5

MODULE

Key Elements of a Labor Program

When the broad strategy and options for labor restructuring have been determined, the next step is to develop the main elements of the labor program. Specific approaches to restructuring are bound to vary among countries and enterprises, depending on local circumstances. But labor programs typically include four main components:

1. Severance payments
2. Pension payments
3. Retraining and redeployment support
4. Employee share ownership schemes.

Each of these components is discussed in depth in the following sections. At the end of each section is a list of the contents of the CD-ROM that accompanies this Toolkit, a list of pertinent Web sites, and a list of additional relevant materials and sources.

SEVERANCE

Severance payments are an important source of temporary income for surplus workers and they need to be designed and put in place early in the restructuring process. Because they are potentially costly for governments, it is important to design them well. This section of the module provides guidance on how to design severance plans, how to assess payment levels, and how to avoid some common implementation problems.

The design of severance packages must begin early in the labor program because it is a critical factor in the success of the program. An early start will provide time to assess all of the options. There is, however, no "cookbook" recipe or formula for determining severance payments.

Severance packages typically include some or all of the following components:

A severance package has a number of elements. Each element may be governed by different legislation, regulations, rules, or agreements.

- **Statutory end-of-service payments,** the levels of which are set out in national or state legislation and over which there is no discretion (without legislative change)
- **Compensation for enterprise-level benefits,** which are payments to retrenched workers for benefits to which they are entitled according to the rules for each enterprise or as part of a formal collective bargaining agreement

- **Ex gratia severance payments** over and above statutory minimums, which form part of a voluntary departure agreement with workers.

Statutory Payments

Statutory payments can be an important part of the overall severance package.

Statutory termination payments are the minimum payments that any terminated worker must receive according to national or state legislation. These payments must be made whether employees leave through voluntary departure, early retirement terms, or compulsory redundancy.

The relevant laws and regulations vary among countries, but typically the main elements of statutory payments are:

- Notice period, or payments in lieu of notice
- Statutory termination benefits
- Gratuity benefits
- Pension benefits
- Earned leave
- Payment of salary or wages in arrears.

Notice Payments

Statutory termination benefits represent the minimum amounts that all retrenched workers must receive.

National labor legislation often provides for a notice period prior to redundancy, typically ranging from one to three months and sometimes longer. In many cases there is the option to provide salary in lieu of the notice period. This enables managers to ask employees to leave the workplace immediately—an option with the following advantages:

- It avoids having retrenched employees working alongside their retained colleagues, which could lead to tension in the workplace.
- It enables managers to move quickly ahead with training and development for retained staff.
- It reduces the potential for theft, poor service, or sabotage by employees being let go.

Statutory Termination Benefits

Statutory termination benefits vary considerably among countries, as table 5.1 indicates. Benefits typically are based on a formula linked to years of service. Often workers must have completed a minimum period of 6 to 12 months of employment to be eligible for these benefits. The International Labour Organisation's "Termination of Employment Digest" is an online resource that details national legislation and statutory severance payments and packages worldwide.

The ILO Web site offers access to comparative data on statutory termination benefits: www.ilo.org.

Gratuities

A gratuity is a benefit paid at termination of service to an employee reaching the date of superannuation or on retirement, resignation, death, or disablement. Some countries have primary legislation setting out the basis for statutory gratuity payments, in addition to other statutory termination benefits. In other cases enterprise-level rules may set the terms of gratuity or supplement the legislation.

Pensions

Pension entitlements are a substantial and important element of a worker's severance package, and they are covered extensively later in this module.

Earned Leave

Some public sector or enterprise terms and conditions provide that termination benefits can include payment in lieu of earned (accrued) leave. For example, in Orissa, India, permanent employees are awarded "earned" leave at a rate of 15 days per year of service. If a worker takes no earned leave during the course 20 years of service, his or her earned leave could total 300 days (15 × 20). At retirement any unused earned leave can be converted to cash, subject to a maximum amount of eight months of salary. In Orissa the payment of unused leave at the end of service is a nonstatutory pay-

Table 5.1: Some Examples of Statutory Termination Benefits

Economy	Notice period	Termination benefit	Other features	Information source
Cambodia	Sliding scale from 7 days (minimum) to 3 months for workers with more than 10 years of service	For workers with more than 1 year of service: 2 weeks' wages per year of service, up to a maximum of 6 months' wages	Workers on fixed-term contracts (rather than indefinite employment) are entitled to a severance payment as agreed in the labor contract, but not less than 5 percent of the total wages paid during the length of the contract	ILO 2000
China	30 days; notice is compulsory	Generally 1 month a year	Trade unions, workers, and labor administration must be consulted	ILO 2000
Estonia (1)	2 months	3 to 4 months of salary, depending on service period	No other liabilities on firms	Orazem and Vodopivec 1996
Estonia (2)		2 to 8 months of wages		Venesaar 1995
Hong Kong, China (Special Autonomous Region)	As contract of employment, unless fewer than 7 days; a legal minimum of 1 month	After 2 years' service at capped rate per year of two-thirds of last salary or HK$22,500, whichever is lower	For collective dismissals there are no legislative requirements for notice, consultation, prior authorization from a judicial or administrative body, or any other restrictions in relation to proposed redundancies	ILO 2000
India	1 month's notice	15 days' wages per year of service, for workers with at least 1 year's service	Workers with more than 5 years of service also are entitled to gratuity payments	ILO 2000
Indonesia	Termination requires prior approval by the labor administration and consultation with trade unions	1 month per year up to a maximum of 5 years	General requirement to avoid redundancy wherever possible	ILO 2000
Kazakhstan	2 months	3 months of salary		Code of Laws on Labor of the Kazakh SSR (as amended to 1994)
Democratic Republic of Korea	30 days' notice	Minimum of 30 days a year	Legal requirements to establish fair and rational standards for selection of redundant employees, and to consult with trade unions	ILO 2000

(*Table continues on the following page.*)

Table 5.1 (continued)

Economy	Notice period	Termination benefit	Other features	Information source
Malaysia	4 to 8 weeks, depending on length of service	4 weeks for 10 days for the first year, 15 days for 2 to 5 years, and 30 days per year for periods in excess of 5 years	Last-in/first-out selection has been imposed by courts	ILO 2000
Nepal	1 month	30 days per year of service, plus gratuity and other statutory benefits	Last-in/first-out, plus: • Non-Nepali nationals must be retrenched first, even if they have not been employed last • Workers and employees who are absent for a long period as a result of poor health must be retrenched first	Labor Act 1992
The Philippines	Approval to terminate is required	1 month a year if dismissed as a result of new technology; 1.5 months if dismissed as a result of enterprise closure or attempts to reduce losses		ILO 2000
Singapore	As employment contract, otherwise statutory minima of 1–4 weeks	None but that determined under collective agreements		ILO 2000
Slovenia	6 months (24 months prior to 1991)	1 month's salary per year of service	Firms are responsible for taking steps to retrain or reassign workers	Orazem and Vodopivec 1996
Sri Lanka	1 month, but must report to commissioner	Labor commissioner determines entitlements but her guidance on criteria given to employers is to pay 2 to 3 months' salary per year of service or full salary for the remaining period up to retirement, whichever is less, subject to a maximum of 50 months' salary	Labor commissioner has absolute discretion to approve applications for redundancy	ILO 2000

Table 5.1 (continued)

Economy	Notice period	Termination benefit	Other features	Information source
Taiwan, China	1 month	2 months' salary for the first 15 years of service, 1 month of salary for the remaining years; maximum of 45 months' salary		
Uruguay		1 month's current salary for each year or fraction worked, up to a maximum of 6 months' salary		www.embassy.org/uruguay
República Bolivariana de Venezuela	Up to 3 months, depending on seniority	1 month of "normal salary" for each year of service; this is doubled, however, if the employee is terminated without just cause. In addition, the employee receives any undistributed, accumulated interest in his or her severance indemnity account.	"Normal" salary for severance is defined as basic salary plus all fixed regular payments and allowances and any profit-sharing payments, all brought to a monthly basis	Coil and Rice 1997
Vietnam	45 days for workers with an indefinite employment contract	Generally, one-half of a month's salary per year of service as severance allowance, plus 1 months' salary per year of service as loss of employment allowance		ILO 2000

ment, but it is defined in the service rules and regulations of individual enterprises. The courts there have enforced the eligibility of retrenched employees for these payments so enterprises have had little discretion in their payment.

Arrears of Salary and Benefits

There is usually no legal or ethical disagreement that displaced workers should receive any salary or other benefits that are due them. Those arrears, however, can be substantial if financial problems have led enterprises to defer payments for some months or years. Arrears may comprise:

- Unpaid salaries
- Unpaid salary increases, cost-of-living adjustments, or scale revisions
- Unpaid allowances or allowance increases
- Unpaid pension fund contributions (both

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Large arrears can come as a financial surprise to the implementing agency. Dealing with them can delay the process and present governments and donors alike with some tough policy decisions.

employees' and employers' contributions).

Arrears can present practical challenges for the agency that is implementing the privatization of the infrastructure sector, among them:

- **Identification of the level of arrears:** Implementing agencies may be unaware of or may underestimate the extent of arrears. Enterprise managers also might have underestimated, hidden, or not reported the scale of the arrears problem. If large arrears come as a surprise late in the restructuring process, there may be a problem in finding funds to meet them at short notice.
- **Additional time delays:** Resolving the problem of how to finance unexpected arrears can take the time and attention of the implementing agency. Disputes with unions can easily arise over arrears. Calculating net arrears can also introduce further complexity and delay. For example, one bus company allowed its staff to keep a portion of passenger receipts in lieu of wages, and the register of these "informal" salaries needed to be reconciled before arrears could be finalized.

Moral hazard is a concern for those asked to finance arrears.

Arrears are a particular worry for ministries of finance and for donors. Rescuing enterprise managers from the problem of arrears may cause greater arrears problems in the future because (a) the rescue signals that government has taken a soft approach to the budgets of SOEs, and (b) if enterprise managers believe that the overstaffing problem ultimately will be dealt with through a generous government severance program (at the time of privatization or before), they have little incentive to tackle overstaffing and to make the hard labor adjustment decisions that are needed on a day-to-day basis.

Statutory payments, together with contractual benefits (described below), can represent a substantial proportion of the overall payments to workers in both middle- and low-income countries. For example, in the privatization program in Taiwan, China, the total severance package for a typical middle-ranked employee with 15 years of service is proportioned as follows: statutory payments (70 percent), compensation for cessation of pension (14 percent), and ex gratia severance (16 percent) (Chang 2002, pp.11–15). In Brazil, federal rail employees who took voluntary departure terms received an average of about US$8,000 in ex gratia severance and US$10,000 in legal entitlements. In India, too, workers in Orissa who accepted the government's voluntary retirement scheme (VRS) received a significant proportion of benefits from statutory and contractual benefits—particularly workers with fewer years of service (figure 5.1).

Statutory termination benefits are usually paid from the current resources of the enterprise. Employers simply make the payment out of current operating expenses when workers reach a specified age or leave the enterprise. Generally there is no method of accounting for these liabilities, even though they can represent a substantial future commitment of an enterprise's resources. Consequently, severance programs can represent one of the most difficult problems in a PPI transaction, because they are legally enforceable obligations that can have dramatic cash flow and solvency consequences during labor restructuring.

In Latin America, however, some countries require workers to contribute to an individual account into which some percentage of their salary is paid on a regular basis. In the event of separation—voluntary or compulsory—workers can withdraw monies from these accounts. Any surplus at retire-

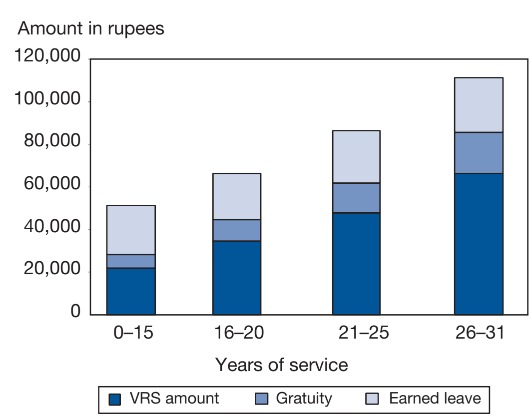

Figure 5.1: End-of-Service Benefits in Orissa, India

Source: Adam Smith Institute, unpublished data, 2000.

ment can be used toward the worker's pension provision. This approach is effectively a severance program funded through forced savings by workers themselves, and similar in some ways to the provident funds described in the pensions section of this module. Brazil has had a program of this type for more than three decades, where displaced workers can use their individual FGTS (Fundo Garantia por Tempo de Servicio) accounts. In the 1990s Colombia replaced its severance pay program with fully funded accounts of this type (de Ferranti and others 2000).

Contractual Benefits

Many enterprises provide a range of benefits, including medical, transportation, housing, food, and other allowances. These benefits are often set out in the administrative rules or regulations for each public enterprise or in collective agreements or labor contracts. The implementing agency will risk industrial unrest and legal challenges on breach of contract grounds if agreed benefits are not provided. Unlike statutory payments, however, the implementing agency does, in theory, have the option to negotiate these payments.

At separation, workers will usually have to be compensated for these contractual benefits as part of the overall severance package through one of two mechanisms:

1. Estimation of the value of each benefit for each worker
2. Conversion of allowances into a single nominal salary (as described in the case of Mexico railways [box 5.1]), which is then adopted as the worker's deemed salary in a severance formula.

In Nepal public enterprises set their own rules and regulations for treating such nonsalary benefits as medical coverage, housing, loans, and food allowances at termination. These allowances have varied greatly, and the government found that it had to engage accountants and consulting firms to undertake detailed assessments for each enterprise in order to estimate the costs of labor adjustment for its public enterprises. In Uganda the rules on termination payments vary among enterprises. Some include standard allowances received with pay as a basis for calculating terminal benefits; others do not include these allowances but do provide formulas that compensate for them (Campbell-White and Bhatia 1998).

