1993, fully implemented by 1996), significantly increased payroll contributions. Second, an unprecedented recession affected economic activity between 1996 and 1999. This event brought back the debate surrounding labor market policies, regulations and institutions due to the fact that it was apparent that the Colombian labor market did not have

enough flexibility to adjust in a somewhat less painful fashion to economic downturns. And finally, the internationalization of the economy from the beginning of the 1990s made evident that the labor supply found it difficult to adapt to the evolution of labor demand, driven by a process of technical upgrade required for the Colombian economy to be more competitive in the new, more integrated world.

The first two points above had a direct effect on the labor market, while the third made itself evident in a more subtle way. The 1993 social security reform (Ley 100 de 1993) increased total contributions for health from 7% of the basic salary (until 1994) to 8% in 1995 and 12% afterwards. One third of the total contribution (4%) has to be paid by the employer (same proportion as in the old system). Additionally, this reform increased pension contributions to 13.5% in 1996 (14.5% for workers that earned more than four minimum wages), from 8% of the basic salary in 1993. This increase was implemented gradually. Contributions were first raised to 11.5% in April 1994 and then to 12.5% in 1995. Employers currently pay 10.1 percentage points of the total contribution, as opposed to 4.3 before the reform. Figure 2, above, is eloquent regarding the steep rise of non-wage costs that employers faced after 1994. Total non-wage labor cost paid by the firm (as a percentage of the basic salary) rose from 42.9% in 1992-93 to 53% after the 1996.

The slowdown in economic activity, on the other hand, caused a drastic reduction in labor demand since 1996, but especially after 1998. This situation was compounded by a sharp increase in labor participation due to the reduction of households' income, stemming also from the recession. Since 1996 and until 2000, urban labor participation increased by an estimated 4.5%, which translates into about 800.000 new people looking for jobs (that is, some 200.000 entrants per year in average). The combination of these two factors led to an unprecedented increase in the unemployment rate since 1996, which only stopped around 2001 (see Figure 3).

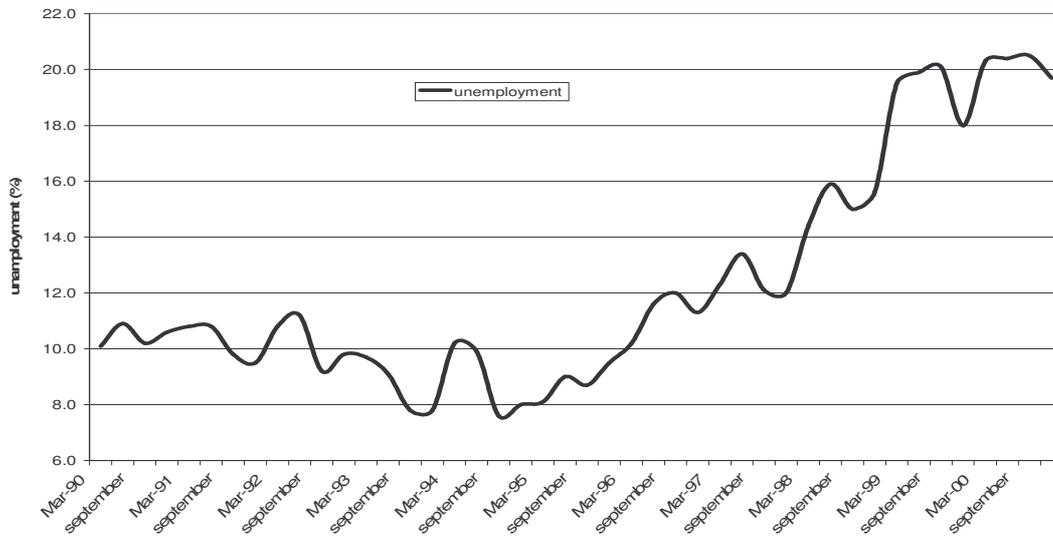
One of the key features of the Colombian labor market during this period was that most of the adjustment to the worsened economic conditions, within the labor market, was borne by the employment level (that is, wages were not able to "help" in the adjustment process). It suffices to note that the level reached by the urban unemployment rate in September 2000 (20.5%) was the highest in the modern Colombian economic history. Informality and under-employment also grew considerably during the period. The other side of the coin was a declining employment rate since 1996. López (2001) reports that this indicator declined from 56% to 53.5% during this period.

Under this scenario, the discussion shifted somewhat from hiring and firing regulations (as it was the case in 1990) to the costs of labor (wage and non-wage) and their negative effects on the adjustment of the labor market to the economic cycle. The costs of labor in Colombia are composed of the wages plus (i) extra charges (overtime, work on holidays, etc.); (ii) earmarked taxes on the payroll to finance welfare programs for the entire population in the areas of training,

childhood development and other subsidies (what is known as “parafiscales”); (iii) health and social security contributions; and (iv) firing and other contractual costs.

Hiring and firing regulations continued to be an important aspect, insofar they affected the adaptability of the labor input with labor demand in a more competitive environment internationally. These two points (the shift in priorities and the “new role” of hiring and firing regulations) will be analyzed in more detail in what follows, seeking to clarify their precise meaning within the broader context of labor reform.

**Figure 3: Unemployment Rate 1990-2000, Urban Colombia**



Source: DANE (Local statistical Agency)

### 3. The 2002 Labor Reform and its impact

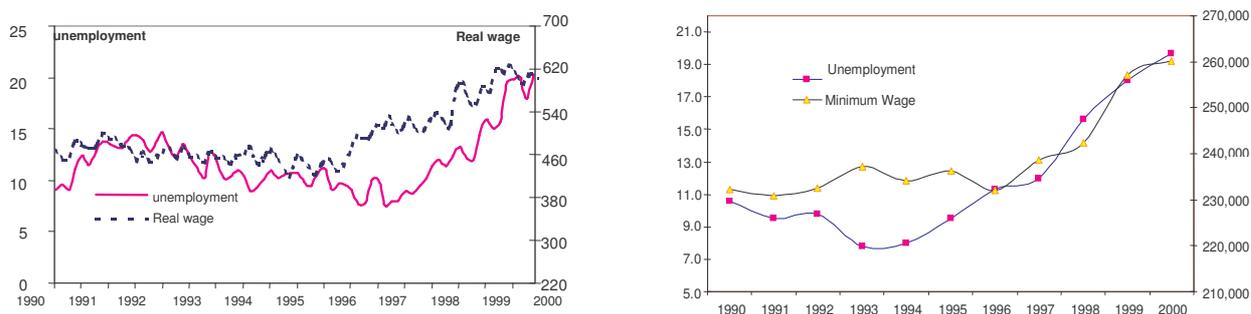
#### A. Background and Content of the Reform

So, by 1998 it was clear that one of the main challenges that the new government would have to confront was unemployment. Thus, an entire team of technocrats began to diagnose the problem recognizing the diversity of its causes (including a team of lawyers at the Ministry of Labor). Some of them were “structural” problems, while others were related to the economic cycle, as explained above. It was apparent that labor regulations were salient between the two groups, to the extent that they made the labor market quite inflexible, complicating its adjustment (economic cycle) and contributing to maintain the long-term unemployment and informality rates high (structural). Additionally, it was recognized that the new, more integrated economic environment required qualified workers with a high ability to adapt to new technologies and to manage information. This was interpreted as implying a profound reform to the overall education system, but especially to the job training system, combined with more flexible hiring modalities, less restrictive

firing regulations and more innovative ways of organizing and managing the time within firms. The final goal would be to avoid a growing mismatch between the supply and the demand for labor due to changing conditions in the labor market.

It was argued that the recession brought to the forefront the structural problems of the labor market. In particular, as mentioned above, high non-wage costs, combined with inflexible wages shifted almost completely the adjustment of the labor market on the only available variable: the quantity of employment. The argument rested, first, in the increase of the social security contributions described above, which counteracted the beneficial effects of the labor reform of 1990, plus other two, more profound observations. First, it was noted that, in sharp contrast to any market, including the informal labor market, the formal labor market did not show any kind of price (wage) adjustment, even during the worst years of the recession (1998 and 99). On the contrary, wages kept growing during that period. Thus, employment fell sharply. Figure 4 illustrates this situation. The left panel contains the evolution of real wages and unemployment, while the right one portrays the evolution of the minimum wage and the unemployment rate.

