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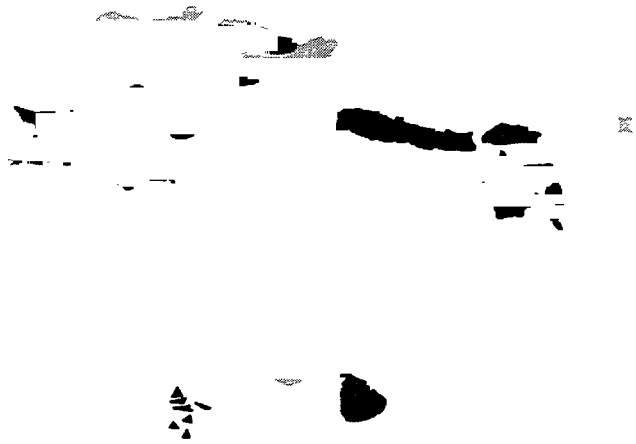

WORKERS' SEVERANCE PACKAGES IN PRIVATIZATION OF STATE-OWNED ENTERPRISES IN BANGLADESH, PAKISTAN AND SRI LANKA: OPTIONS FOR THE FUTURE

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Workers' Severance Packages in Privatization of State-owned Enterprises in Bangladesh, Pakistan and Sri Lanka:

Options for the Future[1]

Abstract

The most common compensation scheme used to retrench labor in the context of privatization of state-owned enterprises (SOEs) is the voluntary departures scheme with compensation based on workers' number of years of service (tenure) and wage. However, both theory and practical experience suggest that this tenure-cum-wage based severance package leads to over-payment and adverse selection, with a possible adverse impact on the SOE's market value. The literature suggests that adverse selection and over-payment problems should be tackled through targeting, i.e. adequately indexing severance payments to workers individual characteristics. However appealing targeting is from the theoretical perspective, satisfactory targeting is difficult because of the information requirements, lack of adequate institutional capacity and for political economy reasons. Therefore, considering the strong presence of labor unions in Bangladesh, Pakistan and Sri Lanka, and the popularity of tenure-cum-wage based severance packages with the unions, it is proposed here three options for future severance packages with realistic and practical surrogate targeting methods. The first option advocates balancing the existing tenure-cum-wage based system with compensation for years of denied service -- thus reducing over-payment and fiscal cost; the second option simply deprives the indispensable workers from the option of leaving the firm -- thus reducing adverse selection; and the third option advocates payment according to workers *observed* outside job opportunities -- also allowing reduction of over-payment and fiscal cost. These options are not mutually exclusive; combinations thereof can be used to pursue the dual goals of reducing over-payment and adverse selection. The revolving door effect is yet another problem that plagues retrenchment schemes. It is suggested that the most effective way of dealing with the revolving door effect is for a government to enact a law banning rehiring of retrenched workers in the public service, and ensure that such a law is adequately enforced.

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1. Background: The Issues[2].

1. In Bangladesh in October 1996, the Government identified 56 state-owned enterprises (SOEs) to be privatized in 1997. Another 46 units have been slated for subsequent divestment. Partly because about 74,500 workers lost their job as a result of restructuring of SOEs between FY 1993 and FY 1995, the forces against employment reduction in the context of the new privatization push are quite strong. However, there are reasons to expect that many of the 400,000 employees working in the country's 200 or so SOEs will be affected.

2. In Pakistan, the Government initiated an ambitious privatization program in 1990/91 in order to improve their efficiency and reduce their drain on the economy.[3] To date, nearly 80 medium and large scale industrial units, two out of four nationalized commercial Banks, one development finance institution, five newspapers, and one thermal power plant have been privatized; and shares of Pakistan Telecommunications Corporation Limited have been sold to private investors. Though fairly advanced, the privatization process needs to be deepened, and the current Government is committed to privatizing several other industrial units and some of the largest public enterprises. This will have far-reaching implications for many of the nearly half a million workers employed in public corporations and the two hundred thousand employed in semi-autonomous bodies (e.g. the Railways).

3. In Sri Lanka, although the recent restructuring of Colombo Gas did not involve any retrenchment as a result of job-protection provided by the law, future restructuring and privatization may affect many of the 100,000 plus workers in the SOE sector, as average labor redundancy is estimated to be as high as 40% in the sector.[4] Currently, the Government is considering establishing golden handshake schemes to retire thousands of excess employees in the Central Transport Board, the Paddy Marketing Board, and the *Mahaweli* Authority (a state-sponsored irrigation and resettlement project).

4. Governments in the aforementioned countries often find it difficult to privatize SOEs because of strong opposition from workers. Workers resist privatization because (i) they fear that private ownership might lead to job insecurity, poor social protection and poor

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2 There is a good awareness of labor issues in privatization both among Governments and their international partners. In the Bank, work is on-going on these issues in PDRPH and PSD.

3 In Pakistan, public enterprises' domestic bank borrowings and foreign borrowings imply an extra-budgetary deficit of nearly 2% of GDP; they contribute to the Central Bank's quasi-fiscal deficit by running excessive overdrafts; and they distort private sector operations by accumulating payment arrears vis-à-vis their private suppliers and contractors

4 Cf. Fiszbein, A. (1992).

industrial relations; (ii) they generally have good conditions of service,[5] and "unless [they] have the security they need to adapt to the future, they will seek security by trying to preserve the past"[6]; and (iii) many of the jobs in public enterprises have ghost-like characteristics i.e. workers are paid but are barely at work. These workers make money on the side or have another full time occupation. The incentive for them to keep their nominal public sector job is therefore high. Workers opposition to privatization is a serious political economy issue and the risk that their opposition may develop into political crises and jeopardize the whole privatization process is not trivial. Many of the redundant employees benefited from political patronage and they often belong to organized, powerful and vocal labor unions, some of which are linked to political parties.

5. With a view to avoiding social and political disruptions, Governments have often resorted to one of two approaches aimed at buying labor unions' acceptance: (i) offering workers rather generous voluntary severance packages as a prelude to privatization or restructuring, e.g. privatization of the Kot Addu power plant in Pakistan or the Leather Corporation in Sri Lanka, and restructuring of the Bangladesh Jute Mills Corporation or the Bangladesh Railways; or alternatively (ii) avoiding retrenchment and offering post-privatization job protection to workers, e.g. privatization of Colombo Gas in Sri Lanka. However, these approaches have significant direct or indirect costs to Governments. Hefty voluntary severance packages represent a toll on their budgets, compete for privatization proceeds that could be wisely used for debt retirement and investment in social infrastructure,[7] and may raise equity questions between insiders (workers to be retrenched) and outsiders (especially the unemployed). As to post-privatization job protection, it is perceived by potential investors as a social responsibility. In order to take up such responsibility they will want to buy concerned SOEs only at discounted prices, thus reducing privatization proceeds to Governments.

