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Inside severance pay

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ABSTRACT

All OECD countries have either legally mandated severance pay or compensations imposed by industry-level bargaining in case of employer initiated job separations. The paper shows that mandatory severance is optimal in presence of wage deferrals induced by workers' moral hazard. We also establish a link between optimal severance and efficiency of the legal system and characterize the effects of shifting the burden of proof from the employer to the worker. Quantitatively, the welfare effects of suboptimal severance payments vary in general equilibrium between 1 and 3 %. The model accounts also for two neglected features of the legislation. The first is the discretion of judges in declaring the nature, economic vs. disciplinary, of the layoff. The second feature regards the relationship between severance and tenure. Our theory gives necessary conditions under which optimal severance is increasing with tenure, as generally observed.

1. Introduction

Most OECD countries have legally mandated severance pay in case of employer initiated job separations. When rules are not specified by the law, it is collective bargaining at the industry or national level to mandate severance to individual employers. For instance, Kodrzycki (1998) reports that 86% of workers in Massachusetts are covered by a severance pay agreement, involving one week's wage per year of service. Such employer-employee transfers are the most important component of individual dismissal costs[2] . The average compensation for unfair dismissals is about two years of pay in case of a worker with at least 20 years of tenure. According to Garibaldi and Violante (2005) who estimated the red tape costs of layoffs in Italy, severance pay accounts for about 2/3 of total dismissal costs. Severance pay also accounts for almost 50% per cent of the cross-country variation in the OECD index of the strictness of employment protection legislation (EPL) for regular workers, the reference measure of EPL in the literature. It is mandatory even in countries with negligible firing taxes to be paid to third parties.[3]

A fundamental difference between severance payment and firing taxes is that the latter is paid to a third party, while the former is a pure transfer. Severance pay differs from firing taxes also in that it is generally dependent of tenure. Furthermore, the amount of severance pay depends both on the nature – disciplinary vs. economic – of the dismissal, and on whether it is deemed fair or unfair by a Court ruling.

Reforms of these regulations are high on the policy agenda and have been explicitly requested by IFI (International Financial Institutions) to the so-called program countries during the Eurozone public debt crisis. Distinguished economists active in the US policy debate have been suggesting that severance should be increased at least during downturns, while several labor economists in Europe

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2 Group layoffs, that is, collective dismissals involving a discrete number of workers of the same firm, are not considered in this paper.
3 See Postel-Vinay and Turon (2013), and Boeri (1999) for a theory of severance pay as a device to buy time and avoid paying firing taxes, in presence of on-the-job search.

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have been advocating the introduction of a tenure-related security contract involving severance being gradually increasing with tenure.

We still lack a proper framework to evaluate severance pay. The extensive literature on Employment Protection Legislation fails to characterise some of the key features of mandatory severance. In particular, it does not take into account that the size of these transfers typically varies depending on the seniority of the worker, on the nature – economic or disciplinary – of the dismissal and on its legitimacy (fair or unfair), as established in a Court ruling.

The purpose of this paper is twofold. First, we provide a normative framework, aimed at extending and systematizing earlier results as to the efficiency of severance pay. Second, we model the relationship between tenure and severance, and we dig into the features of the judicial systems, notably characterizing how the efficiency of the legal system and the rules concerning the burden of proof affect the optimal design of severance. We show that mandatory severance is optimal even in the absence of risk aversion and when there are no ex-ante rents to be split between the worker and the firm, unlike in the efficiency wage literature. Therefore, the "bonding critique" does not apply. What is sufficient to make severance efficient is wage deferrals motivated by deterrence of opportunistic behavior of workers and constraints to wage renegotiations *ex-post.* We provide a formal argument of why severance should be enforced by a co-ordinating mechanism outside the single firm, which is based on the fact that adverse selection stands on the way of severance schemes introduced by individual employers. This mechanism is coherent with the static model of Levine (1991), where efficient hiring levels cannot be achieved when workers are heterogeneous and wages must satisfy a non shirking constraint à la Shapiro Stiglitz. Our model is dynamic and job destruction is properly modeled. In addition, our results hold also in general equilibrium, and we assess quantitatively the impact of removing severance pay. Under reasonable parameter values, the welfare effects of removing severance pay are between 1 and 3 %, depending on the size of the initial severance pay. Our results suggest also that severance should be increasing in the inefficiency of the legal system. We also provide necessary conditions under which the optimal severance pay is increasing with tenure. Our results are empirically relevant. Legal rules about the severance-tenure profile appear to be positively correlated with the wage-tenure profile that we estimate drawing on longitudinal data. We also find that OECD measures of efficiency of judicial systems are correlated with severance pay for individual economic and unfair dismissals in a way which is consistent with the implications of the model.

