Trends in recent World Bank support for severance pay

Understanding recent Bank lending for severance payments to retrenched public employees can aid assessments of new projects with severance components.

This note summarizes the operational perspective and design of severance packages supported by Bank loans and credits. The analysis focuses on severance-funding investment projects approved between fiscal 2000 and 2004, during which time revised expenditure eligibility guidelines were issued (in April 2004; see World Bank 2004). Adjustment projects that supported severance were not analyzed because project documents do not separate severance costs from others. The analysis also did not include investment projects that paid consultants to design organizational restructuring or severance packages but that did not fund actual payments to retrenched workers.

The Bank’s evolving views on severance payments

Severance payments, with their link to retrenchment, are a sensitive issue around the world. The Bank has internally debated whether financing the closure of a government unit—creating the need for severance payments—qualifies as an “investment for productive purposes” under the Bank’s Articles of Agreement.

Over the past 20 years, 96 adjustment operations have supported retrenchment and severance payments in public sector reform projects involving staff reductions. Investment lending involving severance support has been much less uniform. In the context of closing down Liberian iron ore mines, in 1985 the Loan Committee recommended that the borrower bear the costs of severance pay and the Bank finance other project components, including retraining of dismissed workers. But that approach limited the Bank’s ability to support public enterprise reform because severance pay could be funded only indirectly, through adjustment lending.

So, a 1996 Operational Memorandum permitted investment lending to directly fund severance pay for retrenched employees of public enterprises, though not any other type of public employees. But retrenchment is an important part of public sector reform, and funding other types of severance through separate adjustment operations made it difficult to provide the close supervision required for this component. Accordingly, a 2002 Operational Memorandum expanded the scope of investment lending for severance payments beyond public enterprises to other categories of public employment, including ministries, subnational governments, subvented agencies, and service providers.

Severance features of recent operations

Severance funding projects approved between fiscal 2000 and 2004 had the following features:

- The rollout of projects was uneven. During fiscal 2002 and 2003 there were no new investment or adjustment projects involving severance funding (table 1). This slowdown may have been due to a desire among Bank staff to observe the changes resulting from the 2002 Operational Memorandum. Things recovered in fiscal 2004, with the Bank’s Board approv-
Severance support has grown in recent years.

- **Severance funding accounted for a small but growing share of investment lending.** Severance components accounted for 0.9 percent of investment lending in fiscal 2000, 3.4 percent in 2001, and 4.2 percent in 2004.

- **Severance components of investment projects were typically less than 15 percent of the country’s base case IDA/IBRD allocation for investment lending in the approval year.** In fiscal 2004 there were just two exceptions. One was Nepal’s Financial Sector Restructuring Project, where the severance component accounted for 25 percent of the country’s IDA allocation. The other was Poland’s Hard Coal Social Mitigation Project, where severance equaled 50 percent of the year’s proposed IBRD allocation. Poland’s EU accession required it to borrow heavily for retrenchment and severance costs.

- **Some projects supported only part of the severance payments linked to the related retrenchment.** Bank loans or credits did not entirely cover severance components in nearly a quarter (22 percent) of investment projects. In such cases the government or other international organizations provided the balance. For example, the total severance cost in Poland’s Railway Restructuring Project (fiscal 2001) was $335 million. The Bank provided $101 million; the borrower and other sources covered the rest.

- **Most severance support still went to retrenched employees of public enterprises.** As noted, the changes introduced by the 2002 Operational Memorandum were considered necessary because the previous one (in 1996) had restricted severance support to employees of public enterprises. But only a quarter of the severance-funding investment projects approved after 2002 supported retrenchment outside public enterprises. Some teachers will be retrenched in Armenia’s Education Quality and Relevance Project (fiscal 2004), and a small number of postal employees will be retrenched in Niger’s Financial Sector Restructuring Project (fiscal 2004). The volume of severance support also differed markedly: support for employees retrenched from public enterprises was 100 times that for other types of employees.

- **The share of severance components in loans supporting retrenchment covered a wide range.** It was as low as 5 percent of the total loan in the Uttar Pradesh (India) Power Sector Restructuring Project (fiscal 2000) and as high as 100 percent in Poland’s Hard Coal Social Mitigation Project. In half of the reviewed projects, severance components were 20 percent or less of the loan—while in nearly a third, they were more than 80 percent. This finding could have operational significance, such as a need for closer review of projects with severance components higher than 20 percent.

- **Retroactive financing of the severance component was allowed in 31 percent of the projects.**

**Design features of severance payments**

Amounts of severance payments have been guided by entitlements laid down in employment laws and regulations. To encourage employees to leave, some governments have paid more than the statutory amount. When employment laws have not specified severance payments, packages have been determined by negotiations between government and employee representatives. The following trends were noticed in the size and composition of severance packages:

- **The number of employees downsized in Bank-supported retrenchment varied enormously, ranging from 100 (in the Dominican Republic’s**

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**Table 1  Bank projects supporting severance payments, fiscal 1996–2004**

<table>
<thead>
<tr>
<th>Year</th>
<th>Investment projects</th>
<th>Adjustment projects</th>
<th>Total</th>
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<td>9</td>
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<tr>
<td><strong>Total</strong></td>
<td><strong>31</strong></td>
<td><strong>34</strong></td>
<td><strong>65</strong></td>
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</tbody>
</table>

Telecommunications Regulatory Reform Project to 48,000 (in Turkey’s Privatization Social Support Project). Nearly one-third of the projects (30 percent) were tied to large-scale downsizing operations involving 10,000 or more employees.