In an environment of scarce resources, the challenge before Governments is to design severance packages that are satisfactory to workers and their organizations, but do not involve high direct or indirect costs. Addressing this issue is a prerequisite to the successful completion of the large privatization programs that lie ahead for Governments in Bangladesh, Pakistan, and Sri Lanka. This note attempts to provide options for designing appropriate severance packages. The next section draws from international experiences the main factors influencing the design and/or choice of severance packages. Section 3 surveys conceptual issues in designing severance packages. Section 4 analyzes options for future severance packages in the broad context of Bangladesh, Pakistan and Sri Lanka. Section 5 concludes with some implementation issues.

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5 In Bangladesh for instance, SOE workers' average salary is 20 times the nationwide per capita income. And public jute mills' average wage is about 40% higher than that in private jute mills. Moreover, SOEs workers usually have non-pecuniary advantages such as job protection.

6 Former US Labor Secretary Robert Reich quoted in van der Hoeven, R. and Gyogy Sziraczki (1995)

7 In Bangladesh, the government paid for the separation packages through the capital budget. The cost for FY93 through FY95 was Tk 11.3 billion i.e. about 4.4% of the annual development program on average during FY93-95.

2. Factors Influencing the Nature and Size of Severance Packages

7. The discussion of factors influencing the nature and size of severance packages is based (i) on information summarized in table 1 for a number of cases where enough written material was available, (ii) on discussions with Bank staff that have worked on projects involving labor retrenchment and workers severance schemes, and (iii) on general information retrieved from the literature.

8. **The Law (but not just the law).** In most countries SOE workers benefit from employment protection just like civil servants and perceive their jobs as an entitlement. Even in countries where the Government is legally allowed to use forced labor shedding, voluntary retrenchment programs are used instead because of political constraints.[8] Out of 13 cases reviewed in table 1, involuntary retrenchment was used only in the case of the Shenyang Machine Tools Company, China (column 3). The law usually provides that retrenched workers should receive compensation which increases with their number of years of service and their wages (column 5), although in practice most severance payments are above workers legal entitlements (column 4), particularly under voluntary departure schemes.

9. Post-privatization employment guarantees, whereby an anti-retrenchment law protects workers' jobs after a private owner takes over the management of an SOE, are used, albeit rarely. An example of a post-privatization employment guarantee is found in Sri Lanka where the requirement to keep all employees up to the retirement age of 55 was extended to all new owners of privatized enterprises in 1992. In Pakistan, in the case of the privatization of the Kot Addu power plant, workers who elected not to take the voluntary severance package were granted an employment guarantee in the privatized firm.

10. When faced with such anti-retrenchment laws, investors become reluctant to acquire the concerned firms for fear of facing high costs if retrenchment becomes necessary -- for instance in the case of an adverse shock or a slowdown in activity. In Sri Lanka, although weak managerial skills of private owners is to be blamed in some cases of enterprise failure, it is alleged that some investors had to abandon firms that were bought from Government because the law precluded them from using labor shedding to adjust to

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8 Voluntary retrenchment schemes tend to have a high cost because they require generous severance packages to win workers' acceptance to leave their job. Despite their high financial cost, voluntary severance packages are somehow unavoidable in countries with strong and organized labor unions. Voluntary departure schemes also provide a more humane way of reducing workforce than forced departures, they help create public acceptance of reforms, and boost the moral of workers who stay in the job as they see their colleagues treated well.

adverse shocks. The result was a total capital loss for the investors and job loss for all workers in these firms. Anti-retrenchment laws therefore tend to reduce the market value of SOEs undergoing privatization because of risks perceived by investors, thus reducing privatization proceeds to Government. For workers, anti-retrenchment laws are not a definite guarantee against job loss, either.

Table 1: **Synopsis of selected severance packages**

(1) Country Government Service or SOE	(2) Size of retrenchment	(3) Instruments used to achieve retrenchment	(4) Types of severance packages given	(5) Legal requirements/ entitlements	(6) Safety nets	(7) Cost and benefit analysis	(8) Strength and role of the labor unions
Bangladesh Jute Sector 1994-1995	Over 40,000 workers	Voluntary departure program; and Mandatory retirement at age 60.	Two months' pay per year of service, by presidential decree.	One month's pay per year of service.	Retraining for alternative employment and training for self-employment.	Total package varied from $2,600-$13,000 (average of $3,000)[a]. Some rehiring observed.	Strong jute sector unions, obtained wage raise in 1994.
Pakistan Privatization of industrial units 1991-1993[b]	43% of staff of concerned SOEs (about 7,500 workers)	Voluntary departure scheme; or one year of guaranteed employment followed by transfer to a pool of surplus workers with unemployment benefits for up to two years at Rs 1,000/month.	To workers: four months' pay plus one month gratuity per year of service. To officer grade staff: Two months' pay plus one month gratuity per year of service.	One month's wage per year of service.	Employees who stayed on but made redundant after 12 months would receive: training or retraining, start-up capital loans, scholarships for children, grants for marriage of daughters, in addition to unemployment benefits.	Average payment of $3,300 per worker.[c] Anecdotal evidence of most productive workers having left. Some rehiring as contract workers.	Strong labor unions. They negotiated and signed the package with government before privatization.
Sri Lanka Civil Service 1991-1992	43,000 in 1991 (including normal retirement) 25,000 in 1992	Voluntary retirement induced by enhanced pension.	Enhance pension: civil servants eligible to retire after 20 years of service with pension equivalent to 80% of last year's salary; those with more than 20 years of service receive up to 90% of final salary. Pensioners could opt for a 10 year pension in exchange for lump sum 24 months pension benefits.	Pension entitlement based on last 3 years' average salary. The lump sum payment of 24 months of pension entailed a reduction in monthly pension payments.	None.	New hiring at higher wages of thousands of employees (incl. 14,000 teachers) to compensate for departure of essential staff. Pension bill doubled to Rs. 9 billion (2% of GDP)	Strong unions.
India Public Enterprises 1993-1994	76,900 as of June 1995	Voluntary retirement scheme plus separation of temporary workers.	About 1.5 months' salary/year of service or 15 days' salary for each year until retirement at age 58, whichever is less.	15 days' pay per year of permanent service.	Some vocational, demand-driven training for self-employment and several poverty alleviation programs in rural areas.	Average pay per worker $16,400. High cost, (probably due to payment of 3 months' salary in lieu of notice. No rehiring.	Strong unions, necessitating additional severance pay.

