

**LABOUR MARKET DUALITY AND SEVERANCE COSTS: A MODEL BASED ON THE AUSTRIAN FUND**

The Spanish labour market presents a high degree of duality in relation to the compensation received by workers at the end of their employment relationship, with low compensation for those under temporary contracts of short duration and significantly higher compensation for those with permanent contracts and many years of service.<sup>1</sup> These differences can distort firms' decisions when they need to reduce their workforce. In particular, for the same level of productivity, workers who have accrued fewer entitlements, owing to their accumulated years of service or their contract type, tend to bear the brunt of staff reductions since they are owed less in severance compensation.<sup>2</sup> Moreover, quite frequently, the accumulation of these entitlements to compensation, which workers will only receive in the event of dismissal, hampers labour mobility, since those leaving their jobs voluntarily lose any entitlements accumulated hitherto.

One possibility that has been considered, both in the academic literature and in the public debate, to redress these shortcomings is the so-called "Austrian fund".<sup>3</sup> Under this system, firms make monthly contributions to a fund in the name of the worker, who is able to use the fund in the event of involuntary loss of employment, whether as a result of dismissal or contract expiry. In the case of voluntary termination, the worker does not lose the amount accumulated in the fund and can continue to build it up through contributions made by other employers. If it has not already been recovered, the entirety of the accumulated fund is accessible to the worker upon retirement. As a counterpart to firms' monthly contributions to their workers' individual funds, under this system the compensation that firms would have to pay when the employment relationship is terminated is reduced.

Fully or partially replacing the current severance cost framework with such a system could yield significant benefits in the medium and long term.<sup>4</sup> First, under this

system the distribution among workers of the entitlements accrued over the course of their working lives would be less unequal. This is because all workers, without exception, would at some time receive the amounts accumulated in their fund, whereas at present only those who lose their employment are entitled to such compensation. Second, there would be more incentive for labour mobility over the course of employees' working lives, since the contributions built up in the fund are not lost in the event of voluntary termination, while under the current system all entitlements associated with years of service are lost when they change job. Third, from the standpoint of firms, the fact that the entitlements accrued by their workers are recognised gradually, via periodic contributions to each employee's fund, rather than as a one-off payment in the event of future dismissal (at a time when firms might be in a vulnerable financial position), means any liquidity tensions at the company can be smoothed over time. Lastly, and associated with the above, firms would base their employee termination decisions more on productivity and efficiency considerations and less than on the compensation entitlements accumulated by their workers, since the amounts payable by the firm at the time of dismissal would be less closely associated with those entitlements.

However, despite these potential medium and long-term benefits, the introduction of such a model is not without certain difficulties. The first relates to determining a sufficient level of protection against dismissal when the new system is fully operational for all workers. A second important matter, connected with the above, concerns the transition from the existing model to a new system based on such a mechanism. In particular, introducing the new system poses the challenge of recognising the compensation entitlements built up hitherto by current workers under the existing arrangements (and therefore not paid into an individual fund).

1 By way of example, according to estimates based on the Continuous Sample of Working Histories (MCVL by its Spanish acronym), between 2013 and 2016 10% of workers receiving compensation at the end of their employment relationship collected €23 or less, while the 10% of workers who received the highest compensation collected €6,400 or more.

2 For more information on the evidence relating to the impact of Spain's labour market duality on hiring and firing decisions, see Box 6, "Job creation and destruction flows by type of contract during the recovery", *Economic Bulletin*, 1/2019, Banco de España.

3 The fund takes its name from the severance pay reform introduced in Austria in 2002, which replaced the compensation payable by firms to workers at the end of their employment relationship with a system under which firms made monthly contributions to an account in the worker's name equivalent to a specific percentage of their wage.

4 See, among other studies, J. I. Conde-Ruiz, F. Felgueroso and J.I. García-Pérez "El fondo de capitalización a la austríaca: costes y beneficios de su implantación en España", *Estudios Económicos* 6/2011, FEDEA, 2011. The role of an Austrian fund as a complement to retirement pensions, with favourable effects on the stock of capital in the economy and aggregate output, was recently analysed by J. Brogueira de Sousa, J. Díaz-Saavedra and R. Marimon, "Introducing an Austrian Backpack in Spain", *ADEMU WP Series* 139, 2018.

**LABOUR MARKET DUALITY AND SEVERANCE COSTS: A MODEL BASED ON THE AUSTRIAN FUND** (cont'd)

The simulation below offers a quantitative illustration of the two above challenges in the recent context of the Spanish labour market. For this purpose, a hypothetical scenario is constructed under which an Austrian fund model is introduced – with firms making periodic contributions in the name of each of their workers – based on two assumptions. First, it is assumed that this model is introduced alongside a reform of severance costs, whereby, in the long run – once all workers are included in the new system – there is no reduction in the aggregate amounts paid to workers should they lose their employment, nor cost overruns for firms or public finances. Second, it is assumed that all entitlements accumulated under the previous model up until the introduction of the new system are maintained. The short-term costs of introducing this system – as a consequence of recognising the compensation entitlements already

accrued by existing workers – are estimated on the basis of these two assumptions (under any realistic scenario, these assumptions would evidently be matters to be decided by social and economic agents and politicians).

