Reform of Severance Pay Law in Austria
Discussion Paper

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Abstract

In 2002, Austria has reformed its severance pay legislation. In the new system (Abfertigung Neu) individual savings accounts are managed by so-called employee provision funds (“Mitarbeitervorsorgekassen”). The system is funded by employers via a monthly untaxed payment of 1.53 % of gross wages. Accumulated entitlements rest in the employee’s account until retirement, unless the work contract has been terminated by the employer, which makes cash payments possible. Upon retirement, employees can claim a cash payment or convert their entitlements into an annuity.

Aims of the reform are increased labour market flexibility, an extension of eligibility, and an improvement of the capital market. In general the reform eliminates obstacles for worker mobility, and for the firms it converts the unpredictable dismissal costs (at the time of hiring) into predictable costs. Therefore, the reform strengthens the “flexicurity” features of the Austrian labour market. Eligibility for severance pay is extended to almost all employees. The reallocation of funds via the capital market strengthens the funded pillar of the pension system. However, the possibility to claim cash payments after job termination and the relatively low contribution rate imply that the new system does 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.

1. Introduction

In 2002, Austria has reformed its severance pay legislation. Severance pay is one of the most-wide spread programs for workers in the world. There exist at least three hypotheses for the economic rational of the existence of severance payments (see Holzmann 2005, Walther 1999): first it may serve as a social benefit, second as a human resource management tool, and third as a job protection mechanism. Severance payment may be considered as an instrument against unfair dismissal. Another motivation for severance payment is to provide workers with temporary income support in the case of unexpected job loss. Furthermore, severance pay provides incentives for employees to invest more in firm specific human capital.

The issue of severance payment is often discussed in the context of employment protection legislation (EPL). The impact of job security legislation on labour market outcomes is one of most studied topics in labour economics. However, the economic profession failed to provide consistent results on the consequences of EPL on employment and growth. “The clearest result is that EPL indeed has real effects on labour market dynamics … It discourages firing and hiring, lengthens average job duration, reduces frictional unemployment and increases long-term unemployment. The impact on overall unemployment and productivity is unclear” (Young 2003:1). Overall, EPL may slow down adjustment to shocks and impede labour reallocation by
discouraging hiring and firing. This could have negative implications for productivity growth and adoption to technological change. On the other hand, EPL could provide incentives for employees to participate in training, if there is insufficient insurance against loss of firm-specific human capital. The key issue for policy is how to reconcile the employers’ need for flexibility in hiring and firing with that of workers for employment security. Blanchard and Tirole (2004) discuss unemployed insurance and EPL together in a framework with risk-averse worker and risk-neutral entrepreneurs. They claim that a layoff tax can be efficiency enhancing, leading firms to internalise the costs of unemployment.

According to the OECD (2006) severance payment can be a barrier to efficiency-enhancing labour reallocation by discouraging workers from quitting their current jobs to move to better jobs. This problem arises where high tenure workers are entitled to significant severance payments, if they are laid-off from the current job, but loose this entitlement if they voluntarily quit jobs. Against this background the OECD (2006) mentioned the reform of severance pay in Austria as addressing this problem. Austria has reformed its severance pay legislation by changing from a performance-oriented to a contribution-oriented system of individual savings accounts. The reform extends the coverage of the system to all employees in the private sector, but lower average payments are expected.

In this paper we describe the reform of severance pay law and discuss some implications. The remainder of the paper is organized as follows. Section 2 provides some background information about the Austrian labour market and the pension system. Section 3 gives a description of the reform of the severance payment system and the problems driving the reform. We present figures concerning the development of the new system. Distributional issues and the role of severance pay as funded occupational pension are discussed. Section 4 gives an assessment of the impact of the new system on labour mobility and concludes.

2. 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 in Austria, the unemployment rate amounted to 5.2 % in 2005. The employment rate is around 68 % and above the EU-15 average. However, the employment rate of older workers is one of the lowest in Europe.

The unemployment rate has been continually rising during the 1980’s and 1990’s, with the only decline occurring during 1998-2001. However, as a consequence of slow economic development and increased labour supply unemployment has risen again during the last years.

