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Reforming Labor Law
Lessons from Colombia

This Best Practice was adapted from " How to Reform Case Study: Employing Workers—Colombia," prepared by Booz Allen Hamilton in cooperation with USAID for the World Bank Group's 2007 Doing Business Reformers Club Conference.

Executive Summary:

President Uribe capitalized the on the combination of two factors—his high approval ratings upon taking office and a slumping economy—to get a controversial labor reform passed by Congress. Unemployment decreased, but opponents remain unconvinced that this was due to the reforms.

Introduction

When Álvaro Uribe took over the presidency in 2002, Colombia faced a common problem. Labor regulations designed to protect workers resulted in inflexibilities in the labor market that led to high unemployment. As the economy slumped, job creation and, therefore, labor reform became a priority. Uribe took advantage of his post-election honeymoon period to get a new labor law passed by Congress that both increased flexibility in the labor market and established greater social protections.

Employment did increase substantially, but critics contend that this was the result of economic recovery rather than the reforms. Some feel that the president oversold the effects of the reform in order to get the bill passed by Congress and that this threatens the sustainability of the reform.

Context

The business climate demanded more flexible labor laws. By the end of the 1990s, Colombia faced growing unemployment, a fiscal crisis, and low GDP growth. There was agreement among many in the business community that labor reform could help increase the production of goods and services.

Businesses requested more hiring flexibility and a reduction in the special welfare taxes (parafiscales) they had to pay. Store owners needed more flexible workday regulations since the majority of their sales took place on the weekends and at the end of the year. The service sector required more flexibility given that the majority of its business was conducted outside of normal business hours. Finally, the industrial sector was especially interested in labor reform after the U.S. adoption of the Andean Trade Preferences and Drug Eradication Act (ATPDEA) in 2002. The textile industry in particular required increased workdays to take full advantage of the opportunities presented by the ATPDEA.

Reforms were often began but went unfinished. In 1990 President César Gaviria began an ambitious economic liberalization program (apertura). This effort included a labor reform called Law 50, which was sponsored in the Senate by future President Álvaro Uribe. The law liberalized hiring and firing regulations, including reducing severance payments, broadening the definition of "just" dismissals, and extending the use of temporary contracts. In the short term (1990–1994), the law had a positive effect, and unemployment dropped from 12 percent to less than 8 percent. Despite these benefits there was still much that needed to be done to modernize the labor market.

In 1999 President Andrés Pastrana's administration attempted to pass a labor reform that included reducing and increasing flexibility of

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nonwage costs, introducing mechanisms to make wages more flexible, and providing a wider variety of hiring mechanisms. Unfortunately, the timing was poor. The Pastrana government faced low approval ratings, a sagging economy, and a stalled peace process; it consequently lacked the political capital to push through the reform. There was also opposition within the administration. The Minister of Labor and Health refused to sign any labor bill presented to the Congress by the government. In an effort to go around the intransigent minister, the administration attempted to work congressmen who were willing to sponsor the bill, but that effort was swiftly defeated.

"If we don't take action, the unemployment rate could reach 25 percent."

–Minister of Labor and Health Juan Luis Londoño in one of President Uribe's first ministerial meetings

Uribe began his presidency committed to reform. In 2002, Álvaro Uribe was elected president. Unlike his predecessor, he had extremely high approval ratings and a significant amount of political capital. President Uribe and his team were convinced of the need to pass a labor reform bill. Their thinking was informed by the work of the Pastrana administration, studies by the World Bank and the IMF, and discussions with the private sector. Shortly after Uribe took office, members of his administration met with representatives of the private sector, including the owner of a large textile factory in Medellín. The textile factory owner told the officials that if labor costs were not lowered, he would be forced to leave Colombia and relocate to Costa Rica. This anecdote made an impression on the government officials, and combined with the mounting statistical evidence on the need for reform, the president was convinced that the situation required action.

Rising unemployment heightened urgency of the reform. At the end of the 1990s, Colombia faced its worst economic crisis since the 1930s with rising unemployment rates and contracting growth. In 1999 the country's economy shrunk 4.3 percent. By September 2000 the urban unemployment rate had reached 20.5 percent. Despite the record unemployment levels, wages continued to rise, with the real minimum wage increasing by 7 percent. The problem was both cyclical and structural. From 1998 to 2002, 600,000 new people entered the workforce per year. Yet over that period the economy only produced 470,000 new jobs.

The fundamental problem policy makers had to tackle was how to reduce unemployment when faced with inflexible wages and high nonwage costs. When the economy slowed down at the end of the 1990s, the formal sector responded by reducing workers. Informal employment grew as wages in that sector adjusted downward. Particularly vulnerable segments of the workforce were the most adversely affected. In 2001, the unemployment rate among youth between the ages of 18 and 22 reached 30 percent. The government was concerned that if this continued, there could be an explosion of crime.

