

THE SEVERANCE PAY REFORM IN AUSTRIA (“ABFERTIGUNG NEU”)*

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Introduction

Various studies have examined the impact of labour market institutions, such as unemployment benefits, employment protection legislation (EPL), active labour market policy, labour union density, and taxation of labour income on unemployment in Europe (e.g., OECD 2006; Nickell and Layard 1999). The OECD Job Strategy has suggested reforming rigid labour market institutions to tackle the unemployment problem (OECD 1994). The European Commission recommends the “flexicurity” approach, more flexible labour markets combined with a satisfactory level of security for employees, to adapt to the challenges of globalisation and increased structural change. Denmark, Finland, and the Netherlands have been identified as successful countries, which have carried out consistent and comprehensive reform programs in the last few years (Brandt, Burniaux and Duval 2005).

Austria is a country with a comparatively favourable labour market performance. While fundamental reforms of the labour market have not taken place, smaller steps (intensified activation of the unemployed, efforts to raise the retirement age, tightening of the conditions under which job offers must be accepted, etc.) have been the hallmark of the Austrian policy. When compared to other countries, Austria distinguishes itself with its high-quality industrial relations. The strong involvement of the social partners, which is reflected particularly in wage policy as well as in labour market policy, is typical for Austria.

In 2002 Austria reformed its EPL regulations. The reform replaced a conventional severance payments system with a system of individual saving accounts. The system is funded by employers via a monthly untaxed payment of 1.53 percent of gross wages. In

the event of dismissal, workers have the option of receiving severance payment drawn from their savings accounts or taking their accumulated balance to the next job. Upon retirement, employees can claim a cash payment or convert their entitlements into an annuity. This reform of the severance pay law has received international attention as an example for a labour law measure supportive for employment transitions (OECD 2006 and the European Commission 2006a).

The Austrian labour market

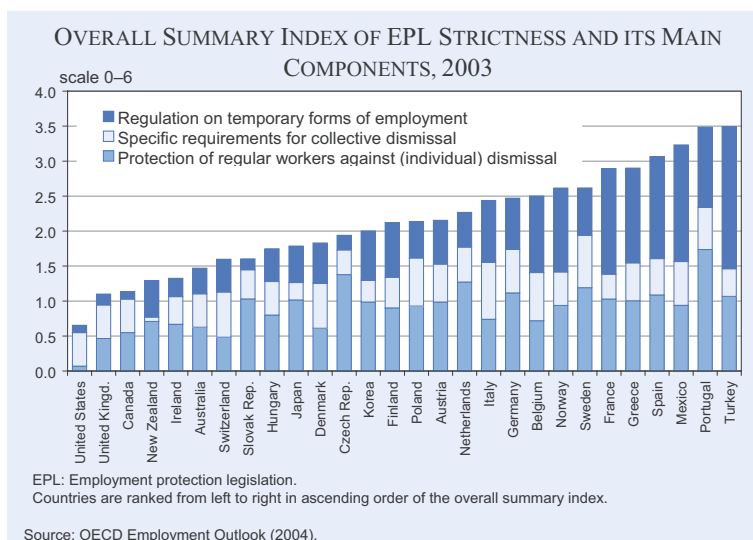
In international comparison the Austrian labour market situation is favourable, although a gradual deterioration has occurred over the last 25 years. Unemployment is traditionally low, the unemployment rate amounted to 4.7 percent in 2006. The employment rate is 70 percent and above the EU average. The Austrian labour market, at first glance, exhibits a high rate of job turnover. In 2006 a total of 1,538 million dependent jobs were taken up and 1,469 million terminated (BMWA 2007). The average total dependent employment amounted to 3,161 million. This dynamic can be explained in large part by the comparatively high seasonality of employment in Austria (Del Bono and Weber 2006). The two dominating industries are construction and tourism, which also experience the most dramatic seasonal fluctuation in demand. This seasonal dynamic is strengthened even more by the design of the unemployment insurance system. In the absence of experience rating, unemployment insurance premiums are the same for every sector of the Austrian labour market. As a result seasonal industries are heavily subsidized with a corresponding increase in seasonal fluctuations and a higher job turnover. 35 percent (557,000) of all positions taken up in 2006 were reinstatements within the same company. Aggregate numbers also suggest that job turnover in Austria parallels American rates. If, however, the sectoral composition and the small establishment size are taken into account, the figures for Austria are much lower (Stiglbauer, Stahl, Winter-Ebmer and Zweimüller 2003). Measures of worker reallocations that do not consider short-term flows indicate that the Austrian labour market exhibits rather low dynamics in international comparison (Stiglbauer 2006).

