Severance Payments and Labor Market Performance

Labor Market Core Course
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Main Messages

• Severance can affect behavior by:
  — providing stability in the employment relationship
  — reducing incentives for formal hiring
  — affecting the timing of job separations
  — inhibiting productivity-enhancing reallocations

• Enforcement as important as regulation itself

• Possible improvements/alternatives to severance
  — Many countries have unemployment insurance
What is the purpose of severance?

• Provide dismissed workers with $ to finance job search
  – Would unemployment insurance be better?

• Maintain consumption after job loss
  – Only works if severance is really paid
  – And really paid quickly

• Reduce firm incentives for dismissal
  – Is there a social cost of dismissing a worker?
  – Perhaps workers collect unemployment insurance or other public subsidies [Blanchard & Tirole (2008)]
Severance: Firm Cost vs. Worker Valuation

• **Poorly designed** severance an example of wedge between firm cost and worker valuation

  — In line with Anton, Hernandez, & Levy (2012); Levy (2008); & Ribe, Robalino, & Walker (2011)

  — Labor taxes or contributions that are valued by workers do not incentivize informality

  — But when worker valuation of legally-mandated benefits much less than firm costs of providing them, incentives for evasion (informality) are high

  — If severance offers insurance to workers who may be fired, why would worker valuation be low?
Why Don’t Workers Value Severance?

• Because firms may go bankrupt
  — Kugler (2005): introduction of severance payment accounts in Colombia led to wage decreases of 60-80% of severance contributions
  — Once possibility that firm can default is removed, workers value the benefit more

• Because it is very costly for workers to force firms to pay
  — Dávila (1997): 30% of workers in Mexico who are unjustly dismissed don’t go to court because of high uncertainty and the long duration of processes
  — More than 2/3 of those who sue settle do so for a low fraction of what the law dictates
Why Don’t Workers Value Severance? (continued)

• Because severance looks more like a lottery than insurance
  —Legally-mandated severance can be generous
  —Some receive those payments (win the lottery)
  —But many get zero or a tiny fraction

• Because money doesn’t arrive when needed
  —Liquidity constrained unemployed workers need money now, not after a long fight
  —Data from one labor court in State of Mexico: time to go through entire legal process and collect (cases that don’t settle) median=742 days
Why is Severance So Costly for Firms?

• Because labor lawyers are expensive
• Because evasion requires costly actions
• Severance may be more costly for large (more productive firms)
  – The fact that small firms may be able to more easily evade many obligations acts as subsidy for smaller (less-productive) firms. See Hsieh & Klenow (2009)
  – Calderon (2010) calculates that for manufacturing firms in Mexico, severance as a share of wage bill is:
    1.5% for small firms
    2.6% for medium firms
    2.7% for large firms
    3.6% for very large firms
Estimates of severance costs in Mexico

Difference between firm Cost and worker benefit
Is pure waste!

Source: Own calculations based on assumptions regarding severance and reasons for worker separation. Percentages represent what the firm would have to pay monthly as a percentage of the wage to pre-finance severance.
Evidence from Labor Courts in Mexico

• Kaplan, Sadka, & Silva-Mendez (2007)
  – Study 2 labor courts in Mexico
  – workers receive less than 30% of their claim
  – A lot of variance, many receive nothing

• Kaplan & Sadka (2011)
  – Study different (local) labor court in State of Mexico
  – Most workers who “win” in court don’t collect
  – Firms almost never pay unless worker engages in costly attempt to seize firm assets
  – Often multiple attempts necessary to force payment
  – After multiple attempts, worker may give up. Court may say there are no tangible assets to seize
More Results from Kaplan & Sadka (2011)

- Estimations of parameters of model imply:
  - Worker valuation less than 30% of judge’s award
  - 40% of firms can successfully thwart seizure attempts
  - If worker forces firm to pay judge’s award after seizure attempt, worker cost is 47% of award and cost to firm is 88% of award (plus award itself)
  - Average cost to firm is 45% of award
  - For firms who are not immune to seizure attempts, average cost is 75% of award
  - These costs are in addition to costs incurred prior to judge’s ruling
Is Severance a Good Form of Insurance?