Enterprise benefits are defined by the administrative rules and regulations of the enterprise.

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Box 5.1: Mexican Railways—The Daily Integrated Salary

At the Mexican National Railroad Company (Ferrocarriles Nacionales de México, FNM), salary for the purposes of the severance scheme was identified as the "daily integrated salary." It was calculated by adding the monthly amount of the base salary to the amounts of a wide range of enterprise benefits and dividing by 30 days of the month. Here is a list of the potential factors in that equation:

- Base salary
- Savings fund (monthly equivalent)
- Christmas bonus (monthly equivalent)
- Payment for vacations
- Special bonus for housing rental
- Special bonus for transportation
- Payment for basic bundle of goods
- Payment for educational support of children
- Incentive payment for attendance and punctuality
- Incentive payment for productivity
- Incentive payment for training
- Tenure bonus
- Performance bonus
- Support for automobile fuel

This formula was used to calculate the salary that applied both for workers eligible for an enhanced early retirement plan (with different retirement ages for men and women), and for those workers who were not eligible for retirement but offered instead a severance plan. Depending on their daily integrated salary, age, tenure, and gender, workers received, on average, between US$10,000 and US$25,000 as a severance payment (based on the average exchange rate in 2000).

Source: López-Calva 2002.

Contractual benefits can be complex. The labor contract for workers in the Mexican national railway (Ferrocarriles Nacionales de México [FNM]) contained more than 3,000 clauses. In such cases renegotiation and simplification of the labor contract and payment rules are effectively essential prior actions to privatization and may include simplification of the rules on compensation for the loss of benefits for redundant workers. In Mexico a temporary contract was agreed to during the restructuring process for FNM—one that simplified the contract to 211 clauses. Following the private investment in infrastructure (PPI), the new railway operators negotiated separate labor contracts (López-Calva 2001).

López-Calva 2001 (a PPIAF case study).

Many governments have chosen to treat housing as a noncore asset and to sell it. Workers may have first refusal or receive discounted prices.

Housing is often an important benefit that needs separate treatment. Two issues must be addressed in this regard:

- **The immediate treatment of displaced workers living in enterprise-provided housing:** The usual arrangement is to allow workers to continue to live in the housing for a specified period after termination, sometimes with reduced rents. For example, Tanzania Telecommunications Corporation Ltd. allowed workers a six-month rent-free period in which to find alternative accommodations. Brazil's railway, RFFSA, allowed separated workers to stay in their housing for one year.
- **The disposal of housing that is no longer needed:** Options include sale of the houses, with employees possibly offered the right of first refusal or a discount on the market sale price; transfer of houses to local or municipal governments (a practice that has been common in transition economies); and transfer of houses to a government property agency that continues to collect rent and manages the disposal of the government's property portfolio in a structured way designed to maximize revenues.

Ex gratia payments are at the core of lump-sum severance packages.

Allowances for travel to home may be part of the normal statutory, enterprise, or contractual benefits or may be provided as a special ex gratia end-of-service benefit for workers. Either (capped) reimbursable costs or, more commonly, a defined allowance is paid toward the costs of transportation to a designated home location for the employee and his or her family and for the transfer of household furniture and possessions. The designated home location is often the location recorded in the employee's service record at the date of joining the PPI enterprise. These allowances are most relevant where there are traditions of migration to work or where ethnic group or family links to the home area are important.

Ex Gratia Severance Payments

Ex gratia severance payments are often provided as part of the overall severance package. Particularly in countries where the need to reward or placate labor is strong and social safety nets are lacking, as well as in countries where labor legislation prohibits outright layoffs, governments have resorted to promoting voluntary departures by offering severance payments that exceed legally mandated requirements.

Developing Severance Formulas

Worldwide, in both private firms and in government, the most common approach for defining severance payments is a formula based on a multiple of years of service and salary. Such formulas are easy for managers to use and are widespread in both the public and private sectors. Table 5.2 describes some advantages and disadvantages of the standard formula.

The formula for severance payments has varied widely among countries and, within countries, among enterprises in different sectors, depending on legal and contractual obligations and the strength of labor unions. Examples of formulas used and the resulting payments in a range of infrastructure enterprises in developing countries are presented in table 5.3.

Additional data tables summarizing the key features of public sector and state enterprise severance programs worldwide.

Table 5.2: Advantages and Disadvantages of Standard Severance Formulas

Advantages	Disadvantages
• Relatively simple to understand, communicate, and implement • Attractive to unions because they can negotiate a formula for a class of workers • Attractive to government because it can set a single formula as part of a uniform approach	• Can be imported easily. Managers in a hurry may sometimes simply copy formulas from another country or enterprise. • Can substitute for analysis of actual needs

Table 5.3: Examples of Severance Formulas and Payments

Economy/ enterprise	Key features of voluntary departure	Other features	Source for further details
Argentina: Buenos Aires Water and Sewerage	Post-PPI voluntary retirement undertaken by the concessionaire	Workers who left under voluntary retirement received approximately US$10,000 in severance	Shaikh 1996
Argentina Electricity	Severance package is approximately 10 percent greater than the statutory termination package	In 1992 workers received approximately US$10,000 in severance.	Shaikh 1996
Argentina Rail	1 month per year of service, with no cap	Approximate cost in 1990 of US$10,000 per worker	Ramamurti 1997
Bolivia Rail	3 monthly wages plus an equivalent of 1 wage per year of work for those with more than 5 years of service, plus statutory unemployment benefits	The amount offered was the same as statutory payments; Bolivian capitalization program had made a policy decision to implement a uniform scheme for all enterprises; no incentive for workers who voluntarily retired	Valdez 2002
Brazil: São Paulo Railway	Workers with 4 to 10 years of service, 1 month's salary per year of service; workers with 10 to 20 years of service, 2 months' salary; and workers with up to 25 years of service, 2.5 months' salaries; workers also receive 180 percent of the accumulated funds in their FGTS accounts (a compulsory employee severance indemnity fund, to which all employees in Brazil contribute 8 percent of their basic salaries each month)	Those who left voluntarily gained a cash bonus of 33 percent of monthly salary per year of service; average total package received per worker was estimated at R$29,870	Carneiro and Gill 1997
Brazil: Rio Grande do Sul State Electricity Company	60 percent of a month's salary per year of service, but capped at 15 months' salary; additional incentive for workers near retirement age is	Average package per worker was R$41,900	Carneiro and Gill 1997

(*Table continues on the following page.*)

Table 5.3 (continued)

Economy/ enterprise	Key features of voluntary departure	Other features	Source for further details
	10 percent of all remaining wages up to the date of retirement; workers also receive 140 percent of the funds in their FGTS accounts		
Brazil: São Paulo Electricity Company	50 percent of a month's salary per year of service for those with less than 10 years' service; 40 percent if more than 10 years of service; no cap; workers also receive 140 percent of the funds in their FGTS accounts		Carneiro and Gill 1997
Brazil Federal Railway	4 to 12 months of salary, depending on years of service, increasing for workers with 6 to 25 years of service and decreasing for older workers with more than 25 years of service; workers who delayed accepting voluntary departure and were made redundant during the period 1 year after privatization received 80 percent of these benefits	Only workers with more than 6 years of service were eligible; workers were allowed to keep their use of housing for up to 12 months and pension payments were continued for 12 months; average payment to workers was about US$8,000, plus US$18,000 of statutory benefits	Estache, Schmitt de Azevedo, and Sydenstricker 2000
Guyana Telephone and Telegraph Company	Severance package equivalent to 22 months of salary		Hinds 1995
India: Federal VRS Scheme (1993–95)	1.5 months of salary per year of service, or 15 days' salary for each year until retirement at age 58, whichever is less, plus statutory benefits	Three times better than statutory termination benefits of 15 days' salary per year of service	Kouamé 1997
India: Orissa State Electricity Board	1.5 months' salary for each year of service, or 30 days' salary for each year until normal retirement date, whichever is less, plus statutory benefits		Ray 2001
Mexico Federal Railway (FNM)	4 months of salary plus 30 days for each year of service; part-time workers receive 3 months of salary plus 20 days of salary for each year of service	Salary was a daily integrated salary, which included base salary plus 12 other allowance elements; workers typically received between US$10,000 and US$25,000 in severance. An enhanced pension package was also provided, funded in part from privatization proceeds.	López-Calva 2001
Pakistan: Kot Addu Power Plant	Based on plan for industrial plant privatization in Pakistan; voluntary departure package of 4 months' basic salary per year of service, plus gratuity of 1 month's basic	Evidence of adverse selection (the most productive workers leaving). Average costs in 1990–93 were about US$3,000, but costs	

Table 5.3 (continued)

Economy/ enterprise	Key features of voluntary departure	Other features	Source for further details
	salary per year of service (the "4+1" rule); officer cadre staff had a less-generous package of 2 months' salary per year of service plus gratuity (the "2+1 rule")	at some industrial plants rose to US$10,000 after 1993	Kouamé 1997
The Philippines: Manila Waterworks and Sewerage System	Severance package based on years of service, using an "adjusted monthly pay" to take into account various allowances (this was around 30 percent higher than basic pay); workers with less than 20 years' service receive 1.5 months per year of service; those with 20 to 30 years of service receive 2 months' salary; and those with more than 30 years of service receive 2.5 months of salary.	Typical package for worker with 20 years of service totaled about US$15,400, roughly twice the standard government package of termination benefits	Cruz 2001
Taiwan, China (Privatization Law)	Severance payment of 6 months of salary in addition to statutory payments.	Applicable to all employees retrenched at privatization or laid off within 5 years after privatization	Chang 2002
Vietnam (Decree 41/2002 on policy for redundant workers in SOEs)	Severance pay of 1 month per year of service (minimum 2 months); additional compensation of 1 month per year of service; lump sum of VND 5 million; continued salary for 6 months searching for job.	Workers can obtain 6 months' training at vocational training centers; workers who are 5 years short of the pension age have the right to continue paying 15 percent of salary to social insurance in order to qualify for pension and death gratuity benefits	Government of Vietnam 2002

In some cases an established uniform formula may already be in place, in which case the key decisions already will have been made. Where the formula is not considered sufficient or where there is no formula in place, a new formula may have to be developed.

At the absolute lower limit, workers must receive the statutory minimum set out in the law. In practice, however, earlier precedents might set a de facto floor for negotiations. The absolute upper limit would be to place a worker on permanent administrative leave with full salary. Although that practice is uncommon, more often the practical upper limit is again that set by previously agreed precedents, even if those precedents are in different sectors and under different circumstances.

Spreadsheet tool for analysis of severance options.

In setting a level of severance for voluntary departure programs, the attractiveness of the package to workers has to be balanced with its affordability for the government. If the payment is too low, workers may not volunteer to leave, and that can threaten or delay the overall objective—a successfully completed PPI transaction. Low levels of severance are sometimes combined with a degree of coercion (for example, threats of compulsory redundancy, unit closure, or wage arrears). Such coercion will engender adversarial relationships

Overpayment is common in publicly financed severance schemes.

with workers, unions, and government, and can damage the political credibility of PPI. If the payment is too high—that is, more than workers would actually need as sufficient compensation for the loss of employment—the government may not be able to pay it, and it may lead to excessive numbers of workers leaving the enterprise, including the best workers.

In practice, developing severance formulas is more likely to produce overpayment than underpayment for several reasons:

- **Political impact:** Except in the face of serious financial crisis, relatively generous severance payments are politically attractive.
- **High levels of compensation:** Salaries and benefits are often higher in the public sector than in the private sector (for example, see Bales and Rama 2002, Bhorat and Liou 2002, Panizza 1999, and box 1.1 in module 1 of this volume).Where program designers recognize a public sector wage premium they can reason that relatively generous severance awards are necessary if workers are to leave voluntarily.
- **Bias by plan designers in favor of generous packages:** This bias can occur for two reasons. First, designers may become too close to the concerns of workers or to the concerns of enterprise managers (for example, how to make downsizing go as smoothly as possible), and align themselves—perhaps unconsciously—with those interests rather than the interests of either public finance managers or society as a whole. Second, by erring on the side of generosity, plan designers can help ensure that the program is a "success"—an example of self-serving bias in their decisionmaking.
- **Availability of donor funds:** Although recurrent expenditures, including salaries, may be tightly controlled (subject to a hard budget constraint), donor funds for enterprise restructuring may be readily available. That combination of circumstances can encourage overpayment.
- **Ability to transfer costs to the taxpayer:** Governments can agree to generous terms (which makes difficult negotiations with unions easier) and then transfer the cost of that generosity to future taxpayers, as in Sri Lanka (Salih 2000).
- **Use of precedents:** Where other organizations have made generous payments (for any of the reasons outlined above), plan designers are likely to make the same mistake, either by meeting previous precedents or simply copying the earlier formula in the name of uniformity.

Where generous and unaffordable precedents have been set, choices must be made between using those precedents or negotiating new severance formulas. The choice will depend on the degree of political support for implementation, the costs imposed by the precedents, and the degree of concern for provision of a social safety net for displaced workers. A cost-benefit analysis of the financial and economic effects of the various options (see module 7) can inform this decision.

In designing severance levels there are various ways to achieve a balance between attractiveness and affordability, and those ways are discussed next.

Setting Minimum and Maximum Levels

A minimum severance level, or a floor, can be set at some point above the statutory minimum termination benefit. A floor can be a useful tool for demonstrating that the severance package is fair and benefits everyone, including lower-paid staff.