EPL considers legal and administrative constraints on worker dismissals, as well as severance payments paid to dismissed employees. Figure 1 suggests that

* This paper draws heavily on Hofer (2006).

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Figure 1



Austria is ranked in the middle of the OECD member countries with respect to the overall strictness of employment protection.¹ Open-ended employment contracts are the norm in Austria. Dismissals can only be contested when the cause is either discriminatory (e.g., gender-specific terminations or because of union membership) or socially unfair, e.g., when the dismissed employee would be more negatively affected than a colleague in a similar position. The partial indicator for regular employment relationships measures the relevant notice periods, the amount of possible severance pay, the estimated court costs and indemnity expenses in the event of an unjustifiable termination, as well as any possible legal difficulties that would accompany the implementation of the termination. Due to the relatively long notice period for white-collar workers, Austria ranks in the middle of OECD members with respect to this indicator. Notice periods differ between blue- and white-collar workers. White-collar workers can be given notice at the end of every quarter, at which point the notice period can range from six weeks to five months, depending upon the length of job tenure. The notice period for blue-collar workers is regulated by collective contracts. If the period is not defined in the contract, it is 14 days by default. While employment protection regulations seem relatively strict on paper, actual practice is a different story

¹ The OECD summary indicator of the overall stance of employment protection legislation is a weighted average of three sub-indicators on dismissal regulations, covering (1) regular employees, (2) temporary employees and (3) collective dismissals. The summary indicator ranges from 0 to 6 and increases with the strictness of EPL (OECD 2004).

² An exemption was made for construction workers. In order to qualify they had to be employed for only 92 weeks during the previous three years, and not necessarily with only one employer.

(Hofer and Winter-Ebmer 2006). Only a relatively small number of cases are brought before a labour court – most of which end in a settlement consisting of severance pay. These kinds of appeals mainly occur when older employees at a firm with a works council are given notice of termination – besides these cases, appeals are very uncommon. Labour regulations seem flexible enough to keep the necessary processes of reallocation from being burdened with prohibitively high costs.

The OECD 2006 advocated making EPL regulations more predictable and minimising the extent to which EPL results in inefficient labour turnover. Severance payment can be a barrier to efficiency-enhancing labour reallocation by discouraging workers from quitting their current jobs to move to better jobs. The reform of severance pay in Austria has been addressing this problem by reducing obstacles for worker mobility.

Severance pay law in Austria

Severance pay was introduced in Austria for white-collar workers in 1921 and extended to all workers in 1979. Austria's previous employment legislation stipulated that employees in the private sector were entitled to severance pay if their employment spell lasted for at least three years without interruption and was not terminated by the employee.² Since the 1970s severance pay had to be paid to an employee who left the company voluntarily – after having

Table 1
Amount of severance pay in the old system

Years of continuous service in one company	Amount of severance pay (calculated from final salary)
Less than 3 years	No entitlement
From 3 to 5 years	2 months' pay
5 to 10 years	3 months' pay
10 to 15 years	4 months' pay
15 to 20 years	6 months' pay
20 to 25 years	9 months' pay
25 years and more	12 months' pay

Source: Compilation of the author.

worked for at least ten years – to enter retirement. The payment amount was based on the last gross monthly salary and the length of job tenure. Starting with two monthly wages after three years of job tenure, payments increased with the duration of the job up to a maximum value of one year's income after 25 years (Table 1). It was taxed at a low rate (6 percent).

The payment had to be made as a lump sum directly out of the employer's cash flow. Within the book accounting system of the enterprises, severance payments were recorded as regular wage increases. Employers had to make provisions in their accounts (book reserve schemes) for at least half of the severance pay entitlements that could fall due. The yearly allocations to the position in the balance sheet reduced the taxable income of the company. Overall, the expenditures for severance payment in 1997 amounted to approximately 2.5 percent of the total wage bill (BMW 2000).