**Figures 4: Unemployment vs. Real Wages (Left) and Minimum Wages (Right)**



But, the labor market adjusted in its own way, which unfortunately turned out to be the most painful one. Figure 5 illustrates the mechanism. In the first years of the decade, informal employment diminished somewhat (right), while formal employment was growing strongly (left). But when the economic environment turned for the worse, the situation reversed itself: in the informal sector wages were able to adjust downwards and informal employment grew. In the formal sector, on the other hand, wages kept growing and thus the adjustment took place reducing employment. Additionally, it was noted how most of the employment that was being generated was of a temporal nature, while permanent employment declined throughout 1995-2000.

**Figure 5: Different Adjustments, Different Paths: The formal and Informal Sectors**



In this sense, the Colombian labor market adjustment had two phases. In the first one, nominal wages, prices and the exchange rate were fixed. In deed, the exchange rate regime was a band and the nominal rate was pegged at its weak end. Hence, the only way to adjust the shock was via changes in quantities: the unemployment rate increased sharply. This is similar to the Argentinean case during the currency board regime. After the exchange rate was allowed to float, an important part of the labor market, mainly the producers of internationally traded goods and services, could adjust via the change of labor costs and domestic inputs in dollars. In this case, the adjustment of the economy was via income of the working classes and of those producers whose prices were fixed in pesos (non-internationally-traded). Employment probably kept falling for these non-traded sectors, but sales and labor demand recovered in the traded ones. This was the case in Mexico and Argentina under the flexible exchange rates regime.

The second “more profound point” was the increase of labor costs throughout the 1990s and the growing discontent on the part of the employers for being the sole financiers of a host of social policies through the “parafiscal” taxes, which amounted to 8% of the payroll. The ILO estimated that the labor costs in Colombia, measured in dollars, grew by 3.1% per year during the decade. This was the result of a completely inflexible set of costs, as described above, including a variety of outlays that made the situation for employers unsustainable, especially during the recessive period. The employers rightly considered that they had to endure an excessive burden by financing the training, childhood and subsidy programs funded with parafiscal taxes<sup>3</sup>.

Taking these considerations into account, in 2000 after a long debate among various government agencies, the strategy to fight unemployment was based on

<sup>3</sup> In addition, there existed evidence that these programs (excepting the childhood ones) were not providing a good service to their target population (see for example, World Bank, 2003). It was also argued that these taxes should have diminished when the social security and health contributions were raised in 1993. Thus, the parafiscals were understood as a legacy from the past with not much justification at the end of the 1990s.

three main pillars. First, an in depth reform to the education system, including tertiary education financing and job training. Second, the implementation of a social safety net that would help the most vulnerable strata of population to cope with the effects of unemployment. Third, a reform of the labor code that responded to the problems stated in the previous paragraphs. That is, a reform aimed to: (i) reduce and flexibilize non-wage costs; (ii) introduce mechanisms that would help to make wages more flexible, either through the mean wage channel or through the minimum wage one; and (iii) provide a wider variety of hiring modalities and ways to organize the time within the firms.

The first attempt to pass a reform with these characteristics was made in 1999, during the first year of the Pastrana government. This attempt failed and no bill was even sent to Congress due to other more pressing concerns on the part of the government (see next section). The second one, which built on the first trial, was carried out in 2001 and was more successful in the sense that a reform bill was presented to Congress, although it was defeated there. This second attempt, however, was instrumental in two respects for the final success of the new government (headed by President Uribe) to pass a new labor legislation at the end of 2002. First, it contained most of the policy changes deemed as important and most of the topics were adequately covered. Thus, it allowed the new government to act quickly and take advantage of its high popularity and political support to get the reform approved. Second, during the discussions and negotiations surrounding the Pastrana reform proposal, the team in charge had been able to build support for it in some segments of Congress and among the employers and other sectors of civil society. This fact accelerated the discussion of the new bill through Congress, and facilitated the consensus building with other political factions and interest groups.

This second reform bill prepared by the economic team of President Pastrana sought to fulfill precisely the three objectives listed in the paragraph before the last. For this purpose, it included the following provisions related to non-wage costs and time use:

- (i) The reduction of the parafiscal taxes from 8% to 5% of the payroll, which directly reduced non-wage costs.
- (ii) The introduction of the apprenticeship contract, which allowed firms to hire “apprentices” and pay them a wage below the minimum and to avoid the payment of parafiscal taxes for a certain period (the duration of the training provided). This instrument sought to flexibilize the wage structure, to reduce non-wage costs and to offer the employer a wider range of hiring modalities. In addition, it provided an opportunity for hard to employ groups (the young with intermediate education, for example) to acquire expertise, and gave employers the incentives to train individuals for the tasks they really needed.
- (iii) The introduction of the “regular working shift” (RWS) as a way of reducing non-wage costs and make more efficient use of the time. This figure simply established that there would be a regular shift of work,

agreed between the employer and the employee, and that this shift could be at any time or cover any days of the week, as long as it did not surpass 48 hours per week. Hours in excess of this number or outside the RWS were to be paid with a surcharge of 40% over the regular wage or by providing equivalent rest time. This sought to eliminate extra payments for nocturnal work (the Law in force established that any work performed between 6 PM and 6 AM was to be considered nocturnal), or for work in holidays if the RWS included those. The only provision was that if the RWS included Sundays or holidays, the free time should be replaced with another day for rest. This measure was thought to be especially useful for sectors such as retail commerce, hotels, or entertainment services, whose hours of work do not necessarily coincide with the usual definitions of diurnal time or rest days; and

- (iv) As a complement of the introduction of the RWS, the Law established that if, for any reason, work should be needed on a Sunday or a holiday outside the RWS (non-regular), it would be remunerated either by paying double wages or by providing a compensating rest day. This measure effectively reduced non-wage costs because the legislation in force stated that work on those days should remunerated with double wages and a compensating day of rest.

In terms of hiring and firing regulations, the main proposals of this reform bill were the following:

- (i) To reduce the floor at which it was possible to use the “salario integral” figure to something between three to five minimum wages;
- (ii) To allow employers to hire workers by the hour, as long as wages, contributions and other non-wage costs were paid proportional to the time worked; and
- (iii) To eliminate the steep increase of the severance payments in the tenth year of tenure. For this purpose, the proposal established that severance payments would be of 45 days of wages for the first year of tenure, and 20 days for every year after the first. In this way, the severance payment schedule looked like the dashed line of Figure 1.

Thus, this reform proposal was seeking to complement and go beyond the policy changes introduced in 1990, basically by deepening the reforms related to hiring and firing regulations and by attacking the problems of lack of wage flexibility and an excessive level of non wage costs<sup>4</sup>. As mentioned before, this reform proposal was defeated in Congress, but the new Uribe administration embraced it and made it one of its priorities. Indeed, they presented to Congress a “social protection reform” package, which included labor and pension reform proposals. The labor reform was similar to the one just described, including some important changes.

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<sup>4</sup> Other policy changes were included in the proposal, basically covering the possibility of training employees during the regular work shift and also covering some aspects related to collective bargaining; we do not highlight them here since they were not very profound and lied outside the main overall objectives of the bill.

First, the Uribe administration removed the provision of eliminating “parafiscales” because it deemed it politically unfeasible, and instead included softer provisions to flexibilize them. It stated that any new blue-collar hire was to be exempt of paying parafiscal taxes for a maximum of four years (although there are some detailed restrictions on the kind of workers eligible for this exemption, and also no more of 10% per firm of the payroll can be exempt at any moment). Obviously, this measure reduces the contributions effectively paid by employers, and also encourages formal employment creation<sup>5</sup>.

The reform also excluded the payment of parafiscal taxes for students under 25 years of age working part time (this was included in Congress). Additionally, the reform further reduced the compensation for work outside the RWS or on Sundays (to 75% of what was established in the previous proposal), and also went beyond in reducing severance payments in the case of “unjust” dismissals. Workers earning below ten minimum wages were to be paid 30 days for the first year of tenure and 20 for any additional year. Workers with wages above ten minimum wages would get 20 days of wages for the first year and 15 for the following ones. On the negative side, the deepening of the salario integral instrument was not included in the final bill.

