Job Displacement Risk and Severance Pay

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Employment contracts often contain severance-pay provisions. Many countries also mandate minimum levels of severance pay and other forms of employment protection. Both privately-contracted and legislated severance pay provisions are commonly increasing, approximately linear, functions of job tenure. A candidate explanation for the existence of severance pay is as a means of (imperfectly) insuring workers against the risk of job loss.

Job displacement risk has two components: the loss of earnings during unemployment and the loss of earnings upon re-employment associated with the loss of pre-displacement tenure. The first component is short-lived, at least in Anglo-Saxon countries where the average unemployment duration is of the order of one quarter. Conversely, a large body of empirical evidence documents that post-displacement earnings losses are large and persistent, of the order of 25 per cent in the post-displacement year and 10 per cent after six years.

The existing literature studying the effects of severance pay in the presence of incomplete insurance markets has considered only the first type of risk and concluded that the insurance benefits of severance pay are negligible. Instead, we reassess the role of severance pay as an insurance device in a quantitative framework featuring *both* transitory unemployment risk *and* persistent earnings reductions upon re-employment. In contrast to previous studies, we find that the welfare gains from the insurance against job displacement afforded by severance pay are sizeable. Most of these gains stem from the fact that severance pay provides insurance against the – persistent – earnings loss associated with job displacement. Finally, the model can account for why severance pay is generally an increasing function of on-the-job tenure. Keeping constant the average severance transfer, the average welfare gain is between 15 and 20 per cent higher if the transfer is (linearly) increasing in tenure. A tenure-independent transfer over-insures workers with low tenure.