Empirical Analysis of the Severance Pay Non-Performance in Slovenia

Milan Vodopivec
Lilijana Madjar
Primož Dolenc

Combining information from the Firm Survey of Labor Costs with the information about claims filed with the Guarantee Fund by workers whose employers defaulted on their severance pay obligations, the paper analyzes the so-called non-performance problem of severance pay – the fact that coverage, and thus legal entitlement, does not guarantee the actual receipt of the benefit – as experienced in Slovenia in 2000. The findings are threefold: (i) one-third of total obligations incurred by firms failed to be honored and only a small portion of defaulted severance pay claims was reimbursed by the Guarantee Fund; (ii) while both men and women seem to be equally affected, workers older than 40 were disproportionally represented among those whose severance pay claims failed to be honored; and, (iii) among firms that incurred severance pay liabilities, larger and more productive firms were more likely to observe their fiduciary obligations and pay them out. These findings corroborate the weaknesses of severance pay as an income protection program, pointing to the large scale of the non-performance problem and the inequities created by it.

Key Words: severance pay, severance pay non-performance, Guarantee Fund, Slovenia
JEL *Classification:* J65, J32

Introduction

Being widely used in both the developed and developing world, severance pay is the most prevalent program offering income compensation in the case of job loss.[1] Despite being so widespread, evaluations show that severance pay not only creates important inefficiencies but also often fails to provide adequate protection. On the efficiency front, severance

Dr Milan Vodopivec is a Lead Economist at the World Bank, USA.
Lilijana Madjar is Director of the Public Guarantee Fund of Slovenia.
Dr Primož Dolenc is an Assistant Professor at the Faculty of Management Koper, University of Primorska, Slovenia.

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pay reduces employment and labor market flows, hinders technological progress and innovations, pushes workers into the informal sector, and creates significant litigation costs (see Addison and Teixeira (2001) for a review of both theoretical and empirical effects). Its scorecard on the income protection front is also rather negative. First, generous severance pay hinders access to formal sector jobs by disadvantaged groups (OECD 1999). Second, the same amount of severance is paid regardless of the duration of the unemployment spell following the separation, resulting in over-payments to workers with short and under-payments to workers with long unemployment spells. And third, severance pay suffers from the so-called non-performance problem – the fact that coverage, and thus legal entitlement, does not guarantee the actual receipt of the benefit.

The non-performance of severance pay is largely an 'uncharted territory,' as only a handful of studies provide hard empirical evidence about this aspect of severance pay. Because severance is not administered by a public authority, information about the incidence of severance pay obligations as well as about how frequently firms actually honor such obligations is rarely accessible. While ad-hoc evidence exists (for example, from litigation cases where workers are suing their employers for the non-payment of severance pay), we are familiar with only two studies that report evidence on non-performance-based on micro-data. One is MacIsaac and Rama (2000), who estimate that in the early 1990s only about half of Peruvian workers legally entitled to severance pay received the benefit (MacIsaac and Rama report that the payment was more likely if workers had a written contract and if they worked in a large, unionized firm that paid social security contributions). The other is Mansor et al. (2001), who report that Malaysian workers who were laid off in 1998 received 83 percent of the total amount of severance pay that they claimed from their employers.

This paper is an attempt to provide further insights into the non-performance problem of the severance pay. It focuses on the Slovenian severance pay program and addresses the following questions:

- How severe is the non-performance problem in Slovenia? That is, of total liabilities arising from the payment of severance, what are (i) the share of severance pay paid out by firms, (ii) the share paid out by the Guarantee Fund of Slovenia, and (iii) the share that failed to be paid out?
- In particular, are any groups strongly affected? That is, what is the

age and sex composition of workers whose severance pay claims are not honored?

- What are the characteristics of the firms that honor their obligations arising from severance pay in comparison to those that fail to do so?