A maximum severance payment, or a cap, also can be set. One of the main potential criticisms of severance plans, especially generous ones, is that highest-paid workers or managers can obtain exceptionally high payments. A cap is a simple measure to prevent such criticism, and can be expressed in absolute money terms or in months of pay. For example, the government of Madhya Pradesh VRS-98 placed a monetary cap of Rs. (rupees) 500,000 on payments to workers.

Establishing Preretirement Rules

On its own, a simple straight-line formula (salary ×

years of service) would give maximum payments to the oldest workers in each cadre of employees. Just before retirement they would have the maximum payment. This is clearly a potential source of influence in employees' behavior: it encourages employees to stay on so that they receive higher compensation amounts, and it discourages earlier voluntary departure. Some empirical formulas attempt to offset this by including an element that reduces payments as the retirement age approaches (see, for example, box 5.2).

Another approach to the preretirement period is to make workers who are past a specified age and within a few years of normal retirement ineligible for voluntary departure. This can improve efficiency because workers approaching retirement clearly have the least expectation of loss. If, however, there is a sharp cutoff, again distortionary effects can arise. For example, if a plan is introduced in which workers with fewer than five years until retirement are ineligible for voluntary departure, there will be a very high uptake of the option to leave by workers approaching cutoff point as well as a degree of dissatisfaction and inequity for workers who for timing reasons just miss the newly introduced benefits.

Adopting Loss-Based Formulas

An alternative approach to the standard way of setting severance amounts, based on labor economics and econometric methods, has been pilot-tested by the World Bank in Guinea-Bissau, Madagascar, and Tanzania, and has been described by Chong and Rama (2000). This approach (which is discussed in greater detail in module 7) recognizes that workers' total incomes often will fall following separation or retrenchment (box 5.3), and it attempts to assess the level of severance that should be paid to offset those earnings losses. The following bullet points summarize the key features of this approach:

Chong and Rama (2000) described the application of a loss-based approach in Guinea-Bissau.

- Although the output from this approach to designing a severance package is a formula, it is one that takes account of the factors that influence individuals' likelihood of gaining income after severance. For example, if better-educated workers are more likely to return to higher-paid employment after separation, the formula will reduce their severance payment. If women workers are more likely to have difficulty in finding a job, the formula will increase their severance payment.
- The formula uses objective data, such as national household survey data, surveys of living standards, or labor force surveys, to generate an econometric earnings function for private sector workers. By comparing incomes and benefits of similar workers in the formal (or informal) labor market, estimates of the likely earnings losses can be made.
- The losses recognized include earnings lost while a worker searches for another job; permanent loss of earnings that arises because a worker transfers to the private sector (remember, many public sector workers earn a premium wage); estimated losses of tangible benefits (for example, transportation to work, food and housing subsidies, and medical benefits); and estimated losses of intangible benefits (for example, job security, flexible working times, oppor-

Loss-based formulas have a more rational basis and address the major weaknesses of empirical "rule-of-thumb" approaches.

Box 5.2: Brazil—Reducing Payments for Older Workers

In Brazil's federal railway privatization, workers with 6 years of service received 4 months of salary, and for every additional year of service that amount was increased by a factor of 1.0595 for each of the 19 increments up to 25 years of service. Workers with 25 years of service therefore received 12 months of salary as an ex gratia voluntary departure payment. For workers with 25 to 30 years of service, payments decreased by a factor of 0.8705, so that a worker with 30 years of service received 6 months of salary as voluntary departure payment.

Source: Estache, Schmitt de Azevedo, and Sydenstricker 2000.

Box 5.3: Earnings Losses after Retrenchment

There are no tracer studies of the long-term impact of retrenchment on workers in developing countries. In industrial countries, however, the evidence is that earnings losses have been both large and persistent. Reviews by Fallick (1996) and Kletzer (1998) on displaced workers in North America indicate persistent earnings losses of between 10 and 25 percent of predisplacement earnings up to 10 years after displacement.

In Turkey earnings after reemployment among petrochemical and cement workers displaced during privatization were 57 percent and 61 percent, respectively, of their earnings prior to layoff. Most workers also lost a range of nonwage benefits (Tansel 1996).

In Ghana follow-up assessments of the earnings of civil servants showed a 48 percent fall after severance, although workers who found wage employment had a much smaller reduction in income. Note, however, that although:

> *under current economic conditions, many retrenched workers can expect their lifetime earning stream to be appreciably lower.... we are persuaded that the difference in earnings before and after redeployment reflects the loss of a rent associated with civil service employment.... What the employees have lost, then, is a privileged post that, one can argue, they should not have held in the first place. Their gain in getting a civil service job was the Ghanaian taxpayer's loss, and vice-versa for the post-redeployment loss in earnings* (Alderman, Canagarajah, and Younger 1996, p. 285).

tunity for bribes, access to equipment, and facilities for private use).

Table 5.4 summarizes the advantages and disadvantages of loss-based formulas. They can deliver the fairest levels of severance payment for individuals. Furthermore, by careful targeting they can reduce the costs of the severance program for government and avoid adverse selection. Estimates of the level of costs savings realized from tailored formula compared with savings realized from an empirical formula are 31 percent for SOEs in Egypt (Assaad 1999) and around 20 percent in the case of the Central Bank of Ecuador (Rama and MacIssac 1996, 1999).

But there also can be some difficulties in adopting a loss-based approach:

- Loss-based formulas are likely to be less relevant where there are existing and well-established precedents for severance formulas. Any change is likely to require substantial effort and to involve negotiations with unions, approval by ministers, and parliamentary debate.
- Delays incurred as a result of designing and negotiating complex severance formulas might threaten the pace of the overall PPI program. A delay in implementation while a new approach and formula are being developed and negotiated could also wipe out any potential cost savings from adopting this approach.
- Data requirements are substantial and the process can be time consuming if enterprise personnel records are poor or if there is little information on nonwage benefits or on the likely postseverance livelihoods and incomes of workers.

Like other severance formulas, loss-based formulas will need to be understood by unions and workers and be discussed during the consultation process:

> *If appropriate compensation is needed to make the workers accept the prospect of downsizing, it is very likely that the package will have to be negotiated with the public sector trade unions. In that case the final compensation package may not be the cheapest one, or the fairest one, but rather a compromise shaped by the bargaining power of all the players involved. From this perspective the [loss-based approach] should not be seen as an example of "mindless social engineering," but rather as a tool to introduce some economic rationality into delicate political negotiations. While the approach*

Table 5.4: Advantages and Disadvantages of Loss-Based Formulas

Advantages over empirical formulas	Disadvantages over empirical formulas
• Tailors the package to compensate individual employees so that the compensation that each employee receives is more fair—those who stand to lose most will receive the most • Reduces the risk of overpayment, which has plagued severance programs worldwide	• Is subject to legislation or existing labor contracts that may preclude different (discriminative) treatment of workers according to factors such as age, gender, ethnicity, and location • Potentially adds time to the work force restructuring process because of the need to locate specialist skills, conduct econometric analyses, and persuade policymakers and unions • Has not yet been implemented beyond pilot (proposed) plans • Has a formula whose derivation is difficult to explain to policymakers and unions when seeking their support

could certainly be refined, it represents an improvement compared to the ad hoc way in which these negotiations are usually carried out (Chong and Rama 2000, p. 26).

Whatever approach is selected, severance payments in early retirement, voluntary departure, and compulsory redundancy schemes can be structured to provide time-based incentives for workers to leave early.

More generous packages for voluntary departure than for compulsory redundancy are the norm. During Brazil's railway reforms, workers were clearly informed that any compulsory retirees would receive only 80 percent of the package given to those who took voluntarily departure benefits (Estache, Schmitt de Azevedo, and Sydenstricker 2000). In Turkey the privatization law offered 30 percent more to employees who volunteered for early retirement (Tansel 1996). Early applicant bonuses can be offered. In the 1992 British Telecommunications downsizing plan, early applicants received an incentive payment.

Estache, Schmitt de Azevedo, and Sydenstricker 2000

Choosing a Uniform or a Case-by-Case Approach

For government the decision whether to negotiate severance on a case-by-case basis for each enterprise or to adopt a uniform severance plan for all public enterprises is a critical preliminary decision. Table 5.5 presents the advantages and disadvantages of each approach.

A case-by-case approach to severance, where payments are negotiated at the enterprise level, has arisen when there is a cautious, incremental approach to PPI and when, in the absence of any overall labor policy or guidelines, labor restructuring is dealt with at the transaction level. In some cases enterprises are also governed by their own labor rules or labor contracts, thus leading to a case-by-case approach. In others, a case-by-case approach has been adopted to ensure flexibility based on the individual circumstances of the company. Some governments, for example, have treated profitable and unprofitable enterprises differently, allowing profitable ones to pay higher levels of severance out of their own resources. That was the case in India and also in Tanzania when the government opted to concession port services and container terminal operation (box 5.4).

Although a case-by-case approach can provide flexibility, it can also create unwanted precedents. Each new award raises the minimum severance level for the next negotiations, and there is a ratchet effect that ensures increasing levels of severance. Such approaches can also fuel distrust in the process and bring the wider PPI program into disrepute, thereby threatening its sustainability

Table 5.5: Advantages and Disadvantages of Uniform and Case-by-Case Approaches to Severance

Approach	Advantages	Disadvantages
Uniform	• Treats all workers more equally • Has a more transparent process • Reduces information asymmetry between government and unions—both know what the deal is • Has predictable costs for severance in future years • Facilitates central (ministry of finance) oversight and control over public spending on severance	• Needs good analysis of long-term downstream costs to avoid danger of government initially setting too-generous limits overall (especially if the first programs are small PPI transactions with low numbers of affected workers) • Prohibits introduction of loss-based formulas tailored to each enterprise
Case-by-case	• Gives most discretion to government in setting severance payments in each enterprise • Allows the tailoring of payments to each work force and—in theory—the potential to deliver the lowest-cost programs for government (in practice, that occurs only if government is politically very strong)	• Signals to workers and unions that the level of severance is—in principle—always negotiable • Encourages bidding up of severance payments (a ratchet effect) and sets a precedent for other PPI transactions • Favors workers in enterprises with the most powerful unions, the most influential leaders, or the greatest potential to inflict economic damage through strikes or industrial action • Is less transparent • Leads to unpredictable costs for work force restructuring • Provides an opportunity for confrontational negotiation on both sides • Is only effective if there is a strong government that is robust in the face of vested interests and case-by-case lobbying • Makes monitoring and control of commitments more difficult if deal making is delegated to enterprise managers

(see box 5.5). Moreover, trade unions often oppose differentiation between enterprises on the grounds that (a) there should be equality of treatment for all workers in SOEs and (b) the financial distress of loss-making enterprises can be attributed to government mismanagement and therefore it is unfair to penalize employees.

Given the potential problems of a case-by-case approach, there are advantages to adopting uniform severance guidelines that, with some measure of flexibility to take into account enterprise circumstances, are applied to all enterprises (table 5.5).

Uniform guidelines can be perceived to provide fair and equal treatment for all workers and help ensure some measure of predictability in the process.

Adverse Selection and Targeting

A major issue in many severance programs is how to avoid adverse selection and rehiring of the best workers. Better targeting and selection of workers help avoid these problems.

Box 5.4: Tanzania—Severance Policies in Port Concessioning

In 1996 the government of Tanzania decided to invite private sector participation in the delivery of port services in Tanzania. They also invited private sector participation in the container terminal operation of the Tanzania Harbours Authority (THA) in the form of a 10-year operating lease. THA was one of the few SOEs in Tanzania with a history of sustained profits, and these profits resulted from its monopoly position and because fees to shipping companies were set in U.S. dollars. THA as a whole employed 3,500 workers; of that number 500 were directly associated with the container terminal business.

During the privatization of the container terminal the problem of how to handle severance came to the fore. Earlier proposals by the World Bank had suggested that government declare a consistent policy on severance. Government had decided, however, to retain its existing policy, which provided that:

- Where an SOE was taking a loss, was unable to fund severance costs from profits, and had to rely on the central government budget to make severance payments, only the statutory minimum severance obligations were to be met by government.
- Where the SOE was able to fund severance payments from profits, it could be permitted to pay an ex gratia sum beyond the statutory minimum.

In pursuing a program for severance of surplus staff, THA decided to offer an ex gratia payment in addition to statutory minimum obligations. Three problems immediately surfaced:

1. Although the number of workers involved and the financial cost were small in absolute terms, whatever was agreed would set a precedent for the other 3,000 THA workers (because the remaining THA operations were also listed for PPI).
2. The workers in the other utilities and infrastructure industries would use the case of the container terminal as a precedent. They would argue that the source of funding was unimportant and that the issue was one of equity.
3. There was a question of selection. The new operator (Tanzania Industrial Container Terminal Services Ltd. [TICTS]) was allowed to select from the 500 employees those whose services it wished to retain. The question arose whether to pay only those who were not selected for reemployment or to retrench all 500 container terminal workers. Again, the workers and unions would take the decision as a precedent.

The government decided that all 500 container terminal workers would be retrenched and paid the statutory dues and that those workers who were not reemployed would benefit also from the ex gratia payment. Those employees who declined reemployment lost their rights to the ex gratia payment—a policy intended to avoid the problem of employees with critical skills declining employment, benefiting from the ex gratia, and later being rehired by TICTS because their skills were critical. The ex gratia payments amounted to about 12 months' pay in addition to statutory payments.

The outcome is that the government has resolved labor issues in the PPI transaction of the container terminal. It also has avoided potential industrial unrest among other THA workers (who were watching and now expect similar treatment). However, the wider problem of inconsistency in the treatment of some 21,000 workers in other utilities and infrastructure remains.

Source: Parastatal Sector Reform Commission, Tanzania; Adam Smith Institute.