## **B. Some Initial Political Economy Issues**

As it is always the case in this kind of reforms, the main losers were formal workers, especially those belonging to strong unions and large firms. The reform package did not include any specific provision to compensate them, and no special measure was taken with this purpose. The only “carrot” was a provision to evaluate the impact of the reform at the end of 2004. A commission composed by the government, representatives of workers and employers, and members of Congress should carry out the evaluation. If the results were negative, the Law orders to change those provisions that are gauged negative, or to completely reverse the reform.

However, the reform did include a host of social protection measures aimed at gaining political and popular support, many of them proposed by Congress. In effect, the “social protection system” was created with the objective of providing protection for the most vulnerable segments of the population against income and employment negative shocks. For the first time in Colombian history, it contemplated the creation of unemployment insurance, the strengthening of public pension and health programs, the creation of a special micro-credit program for small enterprises and the introduction of unemployment subsidies for physically or mentally challenged individuals. In addition, the Law introduced a “subsidy of employment”, consisting basically of a monetary transfer from the government to medium and small enterprises which hire unemployed households heads for blue-collar jobs.

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<sup>5</sup> This measure was on top of the exemption given to the apprentices.

Let us identify the main interest groups related who played an important role in this process. Among them, it is possible to find the strongest opponents of the reform efforts, since they benefited from a very protected and inflexible labor market. The first group, already mentioned, is composed by formal sector workers, especially those unionized and working in medium and large firms, for whom this type of reform represent a direct threat to income and employment stability. This group has been very vocal and always active in the discussions surrounding any reform effort. They have been successful in delaying the passing of reforms by using strikes and other political manifestations. Part of their success has been based on their ability to mobilize other powerful groups that are not directly affected by the reforms, such as the public teachers' union, university students and pensioners. This group has considerable disrupting power. However, formal employees have not been very successful in getting their core message through. That is, despite being always present in the discussions surrounding labor reforms, their postulates have not been included in the final set of policy changes, or only marginally. Thus, it seems that their main interest is to delay or avoid reforms altogether, rather than shaping its content.

The second group is by far the strongest one. It is composed by various subgroups that fiercely defend the existence of parafiscal taxes. The main subgroups within this broader interest group are: (i) the workers' unions of the public and private agencies that administer these contributions and provide the services funded with them. These institutions are the welfare institute (Instituto Colombiano de Bienestar Familiar - ICBF), the public training institute (SENA) and the Cajas de Compensación Familiar (CCFs). All of them are large agencies with strong unions. These institutes manage about \$750 million (approx. 1% of GDP) per year. This large amount of money provides stable and well-paid employment to some 25.000 people in each and every region of the country. Any attempt to eliminate or even reduce the parafiscal taxes is, therefore, a direct blow to their livelihood and their families'. Hence, the opposition to any such measure is fierce and, as it was also the case with formal workers, they are able to mobilize wide support for their cause, especially among the teachers' union; (ii) blue collar workers (particularly those unionized) who directly benefit from the services funded with parafiscal taxes, especially those provided by the CCFs (SENA and ICBF provide their services to the entire population)<sup>6</sup>; and (iii) members of Congress, majors, state governors and other career politicians for whom SENA and ICBF are the preferred places to service their political clientele. In effect, those institutions have been traditionally staffed with employees coming from political recommendations, and the large amounts of money that they handle have been very prone to be utilized with political objectives.

Thus, any attempt of reform parafiscal taxes and the functioning of those institutions could be said to receive opposition "from within". The strong opposition made by these groups explains why the parafiscal system, and the agencies themselves, have been so successful in avoiding profound reform, even in the

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<sup>6</sup> CCFs provide cash and in-kind subsidies to their beneficiaries, which are formal sector workers.

presence of a strong technical background, economic evidence and strong governmental will. The delays and the small pace of the policy changes in this regard may be costing a lot to the country, in terms of resource allocation, public sector finances and welfare losses. These costs have not been systematically assessed yet.

One important point surrounding this discussion is that the main “beneficiaries” of the reform efforts, namely the unemployed and the informal workers and their families, have never had much say in the final outcome of the reforms or in the discussions surrounding them. As it is always the case, that is due to their very weak position and to the natural dispersion of these groups, which avoids forming a “unified front” that allows them to fight for their point of view. Moreover, the lack of understanding of the true objectives of the policy reforms has resulted many times in these groups being co-opted by other interest groups, like the ones mentioned above, to fight for their cause (i.e. to oppose the reform) with the argument that these reforms are just a way to enrich the employers (by reducing their costs) and to generate more unemployment and informality.

#### **4. The Political Economy of the 2002 Labor Reform**

##### **A. The First “Deal”: the Ministry of Labor and the Economic Team at the Beginning of the Pastrana Government**

The 2002 labor reform had actually an interesting genesis, since the people who masterminded it were neither economists, within the realm of the so called neo-liberal intellectual camp, nor public officials from the technical staff of the Ministry of Finance or the National planning Department<sup>7</sup>, nor the multilateral institutions (e.g. World Bank, IMF or IADB). The people who actually inspired this reform were lawyers at the Ministry of Labor. Indeed, the initiators were a group of practitioners with a long experience in labor disputes between private firms, unions and the government, led by the first minister of labor of the Andrés Pastrana administration, a lawyer trained in constitutional law.

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<sup>7</sup> These two institutions are the public sector think tanks, responsible for most of the economic reform packages in Colombia. The National planning Department of Colombia (DNP, for its acronym in Spanish) is a think tank composed by approximately 250 professionals, 5% with Ph. D. qualifications, 30% with master's degree, usually in foreign universities, 65% with training in economics, engineering, agricultural and environmental economics, and social sciences. Most of the staff is confronted with public finance issues. Its organizational structure reproduces that of the Central Government since it is in charge of allocating public sector investment. Hence, it monitors the sectoral behavior of the economy and the evolution of public sector policies, projects and intervention. Its technical staff is regarded to possess better and most consistent knowledge of the workings of the public sector, surpassing the particular ministries. It acts as an office of the presidency, is part of the presidential cabinet, and coordinates the National Council of Economic and Social Policies (CONPES for its acronym in Spanish), where the key public policy decisions on agriculture and manufacturing, infrastructure, health, education and social security, environment, justice and armed forces, decentralization, urban development and utilities are made. Such council is presided by the President of Colombia and is conformed by eight ministers, the Governor of the Central Bank, the Head of the Coffee growers' federation, and representatives of social groups. The CONPES technical documents, drafted by the DNP and publicly available, constitute the memory of public policies in Colombia, with a tradition of already 35 years. It is similar to the Ministry of the Economy in other countries.

They started thinking of this reform as a result of a group of papers that had been produced in the middle of 1998 by a private think tank, Fedesarrollo, within an agenda of research led by James Heckman and Carmen Pagés, and financed by the IADB. In particular, the newly appointment Minister of Transportation of the Pastrana Administration had participated in that research project and produced a paper on the determinants of labor demand (Bernal and Cárdenas, 2003).

The paper concluded: “quite on the contrary [to the belief that the relevant elasticities are low and the efficiency gains associated with labor reform are relatively weak], the payoff of reducing labor costs is substantial. ... These elasticities range from -0.45 to -0.52, depending on the type of labor.” The paper presents different estimation methods and more evidence on particular productive sectors, and also numbers for skilled and non-skilled labor where the elasticity figures are lower; and also quite substantial elasticities for output (between 1 and 2). It also analyses the impact of changes in regulation on adjustment costs. “The conclusion is that changes in severance payments and costs of dismissal, associated with the 1990 labor reform, did not affect the path of employment adjustment. ... Structural reform did not change the relevant elasticities. This means that the main effect of regulatory changes affected labor demand through their impact on labor costs. Since these costs have increased it is likely that the net effect of labor, health and pension reforms has been a reduction in employment generation. According to the estimated elasticities in the dynamic framework, an elimination of the 9% payroll taxes could result in a 1.3% increase in employment in the urban areas. ... [It also concludes that] the wage elasticity of labor demand increases (in absolute terms) during contractions. The impact of output growth on employment is also larger during recessions than during expansions. In this sense, we found an asymmetric labor demand response to the business cycle conditions.”