Because of information availability, Slovenia is particularly suitable for studying the above questions. First, in 2000 the Statistical Office of Slovenia carried out a survey of labor costs incurred by firms, the survey that among others provides information about the amount of severance paid out by each firm. Second, Slovenia is one of few transition countries that has introduced the Guarantee Fund to help the laid-off workers with partial reimbursement of their outstanding severance pay claims, and the information collected by this fund is a valuable source for studying severance pay non-performance.[2]

These two sources – the Firm Survey of Labor Costs and the Guarantee Fund – are thus complementary, one providing information about severance pay obligations paid out by firms and the other about obligations that failed to be paid out by firms. Taken together, the data establish a composite rendering of fulfilled and unfulfilled severance pay obligations in Slovenia.

The main findings of the paper are as follows. First, the non-performance of severance pay has been a significant problem in Slovenia, with one-third of total obligations incurred by firms failing to be honored (in 2000, the year focused upon by the study) and only a small portion of non-paid severance pay claims being reimbursed by the Guarantee Fund. Second, while both men and women seem to be equally affected, workers older than 40 were disproportionally represented among those whose severance pay claims failed to be honored. And third, among firms that incurred severance pay liabilities, larger and more productive firms were more likely to pay them out.

These findings corroborate the weaknesses of severance pay as an income protection program, pointing to the large scale of the non-performance problem and inequities created by it.

The paper is organized as follows. The second section describes the legal framework of severance pay in Slovenia. The third section provides a comparison of severance pay programs in transition countries. The fourth describes the data and methodology, and the fifth section presents the results of the empirical analysis of the non-performance problem of the Slovenian severance pay program. The last section concludes with a summary and policy implications.

Description of the Legal System of Slovenia's Severance Pay

In Slovenia, severance pay is regulated by the Labor Code, the Law on the Public Guarantee Fund, and the Law on Bankruptcy and Liquidation, and is further guided by Collective bargaining agreements, as well as individual contracts (on the managerial level). Mandated severance pay is paid to laid-off workers and workers who retire, with the level of pay proportional to the work tenure of the worker with his or her former employer. To address the non-performance problem of severance pay, a Guarantee Fund was introduced in 1997, with the Fund partly reimbursing the unpaid severance pay claims of workers.

Slovenia introduced a Labor Code in 1990 and a new one in 2003. The 1990 Labor Code mandated severance for early retirees as well as for redundant workers. While for early retirees the law did not prescribe the amount of severance pay, it did so for redundant workers. For each year of service, workers with at least two years of service were entitled to half of their monthly average wage for every year of service, with the wage determined on the basis of the wage paid in the last three months of employment. Other cases for severance pay were not legally binding.

The 2003 Labor Code significantly differs from the previous one, by defining more precisely the obligations on the part of employers and the rights of workers. Workers are entitled to severance pay if they retire or they are dismissed (either because of business reasons or bankruptcy or even in the case of his/her incompetence). Retired workers are entitled to the severance pay of two average wages, calculated from three-months' average wage in Slovenia, or (if more favorable to the employee) two average wages, calculated from his/her three-months' average wage before retirement. In contrast, the basis for the calculation of the severance pay for dismissed workers is the average monthly wage which was received by the employee, or which would have been received by the worker if working, in the last three months before the termination is taken. The employee is entitled to severance pay amounting to:

- 1/5 of the basis for each year of employment with the employer, if the employee has been employed with the employer for more than one and up to five years;
- 1/4 of the basis for each year of employment with the employer, if the employee has been employed with the employer for period from five to fifteen years;
- 1/3 of the basis for each year of employment with the employer, if

the employee has been employed with the employer for period exceeding fifteen years.

It is worthwhile to stress that also under the 2003 law, the severance pay program remains unrelated to the unemployment insurance program. That is, qualifying workers receive severance pay and, in addition, they also qualify for unemployment insurance benefits (which can be received for up to two years, see van Ours and Vodopivec 2006).