According to social insurance register data the average number of individuals in active dependent employment in 2004 was 3,078,544. The average number of individuals registered as unemployed amounted to 243,880. These numbers hide, however, the strong labour turnover in the Austrian economy. In 2004, a total of 1,454,000 jobs were taken up and 1,423,000 employment contracts were terminated (BMWA 2005). Stiglauer et al. (2003) find that yearly job creation and destruction rates in Austria are comparable to the US, at least as one does not control for firm structure.
According to these figures, the Austrian labour market is characterised by high employment
dynamics. However, high seasonal fluctuations in employment are a feature of the Austrian
labour market. The variation in aggregate employment over the year is about 5 percentage points
from peak to trough. In magnitude this is similar to the fluctuations observed in Canada or
Scandinavian countries. Seasonal fluctuations can be explained partly by the big share of the
construction and tourism sector in the economy. Construction and tourism account for 1/3 of the
job seekers. Measures of worker reallocations, that do not consider short-term flows, indicate that
the Austrian labour market exhibits rather low dynamics in international comparison (see
Stiglbauer 2006). Aside from structural factors of the Austrian economy institutional regulations
contribute to the lower frequency of worker movements. Austria ranks in the middle of the OECD
countries with respect to the strictness of employment protection legislation (EPL) in the end of
the 1990s (OECD 2003).

Austria operates one of the most generous and complete PAYG (pay as you go) pension systems
in Europe. The system is financially costly and encouraged early retirement (OECD 2003). The
demographic development threatened the sustainability of the retirement system. Therefore the
Austrian government implemented several pension reforms with the aim to reduce early
retirement and secure the financial sustainability of the public pension scheme. In the long run the
reforms imply a reduction of the replacement rate in the public pension system. In the coalition
program 2000 the federal government stated their intention to develop a three pillars pension
system in Austria. The government intended that the severance payment reform could contribute
to the expansion of the underdeveloped second pension pillar.

3. The Severance Pay System in Austria

3.1 The former legislation

Severance pay was introduced in Austria for white-collar workers in 1921 and extended to all
workers in 1979. Austria’s former employment legislation stipulated that employees in the private
sector are entitled for severance pay if their employment spell lasted for at least three years
without interruption and was not terminated by the employee. An exemption was made for
construction workers. In order to qualify they must have been employed for only 92 weeks during
the previous three years, and not necessarily with only one employer. Note that the employees
have been entitled to severance pay in case of retirement. The payment amount was based on
the length of job tenure and was taxed at a low rate (6 %). 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 yearly income after 25 years. According to the former scheme workers received

- 2 times their monthly gross wages for employment durations of at least 3 years,
- 3 times the monthly wage for at least 5 years,
- 4 times the monthly wage for at least 10 years
- 6 times the monthly wage for at least 15 years
- 9 times the monthly wage for at least 20 years,
- and 12 times the monthly wage for at least 25 years.
Within the accounting system of the enterprises, severance payments were recorded as regular wage increases. Employers had to make provisions in their accounts for at least half the severance pay entitlements that could fall due. Overall, the expenditures for severance payment in 1997 amounted to approximately 2.5 % of the total wage bill (BMWA 2000).

3.1.1 Problems of the former system

Reforming the system of severance pay in Austria has been discussed controversial for a long time (see e.g. EIRO 2001). The former system has been called into question by two main reasons. It has been 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 former system of severance pay law reduced incentives to change employers (OECD 2001). In the case of self-termination of the employment contract the employee lost the entitlement for severance pay. Reducing labour mobility can be justified if it allows firms to recover investment in training, which would be lost if the employee quickly changed jobs. However, it is questionable, if the system was an efficient tool for increasing the qualifications of the workers, given that there is no link between entitlement to severance pay and the costs and the degree of optimal company-based training. 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 former severance pay system was not neutral with respect to sectoral employment. The system was biased against labour supply in industries with high employment fluctuations due to structural change or seasonality as in tourism.

The second major problem of the former severance pay law was the distribution of the entitlements among employees. According to Kristen et al. (2002) only one third of all workers became entitled for severance payments. 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.

The former system implied also some drawbacks for businesses, especially for small and medium sized enterprises (Kristen at al. 2002, BMWA 2006). Liquidity problems could occur if the firms had to make simultaneous severance payments and no provisions had been made.

Most studies on the impact of the Austrian severance pay system are based on theoretical arguments (e.g. Walther 1999) or anecdotal evidence. An exemption is the study of Card et al. (2006), which provides 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 of 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 lower by 8-12 % 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 for severance pay. Card et al. 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. find no evidence for selective firing prior to the 36-month-cutoff.

3.2 The new legislation

In mid-2001, Austria's government announced its intention to reform the country's system of statutory severance pay. The aim was to extend entitlement to a wider range of situations and to introduce an option of using payments to fund occupational pensions. However, important details like required minimum length of service for entitlement had been heavily discussed. 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 over the severance pay reform. In June 2002 the new severance pay law was adopted.

