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Working papers economics - Tax reforms and the labor market in an emerging market economy

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AUTHORS AND/OR EDITORS Granda-Carvajal, Catalina Morales-Piñero, Jesús
What were the effects of the 2012 tax reform on Colombia's labor market? This article shows that reducing taxes associated with labor hiring increased formal employment, reduced informality, and lowered the unemployment rate. These findings provide valuable input for the design of public policies in Colombia and other countries facing high levels of informality and elevated hiring costs.

Publication Date: Wednesday, 23 of September 2026 **Approach**
This study examines the effects of the 2012 tax reform in Colombia, specifically the reduction of taxes associated with the formal hiring of workers (payroll taxes or non-wage labor costs). Its objective is to assess how this measure affected formal employment, informality, unemployment, and overall economic performance.

To this end, the authors develop an economic model that captures the functioning of the Colombian labor market, where formal workers, informal workers, unemployed individuals, and people outside the labor force coexist. The model is calibrated using Colombian data and is employed to simulate the effects of reducing the taxes paid by firms when hiring formal workers.

Contribution
Labor informality has historically been one of the main challenges facing Colombia's labor market. Prior to the 2012 reform, firms faced high costs associated with formal hiring, which could discourage the creation of formal jobs and encourage informality.

This paper contributes evidence on whether reducing these costs effectively helps more workers gain access to formal employment and whether such a policy benefits the economy as a whole. In contrast to many previous studies that focus only on selected labor market indicators, this paper also evaluates aggregate effects on productivity, economic growth, and public finances.

The research is particularly relevant because it provides useful insights for the design of public policies in Colombia and in other countries characterized by high levels of labor informality and elevated hiring costs.

Results
The results indicate that the 13.5 percentage-point reduction in payroll taxes generated a significant reallocation of workers from the informal sector to the formal sector. As a result:

- Formal employment increased by approximately 3.1 percentage points.
- Labor informality decreased by about 5.3 percentage points.
- The unemployment rate declined by roughly 1 percentage point.

The authors conclude that reducing the costs associated with formal hiring can be an effective tool for promoting labor formalization without increasing unemployment. They also find that a substantial share of the initial loss in tax revenues is offset by higher economic activity and the expansion of the tax base resulting from greater formalization. However, they note that complementary measures may be needed to address the fiscal challenges that could arise.

Fuente: https://d1b4gd4m8561gs.cloudfront.net/en/publications-research/working-papers-economics/tax-reforms-labor-market