The Minister of Labor was less convinced of the conclusion that labor reform itself was instrumental in *creating* jobs. He also considered that the goal should not be to reduce hardly won labor concessions. Instead, he viewed labor reform as eliminating possible obstacles to labor creation, once economic recovery started, for which some cumbersome elements of the labor contract should be smoothed, rather than forthrightly attempting to reduce labor costs. This view was shared by the two groups of lawyers gathered around him, one in the Faculty of Law at Universidad Javeriana, where he used to be a professor, and another one at the Ministry of Labor. In doing this, he was pursuing a task agreed upon with members of the economic team and promoted also by private firms.

Notice that the vision of the technical paper, which can be said to reflect that of the economic team at that time, was more aggressive in terms of labor costs reduction and in transforming the structures of the labor code, like severance payments, non-wage costs and payroll taxes. In contrast to economists, the lawyers viewed the key channels for job creation differently, and focused on other type of solutions. This mattered down the road at least in two senses: (i) there was not a unified vision on what to do for job creation; and (ii) at different points in time it was not easy to convince the economic team of this version of labor reform.

The main issues included in the Ministry of Labor proposal were:

- (i) Reduction of the labor shift from 8 to 6 hours for firms with more than two shifts per day.
- (ii) Diurnal shift until 9:00 P.M. (previously, the cost per hour was higher after 6 P.M., due to the night shift).
- (iii) Differentiation between “regular” Sunday work (without extra payment but the compensation with another free day during the week; for hotels, museums, restaurants, etc.), and “occasional” Sunday work (with twice as much the cost per hour).
- (iv) No extra remuneration for holidays work, but an additional day for rest.
- (v) A rise in the severance payment for workers with less than 5 years of tenure; keep it constant that of workers between 5 and 10 years; and reduction for those with more than 10 years, making it equal to the previous group.
- (vi) Reduction of the “Salario Integral” (i.e. without non-salary costs) threshold from 10 to 3 minimum wages (i.e. approximately from \$1,500 to \$450).
- (vii) The creation of a contract specified in terms of number of hours worked.

Once the first draft of this reform was written, the minister called for a meeting with members of the economic team. The purpose was to socialize the proposal within the government, understanding that to make it an actual project of law to be submitted to Congress, it would need the no objection from the powerful Ministry of Finance and DNP. The labor reform would have had to find a place within the legislative initiatives presented to Congress, an already loaded package including projects for sub-national government finances, like the modification of transfers to the regions, the pension system, financial responsibility and a new lotto; as well nationwide initiatives, like a tax and pension reforms, the four-year national development plan, mandatory for every new government, and the following year’s budget. Additionally, the legislative agenda contemplated a new Chapter 11 Law for helping the private sector whether the difficult recession period and a reform to the mortgage financing system, in deep disarray and causing considerable harm to households and the financial system. Figure 6 registers when these projects were presented to Congress, and how did they advance through the House of Representatives and the Senate.

Most of these reforms touched deep chords of the Colombian (or any country’s) economic and institutional arrangements. They were undertaken in the midst of a difficult macroeconomic situation, which we will touch upon ahead, and were proposed by a conservative government, which only counted on 20% of a Congress mainly dominated by the liberal party. Their approval though, implied a well functioning Congress coalition. The way the system has traditionally worked in Colombia is through an entente between the governing party and (some fraction of)

the mayoritarian liberal party. The governing coalition was called *Alianza por el Cambio*, following the name of the movement that took Mr. Pastrana to the presidency. This was indeed an alliance of three types of forces: the conservatives, the center-right wing of the liberal party, and another group of liberals, harder to identify ideologically, that tends to side with whoever is president (opportunistic).

**Figure 6: The Original Legislative Agenda of the Andrés Pastrana Government**

Advance (as of Mar. 2000) of the Projects of law or Constitutional reform presented to Congress since Aug. 1999

	Presented to Congress	House of Rep.		Senate		Approved & Issued
		Committee	Plenary	Committee	Plenary	
2000 Budget Law	Jul 99					4 Law 547, Oct. 99
Sub-national gov. pensions	Aug 99					4 Law 542, Dec. 99
National Lotto for financing health	Aug 99					
New Chapter 11	Oct 99					4 Law 550, Dec 99
Mortgage financing	Oct 99					4 Law 546, Dec. 99
Sub-national gov. Fiscal responsibility	Nov 99					
Transfers to the regions (*)	Nov 99					
Tax reform	Mar 00					
Pension reform	Mar 00					

(\*) Constitutional reform

Source: DNP. Original power point presentation of March 9, 2000.

Facing such a complicated legislative agenda, it was not easy to convince the economic team of the urgency of a labor reform. The lukewarm reception to it among the economic team was partly due to the fact that more urgent challenges were piling up in the macroeconomic front. Indeed, their priorities pointed somewhere else, as it appears in many official documents and presentations of that time. One of those memos, dated in March 1999<sup>8</sup>, presents the economic recovery strategy of the government. It states: “although some key prices like the exchange and interest rates already started to align after the speculative attacks against the weak end of the exchange rate band, which led to the abandonment of that exchange regime, there are still worrisome signals of recession. It is the case of the decline in domestic credit, which reveals both, demand and supply side problems in the financial markets”.

The document describes also a negative spiral in the making, driven by expectations on asset prices, especially real state. “The argument is as follows:

<sup>8</sup> “La Estrategia de Reactivación Económica”, DNP-UMACRO, mimeo, March, 2003.

aggregate demand is depressed due to the unwinding of the Keynesian shock used by the previous government between 1997.I and 1998.I, and due also to the balance sheet adjustment, both in firms and households. Both of them suffered from (i) an increase in liabilities, due to over-borrowing during the 1990s and to the increase in interest rates in 1998; and (ii) the fall in the value of assets as a result of the bust in the real state bubble. Households have benefited from the policies attending mortgage indebtedness. But private firms' refinancing will rely on their own internal resources since the financial system is not willing to help, until its own balance sheets are not clean again. Non-performing loans are rising as well as the risk perception in the financial system. Hence, new lending will not flow and thus, aggregate demand and the prices of assets, particularly real state, will remain depressed, which closes the circle of negative spiral".

On yet another front, in the middle of 1999 the Colombian Government decided to go to the IMF for an economic program, in order to improve its standing vis-à-vis the international financial community<sup>9</sup>. The political economy of this move is also interesting in itself, since until then the Pastrana government had resisted pressures from the Department of State and from the multilaterals to pursue this line of action. The Colombian Government argument had been that in establishing a table of negotiations with the guerrilla group FARC, it could be quite damaging to pursue a program to the IMF, in which Colombia had not been since 1974<sup>10</sup>, and that it would be blamed for anti-popular reforms and impositions from the foreign powers.

The reasons to finally ask for an IMF program were the persistence of a unsustainable fiscal situation (high and persistent central government and consolidated public sector deficits), steady increase in public debt, a delicate balance of payments situation, a financial sector crisis, specially in public and mortgage banks, and a highly complicated international environment due to the Asian (1997), Russian (1998) and Brazilian (1999) crises. The Confidence in the Colombian economy was faltering and help from the multilaterals was badly needed<sup>11</sup>.

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<sup>9</sup> In a press release of Sep. 24 1999, the IMF states that: "Management of the International Monetary Fund (IMF) and the Government of Colombia have reached understandings on all the key elements and policies that would support Colombia's economic program for 2000-2002. After concluding some technical work that remains and the normal process required to finalize the documentation, Colombia's proposed extended fund facility (EFF) program will be presented to the IMF's Executive Board for consideration." The whole package with the multilaterals included contingent FMI resources of US\$ 2.7 billion; as well as fresh lending from IDB, US\$ 1.7 billion; World Bank, US\$ 1.4 billion; CAF (the Andean countries' multilateral bank), US\$ 0.6 billion and FLAR (The Andean countries' international reserves fund) US\$ 0.5 billion.