Approach

From the outset, President Uribe was actively engaged in the reform effort. He had a natural interest in the bill, given his sponsorship of Law 50 as a senator in 1990. Unlike his predecessor, Uribe also wanted to include "social protection" clauses. Uribe was influenced by his principal advisor on labor reform, Juan Luis Londoño. Londoño was convinced that the country required a social protection system, including improved education and health care for workers. Better trained and educated workers would help Colombian companies be more competitive internationally.

Not everyone agreed that there was a need for reform, or at least the type of reform the government was proposing. One of the major workers' unions, the Central Unitaria de Trabajadores de Colombia (CUT), claimed that the problem was the recession, and had nothing to do with the labor code. Even some private sector leaders resisted the change. Nicanor Restrepo, the head of the Grupo Empresarial Antioqueño, one of the most powerful conglomerates in the country, argued that the poorest workers should not have their wages cut. Other members of the business community felt that the labor reform would not create new jobs, only lower wages.

Despite President Uribe's high approval ratings, getting the bill passed by Congress was not a simple endeavor. Uribe had been elected president as an independent, and his coalition in Congress comprised a variety of parties with differing interests. The government used a document produced by the National Planning Department to sway members of Congress. The report stated that if the costs associated with firing workers, work on holidays and Sundays, and the parafiscales were reduced in accordance with the proposed bill, a total of 310,145 new jobs would be created between 2003 and 2006. If the bill were approved in its entirety with resources directed towards training and educational programs, the impact of the reform would be the creation of 1,629,978 new jobs.

Although many congressmen found this to be a persuasive argument, the government had to agree to conduct a thorough evaluation of the effects of the law after two years. If the evaluation determined that the law did not create new jobs, the government would be obligated to present a bill to Congress to modify or revoke the ineffective measures.

A compromise passed. The new law has two principal elements: social protection and labor flexibility. The social protection component of the law includes:

- Employment subsidies for small and medium-sized enterprises that hire unemployed heads of household;
- Unemployment insurance; and
- The creation of a Fund for Social Protection to finance special high-priority government projects.

Key aspects of the labor flexibility component are:

- *Extended workday.* An extension of the workday from 6:00 a.m. to 6:00 p.m. before the reform to 6:00 a.m. to 10:00 p.m. The lengthened workday created two work shifts: 6:00 a.m. to 2:00 p.m. and 2:00 p.m. to 10:00 p.m.
- *Modified apprentice contracts.* The new law lowered the costs of apprentice contracts by 44 percent. Additionally, all companies with more than 15 employees are obligated to hire at least one apprentice. Employers were made exempt from paying parafiscales during the time the apprentices received training. The goal of this reform was to find new ways to hire unskilled youth and increase employment flexibility.
- *Reduction in the cost of firing workers.* Before the reform, workers with less than one-year tenure with a company were paid 45 days' severance. As a result of the reform, those who make less than 10 times the minimum wage are paid 30 days severance. Those who make more than 10 times the minimum wage are paid 20 days severance.
- *Sunday and holiday pay.* Employees who work on Sundays and holidays receive double their salary plus 75 percent of their base pay, which is a reduction from before the reform.
- *Pay for overnight work.* Employees who work between 10:00 p.m. and 6:00 a.m. receive an additional 35 percent over their regular salary, which is less than before the reform.

Results

Attributing Higher Employment to the Reform

Measuring the impact of the labor reform is difficult. Economists who have studied the subject are convinced that the reform has resulted in increased employment. Nevertheless, isolating the impact of the reform is complex since the economy has been growing steadily ever since the reform was adopted in 2002.

Since 2002 unemployment has decreased but GDP rose steadily over the same period.

The question that the government faced was whether employment growth was simply related to the rise in GDP or directly attributable to the labor reform. Some viewed the results as mixed. Alejandro Gaviria, the deputy director of the National Planning Department and a close collaborator of Londoño on the reform, wrote the most widely cited study on the new law's impact. He found that the results of the reform were mixed.

Gaviria concluded that the reform had a beneficial impact on the hiring of apprentices and lowered underemployment, especially in the service sector. Between 2002 and 2003 the number of contracts given to apprentices grew by 89 percent.

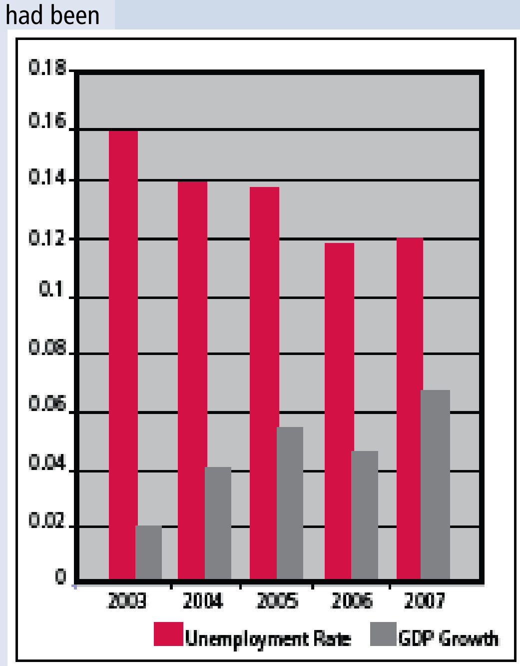
There were, however, some negative effects:

- Employment growth was less than had been expected;
- Fewer workers entered the formal economy than had been expected; and
- Programs aimed at the unemployed and generating new employment had inconclusive results.