- **Total and per capita severance payments also varied.** The size of the entire severance package, whether funded wholly or partly by the Bank, ranged from $1.5 million (in the Dominican Republic’s telecommunications project) to $322 million (in Turkey’s privatization project). Severance payments per employee ranged from $1,600 in Tanzania’s Second Financial Institutions Development Project (fiscal 2000) to $25,000 in Honduras’s Trade Facilitation and Productivity Enhancement Project (fiscal 2004). The average per employee severance payment rose from $3,500 in 2000 to $7,400 in 2001—and to $15,000 in 2004.

- **Redundancy was more common than voluntary retirement as the method of downsizing.** More than half (56 percent) of the projects declared employees redundant, while a quarter funded voluntary retirement. The rest chose a mix of the two methods, depending on whether voluntary retirement was an option for part of the employee population being retrenched. Voluntary retirement is usually considered more expensive than redundancy because it provides incentives for eligible employees to leave. But the average severance package for voluntary retirement ($11,600) was smaller than that for workers declared redundant ($12,300). The reason for this unexpected finding could be that severance packages connected with redundancy paid more than statutory obligations due to negotiations with employee unions or packages provided in previous retrenchment exercises. When voluntary retirement was the selected method, project documents did not explain how adverse selection was avoided. Poland’s Hard Coal Social Mitigation Project was the only one that discussed the pension liabilities associated with early voluntary retirement.

- **Severance pay varied by region.** While projects in Europe and Central Asia supported an average severance payment of 2.7 times per capita gross national income (GNI), in Sub-Saharan Africa the average payment was 39 times per capita GNI. Regional averages were not calculated for South Asia or Latin America and the Caribbean because each region had just two projects.

- **Training and assistance programs for retrenched workers were common but not universal parts of severance funding projects.** Nearly two-thirds (63 percent) of projects had components, funded fully or partly by the Bank, designed to mitigate the hardships facing retrenched workers. But two projects approved in fiscal 2004 (Honduras Trade Facilitation and Productivity Enhancement and Nepal Financial Sector Restructuring) stated that the generous severance obviated the need for separate social mitigation measures for retrenched employees.

- **Training and assistance components were small relative to severance packages.** With a median value of 8 percent of severance costs, this component ranged from 2 percent of severance (in Mali’s Transport Corridors Project) to 20 percent (in Croatia’s Rijeka Gateway Project, where this component was funded by the European Union). This differs from an earlier finding that “for each dollar spent on workers’ compensation, 2 dollars were spent on enhancing safety nets” (Rama 2004). Half of the projects funded tracer studies of retrenched employees.

- **The design of training and assistance was mostly supply driven.** Activities funded for this purpose included communication, counseling, career, and advisory services, management and entrepreneurship training, outreach to opinion leaders, and focused media campaigns. Only 12 percent of project documents displayed evidence of consulting those whom these activities were meant to benefit—the employees being retrenched. As part of Mozambique’s Railways and Port Restructuring Project (fiscal 2000), more than 3,000 potential retrenched workers were asked what hardship mitigation would
Many questions about severance funding remain unanswered.

be most useful to them. Surprisingly, 42 percent said they would prefer being retrenched to continuing in their jobs. A similar survey conducted for Zambia’s Railways Restructuring Project (fiscal 2001) found that employees wanted to be informed about retrenchment as early as possible and that they valued timely disbursement of severance payments. They also wanted fair treatment of all retrenched employees—because during an earlier retrenchment exercise, some retrenched employees had later been rehired at higher salaries.

- Most projects conducted economic—in addition to financial—analysis of investments in severance. Among the factors considered were wages saved, current productivity, probability of retrenched employees finding employment, and future earnings of retrenched employees. The average economic rate of return of the retrenchment component ranged from 9–25 percent, with a median of 15 percent. The share of retrenched employees estimated to find formal employment ranged from 2.5 percent in Uganda’s Privatization and Utility Sector Reform Project (fiscal 2000) to 70 percent in Poland’s Hard Coal Social Mitigation Project. Future income was estimated to be 50–75 percent of the level before retrenchment. Three-fifths of the economic analyses included sensitivity analysis of the possibility of retrenched employees obtaining formal employment or taking up self-employment, and the expected earnings in each case.

Next steps
These findings, while highlighting severance the Bank has recently supported, also raise questions that remain unanswered, because most of the severance-funding investment projects reviewed are still active. Following retrenchment, was the smaller size of public employees maintained, or was there substantial rehiring? How rigorous was the economic rate of return analysis? Were assumptions about retrenched employees finding new employment justified? The stark regional differences in average severance payments also raise the question of whether the Bank’s support for severance is aligned with its mission of reducing poverty.

Further reading

This note was written by Ranjana Mukherjee (Extended Term Consultant, Public Sector, PREM). The author is grateful for useful comments from Erika Jorgensen, Nick Manning, Gary Reid, and Randi Ryterman.

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