a This compares to a mean of $3,700 per worker on average for a batch of 13 SOEs restructured in FY93-95. In this batch the top three SOEs in term of average severance payment per worker were the Directorate ($8,600), TCB ($8,100), and Bangladesh Railways ($7,400).

b In 1996, this scheme was used as a benchmark to design the severance packages given to workers and officers in the privatization of the Kot Addu power plant. The severance packages in the Kot Addu case were more generous than in the industrial units (see box 1).

c In some recent cases (after 1993), the cost per worker was as high as $10,000.

Table 1 contd

(1) Country Government Service or SOE	(2) Size of retrenchment	(3) Instruments used to achieve retrenchment	(4) Types of severance packages given	(5) Legal requirements/ entitlements	(6) Safety nets	(7) Cost and benefit analysis	(8) Strength and role of the labor unions
China, Shenyang Machine Tools Company Limited, Ongoing	about 7,000	Involuntary scheme: some dismissals, attrition and separation with assistance in creating small scale businesses.	No package other than unemployment insurance payments.	Unknown.	Training for small businesses , commercialization of residential housing.	Average payment per worker $12,000. No rehiring.	Unknown.
Argentina Railways - Ferrocarriles 1991-1994	42,800 under attrition 30,000 under voluntary departure with severance pay	Attrition and possibly mandatory retirement age; and voluntary departures.	Only amount paid is known.	Mandated rights about firing: highest monthly wage times the number of years of service.	None.	Average payment per worker $12,000. Increase in productivity. No rehiring as rehiring strictly prevented.	Labor unions exist, mostly urban based.
Bolivia Mining Sector - COMIBOL 1991-1994	4,500	Voluntary departures with some attrition: workers who could not adapt to new mining technology were encouraged to leave.	Average severance equivalent to about three years of wage of miners.	Unknown.	An integrated child development program developed to address the needs of the poorest in urban and sub-urban areas.	Financial and economic benefits are minimal. Average compensation per worker: US$16,000 Some workers hired in mining subsidiary.	National Confederation of Unions plays important role.
Ecuador Civil Service 1992-1994	About 10% of non-educated workers	Voluntary departure.	Two month's salary per year of service.	One and a quarter months' salary per year of service.	Job re-training program initiated but found ineffective. Self employment training offered. Credit constraint eased by allowing withdrawal of own contributions from social security system.	Average compensation per worker: US$5,000 No rehiring.	Unionization exists.
Mexico SOCEFI (Ministry of Trade and Industrial Development) 1989-1992	About 4,500 staff (approximately 40-50%)	Mostly voluntary departures.	Unknown.	Unknown.	Unknown.	No rehiring.	Unionization exits.

Table 1 contd

(1) Country Government Service or SOE	(2) Size of retrenchment	(3) Instruments used to achieve retrenchment	(4) Types of severance packages given	(5) Legal requirements/ entitlements	(6) Safety nets	(7) Cost and benefit analysis	(8) Strength and role of the labor unions
Peru - Income Tax Collecting Agency 1991-1992	High at low skill levels	Voluntary departures or choice to stay subject to a test.	If workers did not opt for a test or voluntary departure, involuntary separation with due pension only paid. If workers failed to test, they were transferred to a national institute. If workers opted for voluntary departure, they receive enhanced pension and package.	Unknown.	None.	No overall financial benefit. But tax collection substantially increased. Voluntary departure pay: US$1,110 on average per worker No rehiring as reentry prohibited for 10 years by law.	Unionization exists. Prevented outright cuts.
Hungary Public Enterprises (particularly steel and coal mining) 1990-1992	20-30% of staff	Mass reduction without additional compensation, enforcement of mandatory retirement age, and attrition.	Only normal pension payment.	Unknown.	Job search assistance, wage subsidy up to 50% for hiring long term unemployed. Self employed assistance provides up to 50% cost of training course, up to 50% of one-year premium on loan insurance for borrowed funds.	Cost of safety net was higher than wage bill savings.	Unionization exists.
Poland Public Enterprises 1990-1993	20-30% of workers, over 500,000	Mass layoffs without additional compensation, some attrition and some early retirement with additional compensation.	Only normal pension payment.	Unknown.	Unemployment insurance payment of 36% of average salary for 12 months, job placement service offered, loans for training for self-employment, public works with payment up to 75% of national average pay.	Cost of safety net was higher than wage bill saving.	Strong pre-existing labor unions.
Turkey, SOEs in textile, banking, steel, coal mining, 1993-1994	35,000 staff of SOEs (as of January 1993)	Voluntary early retirement.	One month's pay per year of service, plus an additional two months' salary as "notification indemnity."	One month severance pay per year of service.	Social assistance payments made.	Unknown.	Strong unions. Their agreement essential for success of privatization.

11. Rather than a life-long employment guarantee, the law might provide for a limited employment guarantee whereby labor shedding is restricted until a given time after private ownership takes over the management of an SOE. This is akin to a postponed retrenchment and may be seen as a way of shifting the burden of retrenchment and severance payment to the private sector. Laying-off after privatization may be more efficient since the private sector -- rather than Government -- would know best its own labor needs.[9] Private ownership may lead to higher investment through fresh capital injection and to increased production (to satisfy previously rationed demand). Increased labor may follow, thus avoiding labor shedding. Indeed, labor increased after the privatization of Colombo Gas in Sri Lanka and that of three enterprises producing respectively brick, leather, and paper in Nepal.[10] However, postponed retrenchment presents a risk of *moral hazard* and poses ethical issues on the part of the buyer. For instance, it is alleged that during the first round of privatization in Bangladesh, the requirement that the new owners should keep labor on for a minimum of 12 months was not followed. Some labor shedding took place before 12 months; after 12 months the out-going workers did not get their accumulated gratuity and only a few got their share of the general provident fund.[11]

12. **Government's Budgetary Constraints.** Privatization is often implemented in situations where the Government has important financial needs. This, and the extent to which other financial sources (such as donors' assistance) are available, may affect the severance packages that a Government is prepared to offer. In some cases, the Government uses part of the privatization proceeds to finance the severance packages, as was done in Pakistan. In addition to the affordability of a particular package, its replicability matters. The Privatization Commission in Pakistan says it tried not to be overgenerous with workers of the Kot Addu power station because a more generous package would not be financially sustainable to replicate in the dozen or so power stations to be privatized in the future. Nevertheless, there are signs that the Government may find it difficult to replicate the severance packages afforded in the past.

