Using Severance To Facilitate Liquidation

In this paper the authors discuss ways in which severance payments might be used to protect workers and to reduce political opposition to liquidation. In particular, they consider how to identify appropriate candidates for liquidation and how to design severance packages for displaced workers from these firms. The authors also look at the design of severance packets and other issues including retraining. They justify Bank involvement and consider ways that World Bank loans can be used to finance severance payments.

The Issues

Although the size of the private sector in the transition economies of Eastern Europe and Central Asia has increased greatly in the past few years, a significant number of enterprises remain in the public sector (World Bank 1996c). Many of these enterprises are suitable candidates for future privatization. Others—including nonproducing mines, enterprises in sectors where the relevant country does not have a comparative advantage, and some munitions firms—might never be suitable for privatization.

Nonproductive enterprises that cannot be privatized will have to be liquidated and their assets sold. Although this will be beneficial in the medium term, the immediate loss of jobs will be wrenching, especially in the one-company towns that are common in the former Soviet Union. Well-designed severance packages can help protect workers and reduce political opposition to the liquidation of nonproductive enterprises.

First, unemployment is high in many transition economies; it might be difficult for laid-off workers to find new jobs. As a result, training programs or small and medium enterprise (SME) loans might be appropriate in some countries.

Loans for severance and loans for SME work complement each other in several ways. First, severance loans will solve the problem of start-up capital for SME development; workers who have participated in these programs will have large amounts of cash to invest. Second, cooperation will be easier because the workers will already know each other. Third, liquidation will free up productive assets that can be used by SMEs. Finally, integrating severance programs with programs for SME development will make the severance loans more attractive to governments and will reduce political opposition.

Although severance pay might reduce labor opposition to reform, there are several additional problems that should be addressed.
**World Bank Involvement**

The World Bank's involvement in the severance programs is valuable for at least three reasons. First, it will provide cash-strapped governments with the funds to finance severance. Second, it will make severance programs more credible (one major stumbling block has been that promised benefits have failed to materialize, making workers wary about government promises of severance). Finally, it will allow countries to draw upon the World Bank's experience in other countries and regions.

Recent World Bank research has identified three problems related to the design of severance packages for public employees: overpayment, adverse selection, and the rehiring of laid-off workers. The last two problems, which revolve around making sure that nonproductive workers leave and productive workers stay, are not concerns when designing severance packages for firms due for liquidation, since all (or most) workers will need to be laid off. Overpayment, however, remains a potential problem and might be particularly serious when severance is financed by the World Bank.

Below we outline three different loan modalities that can be used by the World Bank to fund severance payments for employees of state-owned enterprises.

**Technical Assistance Loans**

Technical Assistance Loans have been used in the past to help fund activities related to the design and implementation of Voluntary Early Retirement Schemes (VERS) and severance packages. For example, in 1994, the World Bank provided a technical assistance loan to the Government of Kenya to buy equipment (e.g., office supplies, computers, vehicles), consulting services, and training to the Civil Service Reform Secretariat (CSRS).

**Adjustment Loans**

Adjustment Loans have also been used to help support the restructuring associated with severance payments. As part of the loan's conditionality, the government must set aside counterpart funds to finance the severance payments. World Bank guidelines note that multi-tranche loans can be used when long-term monitoring of expenditures is necessary and when the cost of severance justifies the size of the loan. Prior to 1996, these were the only type of World Bank loans used to (indirectly) finance severance pay. One example of these loans, noted in Kikeri (1997), was a $300 million Public Enterprise Reform Adjustment Loan to Argentina in 1991, which was used to finance severance pay for employees of state-owned enterprises.

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2. World Bank (1991a). This loan was also supported by a technical assistance loan (similar to the one described above), which is described in World Bank (1991b).
**Investment Loans**

The third type of loan is direct investment lending for severance pay. When making these loans, the World Bank makes funds directly available to the implementing agency, rather than the government paying for severance with counterpart funds. These funds can, under the conditions noted above, then be paid to laid-off workers as severance payments. One loan that has already been made, in accordance with Bank guidelines, is a loan intended to support the restructuring and privatization of federal railways in Brazil (World Bank 1996b). The World Bank made $190 million available for severance payments and the government of Brazil provided $190 million in counterpart funds. A special account was established for both local and Bank funds, in which the Bank would deposit up to $40 million and replenish on account of eligible expenditures.

**Conclusion**

If nonproductive enterprises continue to operate, they will end up either being a drain on public finances (if they receive direct subsidies or tax exemptions) or they will threaten the stability of the banking sector (if they receive subsidized credit).

Supporting the liquidation of loss-making enterprises, therefore, will help the development of the private sector; protect public finances, and will ensure long-term growth in the transition economies of Eastern Europe and Central Asia.
The World Bank
1818 H Street, NW
Washington, D.C. 20433

Lajos Bokros
Director, ECSPF

Gerhard Pohl
Sector Leader, Private Sector Development, ECSPF

Hennie Van Greuning
Sector Leader, Financial Development, ECSPF

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Khaled Sherif (ksherif@worldbank.org),
Knowledge Manager, ECSPF

George Clarke (gelarke@worldbank.org),
Economist, DECRG

Simeon Djankov (sdjankov@worldbank.org),
Economist, ECSPF

To order additional copies, call Khaled Sherif at 202-473-4461;
e-mail: ksherif@worldbank.org. Partnerships is available on-line (http://eca.worldbank.org/ecspf/newsletter.html).