Adverse Selection

In many severance schemes there are concerns about adverse selection: that is, there is concern that the program will lead to the departure of the best workers and thereby result in the loss of critical skills and in the subsequent rehiring of workers who have received public money for severance. This section of the module provides some guidelines for addressing these concerns and making severance more efficient.

When an ex gratia severance payment is offered equally to all workers, it is usually selected by the most skilled and most capable employees. Those employees, who can easily find alternative employment elsewhere in the economy and who believe they have a bright future outside the enterprise, are precisely the people that the restructured enterprise would most want to retain. Overpayment of severance in public enterprises further contributes to adverse selection. In Argentina, for example, early railway retirees were among the most productive

Adverse selection is a common challenge in work force restructuring.

Box 5.5: Problems with Case-by-Case Setting of Severance—Sri Lanka and Zambia

Sri Lanka: Upward Revisions of Ad Hoc Severance Payments

Average ex gratia severance payments in Sri Lanka's privatization program rose from 17.5 months of salary in 1987 to 53 months in 1997. By the time that Lanka Lohan (a steel company) was privatized in 1997, the package was considered so attractive that all workers applied to leave the firm, a clear sign that the package was overcompensating them. The increases took place because of strengthening trade union bargaining power, and the "ad hoc and lackadaisical manner in which labor issues were handled" (p. 190). In Sri Lanka, severance packages customized on a case-by-case basis for each enterprise proved to be downwardly rigid and confusing to the parties involved and they encouraged rent-seeking behavior and hostility to privatization. Another outcome was that government was no longer able to easily afford to restructure labor before privatization.

Source: Salih 2000.

Zambia: Disparity in End-of-Service Benefits Fuels a Distrust of Privatization

The United Bus Company of Zambia was insolvent and was forced into liquidation. Under the applicable bankruptcy law, employees were entitled to 200 kwacha (equivalent to US$0.30) as preferred creditors for the legal minimum end-of-service benefit; for any additional amount they ranked as ordinary creditors in accordance with their contract terms of employment. In contrast, a cleaning worker who left Zambia Telecommunications after working there for only two years reportedly received a payment of 2 million kwacha (US$3,000). Such egregious disparities between the legal and contractual minimums for end-of-service benefits can create opposition to privatization and delay transactions.

Source: World Bank 1996e; quoted in Campbell-White and Bhatia 1998.

employees, whereas many unproductive workers stayed, which led to production problems and shutdowns on various lines. In Pakistan, overly generous severance plans reportedly encouraged the most productive workers to leave.

Enterprise managers are concerned about the potential problem of losing their best people and their knowledge, particularly during periods of transition to new management and new working methods. For PPI investors, however, the transitional challenges of taking over management are more acute because it is vital to avoid disruptions in essential infrastructure services and to keep operations and equipment going until new equipment and systems have been set up.

Approaches to Selection and Targeting

Mechanisms to better target severance payments are the principal solution to the problem of adverse selection. If there is an across-the-board offer with no targeting or selection, anyone who volunteers for severance is automatically able to receive it, although perhaps on a first-come/first-served basis and perhaps with a cap on the number of workers who can take the offer. This approach is most likely to lead to adverse selection.

Better selection or targeting can be achieved in a number of ways, whether undertaken before PPI by government or after PPI by the new investor. Table 5.6 summarizes the advantages and disadvantages of alternative approaches to selection. (Note, however, that in some cases, the implementing agency or the investor may have little choice of selection tools if these are mandated in a collective bargaining agreement.)

Establishing selection procedures is therefore a critical management task in any labor program. Attention to detail and a commitment to enforce selection are essential. The following sections elaborate on the main tools for better selection and targeting: active management selection, management veto, and selection by cadre.

Active Management Selection

The data sets and tools used for staff audits (see module 3) can help managers in the active selection of staff and cadres for retrenchment. Those tools include:

Table 5.6: Advantages and Disadvantages of Alternative Selection Approaches

Selection approach	Advantages	Disadvantages
No targeting (volunteers)	• Has simple rules—either available to all or on a first-come/first-served basis until all available funds are committed • Suits circumstances with weak PPI enterprise managers	• Has maximum risk of adverse selection • Effectively uses no selection tool at all
Last-in/ first-out selection	• Has simple rules—either available to all or on a first-come/first-served basis until all available funds are committed • Can be used to substitute for management decisionmaking in circumstances with weak PPI enterprise managers or weak human resources and appraisal systems • Can be perceived as fair • Is sometimes mandated in legislation	• Has significant risk of adverse selection • Is a crude mechanism for selection
Active management selection	Has a lowered risk of adverse selection	• Is demanding of managers (although staff and skills audits can provide some independent assessments) • Needs to be handled in a transparent manner to avoid accusations of bias • Is the slowest process, needs reasonable personnel records
Management veto	Has a lowered risk of adverse selection	• Is demanding of managers (although staff and skills audits can provide some independent assessments) • Can easily lead to accusations of unfair treatment from the best workers • Needs to be handled in a transparent manner to avoid accusations of bias
Selection by cadre, location, or operating unit	Can deliver a relatively low risk of adverse selection, depending on the structure of the work force and the quality of the staff audit	• Uses a relatively crude selection tool • Does not identify the best or worst workers within a cadre or location • Is open to abuse (e.g., by prior transfers of individuals)

Personnel records are a first source of data, but human resources departments often lack skilled professionals and adequate record-keeping.

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- **Staff and skills audits,** which help identify critical skill sets that must be retained or are in short supply
- **Individual appraisal or assessment records,** based on the normal performance appraisal review on internal competency assessments tests (that is, tests of the ability to do specific tasks), or on a special skill audit
- **Education and qualifications records,** which can lead to poor selection when used alone because they neglect the questions of tacit knowledge and institutional memory

Selection will be a contentious issue, so a fair process is essential.

- **Training records,** and evidence of employee response to training
- **Assessment based on the comments of supervisors and managers,** including assessments of employees' willingness and flexibility to undertake a range of work, as well as their job histories (which offer evidence of increasing levels of responsibility) and their possession of transferable skills
- **Attendance records,** which detail unauthorized leave and medical absences (whether uncertified, self-certified, or certified by a doctor)
- **Special interviews and tests specifically for selection prior to severance** can supplement other data or fill in the gaps where an employee's records are poor or missing if they are undertaken in an objective manner and if they probe and test for relevant skills and competencies.

The primary problem in management selection is that many worker traits are unobservable. Put simply, it is hard for the designer of a severance program to design selection criteria that distinguish between the productive and the unproductive worker on the basis of written records alone. Reliance on only one test may be unwise, as was found in Guinea and Sri Lanka (see box 5.6).

Using a *range* of the above tools is wise, and can help assure workers and unions that the process is being carried out in a fair and transparent manner. Selection tools will be most effective where an effective appraisal system is already in place, together with competent and professional human resources management.

Veto by Management

Giving managers the right to reject applications on an individual basis is another option. In practice this is a difficult route for many managers because they have to be prepared to reject applications for voluntary departure from their best workers. The task is made easier if:

- Relationships between managers and staff are sound, and program communications have not raised the expectation that the departure package is available automatically to all workers. Consider this approach, for example:

  Deselection of certain potential [voluntary departure] applicants was done by personally calling those employees and persuading them not to apply since their future in the company was bright (Ray 2001).

  Ray 2001 (a PPIAF case study).

- All parties have reasonable expectations that prospects in the company will improve after PPI (this will depend in part on the sector).
- Managers are prepared with plans for future salary structure and performance-based incentives to encourage workers to stay.

Selection by Cadre

Selection can be imposed through eligibility restrictions, which only allow certain groups of workers to participate in a voluntary departure plan. The criteria for selection may be related to age, years of service, cadre, grade, operating unit, or location:

- **Age or years of service eligibility criteria:** Some severance packages are only open to workers with a minimum period of years of service. This will discourage younger workers from taking voluntary departure, and is rational where a shift in the age or experience mix is an explicit objective. A problem can arise where mandated last-in/first-out rules combine with minimum eligibility rules to selectively disadvantage newer workers. The approach also may not be appropriate if large numbers of workers have recently been taken onto the permanent rolls (for example, as a result of negotiations with trade unions to regularize temporary workers).
- **Cadre:** If there is overstaffing in particular cadres, tiers, or grades, the plan may be offered only to those groups.
- **Operating unit or location:** Voluntary departure may be offered only to workers in particular units (for example, a construction or

Eligibility is another mechanism for selection and targeting.

Box 5.6: Challenges of Selection—Guinea and Sri Lanka

Guinea: Selection of Water Utility Workers in Conakry

The process of workers to transfer to new water companies was conducted through a series of objective tests (initially managed by the World Bank) that were "supplemented" with recommendations from former managers at the former utility—the DEG. The subjective evaluations raised serious concerns about objectivity (Ménard and Clarke 2000).

Sri Lanka: Worker Selection Processes during Privatization

"It was difficult to screen the high-quality workers from the low-quality workers. Even where exams were held for this purpose, those workers who wanted to leave the firm [through a voluntary departure scheme] performed in the exam very poorly" (Salih 2000, p. 193.)

maintenance unit) or in an operating division that is particularly overstaffed or that is being closed or outsourced.

As with other selection tools, selection through eligibility criteria requires commitment from government, as was found to be true in Sri Lanka (see box 5.7).

The alternative selection approaches discussed above and outlined in table 5.6 are not mutually exclusive and can be used in a mix. To illustrate, there could be no selection for unskilled cadres who are all surplus workers or for all workers in a regional unit to be closed, but active selection by management of all other cadres.

Prohibition on Rehiring

The revolving-door syndrome (where workers are rehired after receiving severance) is indicative of a poorly managed labor program. Many severance schemes therefore set out explicit rules prohibiting rehiring. These are worth having, given the potential political and financial cost of such rehiring. Enforcement is difficult, however, and such restrictions usually can only reduce, not eliminate, the risk of rehiring previously separated workers.

Before they receive their severance benefits employees are usually required to sign a commitment not to return to work in the same enterprise. The design of any restrictions on rehiring will vary among countries and circumstances, but all should address the following aspects:

- **The time period for restrictions:** Are workers barred forever or just for a certain period (one year, five years)?
- **The scope of the restriction:** In the public sector, drawing reasonable reemployment boundaries can be difficult because of the intricacies of government. For example, if an employee is laid off from a state-owned

Box 5.7: Sri Lanka—Experiences of Selection through Eligibility Criteria

"Even when tiers of surplus labour were identified before putting VRS into operation, some workers maintained that this was discriminatory and that the option of voluntary retirement should be extended to all workers. However, the main opposition to targeting tiers for retrenchment came from workers who were not targeted. Opposition came from the more skilled grades of workers who felt they could obtain windfall gains through the compensation packages, since they could find alternative jobs without much difficulty. Hence, identifying tiers of redundancy labour for voluntary retirement was eventually dropped and across-the-board voluntary retirement was applied. This is why the problem of adverse selection (better workers leaving) was common in Sri Lanka's voluntary retirement process.... Even where workers of an identified tier were subject to VRS, the problem of adverse selection could not be altogether avoided because the better workers within the tier opted to leave" (Salih 2000, p. 193).

Governments can ask workers to sign a no-return agreement prior to receiving severance, but it can be difficult to enforce restrictions on rehiring within government.

telecommunications company, can he or she work again for that same company or its legal successors (post-PPI)? For other public enterprises? For other local, state, or federal government bodies? For subcontractors engaged by the PPI enterprise following privatization?

- **Penalties to workers for breaking the terms and conditions:** These may be strengthened by including obligations to repay severance monies or lose the tax privileges associated with severance if workers are subsequently found to be rehired.
- **Mechanisms of enforcement and legislation:** These can present practical difficulties in monitoring and enforcement, and legal challenges in countries where the labor law does not permit restrictions on recruitment.
- **Restrictions on the use of funds:** Some donors have rules that restrict the use of their funds. For example, World Bank loans cannot be used to finance the severance of workers who leave and subsequently are rehired either in another part of government or in the same company after privatization. (See the discussion of financing arrangements in module 1.)
- **The views of PPI investors:** These views should be sought wherever possible. Some plans mandate that workers cannot work again for the same enterprises, but do not restrict workers from working for the new privatized company. This was the case in Brazil's railway privatization (Estache, Schmitt de Azevedo, and Sydenstricker 2000). Elsewhere, however, investors have suffered from voluntary departure schemes that have prohibited workers from being employed by the subsequent PPI company. (See the example of Chile's railway, Fepasa, in box 5.8.)

Enterprise benefits can be complex and time consuming. Detailed manuals may be needed to define exactly how enterprise-level benefits will be treated during severance.

Implementation Issues

Three main implementation issues arise in severance programs: (1) the definition of severance procedures, (2) payment options and procedures, and (3) monitoring and evaluation arrangements. This section covers the first two items; the third item is discussed in module 7.

Severance Procedures

Well-documented redundancy and severance procedures can improve the quality and transparency of severance and can avoid the potential for dispute and opposition during implementation, which in turn may create delays. The advantages of having clearly established procedures are that (a) there is a common understanding on the terms, conditions, and definitions applicable to severance; (b) the prospect of redundancy has been raised and discussed (in some PPI utilities, the culture may still be one of "jobs for life"); and (c) there are clear guidelines for conducting severance activities (such as calculation of amounts owed to each worker or disbursement procedures).

Severance procedures should be set out in a policy statement or in regulations at the government or enterprise level, and usually are agreed to by government and worker representatives before restructuring starts. The CD-ROM accompanying this Toolkit provides an outline of a general redundancy policy and an example of a redundancy policy from a privatized freight railway.

Outline of a redundancy policy.

Redundancy policy for a privatized railway.

In addition to establishing procedures, governments can develop a manual for the entire severance process. The typical content of such a manual is set out in box 5.9.