To protect worker's rights in the case of a firm's insolvency, in 1997 Slovenia – following the 1980 EU directive 80/987 – introduced the Public Guarantee Fund. Workers, legally entitled to severance pay but unsuccessful in its exaction, can claim partial reimbursement of their severance pay claims from the Fund, with the ceiling on such reimbursements being a monthly minimum wage.[3] Moreover, under the 1993 Law on Bankruptcy and Liquidation, workers can sue their former employers that undergo a liquidation or bankruptcy process, with workers' severance pay claims having a priority over other claims (up to a limit – for details, see Kresal Šoltes 1997).

Review of Severance Pay Program in Transition Countries

In putting Slovenia in an international context, we draw heavily on the Schwab (2003) analysis of 21 transition countries.[4] While all these countries mandate severance pay, the countries differ in important details. These include the extent of coverage, eligibility conditions, generosity of benefits and whether benefits should vary with seniority, and what to do when bankruptcy prevents the employer from making severance payments.

ELIGIBILITY

Transition countries mandate severance pay for economic dismissals such as the employer's liquidation, bankruptcy, or reduction of staff due to economic, technological, structural, or similar changes.[5] Many countries require severance pay only for economic dismissals. These countries include the Czech Republic, Georgia, Hungary, Macedonia, Poland, Serbia, Slovak Republic, Slovenia, and Vietnam. In some other countries, though, workers are also entitled to severance pay for a variety of other dismissals. These other dismissals are generally for individual reasons, such as when the worker proves incompetent for the position or is disabled by health reasons.

Not all dismissed workers, even among those dismissed for economic reasons, are entitled to severance payments. Countries differ in eligibility conditions. One-third of the countries included in our analysis require a minimum length of employment with the firm before a dismissed worker is entitled to severance pay. The required seniority ranges from one to three years for economic dismissals, and up to five years for other dismissals. Slovenia and Vietnam require one year of employment before a worker is entitled to severance pay. Bosnia and Herzegovina, Croatia, and Macedonia require two years of seniority. Hungary requires three years of seniority. Bulgaria requires five year of seniority before a worker is entitled to severance pay for dismissals due to illness (but has no seniority requirements for economic dismissals).

LEVEL OF BENEFITS

Of the 21 countries included in our analysis, 13 use a sliding scale connected to years of employment – Bulgaria, China, Croatia, Estonia, Hungary, Latvia, Lithuania, Macedonia, North Korea, Poland, Serbia and Montenegro, Slovenia, and Vietnam; severance pay in the rest of the countries included in the study does not vary with seniority. By design, in sliding-scale countries more senior workers are entitled to more generous severance pay. In general, the level of benefits in sliding-scale countries exceeds those in fixed-benefit countries.

DEALING WITH THE NON-PERFORMANCE PROBLEM

A major issue connected with severance pay is the inability of insolvent employers to make severance payments. Fifteen countries have ratified ILO Convention 173, including four transition countries: Latvia, Lithuania, Slovakia, and Slovenia. According to this convention, countries can choose between giving priority to severance pay claims in the employer's bankruptcy proceedings or creating a Guarantee Fund to protect severance-pay claims (together with unpaid wages) – with Slovenia, as mentioned above, opting for both.

Data and Methodology

Below we describe the micro-level data sources and methodology used in the empirical analysis of Slovenia's severance pay.

DATA SOURCES

The following data sources are used:

- Firm-level data were obtained from the 2000 Labor Costs Survey in Slovenia, administered by the Statistical Office of Slovenia. The sample comprised 3,021 enterprises, selected among those with 10 or more workers. Information included severance pay that firms paid both to laid-off and retired workers.
- Individual-level data were gathered from worker requests to the Guarantee Fund of Slovenia in the period from 1994 to 2003. For each individual, data included unpaid severance pay obligations, requested amount from the Fund, amount paid by the Fund, the gender and age of the applicant, and previous employer.
- Firm-level measure of efficiency produced by production function estimation. We used the value of the error term – ε_{ijt} – for 2000, obtained by the following OLS estimation of translog production function for the Slovenian manufacturing firms for the 1994–2001 period:

$$\ln q_{ijt} = \alpha_0 + \sum_{k=1}^{n} \alpha_k \ln x_{ijkt} + \frac{1}{2} \sum_{k=1}^{n} \sum_{1=1}^{n} \beta_{kl} \ln x_{ijkt} \ln x_{ijlt} + \varepsilon_{ijt}, \quad (1)$$

where the inputs xijkt include measures of labor, capital, and material inputs; α_k and β_{kl} are, respectively, first- and second-order translog production parameters (i refers to individual firms, j to two-digit industry categories, and t to time) – see Orazem and Vodopivec (2008) for details of estimation and data sources used.[6]

Methodology for the analysis of firm-level determinants of severance pay payout. To investigate whether firm efficiency and size affect the likelihood of paying severance pay given that firms incurred such costs, that is, that they laid-off workers, we ran a multinomial logit model with the following options for the dependent variable:

- firm did not incur severance obligations (taken as a baseline),
- firm incurred severance obligations and paid them, and
- firm incurred severance obligations and did not pay them.

As explanatory variables, we used efficiency of the firm and firm size. To capture firm size effects, we used a dummy variable indicating whether a firm had more than 100 workers.

Empirical Results

This section presents the results of our empirical analysis of the severance pay non-performance in Slovenia. As explained above, we focus on

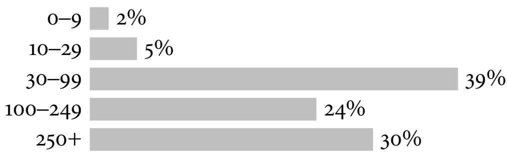

FIGURE 1 Paid severance pay – structure by size, 2000 (computations based on the 2000 Labor Cost Survey)

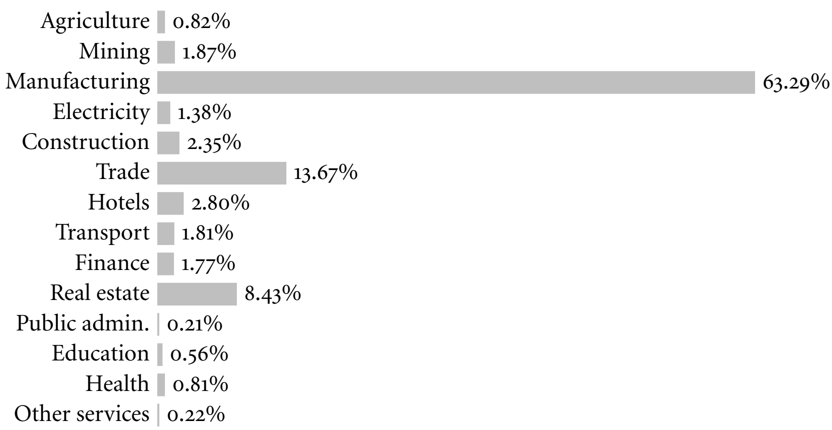

FIGURE 2 Paid severance pay – structure by industry, 2000 (computations based on the 2000 Labor Cost Survey)

the following aspects: the severity of the non-performance problem, the composition of workers whose severance pay claims fail to be paid out, and the characteristics of firms that fail to pay their severance pay obligations.

To put these questions in the context, however, let us first present statistics about severance pay liabilities that were paid out. We focus on year 2000, the year for which we have Labor Cost Survey data. First, the overall amount of severance pay liabilities paid out in 2000 was €17.5 million – 0.085 percent of GDP or 0.2 percent of the total wage bill. While this is a rather modest amount, it certainly is not a negligible one. Second, most of severance pay obligations was paid by large firms; for example, 93 percent of severance pay was paid out by firms with more than 30 workers (see figure 1). Third, the majority (more than 60 percent) of paid severance pay obligations was incurred in manufacturing (figure 2), suggesting that in 2000 this sector was still undergoing an intense restructuring.