Reforming the system of severance pay in Austria had been the focus of controversy for a long time (e.g., EIRO 2001; Klec 2007). The previous system was called into question for two main reasons. It was criticised because of its impact in terms of inhibiting mobility in the labour market and the restrictions on entitlement to severance pay. For employees the previous system of severance pay law reduced incentives to change employers as the employee lost the entitlement to severance pay in the case of self-termination of the employment contract. The second major problem of the old severance pay law was the distribution of the entitlements among employees. The Austrian Trade Union Federation has been demanding the extension of severance pay entitlement to cover not only dismissals but also voluntary resignations and seasonal employment. According to Kristen, Pinggera and Schön (2002) only one third of all workers became entitled to severance payments.

The previous system also involved some drawbacks for businesses, especially for small and medium-sized enterprises (Kristen et al. 2002). Liquidity problems could occur if the firms had to make simultaneous severance payments.

Certain policy makers were in favour of turning severance pay into occupational pensions. In the coalition program 2000 the federal government stated its intention to develop a three-pillar pension system in Austria. The government's intention

was that the severance payment reform should contribute to the expansion of the underdeveloped second pension pillar.

A considerable amount of research has been carried out to evaluate the impact of EPL on aggregate labour market variables. EPL reduces the layoff rate and unemployment incidence by making firing more costly to employers and increases unemployment duration because higher labour costs tend to weaken job creation, the overall effect on unemployment is ambiguous and apparently minimal in practice. However, strict EPL tends to compromise the employment prospects for young workers, women and the long-term unemployed (e.g., OECD 2006; Young 2003; European Commission 2006b). High procedural costs as well as the associated higher insecurity among companies can have a negative effect on employment. Provisions for severance pay can, however, already be made for in the terms of wage negotiations (e.g., Leonardi and Pica 2007).

Most studies on the impact of the Austrian severance pay system are based on theoretical arguments (e.g., Walther 1999) or anecdotal evidence. For low-qualified jobs the system created incentives for employers to terminate employment spells early to avoid accumulating severance pay claims that are not matched by productivity gains. According to OECD (2001), the propensity of employers to terminate employment peaks prior to employment durations associated with discretionary hikes in accumulated claims for severance pay. Moreover, the system was biased against labour supply in industries with over-proportionate employment fluctuations due to structural change or seasonality as in tourism. Card, Chetty and Weber (2006) provide a profound empirical analysis of the impact of eligibility for severance payment on unemployment duration and subsequent job outcomes. They use a regression discontinuity design, comparing the search behaviour of individuals who were laid off just before and just after the 36-month cut-off for eligibility.

According to this study the hazard rate of finding a new job during the first 20 weeks of the unemployment spell is 8 to 12 percent lower for individuals eligible for severance pay. This longer unemployment spell is not compensated via the quality of the subsequent job. Mean wages, job duration and other measures of job quality are unaffected by entitlement to severance pay. Card et al. (2006) use a theoretical job search model to derive the welfare consequences of

severance pay. According to the model, a pure wealth effect causes the reduced search intensity without any efficiency costs. Furthermore, Card et al. (2006) find no evidence for selective firing prior to the 36-month-cutoff.

The reform of severance pay law

In mid-2001 Austria’s government announced its intention to reform the country’s system of statutory severance pay law. The aim was to extend entitlement to a wider range of situations and to introduce an option of using payments to fund occupational pensions. Important details like required minimum length of service for entitlement had already been discussed at length. Finally, the government decided to delegate the drafting of a new severance scheme to the social partners. In October 2001, the social partners reached a compromise and in June 2002 the new severance pay law was adopted.

The severance pay system was changed by the *Betriebliches Mitarbeitervorsorgegesetz*, also known as the new severance pay law (“Abfertigung Neu”). The new system became effective in January 2003. It covers all employment contracts concluded after December 2002. Employment contracts already in place on the date remain, in principle, unaffected until the end of the employment relationship. However, the possibility of a transfer from the old to the new severance payment law is provided. Severance pay claims are shifted to and enforceable by the so-called employee provision funds (“Mitarbeitervorsorgekassen”), which are legally independent from the employers. The employer is obliged to pay a contribution amounting to 1.53 percent of gross wages every month. The contributions start in the second month of an employment relationship and end with its termination. Accumulated entitlements rest in the employee’s account until retirement, unless the work contract has been terminated by the employer, which makes cash payments admissible. Employees may draw severance pay only under the same entitlement conditions as under the previous scheme, and provided money

has been paid into the fund for three years. The contribution periods of different employers will be aggregated. Upon becoming eligible for payment, the employee can choose between cash, further investment at the same employee provision funds or at the employee provision funds of the new employer, or transferring the respective amount as a one-time payment to a pension insurance fund. Upon retirement, employees can either claim a cash payment or convert their entitlements into an annuity. While the former is taxed at a rate of 6 percent, annuities remain untaxed.