<sup>10</sup> During 1984-86 Colombia had a monitoring program with the IMF, but no actual Stand-by Program. Colombia was one of the few Latin American countries that avoided a formal IMF program during the eighties and the nineties, and that punctually honoured all its obligations. For that a record the country's sovereign debt was awarded Investment Grade by the rating agencies.

<sup>11</sup> The program signed by the Colombian authorities, an Extended Fund Facility (EFF) credit for the period through 2002, "is an IMF financing facility that supports medium-term programs that seek to overcome balance of payments difficulties stemming from macroeconomic imbalances and structural problems. The repayment terms are 10 years with a 4 ½-year grace period." See, <http://www.imf.org/external/np/sec/nb/1999/nb9974.htm>. However, the Colombian Government never

Let us summarize, then, the political economy landscape during 1999, when the labor reform hit for the first time the discussion table. As it is evident in Figure 7, the Colombian government found itself in the middle of powerful players, each of them with their own serious worries regarding the sustainability of the whole political and economic equilibrium in the country. Of course, the characterization of the elements involved in the relationships with every one of these players surpasses the scope of this paper. We will focus on the political economy of labor reform, but the figure reveals the richness of the political economy landscape during that time.

**Figure 7: The Political Economy Landscape of the Colombian Government Since 1999**



A brief comment on the peace process with the guerrilla group FARC is due, since it considerably influenced the attitude of the unions towards government proposals, as well as the methodology adopted during year 2000. This is an illegal armed force that was founded in the early sixties by frontier peasants, as a residual of the so-called liberal guerrillas present then in the country. Originally these people did not have a particular leftist revolutionary orientation, but with time and the support of the mostly urban Colombian communist party acquired it. Their major strength lied on being a frontier, armed group, of former colonizers of Colombian common land. Indeed, the country still has a lot of wild forest, basically untouched. These areas provided them with a hideout vis-à-vis the military.

The 1960s and 1970s lived a boom of urban guerrilla groups in Latin America, most of which were brutally dismantled by the dictatorships or strong civil governments of the 1970s and 1980s. This was not the case in Colombia, where

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contemplated disbursing it; it considered the EFF as a "spare tire", according to the Minister of Finance's comparison, to be used only if difficult times were to appear.

conservative governments, like Betancourt (1982-86) and Pastrana (1998-2002) ended up seeking an agreed end of the war, and liberal ones, like Turbay (1978-82), Barco (1986-90) and Gaviria (1990-94) resulted quite more aggressive and only partially effective against the whole guerrilla movement. Some actual truces have been reached during the last decades, saliently with the M-19, which partially led to a new constitution in 1991, and with the EPL, also at the beginning of the 1990s. These two groups demobilized and entered civilian life, participating in politics until now. The FARC changed completely in character (see Bottia, 2003) once Colombia became the world biggest producer of cocaine. Indeed, this illegal drug is cropped and processed mostly in the jungles, and the traffic towards the international markets mostly departs from runaways close to the jungle (Echeverry, 2003). Of course, the guerrilla's traditional position in those areas provided them a "comparative advantage" to, first, offer security to drug producing units, and then to get involved in this business directly.

President Pastrana was elected after two particularly telling episodes. First, the vote of ten million Colombians in favor of a peaceful solution with the guerrillas. Second, a highly publicized encounter with the head of the FARC, Manuel Marulanda (a.k.a. *tirofijo*, sure shot), in the interim between the first and the second round of presidential elections. By then FARC allegedly dominated whole territories of Colombia, had adopted kidnapping and drug trafficking as its main sources of finances, and had jumped from 3 thousand fighters to 16 thousand, and was able to defeat the military in several encounters between 1996 and 1998. These episodes led the new president and the Colombian establishment to the conviction that a negotiated peace was the only way out with FARC. The peace process officially started at the beginning of the 1999, and in principle, no issue was left out of the agenda of discussion. The agreement between the Government and guerrilla negotiators was to start discussing the "Economic model of Colombia"<sup>12</sup>. The peace process went on until the beginning of 2002, few months before the next presidential election, when President Pastrana was convinced of FARC's lack of willingness to actually advance towards a final negotiation.

Summarizing the elements discussed so far, the priorities of the Colombian Government were basically set by the crucial processes and actors portrayed in Figure 7. It needed badly to restart economic growth, which fell 4.3% in 1999, the first yearly GDP decline in seventy years. It sought to reestablish the confidence in the international capital markets, as sovereign debt spreads had started to fluctuate along with those of its Latin American neighbors, between 400 and 700 basis points (bps) during 1999, and to counter the loss of cherished public debt investment grade. It accepted the corset of an IMF program to credibly commit to a fiscal agenda and a deficit reduction path. It kept trying to secure its Congress coalition, in order to grant governability. And last but not least, it was in the middle of a muddy peace negotiation with a powerful and consolidated guerrilla group,

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<sup>12</sup> The authors of this piece actually participated in training the Government's negotiators in different topics, among them, labor market functioning and regulation; and also explaining to both sides of the negotiating table what could be understood by the "economic model", and the feasible ways for its transformation.

well financed and armed, which controlled lucrative business and productive territories of the country.

The legislative agenda was defined, first, to grant fiscal sustainability, both in the central and sub-national governments. And second, to tackle the difficult issues of private sector economic recovery (new Chapter 11) and household finances (new mortgage financing; see Figure 6). Additionally, it had to be crafted very carefully to not introduce excessive noise to the peace negotiations. It is understandable, then, that the reception to the first draft of the labor reform fashioned by the Ministry of Labor was not embraced by the economic team. The clearest manifestation of this state of mind was the shift in agenda and in the cabinet occurred in the August 1999, which included the replacement of the Minister of Labor, and the elimination of labor reform from the legislative package. Instead of being submitted to Congress, it was put on hold. However, soon unemployment would become the main worry to the Colombian economy, and the attention came back to the labor market, as referenced above.

### **B. The Second “Deal”: Different Views of the Economy and of Unemployment**

The year 2000 witnessed a different set of events, led by the governability question. It all started at the end of March when some corruption scandals involving the heads of the Senate and the House of Representatives led to a new political strategy by the executive. President Pastrana had unsuccessfully tried to approve a political reform in 1999, denied by Congress. Considering that with a new scandal Congress will be weak, the president proposed the political reform via a referendum<sup>13</sup>. According to a poll, the approval rate of this proposal was 82%, and the president’s popularity jumped. Since any referendum needs first to be approved as a law, and hence to surpass congressional voting, the president implicitly menaced congressmen saying that he might use “other forms” of pressure (i.e. impeaching congress) if the parliament rejected the referendum (cited in *Revista Semana*, ed. No. 935, Apr. 5, 2000). The relationship between executive and legislative became tense. Events evolved quite rapidly, and in the approval process the Congress included the possible impeachment of the president, a move that negatively affected governability. The international financial markets reacted with spread increases to this sequence of events, and left no alternative to the president but to withdraw the original project of the political reform via referendum.

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<sup>13</sup> The text of the proposed referendum sought: 1) Downsizing congress, 2) eliminating state assemblies, 3) downsizing municipal councils, 4) political death for corruption, 5) changing the electoral system to strengthen political parties, 6) roll call voting in congress, 6) separating the administrative management of congress from congressmen, 7) eliminating deputies for congressmen, 8) assimilating the congress pension system to the general one, and 9) finally asking the Colombian people if wanted to elect a new congress at once. (*Revista Semana*, ed. No. 935, Apr. 5, 2000)

This situation weakened the executive and led to a restructuring of the political equilibrium. The first move, crucial for our subject, was a shift in the policy agenda. To understand the context, let us review the evolution in the economic front. Once the exchange rate and the interest rate corrected their misalignment, and the current account moved towards equilibrium, the main worries concentrated on the fiscal imbalance and the record high rate of unemployment. The former required a reform of the pension and regional transfer systems, which touched deep chords of the Colombian political and social system. The latter demanded the recovery of economic activity and also a reform of the labor code. However, the executive did not count at that moment with the political muscle to present legislative reforms with a real probability of success.