TABLE 1 Severance pay payments, reimbursements, and unpaid claims, 2000

	(1)	(2)	(3)	(4)
Payments made by firms	17.5	64.3	0.085	0.162
Reimbursements made by the Guarantee Fund	0.7	2.7	0.004	0.007
Unpaid severance pay claims	9.0	33.0	0.044	0.083
Total	27.3	100.0	0.132	0.252

NOTES (1) amount (€ million), (2) structure (%), (3) share in GDP (%), (4) share in worker compensation (%). Computations based on 2000 Labor Costs Survey and the Guarantee Fund of Slovenia.

SEVERITY OF SEVERANCE PAY NON-PERFORMANCE

Our results show that in 2000, the non-performance of severance pay posed a serious problem in Slovenia. Out of the total of € 27.3 million severance pay obligations, € 9.0 million – 33 percent – failed to be honored (by firms that incurred these obligations or by the Guarantee Fund – see table 1). The role of the Guarantee Fund in helping with unpaid obligations proved to be very limited, as the Fund only reimbursed € 0.7 million or 7.2 percent of total unpaid severance pay obligations.[7] Indeed, according to its rules (see above), the Guarantee Fund reimbursed unpaid severance pay claims only partially, and so less than 10 percent of the average claim was actually reimbursed (see figure 3).

In the 1990s, the magnitude of the non-performance of severance pay was most likely even larger. Figure 4 shows the number of cases of severance pay reimbursements by the Guarantee Fund in the period from 1994 until 2003. This figure reflects the pattern of transition and suggests that the problem of severance pay non-performance was probably even more serious in the mid-1990s, when the number of workers turning to the Guarantee Fund for reimbursements was more than double the number in 2000. Moreover, in the period from 1994 to 2003 around 43,000 workers failed to receive payment from their former employers despite their legal entitlement.

WHICH WORKERS ARE AFFECTED BY NON-PERFORMANCE OF SEVERANCE PAY?

To find out whether some groups of workers were disproportionally affected by severance pay non-performance, we analyzed the composition of workers reporting unpaid severance claims. We found no evidence of differences between men and women, but workers above 40 years were more affected by severance pay non-performance than younger workers.

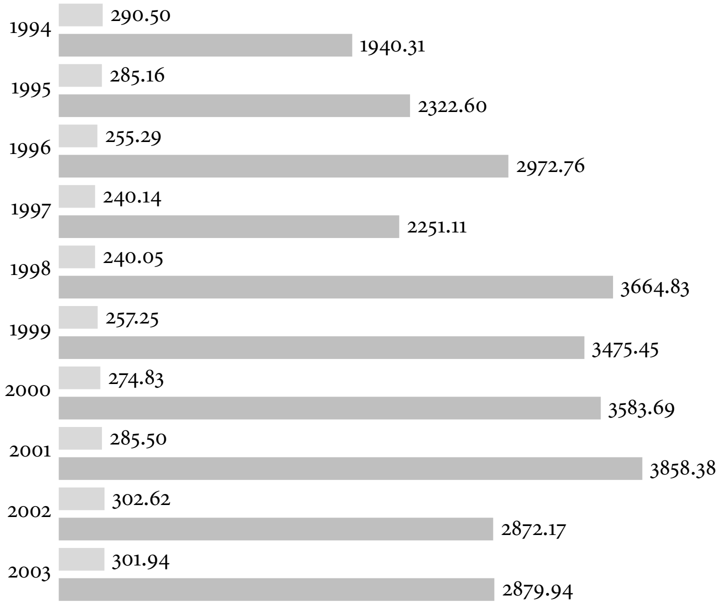

FIGURE 3 Average severance pay claims and reimbursements, 1994–2003 (€, light gray – average reimbursments, dark gray – average claims; computations based on information provided by the Guarantee Fund of Slovenia)

