

Pension Notes

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Recent proposals for improving Colombia's pension system



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Executive Summary

Colombia's pension system comprises a first non-contributory pillar focused on the poorest and financed with general taxes (Colombia Mayor); a second pillar in which a PAYGO system (RPM) and an individually funded system (RAIS) have competed since 1993; and a third voluntary savings pillar with tax incentives. One of the particularities of the system is that the Constitution states that pension amounts cannot be less than the minimum wage, so only a contributory pension is given to those who meet the required contribution term conditions (25 years in the RPM; 22 in the RAIS). Nonetheless, there is an alternative pension provided by the BEPS system (semi-contributory system), which allows those who could not retire (for not meeting the contribution time requirements), to transform their withdrawn balances (plus additional savings) into a "periodic benefit."

One of Colombia's great scourges is its highly informal labor market (the informality rate exceeds 60% of total employment), which means that many workers do not contribute to their pensions, or do so only partially. This situation is exacerbated by low wages, which makes the self-financed pension insufficient. Hence, reality shows that only 1 in 3 workers contribute to their pension, and therefore achieve a low level of contributions and low pension coverage at the end of their working lives. This situation is further exacerbated by the fact that the minimum contribution must be made on the minimum wage, and 50% of workers earn less than that amount, entailing an excessive effort to make the contribution.

In the case of Colombia, labor market reality means that almost 3 out of 4 workers do not manage to retire in any regime (because they do not meet the minimum years of contribution requirement to access a pension). Among those that receive a pension (1 in 4), 60% meet the requirement of 22 years of contributions to receive the assistance of a common solidarity fund

(Minimum Pension Guarantee Fund, FGPM), which enables them to finance a pension equal to one minimum wage. Furthermore, 1 in 4 workers receive assistance from Colombia Mayor, whereas the remaining three do not receive any kind of assistance. Enrollment in the semi-contributory BEPS system, on the other hand, is relatively low. All of this means that about half of the elderly population is unprotected in old age.

A peculiarity of the Colombian pension system is that there is a structural issue in the contributory component, since the public administrator of the RPM (Colpensiones) and the private fund managers of the RAIS (the private pension funds, AFPs) compete under unequal conditions: whereas in the public PAYGO system pensions are determined by the number of years of contributions and the basic taxable salary of the last ten years, in the private sector they are determined by the number of years of contributions and/or the paid-in capital. The most worrying aspect of this unequal competition is that the public system is State-subsidized, with an extremely high budgetary burden that especially finances the pensions of the richest segments of the population, thus being highly regressive. Furthermore, when people fail to meet the RPM's pension requirements, even though the paid-in contributions are refunded, the value of money over time is not recognized (as it is in the RAIS), constituting a *de facto* implicit tax, which aggravates the regression.

Hence, one of the reforms proposed for the Colombian system is to eliminate inequalities between the pensions provided by the RAIS and the RPM. To this end, the RPM would gradually transition to a notional accounts system, eliminating subsidies to high incomes and recognizing interest on returns, thus providing higher pensions in the semi-contributory BEPS pillar. Although this proposal would improve the fairness and sustainability of the defined benefit system, pensions would continue to be financed

by the PAYGO system, which would make it financially unsustainable due to population ageing. We believe that instead of switching to a notional accounts system, a better long-term solution, as pointed out by the Colombian Association of Pension and Unemployment Fund Managers (ASOFONDOS), would be to switch to an entirely individually funded savings system, with a public AFP that competes on equal terms with private AFPs.

In addition to the above, there are three types of proposals for improving Colombia's pension system,¹ which we believe go in the right direction:

1. Expand pension coverage through the establishment and/or improvement of non-contributory pension programs

One of the proposals is that anyone who never had a formal job would receive a transfer from Colombia Mayor of about USD 108 per month, whereas those who contributed at some point, but did not manage to retire (thus being entitled only to a contributions refund), would receive a transfer complemented by the pension of the BEPS scheme. This design would mean that, the greater the savings in the BEPS, the lower the pension of the non-contributory program, concentrating government subsidies in the sectors

with the least savings capacity. An alternative proposal would be to establish a universal non-contributory benefit of about USD 132 for all those over the age of 65 who do not receive a pension from the existing mandatory system.

In this regard, it is essential that the proposed non-contributory pillar be financed with general taxes and not with taxes on work, since they encourage informality.

2. Ensure the sustainability of the pension system by automatically updating the retirement age in line with life expectancy increases.

