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# Wage-shifting effects of severance payments savings accounts in Colombia

Adriana D. Kugler*

*Department of Economics, University of Houston, 204 McElhinney Hall, Houston, TX 77204-5019, United States*
*Universitat Pompeu Fabra, Ramon Trias Fargas, 25-27, 08005, Barcelona, Spain, CEPR, CREA, and IZA*

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**Abstract**

In 1990, Colombia replaced its traditional system of severance payments with a new system of severance payments savings accounts (SPSAs). Although severance payments are often justified on the grounds that they provide insurance against earnings loss, they also increase costs for employers and distort employment decisions. The extent of these distortions depends largely on how much of the costs of severance pay can be shifted from employers to workers. One reason why the effects of severance pay may not be completely shifted is that workers may fear the firm will "take the money and run" by declaring bankruptcy. A system of SPSAs eliminates this moral hazard problem, so it should facilitate the shifting of severance payments' costs to workers in the form of lower wages. Empirical results using the Colombian National Household Surveys (NHS) indicate that the introduction of SPSAs lowered wages by between 60% and 80% of total severance payment contributions. These results are consistent with increased shifting after SPSAs were introduced.


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* Department of Economics, University of Houston, 204 McElhinney Hall, Houston, TX 77204-5019, United States. Tel.: +1 34 713 743 3832; fax: +1 34 713 743 3798.
*E-mail addresses:* adkugler@uh.edu, adriana.kugler@upf.edu.

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## 1. Introduction

In Latin America, much as in Europe, high severance payments and other dismissal costs are often blamed for labor market rigidity and high unemployment rates. On the worker side, severance payments, like unemployment insurance, probably increase reservation wages and reduce exit rates from unemployment (see, e.g., Ehrenberg and Oaxaca, 1976). On the firm side, government-mandated severance paid at the time of separation distorts incentives to hire and fire (see, e.g., Bentolila and Bertola, 1990; Hopenhayn and Rogerson, 1993), at least when such schemes cannot be undone by private transfers from workers to firms in the form of lower wages.[1] One reason why these transfers may not be fully offset is because of imperfections in capital markets that prevent complete consumption smoothing and limit the amount that workers are willing to pay upfront. Another reason is that workers may not be willing to make upfront payments because they may fear that the firm will “take the money and run” by declaring bankruptcy.

In 1990, Colombia introduced a labor market reform that transformed the traditional severance payments system in the formal sector, which required employers to pay severance at the time of separation. In particular, the reform introduced a new system of fully funded Severance Payments Savings Accounts (SPSAs) for formal workers hired after 1990. The SPSAs required employers to deposit a percentage of wages into guaranteed individual accounts available to workers in the event of job separation.

This paper asks whether the introduction of SPSAs reduced distortions in the labor market. The idea is that changing from a traditional system of severance payments to a system of SPSAs should reduce firm default and facilitate shifting of severance payments’ costs to workers in the form of lower wages. Thus, SPSAs should reduce employment distortions in the labor market by neutralizing government-mandated severance with private transfers.

The empirical analysis looks at wages of formal and informal workers (i.e., workers covered and not covered by severance payments) who were hired before and after 1990 (i.e., workers only eligible for SPSAs and workers eligible for traditional severance payments). Using data from the National Household Surveys (NHS) for 1988–1996, I find that the wages of workers covered by severance payments and eligible for SPSAs decreased by between 60% and 80% of employers’ SPSA contributions after 1990. These results suggest additional shifting after the introduction of SPSAs compared to the situation with traditional severance payments.

The rest of the paper proceeds as follows. Section 2 describes the introduction of SPSAs in Colombia. Section 3 presents empirical evidence on the effects of SPSAs on wages. Section 4 concludes.

## 2. Severance payments savings accounts in Colombia

Prior to the 1990 labor market reform, the system of severance payments in Colombia resembled the traditional system in many countries, requiring employers to pay severance at the time of separation.

[1] Lazear (1990) was the first to propose that any government-mandated severance payment could be undone by a ‘voluntary’ transfer from workers to firms. Lazear (1990) also explains why government-mandated severance payments may be hard to undo in practice.