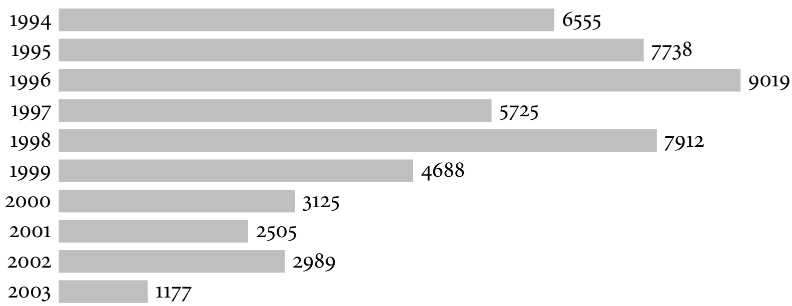

FIGURE 4 Number of cases of reimbursements, 1994–2003 (based on information provided by the Guarantee Fund of Slovenia)

Figure 5 shows that severance pay non-performance has not affected men and women differently, as the reimbursements to men and women were rather similar in size. Over the 1994–2003 period, the Guarantee Fund paid 50.8 percent of total severance pay reimbursements to women and 49.2 percent to men), which correspond well to the employment shares of these groups (in 2000, men represented 51 percent of total employment and women 49 percent).

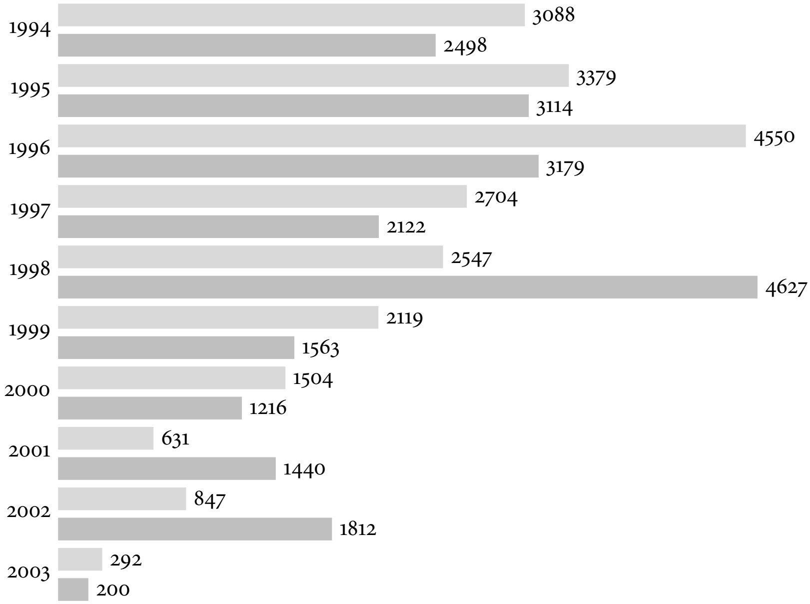

FIGURE 5 Structure of severance pay reimbursements by gender, 2000 (€, light gray – men, dark gray – women; based on information provided by the Guarantee Fund of Slovenia)

Turning to the age distribution of claimants, figure 6 compares the age distribution of severance pay claimants with the age distribution of the active population in Slovenia in the same period (1994–2003). Clearly, among the claimants, workers over 40 years of age are over-represented – while their share in the population is 47 percent and 42 percent for men and women, respectively, their share among the claimants is 64 percent and 51 percent for men and women, respectively.

FIRM CHARACTERISTICS AND NON-PERFORMANCE

The last part of our analysis sheds light on characteristics of firms that are paying out severance pay in comparison to those that are failing to honor their legal entitlements. The estimation of the multinominal logit model (see table 2) shows that the larger and more productive the firm, the more likely it is to honor its severance pay obligations.