The new system (Abfertigung Neu) became effective in January 2003. It covers all employment contracts concluded after December 2002. As regards existing employment contracts, the possibility of a transfer from the former to the new severance payment law is provided. Severance pay claims are shifted to and enforceable by the so-called employee provision funds (“Mitarbeitervorsorgekassen” in the following MVK), which are legally independent from the employers. The employer is obliged to pay a contribution amounting to 1.53% of gross wages every month. 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 MVK or at the MVK 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%, annuities remain untaxed.

The reform extends the entitlement to severance pay considerably. Entitlement starts after one month and does not depend on the way of terminating the contract and job tenure. Instead of losing claim to severance pay in case of self-termination, employees can carry over the balance to the new employment relationship.
While at the former 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 MVK’s invest the employers’ contributions in the capital market, therefore the level of severance payment depends on the annual net yield. Figure 1 shows the evolution of severance pay claims in terms of the individual’s last monthly wage in the former vs. the new scheme (Koman et al. 2005). While in the former 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 value of the former system after 37 years. These calculations assume a rather high rate of return of 6 percent per annum.

3.2.1 Quantities of the employees and employers linked to the new system

The new severance pay system is applicable to all employment contracts concluded after the new law came into force (1 January 2003). For employment contracts concluded before January 2003 the possibility of arranging a transfer from the former to the new severance pay system has been provided for. The transfer to the new system is only possible by a mutual agreement between the employer and the employee.
Up to now almost 2m persons acquired claims in the new severance pay system (see Figure 2). Figure 3 shows the share of all employees in the new system, which are employed in the respective month, over all employees. In September 2006 almost 40 % of the workers are already...
linked to the new severance pay system. Until September 2006 322,143 enterprises have concluded contracts with the MVK’s.

Figure 2 demonstrates that the number of transfers from the former to the new system is low. Only 25,000 persons have changed into the new severance pay system. The transferred claims amount to 145m €. A potential reason for this small number is that a switch to the new system is not financially attractive for workers with long job-tenure. Firms seem to be reluctant to provide adequate offers, as they expect some workers to quit. Overall, due to the high dynamics of the Austrian labour market a considerable share of workers is already in the new severance pay system.

3.2.2 The role of the MVKs

The legislation provides that MVKs must invest the employers’ severance pay contributions in the capital market in order to increase revenues for the employees. The following nine MVKs have been established and licensed by the public authorities:

- BAWAG Allianz Mitarbeitervorsorgekasse AG [http://www.bawag-allianz-mvk.at/]
- APK-Mitarbeitervorsorgekasse AG [http://www.apk-mvk.at]
- BONUS Mitarbeitervorsorgekassen AG [http://www.bonusvorsorge.at]
- BUAK Mitarbeitervorsorgekasse GesmbH [http://www.buak-mvk.at]
- Niederösterreichische Vorsorgekasse AG [http://www.noevk.at]
- ÖVK Vorsorgekasse AG [http://www.oevk.co.at]
- Siemens Mitarbeitervorsorgekasse AG [http://www.siemens.at/mvk]
- VBV - Mitarbeitervorsorgekasse AG [http://www.vbv.co.at]
- VICTORIA VOLKSBANKEN Mitarbeitervorsorgekasse AG [http://www.vvmvk.at]

The employer concludes a contract with one MVK for all workers, which are in the new severance pay system. The choice of the MVK is decided via a employer/work council agreement. In enterprises without work council the employer decides in general. The change of the MVK is possible. Between 2004 and 2005 the assets managed by the MVK’s increased from 365m € to 697m €. In September 2006 the assets amount to one bn €.

MVKs are entitled to retain an administrative fee of 1 % up to 3.5% of annual severance pay contributions. Currently, actual fees charged are mainly in the range of 1.8 % to 2.9 % (GPA 2006). Additionally the MVK’s can charge up to 0.8 % of the invested capital as asset management fee. For the transfer of entitlements from the former severance pay scheme to one of the new funds (which is also possible by way of individually concluded contracts between companies and funds), the relevant MVK may impose charges up to 3% of the transferred amount. The actual charges are in the range of 0.5 % to 1.5 % (GPA 2006).
In the new system the level of severance payment depends on the performance of the MVK's 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% of the investment of severance pay. In 2003 the MVKs did not promise an investment yield higher than between 3% and 4%. In order to compete, they promoted their investment capacities. In 2004 and 2005 the MVK's performed an average annual net yield of 4.6% and 5.5%, respectively (see Figure 4).

