

Mandatory Severance Pay

Martin Rama

(Development Research Group)

Based on joint work with

Donna MacIsaac

What is mandatory severance pay?

- Obligation for the employer to compensate a worker who loses his or her job.
- No obligation in case of misconduct or when job loss is the workers' fault.
- Amount of compensation usually based on salary and years of service.
- Other usual features: minimum service and maximum compensation.

Not the same as mandated job security

- Some countries restrict the ability of employers to layoff workers.
- An administrative authorization might be required, especially for mass layoffs.
- The amount of compensation to be paid is discretionary and often unpredictable.
- The delays involved can be substantial.

How different is severance pay from other income support programs?

	Period														
Program	-...	-1	0	1	2	...	F	F+1	...	D	D+1	...	R	R+1	...
Public works	0	0	0	W	W	W	0	0	0	0	0	0	?	?	?
Training for the unemployed	0	0	0	A	A	A	0	0	0	0	0	0	?	?	?
Mandatory severance pay	0	0	S	0	0	0	0	0	0	0	0	0	?	?	?
Unemployment insurance	-C	-C	?	B	B	B	B?	B?	B?	B?	0	0	P	P	P
Individual savings accounts	-C	-C	+C	+C	+C	+C	0	0	0	0	0	0	P+C	P+C	P+C

Explanation of the previous chart

TIMING OF EVENTS

0: the worker loses his or her job

F: he or she takes a new job;

D: maximum duration of benefits (can happen before or after F)

R: retirement age.

PAYMENTS OR TRANSFERS

W: salary paid by the public works program

S: amount of severance pay received by the worker

A: training allowance

-C: contribution by worker and employer to a program

+C: contribution-defined income transfer

P: old-age pension (P? indicates that enrollment with social security is not necessary to participate in the program)

B: unemployment benefits (B? indicates that no benefit may be received)

Potential advantages of mandatory severance pay

- No need for workers to be enrolled with social security or make contributions
- No need to monitor whether a separated worker is actually unemployed and searching for a job
- Complaint-driven compliance
- No burden on taxpayers
- No incentive for separated workers to remain unemployed to collect benefits

Potential problems with mandatory severance pay

- High separation costs could block adjustments, eventually leading to larger job losses
- High separation costs in bad times could dissuade firms from hiring in good times
- Compensation may be excessive for workers who finds jobs quickly, and insufficient for others
- Administrative burden to determine whether dismissals are justified or not

What do we know about actual effects?

- The theoretical literature reports different effects depending on the model used
- The empirical literature is mainly based on cross-country data (not highly reliable)
- This presentation is based on individual data from a panel household survey in Peru
- The analysis was done jointly with Donna MacIsaac

The severance pay formula in Peru

Date	Regulation	Severance pay formula (W = monthly wage and T = years of service)	Household survey
June 1986	L. 24514	0 if $T < 0.4$ $3 \times W$ if $0.4 \leq T < 1$ $6 \times W$ if $1 \leq T < 3$ $12 \times W$ if $3 \leq T$	
October 1991			Yes
November 1991	D.L. 728	0 if $T < 1$ $3 \times W$ if $1 \leq T < 3$ $T \times W$ if $3 \leq T < 12$ $12 \times W$ if $12 \leq T$	
April 1994			Yes
July 1995	L. 26513	$T \times W$ if $T < 12$ 12 if $12 \leq T$	
November 1996	D.L. 855	$1.5 \times T \times W$ if $T < 8$ 12 if $8 \leq T$	
September 1997			Yes

Coverage among workers

Legal requisites for coverage:

- Salaried worker
- Minimum seniority

Indicators of actual coverage:

- Written contract
- Social security enrollment
- Trade union in enterprise
- Large firm

(Maximum score = legal entitlement + 4 indicators)

Rounds of the household survey

Best: 1994

- Sample representative at the national level
- All effective coverage indicators available

Next: 1997

- Sample representative at the national level
- Unionization indicator not available