It has been proposed to increase the minimum retirement age (from the current 62 to 65 for men; and from the current 57 to 60 for women), and then incorporate automatic adjustment rules on this parameter.

3. Maintain the voluntary pension savings system

In Colombia, the third voluntary savings pillar would be maintained with its existing tax incentives. This is in line with the international trend.

¹ These are proposals put forward by the Foundation for

Higher Education and Development (Fedesarrollo) and Universidad de los Andes.

I. Introduction

Given the challenges the Colombian pension system is currently facing, this Pension Note analyzes the proposals for improvement put forward by several institutions. The opinions of the Foundation for Higher Education and Development (Fedesarrollo), and Universidad de

los Andes have been especially considered. Next, the characteristics of the Colombian pension system, its problems and the proposals for improvement put forward, are analyzed, commenting on their relevance in each case.

II. Proposals for the improvement of the Colombian pension system

1. *Characteristics of the pension system*

As shown in Table 1, Colombia's pension system comprises a first means-tested non-contributory pillar; a second pillar in which a PAYGO system (RPM) and an individually funded system (RAIS) compete; and a third voluntary savings pillar with tax incentives. The official retirement age for accessing an old-age pension is 62 for men and 57 for women.

Article 48 of the Political Constitution of Colombia states that pension amounts cannot be less than the legal monthly minimum wage in force, so a contributory pension will only be given to those who meet the requirements of the system they

enrolled in (in terms of the required number of years of contribution).

Nonetheless, there is an alternative pension provided by the BEPS system (semi-contributory system), which allows those who could not retire (for not meeting the contribution time requirements), to transform their withdrawn balances (plus additional savings) into a "periodic benefit."

The Colombian system ranks 25th according to the Mercer CFA 2021 index ranking.

Table 1



The Colombian pension system

First pillar: Non-contributory public system, which includes the Social Protection Program for the Elderly or "Colombia Mayor." This program provides a pension of 80,000 Colombian pesos per month (USD 21.1) to people highly exposed to poverty.

Second pillar: Mixed competitive system, operational since 1993. People can choose between:

- **Average premium Plan (RPM)**, a public defined-benefit PAYGO system, managed by Colpensiones. Members contribute 16% of their salary to the system (13% to the common fund and 3% in commissions). Requirement for accessing a pension: 1,300 weeks (25 years) of contributions. The taxable base salary considered for calculating the pension is the average salary of the last ten years. Should an individual fail to access a pension, a "substitute compensation" is provided, corresponding to the contributions adjusted for inflation.
- **Individual savings system with solidarity (RAIS)**, a private individual savings system, managed by the AFPs. Members contribute 16% of their salary to the system (11.5% to the individually funded account; 3% to payment of disability and survival insurance and commissions; and 1.5% to the Minimum Pension Guarantee Fund, FGPM). Requirement for accessing a pension: 1,150 weeks (22 years) of contributions, or sufficient accumulated capital to obtain a pension higher than the minimum wage. Should an individual fail to comply with the 1,150 weeks of contributions requirement, a refund of balances, for an amount including inflation and returns, is provided. If the individual meets the 1,150 weeks of contributions requirement, but the contributions do not suffice for financing a minimum wage pension, a pension equal to the minimum wage is guaranteed, financed with the solidarity contributions of all RAIS members through the FGPM.

Semi-contributory pillar: Colpensiones offers periodic economic benefits (BEPS), independent of the general pension system, to those who do not meet the retirement requirements. This enables adding the balances saved in the pension system to those of the BEPS voluntary savings account, to provide a monthly income below the minimum wage. The government offers a 20% savings subsidy for this program.

Third pillar: Voluntary savings with tax benefits.

2. Basic problems of the system

Universidad de los Andes and Fedesarrollo agree on the following issues:

(i) Low coverage

The system has very low pension coverage, which is due to the high informality rate (around 62% of total employment according to the World Bank²). Only one in three Colombian workers contribute to their pension, so very few people achieve the minimum number of years of contributions required for a pension (25 years in the RPM; 22 years in the RAIS). Thus, today the majority of workers (almost three out of four) who contributed to the system do not manage to retire in any regime and end up receiving a refund of their contributions.³ I.e., only 1 in 4 workers receives a contributory pension. Of the population that receives a pension, 60% meet the requirement of 22 years of contributions, but do not accumulate a sufficient balance to enable them to finance a pension equal to the minimum wage, which is why they receive assistance from the Minimum Pension Guarantee Fund (FGPM), allowing them to access a pension of that level (thanks to the solidarity contributions of all RAIS members).