The president convoked a round of discussions with key actors to advance in these three topics (transfers, pensions and labor), before congress reopened on July 20, 2000. The people gathered were: (i) the leaders of labor unions (CGTD, CTC, CUT, the most important worker's unions); (ii) the federations of economic sectors, gathering private firms (agribusiness, big and small manufacturing firms, and commerce); (iii) the political parties (liberals, conservatives and the movement Sí Colombia); and (iv) the universities. Three Discussion Tables (Mesas de Concertación) were established, one for labor reform, another one for regional transfers, and finally one for pension reform. The purpose was twofold, to create a better atmosphere for reform, and to produce a consensus text to submit to Congress. Also, these discussion tables should balance the one established with the FARC, and to bring more actors to propose new reforms for Colombia's future.

The deliberations took place between the beginning of June and the end of July of 2000, a period when Congress rests. We will elaborate on the dealings of the labor reform discussion table, but first let us mention another significant event that took place in July. Before the parliament resumed the second period of sessions, on July 20<sup>th</sup>, it was imperative to improve the relationship with the executive. In particular, the liberal party loudly asked for a fairer treatment and a better channel of communication. This was achieved by the appointment of a new minister of finance from the liberal party. Simultaneously, a former union member was appointed as ministry of labor in order to gather within the cabinet the whole political spectrum of conservatives, liberals, and the democratic left. This new arrangement lasted until the end of the government, and although it created problems for labor and pension reforms, it played a crucial role in securing governability for the remaining of the Pastrana government.

The labor reform was presented to the discussion tables by the head of the National Planning Department, the institution that until the end of the Pastrana administration championed this and the pension reform. The Ministry of Finance concentrated in approving a new tax reform, and both institutions forcefully defended the critical reforms of regional transfers and of public health and education systems. This new package became the new economic agenda of the Pastrana Government. Note that microeconomic reforms started to be forward looking, compared to the ones proposed in the first half of the government, also

critical, but designed to deal more with the problems generated by the recession (New Chapter 11 and new mortgage financing system). Also, notice that the defense of the labor reform shifted from the Ministry of Labor to the economic team (DNP and to a lesser extent MF).

What happened in the labor reform discussion table? This was almost a laboratory on the political economy of labor reform. Let us describe the basic tenants of each group of actors. First, the proposal presented by the economic team analyzed the cyclical and permanent (structural) components of unemployment, attributing the former to the recent fall in economic activity, and the latter to the evolution of labor supply, accelerated due to higher participation rate. Some share of this increase in labor supply was also due to the cycle, but the last decades had witnessed a wave of women and young people entering the labor market at rates unseen before. Another important element was the rise in labor costs as a result of the increases for pension and health contributions, as well as the Colombian system of subsidizing social services<sup>14</sup> (parafiscales). Finally, labor supply and demand had shifted away from each other, as the productive sector's labor demand moved during the 1990s towards high skilled workers and outsourcing, avoiding high firing costs and burdensome stability clauses of the labor code. Hence, the Government defended that higher growth and a change in the labor code were the solution to the unemployment problem. Remember that for the first time in Colombian history, during 2000 urban unemployment rate reached 20.5% and national unemployment, 16.3%.

The response of the labor unions to this diagnosis was that the problems were not lower growth or the regulation of the labor market, but the "Model of Development" of Colombia. Their line of reasoning was: Neo-liberalism and the Washington Consensus have been applied at the beginning of the 1990s, internationalizing the economy, reducing tariffs, allowing the indiscriminate inflow of short term capital and imports of all sorts. Also, Central bank independence, granted in the new 1991 Political Constitution, had practically banned printing money for anti-cyclical purposes. As a result, Colombian competitiveness had been harshly affected, and the Government did not have tools for countering a recession. Finally, along with those macroeconomic reforms, the neo-liberal camp enacted a labor (Law 50/1990) and a social security reform (Law 100/1993), which promised to create more employment and to balance the troubled pension system, but never really delivered. The real solution for unemployment was dismantling the institutional and economic arrangements derived from such agenda, and abandoning the recessionary IMF program. What was needed, in their view, was to protect the internal market, increase wages and protect employment stability to re-activate internal demand and, through this channel, generate more formal employment.

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<sup>14</sup> The institutions that receive parafiscales are: the National Job Training Service (SENA for its acronym in Spanish, 2%), the Family Welfare System (ICBF, 4%), and the so called Compensation Institutions-CCFs (2%), which intermediate subsidies mostly to the middle classes, in form of cash, cheaper goods and services in special supermarkets, health services and holiday facilities. As it was shown in Figure 2, all these costs add up to 53% of labor costs.

Interestingly, the labor unions demanded the withdrawal of all governmental initiatives already presented to Congress, until an agreement have been reached in the discussion tables, or else they would abandon such negotiations. Finally, they strongly rejected any challenge to the rights already granted in the current pension and labor codes. Implicitly, their demand was that any reform should affect the newly employed, or the new people contributing to the pension system, but not their constituencies composed by the incumbents.

The most articulate presentation from the political parties came from one with the lowest representation in Congress (if any), but whose representatives had been decisive players in designing the labor and pension reforms at the beginning of the 1990s, the movement *Sí Colombia*. They presented a vision where the main problem of the Colombian economy was indeed unemployment, but one to which the government seemed insensitive. They defended the need for an unemployment coverage (subsidy without contribution, proposed the unions), and were ambiguous on the need for a more flexible labor code, an attitude attributed to the fact that they were already in campaign for the next presidential election. Interestingly, they separated the unions' positions from that of the unemployed, adding that the former were actually against the interest of the latter. Hence, the presence of the representatives of the unemployed was asked. Finally, they showed that the adjustment of the labor market would come either in shift of the prices (real wages) or of the quantities (number of jobs). Finally, they argued that what was urgently needed to reactivate the economy and generate employment was to reduce public spending (an stop crowding out of private investment) and to give the possibility to the most vulnerable groups of becoming asset owners (their definition of assets included productive and financial assets, plus entrepreneurship).

The federation of big manufacturing firms (*ANDI* for its acronym in Spanish) was against the "model" discussion, and rather proposed that the key issue was competitiveness and the creation of truly productive jobs. It was also the only private sector representative that accepted that the labor code might have problems and should be reformed. The federation of commerce spoke against the elimination or reduction of *parafiscales*, arguing social considerations. The real reason, however, is that many of its affiliates directly benefit from those contributions. The federation of agribusiness (specially representing the cattle and meat industry) stated that the causality in Colombia went from violence to unemployment, and not the other way around, as the labor unions have defended. Finally, the federation of small manufacturing firms warned against the belief that firing people was good business.

Once the labor unions accepted to evaluate the government's proposal (which was the only one on the table), an appealing discussion developed. On analytical terms, the decisive issues for the effectiveness of a labor reform are: (i) will flexibilization in hiring and firing lead to higher formal job demand? (ii) Will a reduction in non-wage costs be actually translated into more hiring or just into higher profits? (iii) Is labor demand actually price-elastic? (iv) Are young people able to benefit from flexibilization of norms favoring their hiring, or their lack of skills and of a first

employment will hopelessly condemn them to unemployment? These are empirical questions, whose definite answer depends on the phase of the cycle (elasticities change along it), along with the type of productive sectors likely to embrace the new easiness and cheapness for hiring new employees. Hence, the answers to each of these questions depend on empirical conditions in the country at hand. In these circumstances, however, economists exert their privileged access to a wealth of data on elasticities, computed for Colombia or similar countries, as well as to the old truths of economic theory. These questions received probably not completely satisfying answers from the economic team, but nonetheless, the best ones available. In the final analysis, in every action of intervention in the economy, there is a considerable ignorance on certain aspects of the economy at that moment, a diagnosis which corresponds to a view of the economy, and a component of faith regarding the true elasticities, the interplay of incentives and the reaction of relevant economic actors.

Unions' leaders reacted with their own data, probably gathered less systematically and presented less elegantly, but nevertheless similarly powerful rhetorically, defending the arguments already presented. The reaction of a congresswoman, invited to the discussion, to this interchange of elasticities and empirical evidence on the past of the labor market is worth mentioning: she said that these discussions were way too technical for the floor of parliament, and that any reform would need a broader consensus to be presented in that arena. Whether people at the table of discussion got finally convinced of either side's opinions was immaterial due to the turn of events that were about to happen.