The reform extends the entitlement to severance pay considerably. Entitlement starts after one month and does not depend on how the contract was terminated or on job tenure. Instead of losing claim to severance pay in cases of self-termination, employees can carry over the balance to the new employment relationship.

While in the old system the maximum level of severance payment is reached after 25 years of employment with the same employer, under the new system the claim increases progressively. The employee provision funds invest the employers’ contributions in the capital market, therefore the level of severance payment depends on the annual net yield. Figure 2 shows the evolution of severance pay claims in terms of the individual’s last monthly wage in the old vs. the new scheme (Koman, Schuh and Weber 2005). While in the old system severance payments increased in stages and reached the maximum level after 25 years of employment with the same employer, in the new system the severance pay will rise continuously and reach the maximum

Figure 2

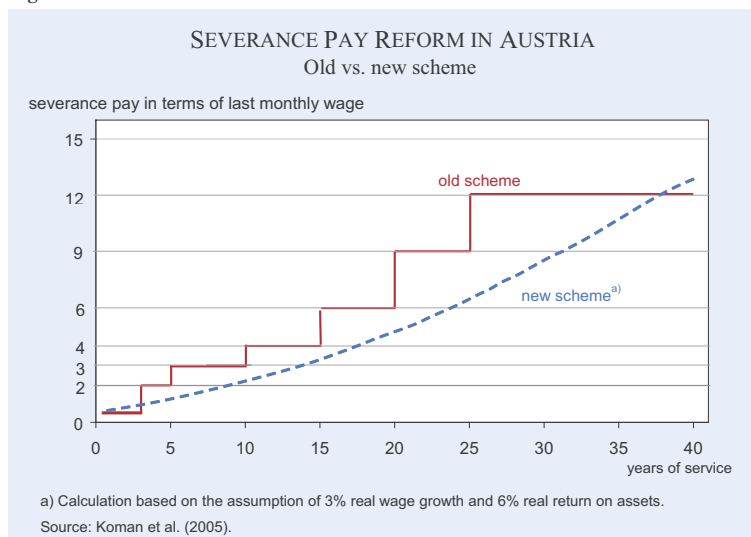
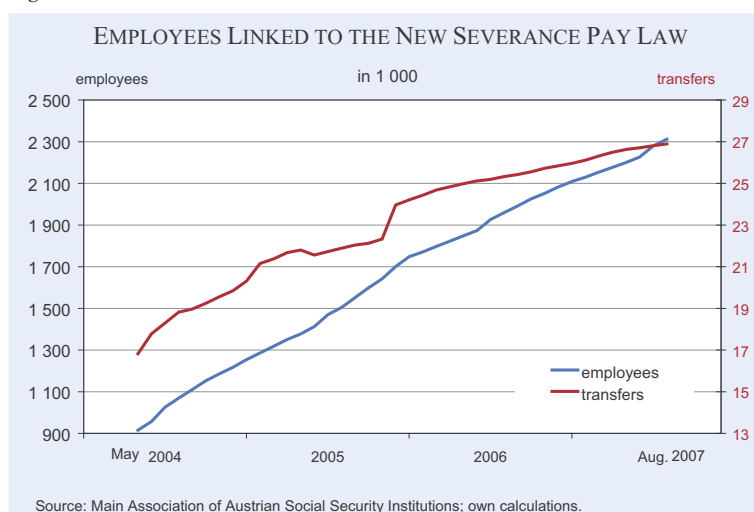


Figure 3



value of the old system after 37 years of contribution. Note, however, these calculations assume a rather high and unrealistic rate of net-return of 6 percent per annum.

For employment contracts concluded before January 2003 the possibility of arranging a transfer from the old to the new severance pay system has been provided for. Figure 3 illustrates that only 27,000 persons have changed into the new severance pay system.

