

Reform of Severance Pay Law Statements and Comments

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The new Austrian severance pay scheme obviously successfully combines regulations that support labour market flexibility on the one hand and enhance individual social security on the other. It therefore corresponds closely to what the OECD and the EU understand as an element of a flexicurity strategy. As there is no general statutory severance pay scheme in Germany, Austria provides an interesting example of how such a regulation could be shaped. We should however, be aware that in Austria severance pay and dismissal protection are complementary instruments and that the introduction of a general severance pay scheme should not be used to justify the abrogation of dismissal protection in Germany. But it could serve as a stepping stone to a kind of “employment insurance” that guarantees an additional income support in the event of contract termination that supports individual professional training and qualification and perhaps even enhances old age security provision for workers.

1. German Policy and Economic Context

Both the employment situation and the institutional setting in Germany are somewhat different from the Austrian case. German economic production is marked by a high percentage of exports but weak domestic demand. Overall effective economic growth has been very low over the past five years (0.9% in 2005).⁷ Accordingly, the unemployment rate steadily increased to 11.7% in 2005, when the number of persons registered as unemployed reached its peak at 4.9 million. The share of long-term unemployed reached 37% in 2005, with older workers being especially affected with a long-term unemployment rate of 53% (50-65 years). The average duration of unemployment amounted to 40 weeks in 2005 (Bundesagentur für Arbeit 2006). Despite a slight reduction in unemployment figures in the early autumn of 2006, reducing unemployment remains the most important domestic policy issue in Germany.

Due to the structure of industry, the dynamic in the German employment system is much lower than in Austria. The labour turnover rate is approx. 24% per annum. This means that more than six million compulsory insured employment contracts are concluded and dissolved each year (Bundesagentur für Arbeit 2006, p. 95). Accordingly, German employees have a relatively long company tenure of 5-6 years (Erlinghagen 2005, p. 1, data of 2001). Dismissals account for one third of all employment contract terminations (28%); another third (35%) is due to employee resignation. About 6% of all terminations are by mutual agreement and 15% result from the expiry of fixed-term contracts (Pfarr et al. 2005, p. 47). The German labour market has a relatively low share of unqualified workers (13%)⁸. Despite these facts, the deregulation of employment protection legislation (EPL) has remained a focus of the employment policy debate because employers find it too rigid and believe it avoids necessary adjustment of the workforce.

⁷ See: <http://www.destatis.de/download/d/vgr/biplangereihe.xls>.

⁸ <http://www.bpb.de/files/B19YYY.pdf>.

2. Transferability of the Austrian Severance Pay Regulation

2.1 Severance Pay as an Element of Dismissal Protection

The core of German dismissal protection is to maintain the employment contract until the dismissal has been accepted by the employee or declared rightful by a court (principle of contract maintenance, *Bestandsschutz*), which means that wrongful dismissal does not necessarily lead to the dissolution of the employment contract. The general Employment Protection Act (*Kündigungsschutzgesetz*) is applicable in firms with more than 10 employees and obliges the employer to justify dismissal by the employee's behaviour, his or her personal characteristics or the firm's economic situation.⁹ Statutory notice periods vary according to tenure and can amount to a maximum of 7 months after 20 years of tenure. Within the probation period (maximum of 6 months), the regular minimum notice period is reduced to 2 weeks. In companies with works councils (about 11% of eligible companies)¹⁰, the employer must listen to the works council's statement before the formal act of dismissal. Without this procedure or in the event of formal mistakes, the dismissal is not effective. However, the works council's consent to the dismissal does not in any way impede the employee's right to appeal against the dismissal within a period of three weeks. And, unlike in Austria, the legal entitlement to severance pay is restricted to very specific and few cases, e.g. when the judge declares continuation of the employment contract to be beyond the acceptable, or as an element of a social plan. But the collective agreements for the public sector determine severance pay in cases of dismissal on economic grounds.