A survey of businesses conducted by Gaviria found that only 3 percent of the 1,021 businesses surveyed identified the labor reform as a "determining factor" in employment growth. The majority of the firms attributed increased demand as the primary reason for greater employment.

"The 2002 labor reform was not passed to benefit the companies currently operating in Colombia. It was adopted so that new companies would be in a position to compete with China, South Korea, Mexico and Brazil."

–Juan Carlos Eheverry, head of the National Planning Department under President Pastrana



Some members of the service sector were negatively affected by the labor reform. Employees who work at night and on the weekends saw a significant reduction in their income. A member of the private security business noted that "people are working more hours; businesses are not hiring new workers."

A common complaint about the reform is that it has not been put to the test by a recession. Since its adoption, the Colombian economy has flourished, with the following year's GDP projected to reach over 6 percent. Critics of the reform also maintain that growth in the economy has nothing to do with the labor law, but rather everything to do with the export of raw materials.

Others Saw Success

The National Association of Businessmen (ANDI) and the Ministry of Social Protection also conducted a survey with very different conclusions from Gaviria's study. According to ANDI, 92 percent of the 191 businesses surveyed believe that the labor reform was beneficial. Fifty-three percent of the businesses also believed that employment increased as a result of the reform. According to the survey, the two most important aspects of the reform were the modification of work shifts and the lowered costs for work on Sundays. Finally, 63 percent of the respondents noted that they intended to increase the number of workers they employed as a result of the labor reform. These numbers contradict Gaviria's findings and underscore the difficulty of judging the reform's effectiveness.

Jairo Núñez, an economist involved in the reform who has studied the issues closely, also saw many positive results from the new law. He found that between 2002 and 2004 the chances of finding work in the formal sector increased by 6 percent. Furthermore, his data indicated that the amount of time that individuals remained out of work fell significantly. Núñez also found that youth and workers with relatively low levels of education benefited the most from the reform.

Another indication of the success of the reforms is related to workers who are approaching their 10-year anniversary with companies. In the past, employees were often fired just before reaching this milestone because of the exceedingly high costs associated with keeping an employee for more than 10 years. Companies would insist that employees approaching their 10-year anniversary go on a break so that they could later be rehired at a lower cost. The new law addressed this issue, and now employees are staying with companies for more than 10 years in greater numbers than in the past.

There is a widely held view that the labor reform has helped Colombian companies become more competitive internationally. Juan Carlos Echeverry, head of the National Planning Department under Pastrana, put it best: "The 2002 labor reform was not passed to benefit the companies currently operating in Colombia. It was adopted so that new companies would be in a position to compete with China, South Korea, Mexico, and Brazil." This is not, however, a consensus opinion. Núñez argued that Colombian wages and wage costs are still far too high to compete with China and other Asian countries.

Conclusions

Reforms of this nature often happen when there is a crisis. The 1999 economic recession paved the way for the labor reform in 2002. A strong executive is advantageous for success as well. Uribe had the political capital to ensure that the labor reform was passed by Congress. Less than five months elapsed between President Uribe taking office and the labor reform being passed by Congress. The speed with which the reform went through ensured that the costs of the reform were low, and underscored the urgency felt by the government.

One of the conditions Congress placed on the bill was a thorough review after two years. If the assessment determined that the reform had not created new jobs, the law would be revoked. This was an eminently political solution to a complex economic issue. In hindsight, it is clear that two years was not enough time for the reform to have real, quantifiable results. Many members of Congress are displeased that the government did not take the two-year analysis more seriously.

There was also backlash against the reform because many believe that it has not delivered what was promised. The government clearly oversold the effects of the reform as a strategy to get it passed by Congress. It is likely that discussions on the reform will be reopened in the upcoming sessions of Congress, especially since the new Minister of the Treasury, Oscar Ivan Zuluaga, was the bill's sponsor in the Senate.

About BizCLIR:

BizCLIR, or the Business Climate Legal & Institutional Reform Project, is a multi-year initiative of the United States Agency for International Development with the goal of improving the efficiency and impact of assistance programs intended to help developing countries improve their business enabling environments. This series, Best Practices for the Business Environment, represents one of many knowledge management components of the BizCLIR project. The goal of the series is to highlight the known best practices, case studies, lessons learned, and in some cases worst practices, so that the lessons can benefit other practitioners in the field. All issues are available at www.bizclir.com.