Figure 4: Performance MVK’s

![Performance MVK’s](source)

The MVK's can invest in the following categories:

- bank assets (at most 25% at the same group of credit institutes),
- loans and credits,
- bonds,
- equities (at most 40%),
- share certificates of investment funds.

In principle at most 50% could be invested in foreign currency and at most 10% bonds and equities of the same company are permissible. The uncertainty and possibility of disbursement of severance payment implies a rather conservative portfolio composition. Figure 5 shows the asset allocation of the MVK's. In 2005 only 7.5% of the assets of the MVK's are invested in equities. The MVK's argue that a high return is only possible, if the portfolio contains more equities. However, due to the possibility of disbursement the expected holding periods are rather short and do not allow a higher share of equities. According to first estimates and the experience in 2006, every second employee eligible for payment will opt for disbursement.
3.3 Severance pay and occupational pensions

In the coalition program 2000 the federal government stated their intention to develop a three pillars pension system in Austria. The government announced to transform the system of mandatory severance payments into a new linear payment system scheme, which should act as funded pillar of the pension scheme. 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. However, the Austrian Trade Union Federation insisted on a choice for employees in the use of their severance pay entitlement, arguing that a compulsory occupational pension scheme (based on investments in the private capital market) would be a first step towards undermining the more secure statutory pension system (see EIRO 2001). 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%, 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. Koman et al. (2005) simulated a multi-pillar pension reform for Austria, using the World Bank’s Pension Reform Options Simulation Toolkit. Their reform scenario involves the move from the current notional defined benefit pension scheme to a notional defined contribution (NDC) scheme at the beginning of 2005, with a complete switch of all active contributors, a full recognition of accrued rights and a full protection of pensions already in payment, and the introduction of a second, mandated fully funded pillar, evaluated under two policy scenarios with contribution rates to the funded pillar of 5 percent and 10 percent, respectively.
Koman et al. claim that the severance pay law reform is only a first step toward the expansion of the underdeveloped second pension pillar in Austria. It replaces the former defined-benefit, final-salary severance payments scheme by a contribution-defined, fully funded system. 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 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.

### 3.4 Fairness of the new system

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. Koman et al. had to make two crucial assumptions. First, they do not observe complete individual employment careers and hence cannot say anything about the accumulation of severance payments during the working life. Second, they assumed no voluntary quits as no information on the cause ending the employment spell are available in the data.

According to the simulations severance payments will be 35 per cent lower in the new system compared to the former scheme in the sample mean. Due to the more pronounced effects of the new scheme those individuals who were disadvantaged in the former scheme will be even more so in the new. Mean payment according to both schemes differs mostly for women, young, and blue-collar workers. Note that the simulations did not consider accumulation effects during working life.

Overall, there are clear hints that the level of severance payments in the new system will be lower as in the former system. This is of course only true for workers, who did receive severance payments according to the former legislation. The reform unquestionably extends the number of workers entitled for severance pay considerably.

### 4. Conclusions

The reform of severance pay in Austria has attracted international attention (e.g. OECD 2006, European Commission 2006). In the new system employers are required to contribute 1.53 % of the gross wage to each workers individual account. This account is managed by the MVK’s, investing the balance in the private capital market. In the event of dismissal, an employee with at least three years of job tenure has the option to receive severance payment in cash. Alternatively, the worker can leave the accumulated balance in the account, which is then carried over to the next job. The latter rule applies for dismissions during the first three years of job tenure and for voluntary quits.

Up to now around 2m employees have acquired entitlements in the new severance pay system. This system provides 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. Therefore the “flexicurity” features of the Austrian labour market are strengthened. The reform extends the number of workers entitled for severance pay considerably, however, it is expected that average severance pay will be lower in the new system.

The former severance pay system was heavily criticised for distorting mobility decisions. 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. As far as I know no study exists, which estimates the quantitative impact on actual labour mobility. One can only speculate that the impact is currently at most modest as many workers with long tenure are still covered by the former legislation. Furthermore, reducing labour mobility may be justified, if it supports investment in firm specific human capital. Moreover, entitlement does not depend on the form of termination of the contract, therefore severance payment is not a layoff tax any more.

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 to claim 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.

5. Literature


Useful links:
http://www.bmwa.gv.at/abfertigungneu/vorsorgekasse.htm (in german)
http://www.mitarbeitervorsorgekassen.at/