• The answer seems to depend in part on design
• Colombian severance accounts improve worker valuation of benefits, resolve uncertainty
• Interesting example from Barbados. Workers can ask government to pay severance if
  — Worker has taken reasonable steps (other than legal actions) to collect, or if employer is insolvent
  — Worker doesn’t have to fight for right to severance
  — Government takes legal action (with additional penalties)
• Alternative: unemployment insurance
Effects of Enforcement

- Almeida and Carneiro (2009 a & b, 2011) study differential enforcement of labor law in Brazil
  - National labor law, only differences in enforcement

- Greater enforcement ...
  - Improves compliance with severance health, & safety conditions
  - Higher unemployment, lower wage inequality
  - Reduce informality
  - Constrains firm size
  - Reduces wages at top of formal wage distribution
  - Reduces self employment
Timing of Layoffs

- Many benefits require minimum level of tenure
  - Mexico: workers who are dismissed without cause only have right to reinstatement if they have one year or more of tenure
  - Many countries require minimum level of tenure for workers to receive severance

- Do these rules regarding tenure and worker rights affect dismissal decisions?

- Case Study: Brazil
  - After 3 months, advance notice is needed for layoff
  - After 6 months, worker qualifies for UI
  - After 12 months, written authorization required from union or labor ministry
Labor Regs and Timing of Dismissals

Source: Gerard (2012) using Brazilian administrative data
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Some Lessons from Brazilian Study

• Incentives matter!

• Job protection measures do protect jobs
  — Separation rates decline when job protection increases
  — But these measures may prevent hiring
  — Or prevent workers from reaching tenure that affords this protection

• Firms fire workers partly to minimize severance

• When money from government is available (case of UI), firms and workers may collude to take advantage
A Trial Period may Promote Turnover

Expected Severance Payment as a percentage of the flow of Wages (by worker tenure)

Fuente: Elaboración propia basada en la Ley Federal del Trabajo y en varios supuestos sobre los despidos.
Se supone un periodo de prueba de 6 meses.
Labor Regs, Job Flows, & Productivity

• Misallocation of resources across firms hurts aggregate productivity
  — Restuccia & Rogerson (2008)
  — Bartelsman, Haltiwanger, & Scarpetta (2012)

• Dismissal procedures impede labor reallocations

• Evidence that impeding reallocations (capital & labor) negatively affects aggregate productivity
  — Eslava et al (2011)

• Protect jobs or protect workers?
Frictions and Firm-Sponsored Training

• How can general training be financed?
  — Becker (1962): Firm shouldn’t be willing to pay
  — Acemoglu (1997) and Acemoglu & Pishke (various) point out that frictions may keep worker at firm
  — If worker can’t leave, firm pays for general training
  — Almeida & Aterido (2008); Picchio & van Ours (2010): empirical evidence that less flexible labor laws associated with more training

• So is there a productivity justification for legislation that restricts mobility?
  — Or would privately bargained severance a la Fella (2004) be sufficient when training is important?
Summary

• Poorly designed regulations create unnecessary wedge between firm cost and worker valuation
  — And therefore generate informality/unemployment

• Enforcement is crucial

• Dismissal procedures may affect timing of separations and impede labor reallocations
  — And therefore affect aggregate productivity

• May be some role for stabilizing employment relationship to promote training
Policy recommendations (my own)

• Avoid mandated benefits that are costly to firms but not valued by workers

• Avoid high costs to labor reallocation

• Take measures to ensure that severance is paid
  — Severance accounts
  — State pays severance when firm can’t/won’t pay
  — Unemployment insurance as alternative mechanism

• Reduce transaction costs associated with regs
  — More efficient labor courts
Thank you!

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