13. **Government's Development Objectives.** The development objectives pursued by Government have a bearing on the nature of severance packages offered to workers. When privatization is seen as a tool for popular participation in the private sector, Government favors offering equity shares at discounted prices to workers, e.g. in mass privatization in Eastern Europe, or favors training and access to start-up capital for redundant workers to start their own business like in Bangladesh, Pakistan, Ecuador, Hungary, China and Poland (column 6 of table 1). A lump-sum cash payment to workers

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9 However, since the burden of labor shedding is passed on to new private owners, they may discount accordingly the buying price of the SOE, thus reducing privatization proceeds. See A. Fiszbein (1992, op. cit.) for a discussion of the pros and cons of labor retrenchment before privatization.

10 In Colombo Gas the buyers were quite happy to live with the staffing levels. They were planning on growing the business and the numbers were inconsequential.

11 Cf. World Bank (1994).

(as opposed to periodic installment payments) is also seen as a way of stimulating the creation of small scale businesses by providing start-up capital to entrepreneurial former SOE workers. However, cash packages may be perceived as a windfall by workers and could lead to increased private consumption and to inflationary pressures.

14. As a labor market policy, some Governments support retraining retrenched workers for alternative employment in the private sector.[12] However, retraining works poorly when it is focused on updating workers' previous skills rather than equipping them with new skills geared at increasing their employability in the private sector. Also, experience shows that retraining works better when it involves the private sector. When provided by the private sector, retraining is more likely to be oriented towards the private sector's skill requirements and is generally better administered. The private sector's involvement usually means that Government distributes vouchers to workers who then buy training services from private training centers. There are also efficiency gains in involving, when feasible, workers' new employers.[13] Another labor market instrument is wage subsidies (used in Hungary, see column 6 of table 1). However, wage subsidies are a form of subsidy to private firms, represent a burden on the Government's budget, and may discriminate against people who are unemployed but were not previously employed in an SOE.

15. **The Political and Negotiation Power of Workers' Organizations.** Whatever the Government's development objectives are, the severance schemes have to meet workers' expectations, particularly if they are represented by powerful labor unions. In Eastern Europe -- except for Poland where labor unions are strong -- labor did not play a major role in privatization. Labor unions were virtually non-existent and had nothing to say. Under mass privatization programs, a large number of shares in privatized firms were sold or given to workers. This program was enough to win their acceptance of privatization and no cash package was needed. On the contrary, in Bangladesh, Pakistan, India and, to a lesser extent, Turkey, unions influenced -- to their advantage -- the severance packages that were arrived at (column 8 of table 1). Using the story of industrial units and the Kot Addu power plant in Pakistan, the box below exemplifies the importance that strong labor unions can play in determining severance schemes.

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12 Retraining can also contribute to increasing the economy's human capital stock, as does assistance to redundant workers in meeting the cost of educating their children.

13 In Cameroon, the Government provides training subsidies to firms employing retrenched workers for more than 6 months.

Box 1: Labor Unions and severance package negotiations: the case of industrial units and Kot Addu power plant in Pakistan

In order to win employees' support for privatization, the Government signed an agreement with the All Pakistan State Enterprise Workers Action Committee (APSEWAC) in 1991. Although APSEWAC represents unionized employees of industrial units and not public utilities, banks and development finance institutions, the 1991 agreement became a benchmark for negotiating all severance packages. Under the 1991 agreement, each worker in units being privatized was offered three options under a voluntary separation scheme.

Option A: the worker could elect to stay on the job. If he does so, the terms of his employment remain the same and his job is protected for 12 months. Ten percent of the shares of the privatized units would be sold to the employees who stay on the job at a mutually agreed rate.

Option B: the worker could elect to leave the unit being privatized and receive, in cash, a golden handshake including 4 month's basic salary per year of service and a gratuity worth 1 month's basic salary per year of service ("4+1" rule). Unemployment benefits of Rs1,000/month for up-to two years were designed for employees who would be rendered redundant after the initial 12 month period.

Option C: employees of a unit could decide to buy-out this unit by matching the highest price offered by competitive bidders.

Non-unionized officer cadre staff were offered similar options, but with a golden handshake including 2 month's basic salary per year of service and a gratuity worth 1 month's basic salary per year of service ("2+1" rule).

Payment of the "4" and "2" parts of the workers and non-unionized officers schemes is shared equally between the Government and the buyer. Up to June 1996, the Government had paid Rs 1.12 billion towards the voluntary separation scheme. Government financed the schemes through privatization proceeds. There is an implicit rule whereby no more than 20% of privatization proceeds should go towards the financing of the severance packages.

Because the WAPDA Central Labor Union is very well organized and fairly powerful, the packages offered to the Kot Addu Power Station (KAPS) workers in 1996 is more generous than that received by industrial units workers. After long negotiations, an agreement was reached, stipulating that: (i) all workers will get a 35% salary raise before privatization, non-unionized officers get a 35% salary raise if they chose to stay with KAPS, or a 25% salary raise if they chose to leave KAPS but stay with WAPDA for a maximum of two years, (ii) workers and officers could chose to leave KAPS and WAPDA altogether and receive a "4+1" or a "2+1" package as under the APSEWAC agreement, (iii) workers who elect to stay on the job are guaranteed security of employment, all their other benefits and entitlements continue, and they can buy 10% of KAPS's shares.

Source: Pakistan's Privatization Commission

16. **Prevailing Labor Market Conditions.** Workers' attitudes towards privatization and their willingness to accept proposed severance packages also depend on prevailing labor market conditions and the business environment. In a growing, labor creating and business generating economy, workers' optimism towards finding another job is high and they may be less exacting in negotiating severance packages. Alternatively, a high level of unemployment, and above-market salary levels in SOEs make negotiations with labor unions more difficult and raise the cost of politically acceptable severance packages.