With respect to the coverage of the other social security programs, the non-contributory system (Colombia Mayor), on the other hand, only covers about 1.6 million people (about 25% of the elderly) and provides subsidies of COP 80 thousand (approx. USD 21) per month, an insufficient amount if compared with the extreme poverty line (COP 145 thousand per month, approx. USD 38). Furthermore, not many people use the BEPS (semi-contributory pillar), since

when they reach the minimum retirement age, they prefer a lump sum payment for the value of the contributions rather than a BEPS life annuity (reflecting a bias for present consumption).⁴

In summary, the current situation is that only one in four senior citizens receives a contributory pension; another one receives COP 80,000 per month from Colombia Mayor, and the remaining two receive no income at all. This means that about half of the elderly population must manage the economic risks they face on their own, to maintain their standard of living. Thus, the pension system does not fulfill its main task, which is to guarantee an income to the population beyond working age.

(ii) The system is regressive and runs at a loss (benefiting relatively higher income people proportionately more)

Although the system pays pensions to few people, much of the fiscal budget is allocated to the payment of pensions. Public expenditure on pensions accounts for about 4% of GDP per year. That deficit is financed by all, but it is used for financing the pensions of a few: in 2020, for each peso that the budget allocated to Colombia Mayor, 9.5 pesos were allocated for a Colpensiones pensioner and 30 pesos to a Public Pension Funds pensioner.⁵ According to Universidad de los Andes, Colombia ranks last in spending on assistance to the most vulnerable senior citizens in the continent (less than 0.2% of GDP).

(iii) The design of the system entails high inequities in the mandatory system

disability, replacement or survival pensions which were formerly paid by the National Social Security Fund, or the insolvent funds of the National public sector, as well as the ministries, administrative departments, public establishments, government industrial and commercial enterprises, and the other official agencies that the National Government determines are responsible for the direct payment of pensions with government contributions.

² <https://www.worldbank.org/en/research/brief/informal-economy-database>

³ In the RAIS, the refund is paid with interest; in the RPM, on the other hand, the refund does not consider capitalization interests.

⁴ According to Macroeconomic Note No. 35, Universidad de los Andes.

⁵ The National Public Pension Fund now pays the old-age,

This happens because two workers with similar work backgrounds are treated differently, depending on whether they were enrolled in the RAIS or the RPM.

On the one hand, those who meet the retirement requirements obtain more subsidies in the public system, which implies a subsidy (understood as the difference between what they receive and what they contributed) to the richest among those enrolled in the RPM, which increases with the level of income.⁶ That is to say, RAIS pensioners who receive a pension above the minimum obtain substantially lower pensions than they would

receive if they retired in the RPM. In other words, in Colombia, subsidies to the public system contribute to increasing inequality.

On the other hand, as already noted, people who contributed to the system but fail to retire, have their contributions refunded. In the RAIS non-pensioners receive these contributions with accumulated interest, whereas in the RPM they receive the value of their contributions without interest.⁷, which means that non-pensioners of the RPM receive up to 7 times less than non-pensioners of the RAIS.

3. Reform proposals

The following stand out among Universidad de los Andes' proposals:

(i) Improve the economic protection of non-pensioners by creating a mandatory semi-contributory pillar that incorporates the Colombia Mayor and BEPS programs

It is proposed to expand social assistance to the vulnerable population, combining the transfer scheme for those without pension savings (Colombia Mayor) with a partial subsidy scheme for those entitled to a contribution refund (BEPS). Thus, if an older adult never had a formal job, he would receive a transfer from Colombia Mayor, whereas for those who contributed to the system at some point, but failed to obtain a pension, this transfer would be complemented by a BEPS life annuity financed with their pension savings, plus the BEPS subsidies granted by the government (20% of the amount allocated to BEPS).

⁶ By way of example, according to the Ministry of Labor, a person with an income of two minimum wages receives a subsidy (understood as the difference between what he receives and what he contributed) of COP 80 million; and a person with an income of ten minimum wages receives more than COP 400 million.

The transfer to those without pension savings (Colombia Mayor) would amount to COP 412 thousand (USD 108) per month, complemented by the BEPS for those who have pension savings. For each peso that an individual has in the BEPS, the transfer from Colombia Mayor would be reduced by 50 cents, until the maximum amount that the BEPS can pay (currently COP 850 thousand [USD 224]) is reached. This would enable: (i) the total benefit that people receive (Colombia Mayor + BEPS) to grow in accordance with their savings; (ii) state subsidies would be lower for those with greater savings capacity; and (iii) the total pension would not be greater than the contributory pension.