Up to now 2.3 million persons acquired claims in the new severance pay system (Figure 3). Figure 4 shows the share of all employees in the new system by month. In August 2007 46 percent of the workers were already linked to the new severance pay system. 361,000 enterprises have concluded contracts with the employee provision funds.

Employee provision funds

Nine privately managed companies were established to collect the monthly contributions, invest them on the capital market and make severance payments to employees who become eligible. The funds work on a for-profit base and are allowed to charge operating fees. Employee provision funds are entitled to retain an administrative fee of 1 percent up to 3.5 percent of annual severance pay contri-

butions. Currently, actual fees charged are mainly in the range of 1.8 percent to 2.9 percent (GPA 2006). Additionally the employee provision funds can charge up to 0.8 percent of the invested capital as asset management fee.

The employer concludes a contract with one employee provision fund for all workers who are in the new severance pay system. The choice of the employee provision fund is decided via an employer/works council agreement. In enterprises

without works council the employer decides in general. Changing the employee provision fund is possible. Between 2004 and 2006 the assets managed by employee provision funds increased from 365 million EUR to 1.13 billion EUR.

In the new system the level of severance payment depends on the performance of the employee provision funds on the capital market. Only the nominal contribution paid by the employer is guaranteed by law. The ministry of finance expected an average annual net yield of 6 percent on the investment of severance pay. In 2003 the employee provision funds did not promise an investment yield higher than between 3 percent and 4 percent. In order to compete, they promoted their investment capacities. In 2004, 2005, and 2006 the employee provision funds achieved an average annual net yield of 5 percent, 5.5 percent and 3.6 percent, respectively. The

Figure 4

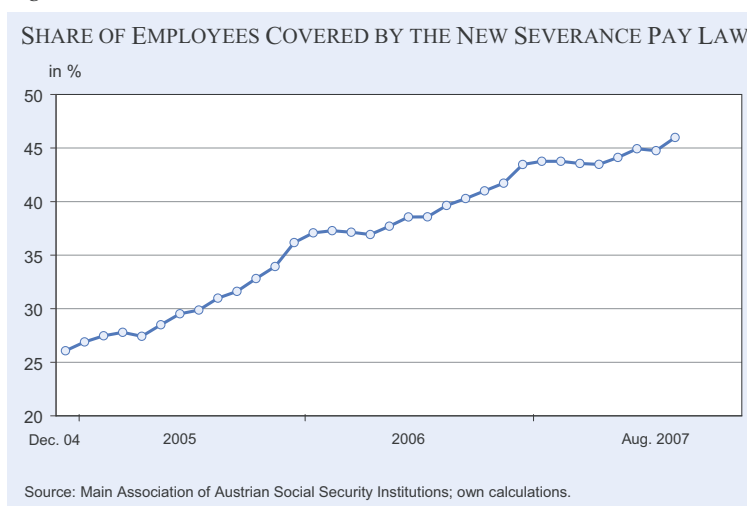


Table 2**Asset allocation**

Assets	in %
Bonds/EUR	82.1
Bonds/Non-EUR	1.2
Equities/EUR	9.4
Equities/Non-EUR	5.6
Real estate	1.7

Source: OeKB.

employee provision funds can invest in bank assets (at most 25 percent at the same group of credit institutes), loans and credits, bonds, equities (at most 40 percent) and share certificates of investment funds. In principle at most 50 percent can be invested in foreign currency and at most 10 percent in bonds and equities of the same company. Table 2 shows the asset allocation of the employee provision funds. In 2006 only 15 percent of the assets were invested in equities. The employee provision funds argue that a high return is only possible if the portfolio contains more equities. Due to the possibility of payouts, the investment horizon is relatively short. Almost every second employee eligible for payment opts currently for disbursement. Overall it is to be expected that the amount of severance payment will be lower compared to the old system.

Discussion

2.3 million employees have acquired entitlements in the new severance pay system. The reform extended the number of workers entitled to severance pay considerably. However, the average severance pay will be lower in the new system. Starting with 2008 the number of persons entitled to severance payment will further increase as the so-called Freie Dienstnehmer, a hybrid status between employed and self-employed, and the self-employed engaged in trade will be included. Farmers will also have the possibility to opt in the system.