17. **The Investors' Perspective.** When investors have to absorb part or all of the cost of severance packages because of postponed retrenchment or cost-sharing arrangements with the Government, they accordingly discount the price they are willing to pay for the

subject firm, because this social responsibility affects their expected stream of profits. A study based on more than 200 privatization episodes in Mexico concluded that cutting employment before selling SOEs has a positive effect on the sale price.[14] Instead of postponing labor retrenchment, the Government may decide to involve the private investor in determining the extent of retrenchment and in sharing the cost of severance packages, as happened in Pakistan (see box 1). When investors are involved in paying for the severance packages, one of two things may happen. If the Government is stronger than the unions, the negotiated packages tend to be low so that the adverse effect on the sale price and hence on the privatization proceeds is minimal. If unions are strong, the Government may allow hefty severance packages and accept a low sale price.

3. Conceptual Issues in Designing Severance Packages

18. This section gives a brief review of conceptual issues that one may have to consider in preparing severance packages. These issues are related to adverse selection, over-payment, the revolving door effect, and targeting. Although voluntary retirement provides workers with a more humane way of leaving their job and causes less grievance among workers, *adverse selection* may occur if the voluntary scheme gives incentive to the best performing employees to take the package and leave their job. There seems to be a positive correlation between workers' productivity and their outside option to find alternative jobs.[15] Similarly, workers with entrepreneurial skills would see the redundancy pay as a source of capital to start their own business.[16] Therefore, there is an important risk that productive and entrepreneurial workers would be among the first to leave an SOE where a voluntary redundancy scheme is offered, leaving the firm with relatively less productive workers. Thus, Kemal (1993) argues that the golden handshake provisions in Pakistan encourage the most productive workers to quit.[17] In the same vein, table 2 below shows that a disproportionate number of "skilled" workers opted for the voluntary separation scheme offered to Bangladesh Jute Mills Corporation (BJMC) workers.

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14 See Lopez-de-Silanes (1997).

15 This is confirmed by two post-retrenchment surveys that find that more educated workers fare better after lay-off in terms of finding a new job (see MacIsaac, D. and Martin Rama (1996) and Tansel, A. 1996).

16 In Turkey, about half of the laid-off workers became self-employed, using their severance payment as start-up capital; they mostly created businesses in the Services sector (cf. Tansel, A. op. cit.)

17 Cf. Kemal, A.R (1993).

Table 2: Skill Characteristics of labor force and participants in the voluntary separation scheme (VSS) during FY1991-93 (BJMC)

Skill category	Percentage in labor force	Percentage in participants in the VSS
Skilled	58	65
Semi-skilled	27	30
Unskilled	15	5
Total	100	100

Source: World Bank (1994)

19. *Over-payment* (i.e. over-compensating workers who leave) is another problem that plague most voluntary retrenchment schemes precisely because of their voluntary nature. Workers accept the voluntary retrenchment scheme if and only if the compensation received more than makes up for the opportunity cost of leaving their life-long public sector job. The opportunity cost -- sometimes referred to as "rent" -- is the difference in present value terms, between, on the one hand, their stream of future pecuniary and non-pecuniary (somehow valued) public sector incomes (i.e. wages and fringe benefits), and on the other hand, the stream of private sector salaries that they are likely to receive, taking into account the cost attached to transitional unemployment, job search, and private sector job insecurity. Thus defined, a worker's rent is likely to be an increasing function of his remaining years of service in the public sector. Over-payment arises if a worker receives a severance payment higher than his rent, as can easily happen under tenure-cum-wage based severance schemes, for long tenure workers with few denied years of service.

20. *The Revolving door effect* arises when retrenched workers who received severance packages are *rehired* by their previous employer, namely the Government. For example in Sri Lanka, retrenched officials were once hired back as consultants in their previous firms. Rehiring may occur for two reasons. First, if due to poor design of the severance package, the most able workers leave, the firm may have to recruit (some of) them back in order to regain productivity -- in other words, adverse selection can be the cause of the revolving door effect. Second, rehiring may reflect political economy forces. However, if pressures to rehire are not resisted, there is little or no economic benefit to society in giving the severance packages. The most effective way of reducing the revolving door effect seems to be by enacting a law banning rehiring in the public sector for a given period after retrenchment as was done in Argentina and Peru (see column 7 of table 1). Hardening the budget constraints of remaining SOEs and the public sector at large is another way of reducing the revolving door effect by making it difficult for SOEs and the Government to recruit. Yet another solution to the revolving door effect (particularly

when caused by adverse selection) is targeting; using information on 41 retrenchment programs involving 37 countries, Haltiwanger and Singh (1996) found that rehiring is minimal in programs that target specific workers by calculating severance payments on the basis of skills and age.[18]

21. More generally the literature suggests that *targeting* is the solution to adverse selection, overpayment and revolving door effects. Indeed in a perfectly competitive environment with perfect information, the Government will propose to workers, identified as efficient or critical to the future operation of the SOE, a severance payment slightly under what leaves them indifferent between leaving or staying with the SOE; therefore, they stay with the SOE (no adverse selection occurs) and there will be no need to rehire them (no revolving door effect). To other workers, the Government will propose severance payments slightly above what leaves them indifferent between leaving and staying (this way no worker will be over-compensated) therefore they leave the SOE. Targeting is achieved by calibrating severance packages to individual characteristics such as workers' chances to find an alternative job in the private sector, the level of salary in that alternative job, and the workers' preference between their current public sector job and another job in the public or private sector. However appealing targeting is from the theoretical perspective, satisfactory targeting is difficult to achieve because workers' characteristics required for such an exercise are generally not observable. The literature on targeting therefore suggests observable proxies such as education, seniority, age and gender.[19] However, even proxy-based targeting is difficult to implement for political economy reasons or for lack of adequate institutional capacity.

4. Options for Designing Future Severance Schemes

22. In this section, we analyze options for designing severance packages that address the above issues in the broad context of Bangladesh, Pakistan and Sri Lanka. Although there are differences across these countries, there are important relevant common features between them. All three countries have strong labor unions and a high degree of unionization in the SOE sectors.[20] They are likely to undergo large privatization programs due to the large number of under-performing SOEs, and as said in paragraphs 1-3, privatization is likely to involve high levels of labor retrenchment in all three countries. Experience has shown that all three countries heavily rely on voluntary labor retrenchment, mainly because of protection provided to SOE workers by civil service status, and the presence of strong labor unions. The risk that hefty severance packages

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18 Cf. Haltiwanger, J. and Manisha Singh (1996).