Concluding Remarks

Being one of the rare examples of its kind, the paper seeks to provide insights into the non-performance problem of severance pay by analyz-

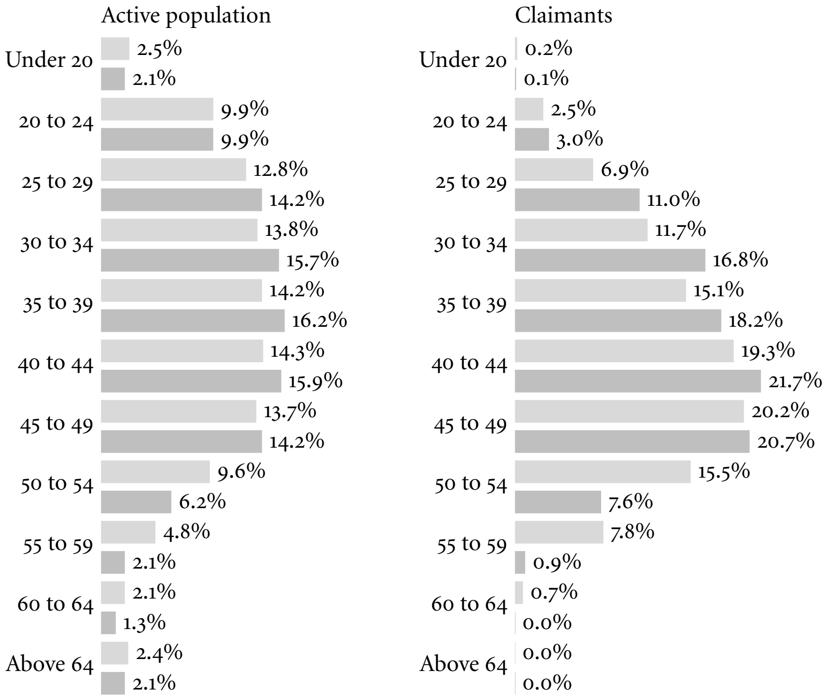

FIGURE 6 Age distribution of claimants and active population in Slovenia, 1994–2003 (light gray – man, dark gray – women; based on the information provided by the Guarantee Fund of Slovenia)

ing the working of this program in Slovenia. Our findings suggest that severance pay non-performance has been a significant problem in Slovenia. In 2000, only two-thirds of total severance pay obligations were actually honored, a small portion of non-paid severance pay claims was reimbursed by the Guarantee Fund, and the rest – one-third of total obligations – was not paid at all. Moreover, we showed that while both men and women were equally affected, workers older than 40 years were more likely than younger ones to be confronted by severance pay non-performance. And, finally, we also found that among firms that incurred severance pay liabilities, larger and more productive firms were more likely to pay them out.

Taken together, these findings shed a rather negative light on severance pay as an income protection program for the unemployed. First, the program fails to protect a significant share of those who are legally entitled to such protection – even after the introduction of the Guarantee Fund.

TABLE 2 Multinomial logit estimates of the likelihood of severance pay non-performance

	Multinomial logit estimates				Descriptive statistics[1]	
	Paying severance obligations		Failing to pay severance obligations			
	(1)	(2)	(1)	(2)	(3)	(4)
(a)	–0.04	0.49	–5.76**	2.17	0.07	0.21
(b)	1.38**	0.28	0.47	0.88	0.61	0.49
(c)	–286**	0.25	–5.35**	0.81		

NOTES The definition of dependent variable: not incurring severance obligations is taken as a baseline, and incurring severance obligations and paying them, and incurring severance obligations and failing to pay them, as other options. No. of observations: 816, pseudo R^2: 0,056. [1] Mean value of dependent variable is 0/08, and its standard error is 0.27. (a) Efficiency of the firm, (b) size of the firm (1 if firm's employment exceeds 100 workers, 0 otherwise), (c) constant; (1) coefficient, (2) robust standard error, (3) mean, (4) standard deviation. Significance at 1 and 5 percent levels are indicated by ** and *, respectively.