Severance procedures generally cover the following areas:

- **Eligibility criteria:** Sometimes legislation or labor contracts will only provide for full-time or permanent employees as eligible for severance. The implementing agency will need to ensure that the treatment of other

Box 5.8: Chile Rail—Severance Benefits and Rehiring Rules

When a PPI investor, Unirail LLC, paid US$31 million to buy a 51 percent stake in Fepasa, a privatized rail line in Chile that the government was putting up for sale, difficulties arose almost immediately. The existing public railway employees had little incentive to stay with the new company because the government was offering them generous pensions to retire immediately. Almost all of them did. Soon the new owners were left with virtually no skilled staff. "This was a really difficult thing for us at all levels," recalls Larry McCaffrey, president of Unirail. "Why they did it, we don't know" (Moline 2000, p. 4).

In 1991 the Chilean Parliament adopted a law offering severance terms to workers who had left EFE, the state railroad. There were two main circumstances:

1. Employees separated from EFE having 25 years of employment, of which at least 10 were with EFE, received a salary each month equal to 1/30th of their monthly salary for each year of service, up to a maximum of 30 years, which is the point of retirement. Thus, a worker with 25 years' experience would receive 25/30 of his last month's salary for the following 5 years, and then he would receive his normal retirement pension. A condition of the above benefit, however, was that the employee could not work for EFE or for concessionaires of EFE (such as Fepasa) during the period of the benefit. The intention of this policy was to avoid the state in effect paying twice for the same employee.
2. Employees of EFE who did not meet the requirements for the above benefit (and therefore were not subject to the rehiring restrictions) would receive a reduced benefit equal to 50 percent of their monthly salary for a period of months equal to half the number of years of service plus one. Therefore, a person with 23 years of service would receive 50 percent of salary for 13 months. The great majority of EFE's employees did not have 25 years of service and thus this benefit applied to most of the 2,200 available employees, from which Fepasa needed about 400.

Neither of these benefits applied to the senior people who were paid more than $1,800 per month and who were free to choose what they wanted.

The principal problem for the PPI investor was that the primary people it wished to hire were the older drivers and electricians with more than 25 years of service because of their experience and their work ethic. Those people, however, did not accept the work because they had a significant financial incentive to stay away. This greatly hurt Fepasa at the time of start-up of operations because the most valuable workers were not available to the concessionaire.

Source: Moline 2000; Unirail LLC, personal communication.

categories of workers is properly defined, including:

- **Temporary, daily paid, seasonal, intermittent, or part-time workers:** Unions will often want to make casual workers permanent as part of the preprivatization restructuring and thus make them eligible for severance, as was the case in India's telephone and power sectors (see box 4.8 and box 5.10). If, however, it is clear from staff audits that there are large amounts of surplus workers in these categories, it may be preferable to make special severance provisions to compensate workers for their losses, provide a social safety net, and secure support (see box 5.10, for example). In practice, given the often very low wages of this group, the incremental cost to government of including temporary workers within a severance program may be small relative to the benefits of doing so. Such calculations will have to be done on a case-by-case basis.
- **Probationary staff, apprentices, and contracted workers** are often excluded from severance plans. The rights of these groups depend much on national or state legislation, which can affect the design of the severance package.
- **Officers and managers:** Senior staff (defined by grade or by salary) may be

Box 5.9: Content of a Severance Manual

What should be included in a severance manual? Circumstances will differ but the procedures could include the following material:

- *Full definitions of all key terms.*
- *A description of the timetable for labor adjustment.* This will include descriptions of any enterprise restructuring activities (for example, closure of operating units, depots, or workshops), levels and scope of downsizing, phasing, and timetable.
- *A standard format or spreadsheet for calculating the amounts due for every worker.* This will be based on an agreed formula.
- *Detailed definitions of the calculation of severance benefits—statutory and contractual.* This will supplement the paper format or spreadsheet because calculating the value of the contractual (enterprise) benefits and allowances, in particular, can be challenging. There may be different schedules and eligibility rules for different groups of workers. And if those benefits are not well defined, if enterprise human resources management has been weak, or if data are missing, then in practice the interpretation of the rules may have been and continue to be subject to considerable discretion. One unit manager may apply rules differently than another, and similar workers can receive different severance amounts.
- *A standard submission format to the decision body for release of funds.* Normally, approval for the release and transfer of funds for severance will require review by the ministry of finance or by a committee involving representation from the ministry of finance. The standard format aims to ensure that all costs are captured, including statutory payments, enterprise dues, ex gratia severance payments, arrears of salary, arrears of pension contributions, other allowances, and other costs arising from the restructuring. If a noncore activity is being sold, closed, or liquidated, there will be other costs to the ministry of finance, such as those associated with salaries of core staff (security and accounting staff often need to be retained), as well as valuation, privatization, or liquidation costs.
- *A standard letter of agreement between the PPI enterprise manager and the government.* This will outline the role of the PPI enterprise manager, as well as public finance arrangements.
- *A standard letter that all workers sign when accepting voluntary departure.* This will include their acceptance of any restrictions on rehiring, and verify their recognition of any tax or social insurance consequences.
- *Terms of reference for the engagement of accountants and auditors to help implement a program.*
- *A standard format for the disbursement of payments to workers.* This format should provide for the signatures of the workers to acknowledge receipt, as well as countersignatures by witnesses (such as independent accountants or auditors).
- *Standard formats for tax purposes as appropriate for the national tax regime.*

excluded from a severance package, given their higher salary and benefits levels. For example, in the concessioning of Chile rail, senior staff earning over US$1,800 a month were not eligible for early retirement benefits (see box 5.8).

- **Definition of salary:**
  - Many if not most plans define basic salary as the base for calculating severance payments.
  - A combined salary and benefits definition is another approach. In the case of Mexico rail (box 5.1), the "daily integrated salary" made up of 14 different elements was used both for severance pay and for early retirement packages.
  - In Chile retirement benefits are calculated on the basis of a "worker's reference salary," which is calculated as the annualized salary over the last five years of employment.
- **Definition of years of service:** In practice this needs to take account of issues such as:
  - Will prior service in another organization be taken into account?

- How are part-years calculated?
- Will service as a temporary worker count?
- Will service as an unregularized temporary worker count?
- What about apprenticeship or probationary periods and interruptions to service (such as times of military service)?

- **Constraints on reemployment.**
- **Treatment of other benefits (loans, medical insurance, and so forth).**
- **Treatment of housing occupied by the workers.**

Box 5.10: Regularizing Casual and Stipendiary Workers in the Orissa Power Sector

Public sector enterprises can engage large numbers of workers on ad hoc or occasional terms. In the Orissa State Electricity Board, for example, 5,336 semiskilled workers, engaged for extended periods as daily paid "nominal muster roll" workers, were regularized as part of the preprivatization restructuring of OSEB. Their remuneration then rose from Rs. 30 per day to about Rs, 3,500 per month. Similarly some 250 so-called stipendiary engineers had been employed by OSEB through emergency recruitment procedures, but they lacked any service benefits other than a fixed stipend. Following corporatization of OSEB, most of these engineers were regularized and made permanent employees of the successor company—the Grid Corporation of Orissa .

Although these groups were relatively weak stakeholders, their regularization helped create a strong positive impression regarding the reform process, and helped to back up the stance taken by the government of Orissa that power sector reforms would not lead to compulsory retrenchment. These workers could have been retrenched but, according to one former chairman/managing director, "possibly with such a beginning we would not have been able to carry on with the reforms" (p. 24).

Source: Ray 2001.

- **Taxation:** Treatment of severance pay varies among countries, with many countries treating severance pay as tax free, and some (such as Malawi) treating it as a taxable benefit.

Payment Options and Procedures

The implementing agency must decide how to pay severance to workers. Early retirement benefits are normally paid from the pension plan. For severance, the main options are to:

- **Provide severance in a single payment.** Many governments favor this approach because (a) employees tend to prefer lump-sum payments, (b) it is administratively simpler, (c) it provides a clean break, and (d) it avoids an impression of continuing government obligations toward the displaced worker. There are risks that a proportion of workers can very quickly dispose of lump-sum payments on consumption. Clearly, some cultural specifics in certain countries may predispose those workers more toward consumption than in other countries—for example, because of the social status of costly weddings or funerals.
- **Provide severance as a salary continuation.** In Chile's rail sector most workers received 50 percent of their salary for a period equal to half the number of years of service plus one (see box 5.10). In a 1,000-response survey of severance practices in the United States, where severance is typically one or two weeks per year of service, 47 percent of organizations implemented severance payment through continuation of the salary (Lee Hecht Harrison 2001); a similar percentage (46 percent) used lump-sum approaches and some offered workers a choice between the two methods.
- **Provide severance over a defined period.** For example, when the Uganda Railways Corporation retrenched 1,300 staff in 1997, severance benefits were paid over a three-year period (Murungi 2002).

There are choices for when and how severance payments are made.

- **Provide all severance as an annuity.** This is unlikely to be acceptable to workers if they have some pension arrangements or if they had the choice between early retirement and a lump-sum payment.
- **Allow workers to freely choose** among a lump-sum amount, staged payments, and an annuity.

Workers' preferences for these different options will vary among countries. Preferences can be determined through well-designed and statistically valid surveys representing all of the work force (all ages, all cadres, and both genders), perhaps as part of the prelayoff worker surveys (described later in this module in the section on redeployment programs). Factors that influence workers' preferences are likely to include:

- **Inflation:** Workers may want to quickly convert a lump sum into a tangible asset, such as housing, and may reject phased payments if there is a history of high inflation in the economy.
- **Degree of uncertainty about the future,** both personal and economywide.
- **Potential for small business:** If workers (or, perhaps, their spouses) can see income-earning opportunities, they may favor the opportunity to invest lump-sum amounts of their severance compensation in establishing a new microenterprise or small business.

Accurate and prompt payments of severance are critical. Workers who are paid incorrectly or late are treated unfairly and can create public dissatisfaction with the process. Moreover, in the absence of clear payment procedures there is a risk that severance monies will be captured by fraudulent people or that there is wide disparity in implementation among different units of the enterprise.

Therefore, the job of the manager in the implementing agency is to ensure that the right worker receives the right amount, at the right time, with no surprises. This generally involves the following steps:

- **Carrying out pre-audits of the proposed funds disbursement system, preferably with the help of the government accounting or auditing staff:** This can help ensure that processes are consistent with national public finance accountability regulations and with the requirements of any donors involved, defended from potential fraud, and able to provide an adequate subsequent audit trail.
- **Hiring accountants to provide implementation capacity:** Accurate calculation and verification of worker payments can be a time-consuming task in large-scale programs. If records are not computerized it might take 30 minutes to check each application. If 2,000 workers are to be retrenched, it would be equivalent to 125 person-days, without allowing for travel times and delays resulting from missing information, unclear rules, and other anomalies. Where internal resources are limited this task can be contracted out to national firms of accountants or to other professional firms of auditors or consultants. Some guidelines for this process include the following: have a panel of accountants to draw from, emphasize the need for independence of the accountants, do not let enterprises select their own accountants, and make the accountants also responsible for the accuracy of the payment process.
- **Developing computerized information technology systems that enable rapid analysis of worker dues:** In the privatization of Brazil's RFFSA, each RFFSA office was equipped with software that gave information on all the incentives offered to each worker and a simulation of the benefits each would obtain (Estache, Schmitt de Azevedo, and Sydenstricker 2000).
- **Monitoring payments:** The scope of work of any subcontracted accountants and auditors can include supervision of the actual handover of payments to workers (see module 7).

Tools (on the CD-ROM)

Sample severance spreadsheet

Outline of a redundancy policy

Sample redundancy policy (EWS Freight Railway)

Terms of reference for a severance consultant

Additional Material (on the CD-ROM)

Carneiro, Francisco G., and Indermit S. Gill. 1997. "Effectiveness and Financial Costing of Voluntary Separation Programs in Brazil: 1995–1997." Economic Notes 25, World Bank, Country Department, Latin America Region. Washington, D.C.

Estache, Antonio, Jose Antonio Schmitt de Azevedo, and Evelyn Sydenstricker. 2000. "Labor Redundancy, Retraining, and Outplacement during Privatization: The Experience of Brazil's Federal Railway." Policy Research Working Paper WPS2460. World Bank, Washington, D.C.

de Ferranti, David, Guillermo E. Perry, Indermit S. Gill, and Francisco H. G. Ferreira. 2000. "Helping Workers Deal with the Risk of Unemployment." Chapter 6 in *Securing Our Future in a Global Economy*. Latin American and Caribbean Studies. Washington, D.C.: World Bank. (Provides an overview of income support programs that have been used in Latin America, including severance pay, public works programs, training programs, and unemployment insurance.)

Gupta, Sanjeev, Christian Schiller, and Henry Ma. 1999. "Privatization, Social Impact, and Social Safety Nets." Working Paper 99/68. International Monetary Fund, Washington, D.C.

Web Sites

International Labour Organisation: www.ilo.org. (Several papers on labor issues in the context of privatization and enterprise restructuring.)

PSIRU (Public Services International Research Unit): www.psiru.org. (A research unit that receives core funding from Public Services International [PSI], the global confederation of public service trade unions. It conducts research on public services, privatization, and globalization, particularly in the water, energy, waste management, and healthcare sectors.)

World Bank. "Shrinking Smartly": www.worldbank.org/research/projects/downsize/. (Site is a clearinghouse for researchers, development practitioners, and government officials concerned about the difficulties encountered in downsizing a large public sector.)

Other Material and Sources

Fiszbein, Ariel. 1992. "Labor Retrenchment and Redundancy Compensation in State-Owned Enterprises: The Case of Sri Lanka." Internal Discussion Paper 121. World Bank, South Asia Region. Washington, D.C.