The German dismissal protection legislation has been strongly criticised for making economically motivated dismissal impossible, jeopardizing the survival of firms in economic trouble and setting negative incentives for employers to hire workers. A number of economists consider replacing dismissal protection by a general rule on severance pay to be a solution to this (hypothetical) problem (for discussion, see Pfarr/Zeibig 2006). Some authors suggest replacing the contract maintenance principle by severance pay in all cases of dismissal; others would restrict this option to dismissals justified by the firm's economic situation. The suggested severance pay levels vary from a half to a full month's wage per year of tenure (some suggest an upper limit), while others suggest that the employee's social situation should be considered. The core idea of all models is that severance pay would render dismissal procedures more transparent and the costs more calculable. In Austria, the protective feature of the old severance pay system, which resulted from high severance benefits when lay-offs occurred, has just been abrogated. It would thus be extremely interesting to know whether an increase in the number of dismissals can be confirmed by research. Especially older workers with high seniority might be concerned as indeed, the unemployment rate for older people, unlike in Germany, did not exceed the overall national average until very recently. In order to avoid abusive use of dismissal in general, it might be interesting to establish some kind of additional monetary disincentive, e.g. by adjusting the level of fund contributions to the frequency to which dismissal is used to terminate employment contracts (experience-rating).

As in Austria, severance pay regulation should be complementary to dismissal protection. One normative argument against the replacement of the contract maintenance principle by severance pay regulation would be that it is hardly possible to determine, in advance, a reasonable level of severance pay that on the one hand would deter employers from dismissing workers and on the

⁹ In smaller companies, general clauses of the Civil Code help to protect workers against unfair dismissal.

¹⁰ http://doku.iab.de/betriebspanel/ergebnisse/2004_11_03_05_betriebsrat_2003.pdf.

other would be considered decent compensation for job loss in all cases. From a constitutional point of view, we doubt that a monetary benefit (which would have to be determined in advance) could replace EPL at all, as the “value” of a workplace depends, among other factors, on the employees’ individual chances of re-employment and the labour market situation.

2.2 Severance Pay as an Element of Temporary Income Support

None of the public unemployment insurance schemes in the EU member states compensates for the full former wage. In Germany, unemployment benefit I compensates at the rate of 60% of the former wage (67% if there are children entitled to maintenance). Since 2006, the benefit is paid for 6 months if the insured person has contributed for at least 12 months of the previous two years, and for 12 months if he/she has contributed for at least 24 months. Older unemployed (over 54 years) receive benefits for a duration of 18 months if they have contributed for at least three years. In 2005, the average unemployment benefit I amounted to €770/month (Bundesagentur für Arbeit 2006, p. 90). Ineligible persons and the long-term unemployed fare even worse in Germany. Those who are registered as unemployed and classified as employable and needy are entitled to an allowance, unemployment benefit II, which barely covers the social-cultural existence level (€345/month & housing allowance). The coverage rate of unemployment benefit I has decreased in recent years (from 39% in 2000 to 29% in 2005; *ibid.* 88, own calculations), due to the growing share of marginal workers who are not eligible for unemployment benefit I. This means that the number of unemployed facing a high risk of poverty is continuously growing and that all forms of additional temporary income support will gain importance. Of course, the very low contribution rate of the Austrian severance pay regulation results in low benefits of about 55% of monthly gross wage after a qualifying contribution period of three years. In Germany, the severance pay level depends on the length of tenure in a firm, but courts’ decisions generally determine the level at about half a month’s wage per year (Höland/Kahl/Zeibig 2006, p. 160). In practice however, employees attain this level after a tenure of over five years.

As in Austria, severance pay in Germany is intended to compensate for economic disadvantages caused by job loss, such as job-search expenses, loss of human capital and loss of income. The fact that eventual severance pay is accounted to unemployment benefit II in Germany appears contradictory, as does the fact that tax exemptions for severance pay were abrogated at the beginning of 2006, so that severance pay is now fully taxable. As an element of additional income support, severance pay should neither be taxed nor accounted for in wage replacement benefits.

If severance pay should have the function of an “employment insurance” that insures employees against “new social risks” (Schmid 2006, p. 3), it should, unlike in Austria, be granted in all cases of job loss, regardless of the nature of termination, as resignation might also be involuntary. Moreover in Germany atypical employment is continuously increasing; this is especially true for marginal workers, who accounted for about 14 % of all dependent employed in 2005 (Keller/Seifert 2006, p. 236). But also self-employed workers, who are not covered in Austria either, need effective social protection when they have to terminate their self-employed activity. In Germany, the recent introduction of voluntary unemployment insurance for self-employed is negated by its restriction to newly self-employed who are supported by specific labour market policy programmes. The introduction of severance pay regulation similar to the Austrian model, which should indeed include self-employed workers, could partly cover those “new risks”. It might however, be necessary to reduce the three-year qualifying period in order to also offer cash

benefits to workers engaged in short-term employment, e.g. fixed-term workers.¹¹ Of course, employers' contributions to such a scheme could be adjusted according to their use of flexible employment (similar to Tangian 2006, p. 44).