(ii) Eliminate inequalities between the pensions provided by the RAIS and the RPM

To this end, it is proposed that the RPM should gradually move towards a notional accounts system.⁸, eliminating subsidies to high incomes

⁷ This compensation in the RPM implies an 'expropriation' of the implicit interests accrued for workers who do not meet the required number of weeks of contribution, which tend to belong to the poorest sector of the population.

⁸ The notional accounts system is a PAYGO funded system, which includes a change in the design of the payment of

and recognizing interest on returns, providing higher pensions in the semi-contributory pillar. Thus, according to the institution, a more sustainable and equitable PAYGO system would be obtained.

(iii) Ensure the long-term sustainability of the pension system

To this end, it is proposed to increase the minimum retirement age (from 62 to 65 in men; and from 57 to 60 in women), and then incorporate automatic adjustment rules on this parameter.

On the other hand, Fedesarrollo's proposals⁹ are:

(i) Establish a free, universal coverage defined-benefits first pillar. This non-contributory benefit would provide COP 500 thousand (USD 132) to all individuals over the age of 65 who do not receive

a pension from the existing mandatory system, or who will not receive it in the future, in accordance with a transitional rule (for example, 10 years).

(ii) A second individual savings contributory pillar. Existing private funds, Colpensiones, and other duly regulated savings mechanisms would be part of this pillar. Hence, there would be more competition. The existing contribution rates would be maintained, but the contribution to the FGPM would be eliminated, so that 13 percentage points of the 16 would be paid into the contributor's account.

Colpensiones would migrate to a notional accounts model.

(iii) A third voluntary individual savings pillar, maintaining incentives for voluntary savings for old age up to a limit defined in tax units.

pensions, since it informs members of a fictitious account that serves as a guide for calculating their pensions. This design enables incorporating automatic periodic adjustments, which gives it an advantage over traditional PAYGO systems. To

review the Analysis and international experience on notional accounts prepared by FIAP review [Pension Notes 52](#).

⁹ Source: <https://quehacer.fedesarrollo.org.co/pensiones>

IV. Conclusions

Given the difficulty of increasing coverage in the short term, FIAP has proposed that¹⁰, well-designed and means-tested non-contributory pension programs must be strengthened. Hence, proposal 1 of Universidad de los Andes, and proposal 1 of Fedesarrollo go in the right direction since the proposed pension amounts are above the poverty line.

Universidad de los Andes' Proposal 2 for equalizing the conditions between the RAIS and RPM contributory systems, would improve the equity of the system and enable focusing subsidies on the poorest people, so it is also positive. However, the proposal of both institutions to transform the RPM into a notional accounts system, deserves an additional comment: although the design of a notional accounts system improves the sustainability of the defined-benefits system, these are still PAYGO financed, so that the same deficiencies remain compared to the individually funded systems in terms of pension payments, mainly consisting in their financial unsustainability and the lower returns obtained.¹¹ A better long-term solution would be to gradually move towards a full individually funded system, understanding that notional accounts may be an

intermediate option if the fiscal means for financing the transition do not yet exist.

Thus, an alternative to Fedesarrollo's proposal is that of the Colombian Association of Pension and Unemployment Fund Managers (ASOFONDOS), which consists in switching everything to individual funding, with a public AFP that competes on equal terms with private AFPs. This implies reducing the number of weeks of contribution requirement for accessing a pension, from 1,300 to 1,150 weeks, for those who are currently enrolled in the RPM.

Universidad de los Andes's Proposal 3 to increase the retirement age is both pertinent and necessary. Countries around the world are adjusting their parameters due to population aging, and Colombia has one of the lowest retirement ages in Latin America.

Fedesarrollo's proposal 3 is adequate; voluntary savings are increasingly important in the world, especially in countries with PAYGO systems. Other options for increasing voluntary savings, applied worldwide, are: grant greater liquidity to voluntary savings, strengthen employers' contributions (*matching contribution*) and the implementation of automatic enrollment plans.

¹⁰ You can review FIAP's proposals for improving pension systems in [Pension Notes 63](#).

¹¹ The advantages of the individual savings system over the

PAYGO system are discussed at length in the Document ["Reversals."](#)