As already mentioned, President Pastrana appointed as Minister of Labor a former charismatic union leader, with vast experience in negotiations, and no appetite for an unpopular labor reform that would certainly enrage his constituency right at the beginning of his tenure. Also a new Director of the DNP was appointed by the president (coauthor of this paper, and former deputy director), and on his first presentation in public, during a meeting of the confederation of big manufacturing firms, offered the blueprint for labor reform that had been discussed within the economic team. To begin with, its name had been changed from "flexibilization", already a bad word in the labor sector argot, to "adaptability". The idea was presenting the reform as achieving a better matching between labor demand and supply. This is more than semantics, since it recognized that this was not an attempt to modify the labor code and to reduce non-wage payments, minimum wage or other deep arrangements of the labor market. Instead, it aimed at smoothing the functioning of this particular market, more in the vein defended by the lawyers at the beginning of the government, than in the one championed by the economists. The key elements of the proposal were:

- (i) Reduction of the labor shift from 8 to 6 hours for firms with more than two turns per day.
- (ii) Creation of the RWS.
- (iii) Differentiation between "regular" Sunday work and "occasional" Sunday work.

- (iv) No extra remuneration for holidays work, but and additional day on vacations.
- (v) Change in the severance payment schedule.
- (vi) “Salario Integral” from 3 minimum wages on.
- (vii) Options for participation on firms’ profits.

According to the technical staff of the DNP, the reductions in labor costs resulting from such reform could generate between 200 thousand and 350 thousand new jobs in the following three years.

Either the media understood the explosive situation and immediately interviewed the newly appointed labor minister, or he considered this the perfect opportunity to launch an attack on such an initiative, but the immediate result was a huge controversy in the media, loudly voiced by the minister and echoed by all the union leaders. The storm ended a couple of days later when the president said that such proposals were actually being considered within the government, and that the new minister of labor should come up with a better alternative for job creation to the internal discussions. This put an end to that particular debate, but not to the permanent disagreement during the following two years between the minister of labor and the economic team (minister of finance and head of planning), on labor and pension reforms. The former made it absolutely clear that his signature was indispensable for submitting a government labor reform to Congress, and that that was out of question as long as he was minister.

This put an end to the intention of actually presenting a labor reform, but not to the campaigning of the government economists for it. In repeated presentations of the economic team the issue was raised and kept alive. And finally, the reform proposal, drafted by the government, was presented to Congress at the end of 2001, but as being conceived and designed by a small group of congressmen. That is, the trick was to make the bill look to have been born from within Congress, and not from the government. The final draft presented to Congress included the reforms just referenced, plus the reduction of parafiscales from 8% to 5% of the payroll. Although it was finally defeated in the discussion in Congress, this bill was instrumental for creating a public discussion around it and for selling the idea to key players in society. In particular, the economic teams of the candidates to the 2002 presidential elections became sensible to the reforming diagnosis. Some of them had participated in the discussion tables the middle of 2000, and were intellectually and personally closer to the officials from the economic team.

It is also worth mentioning that along this period the IMF, the World Bank and the IADB insisted in including labor reform as part of the Letters of intent or as conditionality for some loans. The Pastrana Government systematically rejected these requests since there was no consensus within the economic team of the feasibility of this reform in Congress, and there was the conviction that this type of reform losses credibility if it appears in any form as an outside imposition.

In saying this, it is important to stress that the reform experience in Colombia has shown that it takes years of slowly “selling” a reform to key newspapers analysts, congressmen, former presidents and directors of political parties, representatives of the productive sector and the academia, until an initiative actually gains momentum. During these periods, it is normal to observe that actors that at some point defend some reform can turn against it, or the other way around. The tides of opinion and the relative strength of diagnoses shift quite dramatically, and it is frequent that people who had opposed a proposal end up approving it in Congress, or defending it in the press at some point.

### **C. The Third “Deal”: a New Government Embraces the Reform Initiative**

The new government’s Minister of Labor championed the approval of the labor reform, this time without the enthusiasm of his colleague from the MF. The reason was that the latter was worried by some new articles including unemployment subsidies that were about to create additional expenditure pressures, inadequate for the fiscal reality of the country. Another interesting fact is that the reform blueprint was the one presented by the previous government, as it was described in the previous section. The main additions from the Uribe Government were the unemployment subsidy, reviving the reform of the on-the-job-learning contract (apprentice contract), which the Congress committees slightly modified, and the inclusion of the Compensation Institutions (CCFs) as key for social distributive policy.

The Congress committees included a series of articles directed to create demand for SENA students, the mandate to the government to create incentives for independent workers to register in the social security system, reduction in payroll taxes for firms that hire people between 16 and 25 years old and older than 50, among the most important.

A final element is the statement of purpose, written by the congressmen who presented the initiative, and which is clearly addressed to the Constitutional Court, which became another important actor within this reform. In particular, this court could reverse the final Law, once approved by Congress, if it deemed it as standing against the rights of the people, or if it found any mistake in the procedures to get it approved. The statement develops a long and deep argument explaining how this type of reform it is not against the *Estado Social de Derecho* (a mixture of the Social Welfare State and the capitalist property rights system), which is at the beginning of the 1991 Colombian Constitution. Indeed, the Court has already a tradition of controversial rulings imposing to the executive all types of mandates, basically justified on interpretations of that concept of the state. In this case, Congress wanted to armor the reform against one of those rulings, since this labor reform actually affected workers and modified some existing arrangements of the labor code.

**Table 1: The Process of Labor Reform 1999 - 2002**

LABOR MINISTRY	PLANNING DEPART.	URIBE GOVERNMENT & CONGRESS COMMITT.	HOUSE	SENATE
Jul. 1999	Aug. 2000	Sep.–Dec. 2002	OK	OK
Labor journey from 8 to 6 hours for more that two turns per day	same		OK	OK
"Daily" journey from 5 A.M. until 9 P.M.	same	from 6 A.M. until 10 P.M.	OK	OK
"Regular" Sunday work vs. "occasional" Sunday work	same	Extra-cost rose from 25% (Uribe Gov.) to 75%	OK	OK
No extra remuneration for holidays work	same	Employee can choose money or an extra day	OK	OK
Severance payment table modification at 5 and 10 years	same		OK	OK
"Integral wage" application from 10 to 3 minimum wages	same		OK	OK
Change in the learning-on-the-job contract	NO	No payroll taxes for students: min 4 hours/week	OK	OK
New labor contract in terms of number of hours worked	NO		OK	OK
	Option on profit partic.		OK	OK
		CI* and SENA for social protection	OK	OK
		Unemployment subsidy with contributions	OK	OK

(\*) CI: Compensations Institutions.

## 5. Reform Implementation and Evaluation

### A. Evaluation

Although it is still too soon to make a rigorous assessment of the reform effect on key labor market outcomes, the government has claimed that there are some initial positive signals. These signals correspond to the higher pace of employment generation in 2003 and reductions in unemployment duration and informality. Of course, many factors affected those outcomes, but a simple statistical exercise allowed partial disentangling of the pure reform effects. Additionally, the government carried out a survey among employers to gauge the impact of some specific provisions.

Regarding employment generation, the local statistical agency (DANE) reported that between June/02 and June/03 more than 750.000 new jobs were created, which would be translated into a high growth rate of about 5% of the employment rate, compared to a 3% growth of GDP. The percentage growth of employment in this period more than doubled the one observed in the previous year (June/01-June/02). Importantly, this behavior concentrated in urban areas, where the effects of the reform are expected to be greater.

The statistical exercise referenced above (a simple decomposition procedure) revealed that about 60% of that increase was due to economic growth alone. Thus,

40% (300.000) of the new jobs were generated by other factors, attributed particularly to the labor reform. The informality rate also declined from 61.5% to 60% during the period. But what seems to be more important is that, for the first time since 1997, in 2003 the formal sector was more dynamic than the informal one in terms of job creation. In the main urban areas formal employment grew by 5%, while informal employment rose by only 2%. Unemployment duration, on the other hand, declined from 53 to 49 weeks in the same period.