Regarding the first of the above assumptions, on the information provided by the Panel of Data on Firms and Workers (PET by its Spanish acronym), available for the period 2013-2016, if firms' contributions to workers' individual funds are equivalent to six days of pay per year of service and the severance and termination costs for existing contracts are reduced by 50%,<sup>5</sup> in the long-term the total costs paid by firms – including both the regular contributions to individual funds and the new severance payments – would be very similar to the total severance payments that firms would pay under the current model (see Table 1, columns 1 and 2).<sup>6</sup>

Table 1  
SIMULATION OF TOTAL COSTS FOR FIRMS OF THE CURRENT SYSTEM OF SEVERANCE COSTS AND OF A MIXED SYSTEM COMBINING AN AUSTRIAN FUND AND A REFORM OF SEVERANCE COSTS

€m	Total costs paid by firms under the current system	Total theoretical costs that firms would pay under the mixed system in the long term	Total costs paid by firms under the mixed system in the transition, without the support mechanism (a) (b)	Total costs paid by firms under the mixed system in the transition, with the support mechanism (a)			State contribution to individual funds in the transition to the mixed system, with the support mechanism (d)
				Severance compensation	Contributions to individual funds (c)	Total	
	(1)	(2)	(3)	(4)	(5)	(6) = (4) + (5)	(7)
2013	7,236	6,832	9,868	6,653	536	7,189	2,679
2014	6,809	6,810	9,057	5,651	1,135	6,786	2,270
2015	7,242	7,194	9,267	5,694	1,786	7,481	1,786
2016	6,501	7,044	8,560	4,767	2,529	7,296	1,264
Total period 2013-2016 (e)	27,998	28,010	37,093	23,082	5,979	29,062	8,031

**SOURCES:** Banco de España, based on data from the Social Security General Treasury (Panel of Data on Firms and Workers, 2013-2016).

- a** The total costs paid by firms under the mixed system during the transition are based on the assumption that the reform of severance costs is introduced on 1 January 2013. For workers registered prior to that date, the firm would have to pay the severance costs under the current system corresponding to the accumulated years of service up to 1 January 2013, plus the severance costs under the reform (half) for the years of service accumulated between 1 January 2013 and the date of termination.
- b** Note that column (3) corresponds to the sum of columns (4), (5) and (7).
- c** The firms' contributions to individual funds are equivalent to one day of pay per year of service in 2013, two days in 2014, three days in 2015 and four days in 2016.
- d** The State's contributions are equivalent to five days of pay per year of service in 2013, four days in 2014, three days in 2015 and two days in 2016.
- e** The estimated costs for the period 2013-2016 do not exactly match the sum of the costs estimated for each year. This is because the estimate for the period 2013-2016 uses the mode of each firm's size throughout the period as population weight, while for the annual estimate each firm's size in each year is used.

5 Equivalent to 16.5 days' pay per year of service for unfair dismissal, 10 days' pay per year of service for fair dismissals, and 6 days' pay per year of service for the termination of temporary contracts. The compensation ceilings would remain unchanged.

6 The exercise estimates the severance and termination costs under the current system for the period 2013-2016 and compares them with the same costs that would be incurred under the system proposed in this box, combining an Austrian fund with lower severance and termination costs. Under both systems, the total figure paid by firms is approximately €28 billion over the four years analysed. It is important to note that a more precise calibration of this exercise would need to take into account the average compensation over a complete economic cycle and not only in the period 2013-2016, but PET data are only available for this specific period.

To estimate the costs of transitioning to the new model, PET data are once again used for the period 2013-2016 and a hypothetical scenario is assumed under which the reform comes into effect on 1 January 2013.<sup>7</sup> Under this hypothesis, the costs arising from each dismissal or termination are simulated, according to cause for termination, wage and contract start date, such that the compensation entitlements accumulated by workers prior to the reform are maintained. This latter circumstance gives rise to a cost overrun in respect of the funds needed to maintain the system in the long term, once all workers are included therein.

Column 3 of Table 1 shows the results of the simulation for each year. Specifically, in the transition to the new system (in the period 2013-2016) the total cost payable by firms – including both contributions to workers' individual funds and severance payments – would be higher by approximately €9 billion as compared with the current system. To cover this gap, the possibility is considered of the State financing a share of the firms' contributions to the new fund, albeit only in the short term and in a decreasing amount over time: five days' pay per year of service in the first year after the reform, four days' pay in the second year, and so on, such that firms would fully cover the payments to the fund six years after the approval of the reform.