The new severance pay system offers advantages for employers and employees. For employers liquidity problems due to simultaneous severance payments are prevented and there is no uncertainty related to the costs of severance pay at the time of hiring. For the workers, job mobility costs are reduced because they do not lose their entitlement to severance payment when quitting a job. The former severance pay system was heavily criticised for reducing labour

mobility. The loss of entitlement to severance pay created a strong incentive for workers with long job tenures not to quit. The new severance pay system eliminates this disincentive with respect to labour mobility. Currently no study exists, which quantifies the impact on actual labour mobility. It is very likely that the impact is currently modest as almost all workers with long tenure are still covered by the old legislation. Furthermore, reducing labour mobility may be justified if it supports investment in firm specific human capital. However, it is questionable if the old system was an efficient tool for increasing the qualifications of the workers, given that there was no link between entitlement to severance pay and the costs and the degree of optimal company-based training.

Originally, the government did not wish to provide for the possibility of paying severance pay directly to employees on the termination of their employment relationship, but favoured a model in which severance pay entitlement went purely to fund occupational pensions. In the end, the social partners and the government agreed on a compromise where severance pay paid directly to employees on termination of their employment will be taxed at a flat rate of 6 percent, whereas severance payments saved towards a private pension will be tax-free. It was an explicit hope of the government that the severance payments reform would also contribute to the expansion of the underdeveloped second pension pillar in Austria. The reform replaces the former defined-benefit, final-salary severance payments scheme by a defined-contribution, fully funded system. According to Koman et al. (2005) the severance pay law reform is a first step toward the expansion of the underdeveloped second pension pillar in Austria. The contribution rate of 1.53 percent is, however, too low to generate a significant second pillar retirement income that could help to maintain current replacement rates. Based on retirement income projections and simulations of the pension reform for the blue and white collar workers' pension system, Koman et al. (2005) concluded that an increase of the contribution rate up to 5 percent could already be a major step toward a sufficient second pillar retirement income.

The reform improves the role of the capital market in Austria and helps to strengthen the funded pillar of the pension system. However, the possibility of claiming cash payments after job termination, which decreases the expected return on the capital market,

and the relative low contribution rate imply that the new system may not generate a sufficient second pillar retirement income. One should note, that the available evidence indicates that disbursement is preferred to acquiring pension claims by a considerable number of workers.

As a result of the new provisions, many more employees are now eligible for severance pay, in particular employees with short-term employment. One explicit aim of the Austrian reform was to create more fairness in the distribution of severance payments among employees. In order to evaluate the distributional effects of the Austrian reform Koman et al. (2005) performed an empirical analysis on a cross section of completed job spells of different durations for which they compared severance pay in the two schemes.

According to the simulations, severance payments will be 35 percent lower in the new system compared to the old scheme in the sample mean. Due to the more pronounced effects of the new scheme those groups who were disadvantaged in the old scheme will be even more so in the new (Koman et al. 2005). Mean payment according to both schemes differs mostly for women, young, and blue-collar workers. Note that Koman et al. (2005) had to make two crucial assumptions. First, they did not observe complete individual employment careers and hence cannot say anything about the accumulation of severance payments during an individual's working lifetime. Second, as Koman et al. (2005) had no information on the reason for ending the employment spell, they assumed no voluntary job terminations. Overall, there are clear hints that the level of severance payments in the new system will be lower than in the old system. This is, of course, only true for workers who did receive severance payments based the previous legislation. The reform unquestionably extends to a considerable degree the number of workers entitled to severance pay.

Conclusions

Overall, the reform of the severance pay system in Austria was successful. The new system provides advantages for employees and employers. From the viewpoint of the employers, the (expected) costs of dismissal – which are lower than with the previous regulations – are already known from the start of employment. For employees, the mobility-hamper-

ing loss of severance pay in cases of resignation is no longer relevant. The new severance pay system will enhance external flexibility. One can, however, criticize the fact that the manner in which the employment contract is ended has no influence on the amount and form of the employees' right to severance pay – in other words, the new severance pay system in Austria contains no elements of a layoff tax. The aim of a layoff tax is to make firms internalise the costs of excessive job turnover. Moreover, the possibility of early payouts implies that employee provision funds cannot place a high percentage of the capital in long-term investment schemes, therefore limiting potential yields.

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