19 Sometimes it is further suggested that if accurate observable characteristics cannot serve as good proxies for individual characteristics, an auction system should be used whereby each worker is asked to indicate the severance payment that would induce him to leave the firm. However, there are risks of collusion in an auction system, particularly where labor unions are well organized and collective bargaining is common. Cf. Levy, A. and Richard McLean (1996).

20 In Bangladesh for instance, the degree of unionization in the jute and textile mills was estimated at over 90% in 1991.

may have negative side effects on private sector employment is high in all three countries due to the large size of the public sector[21] and the link between labor unions across the SOE sector and the private sector. If private sector workers were to be retrenched, they would want to receive packages similar to what their public sector counterparts receive. And the prospect of expensive severance packages may cause private firms to hoard labor and limit new recruitments to the extent possible, thus dampening the creation of new jobs.

23. The rest of this section looks at three options that could be considered for designing severance packages in cases where privatization is preceded by labor retrenchment. They take into account the strong presence of labor unions and the popularity of tenure-cum-wage based severance payments with the unions. Recognizing the implementation problems with targeted severance packages, the options retained here revert to some surrogate targeting. The first option advocates balancing the existing tenure-cum-wage based system with compensation for years of denied service -- thus reducing over-payment and fiscal cost; the second option simply deprives the essential workers from the option of leaving the firm -- thus reducing adverse selection; and the third option advocates payment according to workers *observed* outside job opportunities -- also allowing reduction of over-payment and fiscal cost.[22]

Option 1: ***A Package with a Forward-looking Component***

24. Objective: The main objective of the package with a forward-looking component is to avoid over-payment by reducing the difference between the severance package given to a worker and the opportunity cost of leaving his public sector job (or rent). Assuming public sector employment is a life-long employment, and that workers value the salary, job-security, pension and other benefits and prestige attached to public sector jobs more than the salary and other benefits they may receive in the private sector (taking into account the uncertainty of finding an alternative job and the insecurity of a private sector job), a worker's opportunity cost of leaving his public sector job is an increasing function of his number of denied years of service (see paragraph 19). Workers with a long tenure and a consequently short period of remaining service would have a lower opportunity cost, ceteris paribus. Paradoxically, the traditional tenure-cum-wage based severance schemes provide workers with a payment that is increasing in their tenure and decreasing in their denied years of service. Therefore under a tenure-cum-wage scheme, enticing short tenure workers by meeting their (high) rent would mean paying the equivalent of several months of salary per year of service. This would tend to have the side effect of overcompensating long-tenure workers. The cost of engaging in such a scheme can be very high, particularly if the distribution of departing workers is skewed towards long-tenure workers.

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21 In Bangladesh SOEs and the central government had a total employment of 1.6 million in a total of 4.8 million in formal employment in 1991-92 (cf. World Bank (1994) op. Cit.)

22 The severance package options considered here are mainly for privatization but could be adapted for enterprise restructuring.

25. In order to avoid over-payment, it is proposed, as a substitute to targeting, to add a forward-looking component to the traditional backward-looking severance schemes, that is adopting a formula that *takes into account the number of years before workers reach normal retirement age or the number of years of denied service*. Such a mixed backward and forward looking package was used during the privatization of Indian public enterprises in 1993-1994 and in the privatization of the Korea Tobacco and Ginseng Corporation (KTG) in 1987. In the KTG case, retired workers received a severance payment based on number of years of past service plus a sum equivalent to their last monthly wage multiplied by half their remaining years until compulsory retirement age. Based on a simulation, Assaad, R. (1996) showed that the purely backward-looking severance scheme is more costly from the fiscal standpoint than formulas that index on wage and years of denied service (with a fixed component that does not vary among workers) in the case of Egypt.[23] Based on data on BJMC, box 2 corroborates this and shows that substantial savings can result from the use of mixed forward- and backward-looking schemes.

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23 Cf. Assaad, R. (1996).

Box 2: Per worker average cost comparison of severance payments under alternative schemes using the case of BJMC.

Average age of workers: "Bangladesh: Privatization and Adjustment" provides that 85% of BJMC workers who opted for the VDS were in the age group of "45 & above". Those in the "below 30" and "30 to 45" categories represented respectively 5 and 10%. Let's assume that the average age of the "45 & above" is 47, and that of the "below 45" (i.e. "below 30" and "30 to 45" combined) is 35. Let's further assume that the typical worker at 47 years old has a tenure of 25 years and that the 35 years old has a tenure of 13 years.

Thus 85% of workers are 47 years old with 25 years of tenure on average; 15% are 35 with 13 years of tenure on average.

Data on manufacturing SOEs workers reported in "Bangladesh: Privatization and Adjustment" provide that average monthly basic wages in manufacturing SOEs are as follows:

Tk 1,100 for workers with 10-14 years of tenure,
Tk 1,400 15-19
Tk 1,750 20-24
Tk 1,900 25-30

Let's assume that BJMC workers' salary is 25% higher than the average for manufacturing SOEs. This assumption is made in order to have an average severance package under the standard backward looking scheme that is close to actual average of Tk 106,000 per worker. This gives an *average wage for the 85% of workers in BJMC with 25 years of tenure of about Tk 2,375 (1,900*1.25) and Tk 1,375 (1,100*1.25) for the 15% with 13 years of tenure.*

Based on these assumptions, we can compare the per worker cost of severance packages under alternative schemes:

	Standard scheme (purely backward looking)	Purely forward looking scheme	Mixed forward and backward looking (50/50)
Workers above 45 (85% with 25 years tenure and 8 years of denied service)	118,750	38,000	78,375
Workers below 45 (15% with 13 years tenure and 20 years of denied service)	35,750	55,000	45,375
Weighted average using 85% and 15% as weights	106,300	40,550	73,425
	Savings over standard scheme	62%	31%

Source: World Bank (1994) and author's calculation

26. If the length of service weighted salary in the workforce -- or among potential leavers if those can be identified *ex ante* with some precision -- is higher than denied years of service weighted salary, the purely forward-looking scheme would provide the maximum savings over the traditional backward-looking scheme. However a purely forward-looking scheme may under-compensate long-tenure workers; because of substantial non-

pecuniary benefits attached to their position, their forgone salary may grossly understate their opportunity cost of leaving the SOE. Although this may be a desirable outcome for Government and potential investors if it is felt that that long-tenure workers with management experience should stay with the SOE, it may not be politically feasible if long-tenure workers feel uncomfortable about higher compensation being given to more junior workers (particularly if long-tenure workers control labor unions' leadership). A mixed forward and backward-looking scheme may be more feasible and still allow for substantial savings. The right mix and the relative importance of the forward-looking and backward-looking components in the mix will vary from case to case, depending on the age and wage composition of the workforce and on political economy factors. For instance, if too heavy a weight is put on the forward-looking component of the mix, younger and possibly efficient workers will find it attractive to take the package and leave the SOE. Box 3 shows that a combined forward and backward-looking scheme was once proposed in Sri Lanka but was never implemented. It is not known whether this is because the proposed scheme would have under-compensated (some) workers or because workers knew they could secure heftier packages thanks to their bargaining power.