Second, the program is prone to creating inequities, as it disproportionally affected older workers. At the same time, our findings also provide some clues about how to make the program more effective. The fact that less productive – and hence less profitable – firms are less likely to honor their obligations suggests that non-performance is strongly related to the non-funded nature and limited risk-pooling of severance pay, and thus the recommendation of converting severance pay to a funded program.

Let us conclude with recommendations for better coordinating severance pay with other income support systems for the unemployed. First, countries with both unemployment insurance and severance pay programs (Slovenia being one of them) can save on costs without reducing insurance by better coordinating payments under the two programs. Namely, unemployment insurance eligibility rules could be adjusted so that insurance benefits would only start after the severance benefits 'expire,' that is, after *n* months, if the individual received *n* monthly wages as the severance payment (such a program is in place in some developed countries, for example, in Canada – see Vodopivec 2004).

Another possibility – explicitly addressing the non-performance problem – is the conversion of severance pay to pre-funded unemployment insurance savings accounts (UISAS), a reform implemented by Austria in 2002.[8] Besides correcting for the non-performance problem, UISAS would improve efficiency by removing obstacles to labor market flexibility and reducing litigation costs. Lastly, the most radical option is the introduction of an integrated severance and UI system (Chilean model), consisting of two components: UISAS and a solidarity fund, with benefit recipients first drawing benefits from their UISAS and upon depletion, reverting to the solidarity fund (for details of the reform, see Acevedo, eskenazi, and Pagés 2006, and for theoretical considerations, Parsons, forthcoming).

Acknowledgments

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Notes

1 See Holzmann, Iyer, and Vodopivec (2008) for a survey of the incidence of the severance pay around the world and a review of the origin, economic rationale, and current attempts to reform severance pay programs.

2 Guarantee Fund also exists in Estonia, Romania and Uzbekistan.

3 Under the 1993 Law on Bankruptcy and Liquidation, workers can sue their former employers that undergo a liquidation or bankruptcy process, with workers' severance pay claims having a priority over other claims (up to a limit – for details, see Kresal Šoltes 1997).

4 Three socialist countries (China, North Korea, and Vietnam); eight successor countries of USSR (Azerbaijan, Estonia, Georgia, Kazakhstan, Latvia, Lithuania, Russia, and Ukraine); five successor countries of Yugoslavia (Bosnia and Herzegovina, Croatia, Macedonia, Serbia and Montenegro, and Slovenia); two successor countries of Czechoslovakia (Czech Republic and Slovak Republic), and three former socialist European countries (Bulgaria, Hungary, and Poland).

5 Most OECD countries also have mandatory severance pay programs, but some – including Australia, Denmark, Finland, Germany, Japan, Netherlands, New Zealand, Norway, Sweden, and the United States – leave such arrangements to collective bargaining or rely on the common law provisions. For example, in the Netherlands, even though the law does not require severance pay, employers often make payments to dismissed workers to avoid legal proceedings for an 'obviously unreasonable dismissal.' The cantonal courts have even created a statutory-like formula for the amount of severance payments.

6 Alternative measures of efficiency, obtained via fixed effects and random effects estimation of the above translog production function, yielded similar results.

7 It is possible that some workers received additional reimbursement from bankruptcy or liquidation proceeds – we do not have any information about such reimbursements.

8 In 2002, Austria converted its severance pay to a fully funded contributory system akin to unemployment insurance savings accounts (Koman, Schuh, and Weber 2005). The reform extended the entitlement to workers with short tenures and removed obstacles to worker mobility, granting full portability and allowing the accumulation of benefits from the beginning of an employment spell. Employers pay 1.5 percent of each worker's salary to each individual worker, with resources held in a central account and invested in the capital market. Laid-off workers with job tenure of three years or more can withdraw accumulations in their accounts or keep them and claim them upon retirement. Workers who separate voluntarily or have tenures of less than three years are denied the right of immediate withdrawal, a feature that may hinder worker mobility.

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