ILO (International Labor Organisation). 2000. *Termination of Employment Digest*. Geneva: International Labour Office.)For updates, see also the following area on the ILO website: www.ib.org/public.english/dialogue/ifpdial/publ/publ_empt.htm.)

Lee, Barbara. 1991. "Should Employee Participation Be Part of Privatization?" Research and External Affairs Working Paper 664. World Bank, Washington, D.C.

Starcher, George. No date. "Socially Responsible Enterprise Restructuring. A Joint Working Paper of the International Labour Organisation and the European Bahá'í Business Forum." International Labour Office, Geneva. Available at www.ilo.org.

PENSIONS AND PPI

This section identifies the key pension challenges facing the implementing agency and provides a brief introduction to pension plans for implementing agencies that may lack pension expertise.

The Pension Challenge

Implementing agencies face several challenges related to pensions. First, dealing with the accumulated liability of pension benefits that have already been promised and earned by current workers often is essential to determining whether privatization is feasible. Accumulated pension obligations may take a variety of forms, some of which may not be readily apparent in the financial records and statements of an infrastructure enterprise. Workers in potential PPI enterprises quite often are enrolled in the pension plans of civil servants or participate in the so-called provident funds established to provide some mechanism for mandatory retirement savings for salaried or formal sector workers.

In other cases special supplementary arrangements have been created to provide additional benefits to workers in industries of strategic significance (such as transportation, defense, and law enforcement), for workers in difficult or dangerous occupations, or for workers in highly skilled or high-pay industries. These benefits may be in the form of supplements to existing public social security programs or special-purpose pension arrangements to provide benefits to workers in a particular enterprise or industry. Both are often operated on a largely unfunded or "pay-as-you-go" (PAYGO) basis in which obligations are treated as a current operating expense rather than paid from reserves or asset pools to which payment is made at the time a future obligation is incurred.

This generally leads to circumstances in which, on an economic if not legal basis, there is a large liability for future benefits that are not accounted for and for which funds have not been set aside. When workers are covered by special-purpose pension arrangements, they can be legally enforceable obligations. When they participate in public or civil servants' programs—although these may function on a PAYGO basis, they are likely to perceive accrued pensions as implicit obligations that must be settled when an entity is privatized.

Accrued pension liabilities typically are not fully (if at all) reflected in financial statements. These obligations, often referred to as arrears or unfunded pension liabilities, can be substantial. In industries with declining labor forces or aging worker populations, past pension obligations may be the single largest liability when properly measured and may represent a multiple of the market value of an entity. For these reasons PPI investors may be reluctant to take over an entity until they are assured that accrued pension obligations are fully resolved.

Second, pensions are a central concern as well as an effective tool in restructuring a labor force through downsizing. Providing early retirement programs or establishing arrangements in which workers can retain or access some of the value of their accumulated pension benefits is commonly used to provide incentives for voluntary departures or to achieve work force reductions in the least disruptive or controversial manner. These strategies have significant financial implications and may have substantial political and social policy consequences so they must be carefully developed with consideration for their objectives and costs. (Those considerations are discussed later in this module.)

Finally, designing the pension program to meet the future needs of a privatized entity is a key element of its viability as a going concern. In nearly all circumstances, including those in even the most fully developed economies, access to a reliable means of saving for retirement and providing old-age income security are crucial aspects of attracting and retaining high-value added labor. Workers in key management positions or with particularly valuable skills may be attracted to PPI candidates solely on the basis of the access they provide to reliable pension programs. This is especially true in developing or transition economies in which there are few competing alternatives available.

The way in which pension programs are structured in anticipation of or following privatization inevitably involves tradeoffs between controlling costs and providing sufficiently generous benefits to recruit and retain an appropriate work force. Available is a range of choices in the design of a pension program that will need to be carefully considered in the context of the type of workers required, the consequences of the choices made, the usefulness of the choices as a labor management tool, and the pattern and level of associated costs.

Some types of pensions are very effective in attracting younger, educated workers, often those with highly valued and marketable technical skills. Other types are more effective in retaining older workers or key management staff. Some pension arrangements have lower or more predictable costs, whereas others enable sponsors to constrain cash outlays in early years but may involve greater uncertainty about their long-run expense. These choices and tradeoffs are essential to the value and viability of a privatization candidate and are discussed further below. (See also the case of Morocco rail presented in box 5.11.)

Types of Pension Plans

Pensions are essentially collective arrangements designed to provide income for people no longer able to work because of age. In nontraditional societies or in industrial economies in which the multigenerational household is no longer the norm, pensions provide a means for the elderly population to survive. Pensions can be organized and run by government and public institutions, by private firms, or by a combination of both.

Pensions may be organized as contractual savings in which a worker builds up assets or credits that are returned in a variety of forms as income following retirement or through the redistribution of income from active to retired populations. Pensions are typically afforded tax privileges under which income taxes on the value of payments or contributions are deferred until the time they are received as retirement benefits. This "consumption tax" treatment often has significant fiscal consequences and may be the single largest tax privilege in many countries.

Although there is a wide variation in their specific design, there are two basic types of pensions. The older and more traditional pensions are those that promise workers a level of income for the rest of their lives after they reach a specified retirement age. These generally establish a benefit level based on a formula that takes into account wages earned and years of employment covered under the plan. These are broadly termed *defined-benefit plans* and include the majority of the public social security systems, civil servants' pension plans, and many older occupational plans. Some defined-benefit plans try to set aside sufficient funds to pay the benefits by estimating their future value at the time they are earned and are therefore called *funded* plans. Others—commonly public social security and civil servants' plans—pay benefits out of current receipts and are called *unfunded* arrangements.

Glossary of pension terms

The first challenge is to meet pension obligations that have been promised and earned by current workers.

The second challenge is to use pensions as an effective tool for labor restructuring through early retirement.

The third challenge is to design pension plans for the post-PPI enterprise.

MODULE 5

Box 5.11: Morocco Rail—An Unsustainable Pension Scheme

In 1996 the government of the Kingdom of Morocco approached the World Bank for support for the restructuring of the state-owned railway, Office National des Chemins de Fer (ONCF). A key element of the restructuring was the conversion of the enterprise from a public corporation to a joint stock company. Although the ratio of staff costs to traffic revenue was better than that of most European railways at the time, it was still too high to ensure a sustainable financial position for ONCF, especially in the face of stiffer road competition. Labor costs were to be brought down to about 30 percent of operating revenues; this would involve a reduction in personnel from 13,800 in 1995 to 10,000 in 2000.

Corporatization would not be possible, however, without changing the pension arrangements. The ONCF pension plan was an internal fund, more favorable than the common system applied to private enterprises, with pension benefits paid directly by ONCF. Retirees were paid their rights directly from the yearly staff and employer's contributions plus a variable amount paid by ONCF to match the deficit. The system placed a major burden on ONCF finances. The high cost of the pensions was the result of very generous arrangements. The plan rules set the normal retirement age at 55 years (50 for drivers, compared with 60 years in the national retirement fund), and offered proportional early retirement after 21 years of service, an annual contribution rate of 2.5 percent, a high reference wage, wage-based indexing, and supplementary allowances and reversion of pension rights for family members. These benefits were unsustainable and would require an annual contribution rate of 50 percent if it were even to achieve a real financial yield of zero percent. Measures to change ONCF's pension system were urgently needed because the downsizing program, plus a staff age profile leading to steadily increased retirements (the number or retirees increased by about 200 annually), would make the plan even less tenable.

Source: World Bank 1996d.

Other pensions essentially provide a savings account for each individual in which contributions from the worker (and often the employer) accumulate. The value of these contributions and the earnings from their investment accumulate in these individual accounts. On reaching a specified age, or sometimes under other conditions such as separation from employment, the worker becomes entitled to the value of the account. In these arrangements there is no promise of a benefit level; all that is promised is the commitment to maintain the account. The benefit received is directly linked to the value of contributions made, so these are generally called *defined-contribution plans*.

The observation is often made that in defined-benefit arrangements the sponsor incurs all of the risks of unanticipated changes in investment returns or from miscalculations about the amount of time workers will live after retirement, whereas in defined-contribution arrangements these risks fall primarily on the individual worker. This principle is central when considering any restructuring of pensions in the privatization process.

Any type of pension can be organized on a national basis, by a single enterprise, or by a group of related employers. Pensions can be organized and administered by public or private institutions or by a combination of both. Workers in infrastructure enterprises may be covered by any of these types of pensions operated by either type of institution or through a combination of arrangements.

Some of the more prevalent types of pension arrangements are:

- **National pension plans:** Some countries have established government-run social security programs that generally cover all workers in the so-called formal sector—those who are receiving money wages. Coverage is typically limited to this group because it is only through wage records that taxes and contributions can be collected and benefit levels can reliably be set, although in many circumstances this relationship is tenuous at best. In developing economies only a small fraction of the total population may be covered—typically including infrastructure workers.

  National pension schemes are typically operated primarily on a PAYGO basis and consequently have large unfunded and quite often untenable levels of future benefits. These arrangements can range from modest in scope to very generous (from those that seek to replace half of a worker's income to those designed to replace nearly all of a worker's income, even if that is not feasible over the long term). Infrastructure workers, especially in strategic or dangerous industries, may be afforded special privileges in these plans that provide higher income replacement rates or retirement at a younger age. Compensating workers for the loss of these special privileges can be very complicated and expensive and thus represents one of the more difficult pension problems in privatization. Public plans facing financing shortfalls may also seek payments to cover these future commitments if they are to be maintained—an expense that can be a major issue in privatization.

- **Civil servants' pension plans:** Many countries without national schemes or those with modest benefit levels have established special pension programs for civil servants. These are often designed to provide nearly full income replacement, often at young retirement ages, to compensate for the presumed lower pay levels of civil servants or to retain members within the career civil service. Regardless of whether either of these motivations is necessary, the tradition of high pension levels for civil servants is maintained in many developing countries. They are nearly always defined-benefit plans, although this is slowly changing. They may be operated in conjunction with a national plan or they may move covered workers into a separate arrangement.

  Infrastructure workers are often included in these arrangements and may perceive themselves as having forgone a significant por-

Two basic types of pensions:

- **Defined-benefit plans, where the risk lies with the sponsor**
- **Defined-contribution plans, where the risk lies with the employee.**

National pension plans usually are PAYGO.

tion of their potential wages or other employment opportunities in the expectation of future high pension levels. This may or may not comport with reality, however, because with civil servants more broadly the expectations and perceptions will be key issues in any labor restructuring. Civil servants' plans commonly are operated on an unfunded or partially funded basis.

As with national plans, these plans may not have aligned required contributions with the needs of long-term solvency and thus may represent an indirect source of subsidy for infrastructure entities. This not only distorts the measurement of actual compensation costs on an ongoing basis but may lead to demands for a very high payment to settle previously accrued but unfunded obligations when an employer tries to withdraw from the plan upon privatization.

- **Provident funds:** Former colonial powers, particularly the British, established a particular type of savings institution known as provident funds, and these remain common in many developing nations in South Asia and Africa. These are defined-contribution arrangements in which an account is established for each participant and the contribution of a specified portion of wages is mandatory. Contributions often must be made by employers as well.

  Typically the funds are invested in safe but low-yielding assets, usually debt instruments of the government. Participants are often permitted to borrow the funds for specified purposes—the purchase of housing is a common example—and are entitled to receive the total amount that has built up in their accounts when they reach a specified age. In some instances provision is made to convert the account balance into a lifetime annuity.

  Although provident funds are primarily established as retirement savings vehicles, they are often used for a far broader range of purposes. Workers often deplete the full value of these savings to pay for relatives' funerals, weddings, or education expenses or they are permitted to withdraw funds when leaving a job before retirement age. Because they are purely defined-contribution in nature and therefore, by definition, fully funded, these types of pension arrangements pose fewer problems of past liabilities or future commitment during PPI. They can, in fact, be a type of vehicle that essentially provides a source of severance pay to mitigate the short-term consequences of labor restructuring.

- **Occupational or employer-sponsored private pensions:** The least common but in some respects most problematic type of pensions likely to be encountered in a privatization initiative is occupational plans. These are special pension arrangements that have been established to cover workers in specific enterprises, sometimes called *single-employer plans*, or a group of related employers or members of a trade union, sometimes called *multiemployer plans*. Occupational pensions can be the only source of pension coverage in circumstances where there is no national pension program or where employees in certain industries are excluded from other arrangements. They also can be integrated into other plans, usually designed to provide supplementary benefits where income replacement rates are low or to provide for earlier retirement ages. Traditionally these types of pensions have been of the defined-benefit type; however, there is a recent trend toward defined-contribution plans.

  Occupational pensions are extremely diverse in form. They impose particular problems for implementing agencies because most developing countries have not established any sort of comprehensive rules or requirements for their establishment or operation. This can result in circumstances in which the benefits promised are not clearly specified, and that leads to considerable controversy about their settlement. Workers may be led to expectations about their pensions

Provident funds are defined-contribution plans.

that are considerably at odds with the terms of the arrangement or the resources available.

Most significantly, occupational plans often result in substantial future financial commitments that have not been measured or accounted for in a reliable fashion and that have no funding set aside to ensure they can be met. These problems are especially pronounced for defined-benefit arrangements, but may also occur when defined-contribution plans must be funded or when the funding is not segregated from the sponsor's other financial arrangements. They do, however, afford opportunities for using pensions to manage labor restructuring or to provide incentives to manage a work force, as discussed in subsequent sections.

Addressing Prior Pension Obligations

This section examines the issues and choices that must be addressed in assessing the feasibility of privatization and in resolving the existing pension obligations during implementation.