A general entitlement to severance pay would however, solve the basic problem of justice as the German rule has very selective effects: Only 10% of all employment contract terminations are compensated by severance pay (Pfarr et al. 2005, p. 66).

2.3 Severance Pay as support for labour market mobility and life-long learning

The call for enhancing labour market mobility was one stepping stone for the Austrian reform process. However, it is unclear to what extent flexibility enhances the national economy's productivity. Long firm tenure does not necessarily reflect high institutional barriers to dismissal but rather a human resource strategy adapted to the firms' specific needs. Especially firms that produce high-quality export goods and have a large number of research and development employees, will be interested in stabilising a high-potential workforce in their company. But generally speaking, stable work contracts and high wages will motivate workers to deliver high performance in any part of the economy (Shapiro/Stiglitz 1984). And, although higher benefits – stemming from unemployment insurance or severance pay regulation – statistically increase the duration of job search, this does not necessarily impede labour market efficiency. Empirical comparative studies have shown that longer job search periods correlate with a higher qualification match between offer and demand (Büchel 2005; Gangl 2002). Public policy makers should thus take account of the trade-off between quick re-integration and labour market matching processes.

The former Austrian severance pay regulation scheme set incentives for human capital investment by both firms and employees. But again, instead of lump-sum benefits, experience rating would have a more equalising effect: Employers could choose between the flexible use of a more or less qualified workforce or employing and training their workforce on a more stable basis. We think that the French system of training funds, where employers pay higher contributions for fixed-term employees provides an interesting institutional example (Bosch 2003, p. 3).

As job loss goes along with the loss of firm-specific qualifications, employees should use periods of unemployment to develop or maintain their general qualifications and employability. Active labour market policy supports this objective by offering qualification and training measures. The German employment promotion legislation provides no general legal entitlement to professional training.¹² A basic problem in German public qualification and training policies has always been to match the content of courses with the interests and needs of the unemployed. Alongside the problem of quality, there is also the problem of quantity as public measures cover only a very small share of the unemployed: In 2005, only 2.7% of registered unemployed persons participated in vocational training or qualification measures. However, those who participated in

¹¹ In Germany, the law allows fixed-term contracts for terms of up to 24 months without justification. On average, about 8% of dependent employees (excluding apprentices) have a fixed-term contract. Indeed, in West Germany over one third of new entries to the labour market (East Germany nearly the half) have fixed-term contracts (data from 2002).

¹² Professional qualification measures are therefore restricted to particular cases, e.g. a training course may be provided if the job seeker has no formal qualification or if he or she has worked for more than four years in a non-qualified position and the chance of being reemployed in a comparable position is very low. Short-term training measures are more easily accessible but their duration is restricted to a maximum of 12 weeks per annum.

short-term training measures amounted to approximately 19% of the total unemployed (Bundesagentur für Arbeit 2006, p. 127, own calculations). Of course, it should remain the task of firms and public employment policy to enhance opportunities for training and qualification. However, severance pay regulation could compensate for job search efforts and encourage training participation since public benefits provide only partial compensation for job search costs, and unemployment benefits do not usually allow for additional investment in training and qualification. Accordingly, social plans that provide severance pay could place a stronger focus on training and qualification periods. However, any income support benefit during periods of qualification should not be taken into account in the duration of unemployment benefit I.