Probably the most convincing piece of evidence comes from the employers, who assess in a special survey that the reform has impacted them positively. The survey was directed to 75 formal firms in diverse sectors of the economy (medium size most of them). The focus on formal firms was due to the fact that they are expected to benefit from the reform. First, 41% of the surveyed employers said to have increased the number of workers between June/02 and June/03. Close to 20% of them (i.e. 8% of the total, about 15 firms) said that they did so because of the labor reform introduced in 2002. This group stated that a very effective incentive was the reduction of the cost of Sundays and holidays' work, while 80% answered that the reduction in the cost of nocturnal shift was instrumental as well. Other instruments that were deemed important were the employment subsidy (40%) and the exemption of parafiscal taxes (25%).

Additionally, 37% of the firms surveyed stated that they had increased the number of apprentices due to the provisions included in the labor reform in this regard. The survey also asked about the future: 20% of the firms responded that they plan to increase their payroll in the next three months. Among these, 47% said that they would be able to do so because of the incentives provided by the labor reform. In particular, the incentives that they consider the most important in the near future are the exemption of parafiscal taxes (30%), the reduction in nocturnal costs of labor (29%), the fall in the costs of work on Sundays and holidays (28%) and the subsidy for employment creation (20%).

Finally, the social protection programs introduced by the reform are in the process of final regulation by the executive, basically because they need substantial financial resources to operate properly. These resources are currently being gathered from a diversity of sources, which implies a high level of maneuvering. At the end of 2003, the only program in place is the unemployment insurance, which in its first stage is administered by the CCFs and is providing compensation in the amount of 25% of the minimum wage for six months to 21.000 unemployed household heads (about 0.9% of the total unemployed or 1.4% of the urban unemployed).

## **B. Implementation**

The qualified technical team in charge of the implementation of the reform was lead by a respected labor/social economist, who unfortunately died at the beginning of 2003. After his passing, the leadership has been more diffused, but it still keeps a technical "bias". For the most part, the same team that was involved in

the design of the reform has been in charge of its implementation. Even with the change of government in 2002, many of the members of the team that participated in the design of the second bill during the Pastrana administration continued to be involved in the production of the final bill during the Uribe government, and in the implementation of the reform afterwards.

The new additions to the team, however, had been interacting closely with the Pastrana government in the design of the reform through many channels, such as specialized seminars, technical discussions and even consultancy work. Moreover, many people involved in the design and implementation of the 2002 reform were also involved in the 1990 reform. This has been a feature of policy-making in Colombia, sometimes criticized by unions and congressmen, but that has lent stability and consistency to the reform processes in the country. Thus, it is likely that part of the success in passing two politically laden reforms in a little bit over a decade is due to the continuity of the reform agenda, and the conviction among this group of economists regarding the policy changes needed.

For the implementation of the 2002 reform and, more generally, for the implementation of the entire “social protection” reform package, a new government agency was created, or rather than created, it emerged as the merger of two ministries: the Ministry of Labor and Social Security (ML) and the Ministry of Health (MH). The new institution was given the Name of Ministry of Social Protection (MPS). One of the main responsibilities, in conjunction with the National Department of Planning (DNP), is to implement the new labor code, especially in what has to do with the proper functioning of the new instruments for social protection, the regulation and monitoring of the apprenticeship program and the reform to the job training system.

This is an important institutional change since previously most of the technical expertise was at DNP, which was the “natural” leader for design and implementation of key reforms. Under the current arrangement, the MPS is strengthening its technical muscle, departing from a very low base stemming from the old ML and the MH. It is important to note that all the public agencies related to the labor and social reform are now directly dependent on the MPS, including the training agency (SENA) and the Social Security Institute (ISS), among the most important. Thus, MPS’ scope of action is ample and its financial muscle as well. Therefore, part of the future performance of the labor reform would depend on the how successful is the MPS in developing a good technical base that allows it to implement correctly the reform, and evaluate its impact.

The implementation of the 2002 reform, in its difficult aspects (such as the apprenticeship contract and the reform to the training system), shows a mixed panorama. The apprenticeship contract was regulated through a decree issued in May 2003 that still needs further regulation for the instrument to be completely operational. The reason for the slow progress seem to lie on the fact that, although regulatory decrees need not Congressional approval, opposition from labor unions and other powerful interest groups (notably the teachers’ union) has been intense.

Additionally, the Uribe administration focused on economic issues, on reforming central government (downsizing and improving its efficiency), and confronting the fiscal difficulties. Both of these endeavors require quite unpopular measures, fact that forced the President to put on hold further regulatory efforts in the labor arena for a while. Regarding the training system, until very recently (December 2003) nothing was done on this front, partly because of the same reasons just expounded, and partly because there was no agreement within the government on what was the best course of reform. Initial agreements were reached on November- December and thus the subject began to move along, through a decree forcing SENA to contract training with private firms in certain circumstances and thus, favoring competition in this market and choice on the part of the beneficiaries. The issue of certification, crucial for the success of this scheme, has not been resolved however, which implies that a lot of fine-tuning and internal agreement is still needed.

## **6. Concluding Remarks**

The Colombian experience with labor market reform during the 1990s provides some important lessons. First and foremost, difficult policy changes such as the ones within the labor market usually take a long time and can hardly be carried out rapidly. This is true for the design, approval and implementation processes. When the issues that motivate the reform arise, there is a period of awareness and “digestion”, which involves diagnosis and actually coming up with sensible reform proposals. Then, there comes a process of consensus building with a very diverse set of groups which, as noted in the text, is key to be carried out before going for legislative approval. This process starts, many times, by building an agreement within the government, a task often neglected or taken for granted, but which may entail crucial delays or even the abortion of the whole process, be it in the design, negotiation or implementation stage. Then, the process involves other key groups within civil society, in which the phase in the “government life cycle” is critical for the actual likelihood of success. Indeed, the first year momentum of any government, when societies accept almost anything the new government presents should not be missed. Finally, the formal process of legislative approval reflects the basic equilibrium between the political forces.

The key point is that these long and complicated processes require inevitably the endurance and the conviction of a large group of individuals (large because usually the turnover is high) that keep pushing the key messages and policy changes, even if the political landscape changes dramatically during the period. To put it in the terms of the paper, the reform effort (the whole “deal”) is composed by a series of “sub-deals” that end up ensuring success at the end. It is critical that the team’s diagnosis and motivation remains through all the steps, which will comprise a series of failed and successful deals.

Second, in Colombian seems to be important the fact that the group in charge of the design, approval and implementation of the reform was basically the same and fairly homogeneous technically and politically. In fact, it was very similar in both

reformist episodes, 1990 and 2002. This assures, among other things, that what is implemented is what actually the reformer had in mind. The absence of this “in paper simple” principle has been an important determinant of the failure or important complication or delay in the implementation of other reforms in Colombia.

Third, within a complicated and politically laden reform, such as the labor one, there was a quite tricky issue: the parafiscal tax system. Strong players and stakeholders who derive substantial rents from the status quo become active against the whole reform process. The approach of the “lawyers” in 1999 was to avoid this type of confrontation due to the conviction that no gain will be reached and probably considerable pain would be inflicted. From the point of view of the economists, Real-politik indicated that it was better to comply with this strategy, and avoid the risk of jeopardizing success for the entire reform effort.

Finally, in relation to the debate with the groups of interest, the problem of diagnosis and of the “right model” is deep and has received little attention. Economic models and empirical evidence are seldom the basis of analysis for interest groups. Often, they successfully stigmatize the reforms as the culprit for unemployment and workers’ income reduction. Selling a better story proves quite hard for a technical staff barely experienced in the rhetoric used in those battlefields. In contrast, union leaders have made their careers fiercely fighting in that milieu. Also, public officials or private managers of the labor market institutions that benefit from the status quo, command substantial financial resources to counter the reforming agenda. Politically and financially it is understandable that Congress’ reaction is normally cold, to say the least, towards these type of initiatives. That is why the two reforms presented in this paper have been approved during the first year of two administrations that threatened congress with general impeachment: the Gaviria and Uribe ones. The Pastrana administration fought for it, but did not succeed because, understandably, it was not a priority during its first year in office.

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