Measuring Existing Obligations

Pensions essentially involve the commitment by an employer to provide resources intended to be converted to income following the retirement of covered workers. This commitment can be as simple as an obligation to forward a specified portion of a worker's pay to an individual savings account (for example, to a defined-contribution plan or provident fund) or the far more complex responsibility to fund and administer a program that will provide a monthly payment to replace a specified portion of a worker's final salary for the remainder of the worker's life (a defined-benefit plan based on final salary). In many circumstances the cost of these obligations represents the single largest long-term financial obligation of an enterprise. How this obligation is addressed will be a key determinant of the market value of an enterprise and will be critical to its long-term viability. There are several steps involved:

Step one: The first step in this process is to obtain a comprehensive understanding of all of the potential pension commitments that currently exist. Pensions are an integral aspect of labor negotiations and work force management. Although this is typically a formal process, perceptions and expectations are often as important as formal legal agreements. Care must be taken to be as thorough as possible in obtaining a full picture of the existing pension system.

Pension agreements may be contained in forms ranging from national laws covering all workers, collectively bargained agreements between workers and trade unions, formal plans outlined in legal documents executed by an employer, and informal agreements or acknowledged practices by an employer. Many countries do not have well-developed labor codes or pension regulatory regimes that establish standards for pensions. The extent to which any of these obligations is binding will depend on the laws and traditions applicable to individual circumstances. It is likely that some important practices and expectations will not be well documented.

At a minimum the relevant national laws and documents describing schemes for civil servants, provident funds, or any employer-specific arrangements will have to be obtained and carefully reviewed to assess the extent of an employer's pension obligations. It is generally advisable to consult with officials of government-operated pension schemes, employee representatives, and any staff responsible for an enterprise's human resources or personnel functions to identify any undocumented agreements or practices that are relevant. A thorough familiarization with any regulatory requirements having a specific focus on funding requirements, vesting rules (requirements for the irrevocable right to benefits when certain conditions are met), and procedures for the resolution of benefit disputes is advisable. This process should result in a complete inventory of potential pension obligations.

Step two: The second and likely far more difficult step will be to develop reliable measures of the scope and cost of existing pension obligations. This step can be divided into two components: (1) the value of pension obligations accrued to date (sometimes called the accumulated liability or the accrued-benefit obligation) and (2) an estimation of the future and magnitude of pension obligations (variously referred to as the periodic costs or projected-benefit obligations, among other terms).

If the pension obligations are solely defined as contribution in nature, valuing the commitments to date may be as simple as determining the value of the various accounts and making judgments about the potential expense of fulfilling the contribution formulas in the future. These expenses usually can be readily expressed as either a fixed amount per period, usually a month or year, or as a percentage of wages.

The most critical aspects of the process for defined-contribution plans usually will be to determine the extent to which contributions to individual accounts have actually been made as promised and to identify the extent to which assets shown in account balances are actually present. This process nearly always will require engaging the services of a reliable financial accountant to conduct a thorough audit of the records of accounts to verify that (a) the accounts have been maintained properly and (b) that the assets are present as required or indicated.

Common problems likely to be encountered are sponsors who delayed forwarding required contributions or who substituted promissory notes or other "paper" obligations (perhaps even "shares" of the enterprise) for cash contributions. This is especially common when enterprises face problems raising working capital or other liquidity issues so that particular attention should be given under these circumstances.

An additional challenge will be to determine that the value of the assets held in accounts is accurately represented. Investments may be shown at their purchase price or some type of "book value," which may not indicate their current value. In many circumstances the accepted accounting treatment may require these approaches, so particular attention to valuation methods will be needed to obtain an accurate assessment. Considerable future problems can result when the actual value or the "market value" of assets is at odds with the value shown in workers' or a pension fund accounts, even if it is consistent with applicable financial accounting practices that may require assets to be carried at their purchase price until actually sold. It is very important to understand potential differences and obtain a current value in these circumstances where the actual value may be less, especially if there is a possible obligation of the pension sponsor to compensate for any shortfall.

Legislation and plans are the essential starting points for a review of pension agreements.

MODULE 5

Some countries may have established periodic audit requirements for pension funds. Unless there is an extremely strong system of auditor quality assurance and such an audit has been done very recently, it is generally advisable not to rely on an existing audit for these purposes. Even the most developed systems with strong compliance measures experience significant problems with the timely forwarding of pension contributions and the reliability of their financial statements. When enterprises face cash flow problems or when managers face significant uncertainty about their future employment contracts, pools of assets in pension funds often are among the most vulnerable to fraud, theft, or other manipulation. A recent and independent financial audit is therefore essential in nearly all circumstances.

Another common challenge in evaluating defined-contribution plans is the assessment of severance-type arrangements or other contingent future liabilities. Provisions providing one-time payments on the attainment of a specified age or on the termination of employment may be incorporated into pension plans, contained in national laws, included in individual employment contracts, or simply a matter of tradition and expectations. The latter especially may be an issue among senior managers. The cost of these provisions can be of equal or sometimes greater value than the regular contribution requirements and should be included in any assessment of future expected costs.

The process for defined-benefit plans is partly parallel because it also includes a similar need to obtain a reliable accounting and valuation of any

"Book" and "market" values of pension plans may be very different.

funds that have been set aside for pension purposes, thus imposing a similar need to undertake a reliable audit. In addition to this, however, is perhaps the most difficult and challenging aspect of dealing with pension issues—valuing the accumulated and future liabilities.

Almost without exception this requires the services of a professional actuary with experience specific to pension schemes. This is a process with two major elements: (1) obtaining very specific information about the employment history, wages, and demographics of the group of workers covered by the pension plan; and (2) arriving at reasonable assumptions regarding future patterns of employment, investment returns, and the life expectancies of the covered workers. The valuation of defined-benefit liabilities, because they often extend decades into the future, is highly sensitive to the accuracy of the underlying information and assumptions, thus perhaps making the development of these assumptions the most important aspect of the process.

Professional help is often needed for a pension review. The CD-ROM contains terms of reference for a pension consultant or actuary.

Countries with a long experience of defined-benefit pensions may have standards of practice or legal requirements for many of these factors. However, these are unlikely to exist in developing economies. Standards from other countries, because they are based on specific experience with investment returns and life expectancies among other key factors, generally are not transferable. Often a starting point for these assumptions can be derived from factors used by national pension systems, but in the end an assessment of reasonableness on a case-by-case basis will be needed. In most cases the judgment of a professional actuary will have to be relied on for these determinations. If there is not an established and reliable actuarial profession in a country—which is often the case—the magnitude of the costs and associated future financial risks may make incurring the expense of engaging the services of an established international firm a prudent course of action.

Step three: In order to fully and accurately assess the current status of pensions, estimates are also needed of the value of supplemental or contingent benefits. These benefits basically are additions to the regular benefits paid at normal retirement age and will typically include severance arrangements, provisions for which allow pensions to be paid at an age prior to the regular retirement age often triggered by labor force reductions, and additional benefits paid to workers in dangerous or difficult occupations. Because they often are not formal obligations until some future event occurs, these kinds of benefits frequently are not included in the accounting for pension obligations. They may, however, be legally enforceable and may represent a substantial portion of the current pension obligations (for example, privilege pensions in Central and Eastern Europe—see box 5.12). Special care must be taken to identify all of these obligations in the initial inventory of pensions and to estimate the future magnitude of their costs. Assigning some probability of these benefits being paid and deriving a measure of the current liability are often major parts of the work of an actuarial evaluation.

Determining the Funding Status

Assessing the status of current obligations will yield two key measures of the overall financial status of pensions. The first of these measures is often referred to as the accumulated- or accrued-benefit obligation. This is essentially a measure of the current value of funds set aside or previously paid as contributions in relation to the expected value of the pension benefits promised. This amount can either be expressed as a percentage or other ratio or as a net value. Pensions with a negative ratio of assets (or aggregate contributions) to future benefit obligations are commonly referred to as underfunded or are said to have pension arrears. Although there are international moves to improve the quality of pension disclosure in financial accounts (see box 5.13), many enterprises in developing and transition economies will lack good information on their pensions. The scale of pension obligations and problems of underfunding may therefore not be fully apparent until revealed in the PPI process.

Box 5.12: Privileged Pension Rights in Central and Eastern Europe

In some countries, particularly the transition economies, public sector employees were usually given "pension privileges." These privileges could be enhanced retirement benefits, retirement at an earlier age than private sector workers, or a combination of both. Privileged pensions were widespread in these countries. For example, in Ukraine more than 25 percent of pensioners are younger than the minimum retirement age because they were able to retire early under privileged arrangements.

Privileged pensions are granted for one of two main reasons: to compensate for the lower wages paid to employees and to compensate for the special type of work that the employee does. A typical example of the first category is white-collar civil servants; the second category would be typified by airline pilots or coal miners.

Most transition countries are reforming their pension systems with three typical outcomes for privileged pensions:

1. Abolition, with compensation to workers in the form of higher wages that could be invested in voluntary schemes
2. A requirement that workers who receive privileged pensions have these as a condition of their employment, and that by choosing to work in the sector, they agree to participate in a voluntary plan
3. Greater transparency of the financial transfers needed to meet privileged pension obligations in those countries or industries where some form of continued public subsidy has been proposed (for example, in Ukraine's coal-mining sector).

Hungary

The government effectively abolished all privileged pensions when the country introduced its new state pension system in 1999, with the compensation being a pension payment to a voluntary scheme. So a PPI investor in Hungary would only have to decide whether it would maintain the level of voluntary contributions that the government was currently paying. Although this is relatively easy, there are other issues. For example, workers who are civil servants can withdraw their benefits from a voluntary plan tax free. Naturally they would be reluctant to give this privilege up, and a prospective employer may have to negotiate the continuation of this arrangement when PPI occurs or possibly have to increase the contribution rate to maintain the after-tax benefit. For both the implementing agency and the PPI investor, however, this is preferable to negotiating the total package with workers and unions.

Russia

The implementing agency and the investor face some complex legislation relating to pension privileges. The situation is complicated by how long the employee was working in the privileged pension position but, generally speaking, employers have to make an additional contribution to compensate for the loss of pension privileges. The amount of contribution is subject to negotiation and the vehicle for the payment is likewise complicated. It is possible to pay contributions in lieu of pension privileges either to the Russian pension plan or into a licensed voluntary pension plan. The law gives the choice of plan to the employer, but a new PPI investor is likely to be under some pressure to establish a voluntary pension plan in order to receive the privileged pension contributions.

Whether a pension is part of a national or civil servants' system operated on a PAYGO basis or covers only the workers in a single enterprise, the funding status must be evaluated carefully. The collection of contributions from public enterprises is often lax and there may be substantial amounts of past contributions owed that are not accurately accounted for. Few countries have well-developed requirements for the prefunding of defined-benefit plans, and even when these are present the assumptions used for determining the required level of assets may be considerably at odds with reality.

Funding shortfalls also can be present in some defined-contribution arrangements where the fair value for the assets is less than the value of accounts. Severance payments or informal obligations are rarely funded in advance. When done properly, a full measure of the accrued funding status presents a full measure of the financial obligation the enterprise is likely to have to resolve at some point and often can be a major aspect of the evaluation of the future demand on cash flows as well as overall financial solvency. The measure of the accrued funding status is likely to be the single most important number

Box 5.13: Accounting Standards for Defined-Benefit Plans

The international accounting standards (IAS 19) for pension benefits, introduced in 1999 by the International Accounting Standards Board, require that contributions in a defined-contribution plan be recognized as expenses. In contrast, the standards for defined-benefit plans have become more stringent, aiming to fully expose pension liabilities, and state that:

- Current service cost should be recognized as an expense.
- All companies must use the projected unit credit method (an accrued-benefit method) to measure their pension expense and pension obligation.
- Projected-benefit methods may not be used.
- The discount rate is the interest rate on high-quality corporate bonds of maturity comparable to plan obligations.
- Plan assets and reimbursement rights must be measured at fair value.
- Defined-benefit obligations should be presented net of plan assets.
- Reimbursement rights should be presented as a separate asset.
- A net pension asset on the balance sheet may not exceed the present value of available refunds plus the available reduction in future contributions resulting from a plan surplus.
- If the net cumulative unrecognized actuarial gains and losses exceed the greater of (a) 10 percent of the present value of the plan obligation and (b) 10 percent of the fair value of plan assets, that excess must be amortized over a period not longer than the estimated average working lives remaining for employees participating in the plan. Faster amortization, including immediate income recognition for all actuarial gains and losses, is permitted if an enterprise follows a consistent and systematic policy.
- Past service cost should be recognized over the average period until the amended benefits become vested.
- The effect of termination, curtailment, or settlement should be recognized when the event occurs.

Source: International Accounting Standards Board Web site: http://www.iasb.org/) "IAS 19: Employee Benefits."

derived from an evaluation of pensions and it provides the basis for the key strategic decisions discussed in the following sections.

The second element of the funding status is the development of a measure of future or projected pension-benefit obligations. This element provides a measure of the expected levels of future costs that would be incurred to maintain the existing pensions. There are two potential aspects of this. First, most of a projected obligation will comprise the costs associated with additional periods of employment by the covered workers. These costs will include the contributions required for defined-contribution plans and PAYGO systems or the additional years of work that will factor into the benefit formulas of defined arrangements. It is extremely helpful to distinguish between the various contributing factors for the projection (that is, employment patterns, mortality expectations, and the like) as it is developed because these factors will specify the costs and savings of alternative pension strategies.

A second element, usually much smaller, is the projected increase in wages or salaries that would raise the ultimate level of benefits even if no additional years of work were covered under the arrangements. Although it adds complexity, it is helpful to distinguish between the two elements because they will enable a more precise evaluation of the costs of options for addressing future pensions, as discussed in subsequent sections. Although it should be calculated separately, this second component is usually combined with the accumulated liability to derive the funding status.