Columns 4 and 5 of Table 1 show the amounts payable by firms as severance pay and the contributions to workers' individual funds, respectively. As can be seen, the total of these amounts for the overall period analysed (column 6) is very similar to that in column 1, which is the amount payable under the current system. Meanwhile, column 7 of Table 1 shows the cost of this transition mechanism to the State. In line with the design of the mechanism, that cost would gradually decline each year and would amount to approximately €8 billion during the period 2013-2016. Extrapolating those amounts to 2017,<sup>8</sup> the final year of the proposed transition period, the total cost to public

finances of funding the transition would be approximately €8,660 million. These costs could be financed, at least in part, using the NGEU funds. Indeed, the European Commission's regulation states that the reforms eligible for such funds must help bolster growth and enhance economic or environmental sustainability, and cites pension system and labour market reforms as specific examples.<sup>9</sup>

It is worth emphasising that this quantitative illustration of the possible requirements entailed in implementing a system based on the Austrian fund in Spain has some limitations which should be taken into account when interpreting the above results. First, the analysis is static, in that it does not consider the possibility of firms and workers changing their labour decisions in response to the introduction of the proposed new system. This is indeed unrealistic. Firms might be more inclined to lay off workers since the marginal cost of making that decision would be reduced by half, and those lay-offs would be less concentrated among the workers with the fewest years of service. In view of this possibility and to strengthen the incentives for firms to internalise the costs arising from the termination of their employment relationships (both in terms of the worker's circumstances and spending on unemployment benefits), consideration could be given to introducing a bonus-malus system, under which firms with lower labour turnover pay lower Social Security contributions, and vice versa. Meanwhile, labour mobility would foreseeably increase since workers would be less reluctant to lose their accrued entitlements and less afraid of being the first to be laid off when they move to a new company. This increase in voluntary mobility would allow workers to find a better job match for their skills, with the concomitant aggregate benefit for the economy.<sup>10</sup>

Second, the data available in the PET restricts the period of analysis to the years from 2013 to 2016, which was a period of economic recovery. It should therefore be taken

7 Lay-offs with a contract start date after 1 January 2013 receive half of the compensation envisaged under the current system (16.5, 10 or 6 days' pay per year of service, depending on the cause of termination), while lay-offs whose contract began before that date receive the amounts established under the current system duly adjusted for the proportion of time worked prior to and after the reform. From 1 January 2013 onwards, all workers receive the contributions made to the Austrian fund.

8 The total cost of the Austrian fund is relatively constant over the years considered. Therefore, bearing in mind that in 2017 the State would pay one day's contribution as opposed to two in 2016, the cost in 2017 would be approximately half the €1,264 million paid in 2016.

9 See "Commission Staff Working Document. Guidance to Member States Recovery and Resilience Plans", SWD 205 final, European Commission, 2020.

10 See, for example, A. Kettemann, F. Kramarz and J. Zweimüller, "Job Mobility and Creative Destruction: Flexicurity in the Land of Schumpeter", Working Paper No 256, Department of Economics, University of Zurich, 2017.

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into account that the exact calibration of the parameters of the above simulation could change if a longer period combining different cyclical phases is considered.<sup>11</sup> Consequently, the quantifications presented here should be interpreted with due caution.

Lastly, under the calibration used in the simulation, the aggregate amounts earmarked for employment protection would remain unchanged in the long term. However, their distribution would be altered, such that the reform would benefit some types of firms and workers and disadvantage

other groups relative to the current situation.<sup>12</sup> Specifically, the new system could be relatively beneficial for firms with a high number of lay-offs. Therefore, as has been indicated, it might be appropriate to complement the new system with a bonus-malus arrangement to mitigate this bias. From the standpoint of workers, the new system would particularly benefit those laid off after few years of service and workers changing job voluntarily. The detailed study of these redistributive effects and of the policies that could be deployed to mitigate them should be subject to in-depth analysis in future.

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11 In principle, the MCVL could be used to produce a more precise calibration. However, in this sample, the information on the causes of employment termination prior to 2013 is inadequate, particularly for temporary workers, since terminations by contract expiry cannot be distinguished from other causes. Assuming that all involuntary terminations of temporary contracts are due to contract expiry (which have been the majority since 2013), the total compensation paid under the proposed reform in the period 2000-2019 would be very similar (0.2% lower) to that under the current system, while the distribution over time would be less concentrated in periods of recession.

12 See A. Hijzen and A. Salvatori, "Introducing individual savings accounts for severance pay in Spain: An ex-ante assessment of the distributional effects", *OECD Social, Employment and Migration Working Papers*, No 259, OECD Publishing, Paris, 2021.