Box 3: The Bulumulla Package in Sri Lanka

In 1991 in Sri Lanka, the Government appointed a committee to study the payment of compensation to redundant staff in Government Corporation and Statutory Boards. The committee recommended a package popularly known as the Bulumulla Package. Under the Bulumulla Package, workers were to receive half a month's salary per year of employment (the backward-looking component) and a compensation for denied service (the forward-looking component) according to the following formula:

Total compensation = [half a month's salary x years of service]
+ [one month's salary x (55-age)] x [(age/55) x (years of service/30)]

Note that the forward-looking component of the formula is multiplied by a coefficient which increases with worker's age and years of past service. It may have been so designed in order to avoid over-payment to young workers with many years of denied service. The formula was not implemented in the end (it did not find supporters among workers probably because it would have led to a high concentration of payments around the mean). The Government is currently looking into designing a new severance package.

Source: Fiszbein, A. (1992)

Option 2: *A Limited Voluntary Retrenchment Scheme*

27. Objective: The limited voluntary retrenchment scheme has as its main objective to reduce the loss of efficient workers, i.e. reduce adverse selection. Under the proposed scheme, workers would be given the opportunity to elect to stay with the firm or to leave. However, *the firm would retain the right to accept or refuse a worker's resignation.* The screening of voluntary resignations will be done with new investors' participation. Severance packages would be given only to those workers whose voluntary resignation is accepted by the firm. If a worker whose voluntary resignation is not accepted by the firm refuses to stay, his resignation would be treated as a normal resignation initiated by the worker and fall outside the limited voluntary departure scheme. Those workers who elect

to stay with the firm or who accept to stay when their voluntary resignation is not accepted will continue to work in the firm, possibly on new employment terms. The new employment terms may include a period of employment guarantee and increased wages. Workers who stay would retain any pension rights they may have gained before the implementation of the scheme. These would be payable to them if and when they leave the firm subsequently or upon normal retirement. A similar scheme was used in the Ghana Civil Service reform program where voluntary separations were conditional on employment not being critical to the performance of the worker's ministry or office.

28. In addition to reducing adverse selection, the limited voluntary scheme might reduce the perceived social responsibility transferred to the investors as retrenchment is done up-front. Also, by involving the private sector, the limited voluntary departure scheme may lead to a more appropriate skill mix for the firm. The question of downsizing before or after privatization does not arise with the limited voluntary scheme because it involves the private investor in the determination of labor size and composition, with Government bearing the responsibility for reducing the workforce and making severance payments. The caveat is that with a scheme of this kind, the population may feel that too much power is given to private investors as they are given the right to decide which workers to keep in the firm.

Option 3: ***A Job Opportunity Package***

29. Objective: The objective of this option is to reduce overpayment by adjusting workers' severance payment according to their *observed* outside job opportunity, while facilitating re-employment and self-employment. This option recognizes the practical difficulties inherent in using *ex ante* workers outside job opportunities and potential alternative salaries as these are generally not observable.

30. Under the job opportunity scheme, severance payments would be made in inflation-adjusted periodic installments. Retrenched workers will receive training, job placement assistance and counseling, and *the size or payment modalities of their severance package would be adjusted if they find employment or establish their own business.* If a worker finds employment after retraining and counseling, severance payments will be revised downward based on the worker's new salary. However, accrued pension will be paid in full. Also, full salary payment will be made during the training period. If a worker starts a small business after retraining and counseling, part of the severance package would be given in lump-sum as a start-up capital, and the rest will be paid in the form of reduced installment payments. Additional capital assistance may be provided through a capital development fund administered by a private commercial bank. Rather than receiving training up-front, a worker may find another job before being retrained. In this case, he would organize his training in consultation with his new employer who would receive a training subsidy from the Government.

31. A job opportunity package is indicated where employment protection is a key condition to privatization, and would offer an alternative to reverting to anti-retrenchment

laws, which, as said earlier, can be costly both for Government, workers, and investors. In addition to reducing the budgetary cost of severance packages, a job opportunity scheme would prevent possible revolving door effects as it allows for the monitoring of retrenched workers' job searches. The job opportunity package also has the potential of boosting private sector development and employment creation. It offers a menu: partial cash payment to entrepreneurial workers and a stream of minimum income to the more risk averse. However, the job opportunity scheme is associated with a moral hazard problem: some workers may postpone their job search as they may want to benefit from full severance payment for the longest possible time. Moreover, monitoring a job-opportunity package of the kind suggested here would require a strong institutional capacity on the part of Government as well as a good information flow from the job market to the Authorities. Therefore the job-opportunity package must be selected very carefully.[24]

32. The three options outlined above are not mutually exclusive. Rather, combinations thereof may be used depending on objectives being pursued. A scheme with a forward-looking component can be combined with the limited voluntary retrenchment scheme to pursue the dual goal of reducing over-payment and avoiding adverse selection if departing from traditional purely backward-looking schemes is politically feasible. If not – and/or if labor market policy is high on Government's agenda – the job opportunity package and the limited voluntary retrenchment schemes can be used in conjunction to reduce over-payment and adverse selection. The chart on the next page gives a decision flow diagram on the alternative options.