2.4 Severance Pay as an Element of Old Age Security Provision

In Austria, one objective of the severance pay reform was to strengthen the second pillar of old age security provision. In Germany, recent reforms to the pension system (2001/2004) were undertaken to strengthen the second and third pillar of social provision for old age by introducing tax-incentives for employees (*Riester-Rente*, *Eichel-Rente*). At the same time, the replacement rate in the public pension scheme has been reduced to 67% of a net average income (data valid for a pensioner with a contribution period of 45 years). Experts expect a further reduction of this level to 63% by the year 2015 and to 52% in 2030 (Steffen 2004, p. 2). In 2004, 46% of workers in the private sector were covered by their firm's insurance scheme and four million additional private pension insurance contracts were concluded by the end of 2005 (Riedmüller/Willert 2006, p. 206). 41% of private firms offer occupational insurance schemes.¹³

It seems that the present Austrian severance pay regulation is not an appropriate means of providing effective old age security for all employees because a large share of workers, especially those who are ineligible or receive low unemployment benefits, will choose the whole cash benefits rather than saving their benefit till retirement age. Only about one third of workers find a new job immediately, without an interruption to their employment, and consequently do *not* need the cash benefit (38,7% in Austria; 41% in Germany; Bielski et al. 2003, p. 89). The average duration of unemployment is much shorter in Austria so that a much higher number of needy workers can be expected in Germany. Nevertheless, it would be a valuable *additional* source of old age security provision for all workers if, for example, entitlements were split into guaranteed entitlements that were paid at the end of the working career (e.g. 20-30% of the whole contribution amount) and conditional entitlements, paid in the event of contract termination. Moreover the present Austrian severance pay legislation does not provide greater protection for people with higher social risks, for instance those with fixed-term contracts. One possibility would be that employers could pay higher contributions for these people, i.e. the higher the social risk, the higher the contributions that employers would have to pay. Tax incentives, such as those in Austria, certainly make it more attractive to save the benefit until pension age however, the income support effect and incentives to invest in training should not be reduced thereby. In any case, the individual account model of the Austrian severance pay legislation establishing individual accounts, does not allow for the redistribution of risks between different groups of employees, as an insurance model would do.

A revised severance pay scheme would enhance pension provision especially for many atypical workers and the long-term unemployed, who have a very low level of coverage in the public scheme. However, the temporary income support function should be maintained. Unlike the

¹³ Deutsches Institut für Altersvorsorge, http://www.dia-vorsorge.de/df_040301.htm.

Austrian scheme, it should enhance redistribution among good and bad employment risks. Under no circumstances should severance pay regulation be used to justify or compensate for further reductions in the public pension scheme.

3. The Current Debate

Alongside further cuts to social benefits, the abrogation of dismissal protection figures among the most debated measures for combating high unemployment. Empirical research shows however, that EPL has no direct or clear effect on the level of employment or unemployment even though employment regimes with rigid EPL may display longer durations of unemployment (OECD 2004). Longer unemployment periods may be advantageous, if mismatch problems in the labour market can be reduced. If German firms have problems with the application of dismissal protection, a reasonable and appropriate policy solution would be to render labour law more transparent e.g. by reduction of indefinite terms or introducing a uniform employment contract act.

Deliberations on the introduction of an employment insurance scheme have remained very implicit in political debate (see Schmid 2006 for substantive suggestions). However, the introduction of a revised severance pay scheme to the German employment system could be a stepping-stone to comprehensive “employment insurance” according to the flexicurity strategy. Although the German public discourse is dominated by the perceived need to reduce labour costs in order to enhance the competitiveness of the German economy and to encourage employers to increase their workforce, there might be a small opportunity window. As the federal employment service generated an unexpected surplus of €10 billion through its saving strategy and cuts in expenditure for active labour market measures in 2006, the government aims to decrease the contribution rate to unemployment insurance by 2.3 percent points by January 2007.¹⁴ Part of this saving could be contributed towards a severance pay fund according to the Austrian model.

The introduction of a severance pay regulation according to the Austrian model in Germany would, however demands more thorough research on the complementarity and/or the functional equivalency of severance pay with existing regimes of employment protection, unemployment insurance, life-long learning and pension provision schemes. It would then remain a political task to decide about the policy objectives, e.g. whether severance pay should serve as a kind of flexibility or employment insurance, and to develop a modus of financing that would meet consensus among both the employers and the employees.

¹⁴ The share of social insurance contributions amounts to 41% of labour costs in Germany. This amount is split up into 19.5% for the public pension scheme, 13.3% on average for health care funds, 1.7 % for long-term care insurance and 6.5% for unemployment insurance. Employers and employees pay each a half of these contributions.

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