Worst: 1991

- Sample not representative of all the country
- Contract and size indicators not available
- Severance pay may be from public sector
- Mandatory job security still in force

Coverage in Peru, in 1994

Coverage indicator in current job		Consumption quintile (based on entire population)					
		1	2	3	4	5	All
Legal	No	84.88	83.99	80.24	73.49	70.95	78.85
	Yes	15.12	16.01	19.76	26.51	29.05	21.15
Contract	No	99.50	99.39	96.98	94.08	89.86	96.04
	Yes	0.50	0.61	3.02	5.92	10.14	3.96
Social security	No	99.44	97.41	94.59	89.42	83.85	93.08
	Yes	0.56	2.59	5.41	10.58	16.15	6.92
Trade union	No	99.75	99.11	98.71	97.43	95.61	98.16
	Yes	0.25	0.89	1.29	2.57	4.39	1.84
Large firm	No	99.25	98.43	95.43	92.21	88.58	94.87
	Yes	0.75	1.57	4.57	7.79	11.42	5.13
Private sector workers		21.30	19.45	20.59	19.04	19.61	100.00
Wage earners	No	55.26	42.85	36.23	27.49	23.45	37.40
	Yes	44.74	57.15	63.77	72.51	76.55	62.60

Coverage in Peru: Main findings

- One in five private sector workers (one in three wage earners) is legally entitled to severance pay
- One in ten private sector workers has at least one attribute that makes compliance likely
- Legal coverage is correlated with wealth, because the salaried relationship is correlated with wealth
- But indicators of actual coverage are correlated with wealth even among wage earners

A comparison with other programs (Based on legal entitlement)

Program and country	Workers legally covered by the program	Actual beneficiaries in % of unemployed	% of actual beneficiaries in each population group, from poorest to richest				
			Poorest	2 nd poorest	Middle	2 nd richest	Richest
Public works in Argentina	In principle all	7.5	78.6	15.3	3.5	2.1	0.4
Training in Mexico	Eligible on age, education	29.4	69.9	15.5	8.1	5.0	1.5
Severance pay in Peru	21.2 % of all private sector	3.6	4.7	9.5	28.6	33.3	23.8
Unemployment insurance in Brazil	39.6 % of urban workers	11.8	10.6	24.6	19.1	25.1	13.6
Individual accounts in Colombia	47.2 % of urban workers	Unknown	0.0	4.3	Not applicable	19.1	76.6

Who “pays” for the program?

- If wages were identical for eligible and non-eligible workers, the burden would fall on employers
- But workers could “pay” for their coverage through lower wages
- Or they could take advantage of separation costs to bargain for even higher wages
- Assessing the impact of coverage on wages is difficult because of self-selection bias (e.g. only the “best” workers reach the minimum seniority)

How to address the self-selection bias?

Household fixed effects:

- Compares covered and non-covered workers in the same household, in 1994, assuming they are equally “good”
- Problem: cannot be used for consumption

Individual fixed effects:

- Compares the same worker in 1994 and 1997, looking at moves in and out of covered jobs
- Problem: some coverage indicators not available in 1997

Impact of coverage on wages

- Hourly wages of covered workers are 10% lower than those of non-covered workers
- Monthly wages are 10% higher, because coverage is more prevalent among full-time workers
- These results are based on household fixed effects and “control” for other individual characteristics of workers (e.g. age, education, etc.)

Impact of coverage on consumption

- Consumption among those who lose their jobs and do not get severance pay falls by 15%
- Consumption among those who do get severance pay increases by 10%
- These results are based on individual fixed effects, and “control” for other household characteristics (e.g. access to credit)

Conclusions

- Mandatory severance pay reaches a considerable fraction of wage earners in Peru
- Legal coverage is more prevalent among the richest half of the population
- Actual coverage is even more skewed towards relatively better-off workers
- Workers may pay for their coverage through lower wages, reducing the burden on employers
- But the Peruvian severance pay formula is too generous, as it leads to an increase in consumption