The plan of the paper is as follows. Part one reviews our contribution to the extended literature on EPL. Next, it characterizes two neglected features of EPL, the discretion of judges in setting the level of severance pay depending on whether the individual dismissal is disciplinary, economic, fair or unfair, and the tenure profile of severance pay. Part two presents the model with moral hazard of the employees, and evaluates optimal severance pay under these circumstances. It also provides a formal argument of why severance should be mandated to individual employers. Part three extends the model looking into Court rulings as to the nature of dismissals, endogenizing the probability that not investing workers get severance pay for economic dismissal and that the dismissal is considered unfair. Part four extends the results to the general equilibrium, and provides numerical simulations of the effects of different levels of severance pay on welfare and unemployment. Part five goes back to the data investigating the correlation between severance and efficiency of judicial systems, and the severance tenure profile under different regimes as to wage deferrals and involvement of Courts in layoff procedures. The final section summarizes our key results and concludes.

2. Severance pay: literature and neglected features

2.1. Our contribution to the literature

Employment protection legislation is one of the most widely investigated institutions in the labor market.[4] The theoretical literature, pioneered by Bentolila and Bertola (1990), Bertola (1990) and Lazear (1990), typically treats EPL as a firing tax to be dissipated or paid to a third party by the employer in case of a layoff. Severance pay - a transfer from the employer to the worker contingent on employer initiated separations-[5] is generally not framed in these models, as Lazear (1990) neutrality result indicates that, with wage flexibility and risk neutrality, it only affects the tenure profile of wages leaving employment, hiring and separations unaffected. When instead, wages are rigid, severance pay increases unemployment Garibaldi and Violante (2005).

Why do we need then severance pay then? There are three key rationales for severance pay according to the literature.

The first draws on moral hazard and adopts the standard setup of the efficiency wage models à la Shapiro and Stiglitz (1984). A severance paid to fired workers that did not shirk acts as a commitment device to an employment policy that does not strongly react to negative shocks. By playing this role, severance reduces labor costs. Without the severance, wages would have to be increased to deter shirking. Fella (2000) and Fella (2012) draws on this initial intuition by Saint-Paul (1995) to show that an optimal severance can be as high as to equalize wages across all possible productivity realizations. These results have been extended by Baumann (2010) to the case where even some shirkers can receive severance pay and to double moral hazard (of employers choosing over projects having different levels of risk, in addition to employees deciding as to whether to put effort). This extension builds on the work by Galdon-Sanchez and Guell (2003) who introduced the possibility that shirkers 'can get away with it' in a standard model of employment protection, but did not evaluate the efficiency properties of severance schemes. Stähler (2008) extends the idea of Galdon-Sanchez and Guell to explicitly consider judicial mistakes for disciplinary dismissal, but he also does not consider efficiency issues.

This explanation of severance is subject to the 'bonding critique' which challenges the efficiency wage literature. A cheaper deterrent to opportunistic behavior is for firms to commit to a wage schedule offering initially lower wages (even below the marginal product) and higher wages if confirmed in the firm. In other words, severance pay is not needed when there are wage deferrals allowing for wages increasing with tenure as those documented by the empirical literature estimating Mincer-type wage equations.

The second argument for severance pay rests on risk aversion. Severance pay protects workers against uninsurable labor market risk, just like unemployment benefits do. Under full insurance, Blanchard and Tirole (2008) show that severance pay has to be preferred to unemployment benefits because it internalizes the costs of layoffs. By the same token, employers could pay themselves the unemployment benefits. There is, in other words, a full substitutability between severance pay and unemployment benefits when the latter can be experience-rated.[6] When full insurance is not feasible, there is no longer full substitutability between the two institutions. There is always a role for the state in the provision of unemployment

[4] See Boeri and vanOurs (2013) for a review of this literature.

[5] Our definition of severance clearly does not encompass deferred compensation schemes, such as private pension arrangements, which are paid at retirement or at any separation, including voluntary quits.

[6] Pissarides (2001) shows in a model with risk aversion that when severance pay is optimally set, exogenous unemployment benefit does not influence equilibrium unemployment.