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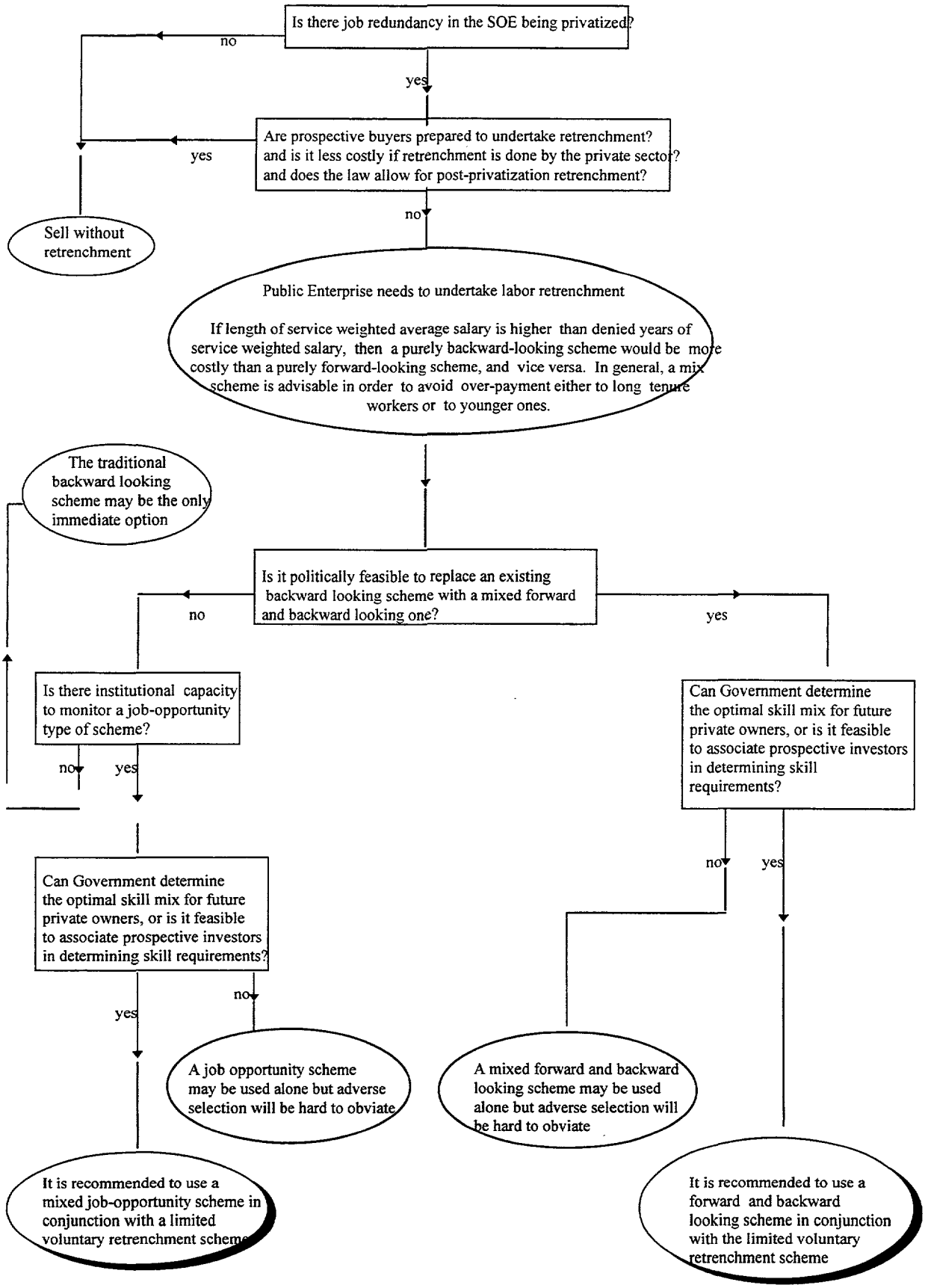
24 Unlike the first two options, we do not know of a practical case where a job-opportunity type of package was used.

Chart: Decision flow diagram on options for severance schemes



5. The Challenges of Implementation

33. Once designed and accepted by labor unions, severance packages still have to pass an implementation test having to do with the speed of implementation of the privatization program, the availability of financial resources and the quality of the macroeconomic environment. In the past, delays in carrying out announced privatization have caused erosion of staff and management morale, as well as asset deterioration and stripping in several public enterprises particularly in Pakistan.[25] This phenomenon can have dramatic effects on the market value and the sale price of firms, with potential implications for the Government's capacity to pay for severance packages. In the future, privatization programs should be carried out soon after their announcements.

34. Severance payments usually entail a large up-front cost and yield benefits to the economy only in the medium- to long-term. The short-term cost may well exceed the wage bill savings, putting pressure on the Government's ability to meet the cost of severance packages.[26] The inability of the Government to fully finance severance payments may in turn exercise a break on the speed of privatization and undermine ongoing reforms. Where this happens, it may be appropriate to garner resources from bilateral and/or multilateral donors to finance the severance package.[27] In this respect, the Bank now has spelt out the modalities for using counterparts' funds in SAL or SECAL loans/credits and for directly using loan/credit proceeds under investment lending to finance severance pay[28].

35. An unstable macroeconomic environment can also jeopardize the implementation of severance packages. Under a voluntary scheme involving cash payments, high inflation may compound the cash requirement on the Government by increasing the number of employees who elect to take the retirement scheme because high inflation makes cash payments more attractive than future salaries. This may complicate the implementation of the scheme and erode its credibility if the Government is cash constrained. Another way in which high inflation complicates implementation is by stretching the pay-back period, [29] because high inflation puts a heavy discount rate on future salary savings that result

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25 In the case of Mexico, a study showed that firms with a shorter elapsed time between the first rumor of privatization and the announcement of the winning bidder fetched higher prices, with the price dropping by 24% for every additional year (see Lopez-de-Silanes, 1997)

26 Although experience has shown that when Government is strongly committed to privatization and economic reform, the short-term cost of severance packages generally does not represent a serious impediment.

27 In Bulgaria, in order to meet the cost of severance packages, the Bank recently provided a rehabilitation loan. Bank support gives assurance to workers that severance payments will be actually made and helps build confidence in the program.

28 These modalities were spelt out in an operational memo in March 1996.

29 The pay-back period is the (estimated) number of years such that the present value of wage savings plus other economic benefits (e.g. rise in productivity and demonstration effect on other similar organizations) equal the

from labor-shedding. It is therefore optimal to undertake privatization of SOEs and implement severance packages as part of a broader macroeconomic adjustment process. Macroeconomic adjustment would help reduce inflation where it is high, and facilitate the mobilization of international financial resources that could be used to complement the Government's own resources in financing the short-term cost of severance packages.

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present value of severance cost plus other economic costs (e.g. disruption in production, demonstration, decline in product quality).

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