Resolving Existing Pension Obligations

PPI investors will be extremely wary of becoming involved in circumstances where large financial obligations for previously promised pension benefits are present or may arise in the future. This makes the evaluation of the status of pensions as outlined above an essential early task in the PPI planning process. Evidence that all prior pension obligations are fully addressed, either through paid-up contributions or assets set aside that are sufficient to cover their anticipated value, will substantially diminish investors' actual or perceived risks, thereby removing a significant barrier to privatization. Conversely, the presence of unfunded or significant future obligations requires the development of a strategy to address them. There are three potential types of strategic approaches with many variations and combinations possible:

1. Renegotiate or modify the past pension obligation to bring the liability to a manageable level
2. Freeze or "ring-fence" the past obligation and establish a means either to set aside funds to meet the obligation or to transfer the obligation and associated risk to another entity
3. Establish a viable approach to resolve the past liability by setting aside assets or scheduling the payment of contributions in arrears on a schedule that is sustainable for the enterprise as a going concern.

Reduce Accrued Pension Obligations

The lowest-cost approach to resolving past pension liabilities obviously is to reduce the magnitude of the liability. The viability of this approach is likely to be determined by a combination of legal constraints and the assessment of potential consequences to labor or government relationships. The simplest method obviously is to renounce any obligation or commitment to previously earned pensions or to the portion of those that are in arrears or unfunded.

The capacity to do so will be determined by the legal constraints, which should be an integral part of the inventory of pensions discussed above. Prior pension obligations can be reduced through a retrospective modification of the benefit formulas, including steps such as:

- Reducing the proportion of wages replaced for each year of covered work
- Increasing the age at which retirement is permitted
- Increasing vesting periods (the period of participation in the pension system after which benefit rights are irrevocable)
- Terminating the pension and discontinuing any past benefits (in extreme circumstances).

The implementing agency should, however, recognize that some of these steps may be explicitly prohibited by law or may be vulnerable to a challenge under commercial or labor codes.

The advisability of such approaches is likely to be determined by the impact on labor relations and the extent to which government agencies administering national or civil servants' plans are willing to permit entities to withdraw workers from participation and eliminate any future liability for contributions that are in arrears. Workers in public infrastructure entities, especially those included in civil servants' schemes, are likely to represent powerful political constituencies and strongly resist such steps. Public pension schemes operating on a PAYGO basis and experiencing both short- and long-term financing problems also are likely to oppose such approaches.

Freeze Past Obligations

An intermediate approach to addressing past obligations is to freeze the existing obligation at its current level and take steps to address it in a manner that is viable for the future. In this approach the past pension obligations are honored, but additional benefits do not continue to accrue or they accrue at a different level or in a form more affordable or aligned with the anticipated needs of the future. The separation of accrued and projected components during the evaluation of liabilities should provide a basis for judgments about the potential cost reductions of such an approach. This decision is closely associated with the determination of an appropriate prospective pension arrangement because closing down existing pensions in this manner has consequences for the future design.

Alternatives for resolving liabilities include development of a schedule for amortizing any shortfall over a period that matches a projected future funding stream, paying lump-sum settlements to affected workers in exchange for the settlement of the

There are three approaches to resolving unfunded pension liabilities.

obligation, "laying off" the liability through a contract with a life annuity provider or in some cases even permitting a public entity to take over the pension obligation in exchange for an agreed-on fee or future series of payments. In cases where there is considerable uncertainty regarding the capacity of an enterprise to fulfill future obligations and remain a viable concern, workers may be willing to accept one-time cash payments of lesser present value than the benefits they forgo in the settlement of future pension rights.

This process can be considerably complicated when a guarantee of pension benefits has been provided by a government agency or when there is an attempt to withdraw from a civil servants' or other publicly managed defined-benefit plan that may be operated on a PAYGO basis. In these cases a negotiated settlement of future liabilities that is well in excess of the value of contributions to date may be required.

Fully Fund Any Shortfall or Arrears

The least controversial and disruptive, as well as the most direct, method of resolving existing pension obligations is simply to pay their full cost on a present-value basis. If this is financially viable and desirable it may be accomplished in a variety of ways:

There are five sources of finance to meet any shortfalls in existing pension obligations.

1. **The government budget:** For example, the German government agreed to contribute US$1.25 billion into a new private pension plan in order to allow withdrawal from the public pension plan by Lufthansa Airlines. That amount would provide half of the capital needed in a new plan to meet the existing obligations; the airline would finance the other half (Guislain 1997, p. 78). More commonly, where governments take on responsibility for payments under existing plans, the obligation may be paid from the existing PAYGO system (for example, for early retirees in state-managed, defined-benefit plans).
2. **Proceeds from the sale of assets belonging to the enterprise:** These assets may be rolled into a separate fund that combines existing past liabilities and the obligations from future ones. Examples of the separation and isolation of pension assets and liabilities are provided by the cases of Tanzania Telecommunications Company (box 5.14), Japanese National Railways (box 5.15), and South American mines.
3. **Privatization proceeds:** Some countries have first sequenced the sale of valuable enterprises to build up adequate funds to finance the labor adjustment, including pension costs. Proceeds can either be monetary transfers, or—as in the Bolivian capitalization program (see box 1.9 in module 1)—transfers of government shareholdings in public enterprises into private pension plans. If the PPI investor is willing to take on pension liabilities, but at a reduced purchase price, that discount is effectively the same as the forgone privatization proceeds.
4. **Donor loans and grants:** Large sector reform and structural adjustment lending programs are a potential source. For example, World Bank loans financed severance packages for redundant workers, including pension liabilities payments, in the restructuring of the Polish and Brazilian rail sectors and the privatization of Togo's telecommunications sector.
5. **Rescheduled liabilities that are paid later from the profits of the PPI enterprise:** In Romania the privatization of the Sidex steel factory involved negotiations among government, investor, and unions on the restructuring of arrears of social taxes—including pension contributions—that had accrued. Sometimes, this rescheduling may include the negotiated write-off of some debts, or the use of debt instruments by government (government bonds and securities) or by the PPI enterprises (corporate bonds). An example is the Moroccan Railways Corporation, which agreed with the government of the Kingdom of Morocco to finance unfunded pension provisions by issuing bonds over a five-year period.

Box 5.14: Tanzania Telecom—Pension Plan Restructuring

In 1998 Tanzania's privatization agency, the Parastatal Sector Reform Commission (PSRC) embarked on the privatization of Tanzania Telecommunications Company Ltd. (TTCL). An initial review revealed four pension plans in which employees were enrolled, and significant unfunded pension obligations that arose primarily from the East African Postal and Telecommunication Pension Fund (EAP&TPF) of the former East African Community (EAC). These liabilities presented a major problem, threatening to derail the privatization. They had been transferred to TTCL when EAP&T was separated into telecommunications and postal operations in 1994.

The government agreed that the privatized TTCL should transfer its employees to a new accumulation plan(s) and that unfunded liabilities would be removed from TTCL's balance sheet. To facilitate this, a new company called Simu 2000 Ltd. was created. It took over TTCL's unfunded pension liabilities and was required to ensure that the future pension obligations from these older pension plans are met. Simu 2000 Ltd. took over existing EAP&TPF assets plus noncore TTCL assets, in exchange for also taking over future pension liabilities.

Simu Ltd. was mandated to establish a small management team of no more than five employees, and to arrange for the sale of some of the assets and the transfer of proceeds to the National Social Security Fund (NSSF). The NSSF invested the proceeds and paid a fee of 7.5 percent of the total sum invested. Simu 2000 Ltd. was required to meet the monthly payment of pensions to the existing ex-EAP&T pensioners, and an initial advance was provided by the PSRC to cover this cost for three months and the initial administrative cost of setting up Simu 2000 Ltd.

Source: Parastatal Sector Reform Commission, Tanzania; Adam Smith Institute.

Some PPI programs have created special funds to finance the costs of retirement. In the privatization of Mexico's national railway, a trust fund was set up to finance the retirement benefits of those workers who retired prior to privatization. This fund was negotiated between government and the labor union, and included part of the privatization proceeds and public funds from fiscal sources. The company transferred the pension liabilities to the federal government (López-Calva 2001).

López-Calva 2001 (a PPIAF case study).

Pensions and Labor Restructuring

This section discusses how pensions can be used in labor restructuring because such adjustment is often a major part of any process of privatization.

The implementing agency may face difficult pension issues and negotiations with workers and unions during work force restructuring. Pensions can often represent a large portion of the compensation package for workers in these enterprises, especially if workers are enrolled in generous industry-specific or civil servant defined-benefit plans. Pension arrangements can also be adjusted to provide incentives for workers to leave employment voluntarily or used to cushion the impact on those who may be separated involuntarily. Various approaches with many feasible combinations are possible for integrating pensions into a labor restructuring strategy. These approaches can be considered in the context of two major categories: early retirement programs and voluntary departure incentives.

Early Retirement Programs

The least disruptive and contentious way to restructure a work force is to induce voluntary early retirement. Whether this is practical is a question of cost and of targeting the availability to redundant workers while retaining those who are essential to a going concern. Whether the benefits are enough to induce employees to volunteer for early retirement will depend on the type of plan offered (defined-benefit or accumulation), the levels of benefits promised, the vesting arrangements, participant eligibility, and other rules of the program—as well as employees' assessment of alternative employment options.

Early retirement can be structured in three main ways—by providing:

Box 5.15: Japan Railway's Recurring Pensions Challenge

"Over the protests of the seven direct descendants of the former Japanese National Railways, the Diet [Japan's parliament] approved legislation in October 1998 [for] a 60-year plan to pay off the ¥27.8 trillion ($205.9 billion at ¥135 = $1.00) worth of debt that remains from JNR's 1987 privatization. Although Tokyo will shoulder most of the debt, the seven rail companies created from the now-defunct government railroad will be forced to take on ¥180 billion ($1.3 billion) worth of unfunded pension liabilities owed to former JNR workers now employed by them. The repayment plan has caught the attention of American shareholders of three of the Japan Railway firms as well as some U.S. legislators.

At the time JNR was privatized in 1987, it had ¥37.1 trillion ($274.8 billion) worth of red ink on its books. The seven companies that took over JNR's passenger and freight rail operations agreed to assume ¥14.5 trillion ($107.4 billion) of the debt, while the rest—¥22.6 trillion ($167.4 billion)—was transferred to a new company, JNR Settlement Corp. JNR Settlement was supposed to whittle down the debt by selling off JNR assets, especially prime real estate holdings. The company also held all shares of the seven JR operating companies and so benefited when the three strongest—East Japan Railway Co., West Japan Railway Co., and Central Japan Railway Co.—publicly listed their shares during the past two years. Because of falling real estate prices and other factors, JNR Settlement not only has been unable to reduce its handed-down debt but has seen it grow to nearly ¥28 trillion ($207.4 billion).

The ¥4.3 trillion ($31.9 billion) in pension liabilities will be taken over by a new company, Japan Railway Construction Public Corp., which, in turn, will derive income from selling JNR Settlement's real estate assets, offering more shares of JR companies to the public and forcing JR Group firms to pay ¥180 billion ($1.3 billion) of the cost.

The JR companies feel that Tokyo is being unfair in forcing them to pay an extra share of the pension liabilities. When their private pension plans were absorbed into the government's pension system in April 1997, the administrators of the public plan said that the JR Group's pension scheme was under funded by ¥940 billion ($7 billion). JNR Settlement agreed to absorb ¥770 billion ($5.7 billion) of the liability, and the seven operating firms took on the remaining ¥170 billion ($1.3 billion). The septet now says that the Tokyo government is reneging on the deal by making them pay another ¥180 billion ($1.3 billion)."

Source: Choy 1998, pp. 6–7.

1. An immediate but reduced pension
2. An immediate but enhanced pension to compensate in part for the lost opportunity to earn future benefits
3. A normal pension beginning at retirement age, perhaps with some lump sum at the time of early retirement.

Each of these three options is considered below.

With the first option, the worker who retires early receives an immediate pension payment but at a reduced level. A typical adjustment that is "actuarially fair" is to provide the same benefit formula for each year of service but then to reduce it by 5 percent for each year below the normal retirement age. Smaller percentage reductions may provide a similar equivalence if life expectancies are lower, as is often the case in developing countries. Care must be taken, however, to ensure that the longevity factor used is consistent with the characteristics of the affected workers, who may differ from the broader population. The estimation of an appropriate offset should be a relatively straightforward calculation for an actuary who has completed the evaluation of defined-benefit plans as discussed in previous sections. Pensions may remain at a reduced level until the worker reaches normal retirement age, or they may remain at a reduced level until death. An alternative approach that can be combined with adjustments in the benefit level to achieve lower initial reductions (and thereby strengthen incentives) is to eliminate or constrain the indexing of benefits until normal retirement age.

Statutory provisions may apply, too. For example, under Egyptian social security regulations workers who are aged 50 or above can receive a retirement pension if they retire early. However, the pension is reduced significantly from what they would receive if they retired at age 60 (the normal retirement age). The amount of reduction is determined by a complicated formula that distinguishes between basic and variable components of wage. The loss of benefits amounts to 66 percent of full benefits for retirement at age 50, 57 percent at age 53, and 40 percent at age 57 (Assaad 1999, p. 141).

The second option is a pension that is available immediately and enhanced to cover the opportunity cost of forfeited future benefits. With this option, the enhancements may take the form of crediting the employee with more years of service than have been worked (added years) or of giving an additional lump sum to purchase an annuity for an extra pension benefit (the lump sum may be linked to years of service or to years remaining until normal retirement age).

Although such enhancements create a powerful incentive for early retirement, their costs must be carefully evaluated. What may appear to be small additions to credited years of service can have large consequences for the funding status that will need to be paid in the future.

With the third option for early retirement, payment of the regular benefits begins when the worker who has taken early retirement reaches normal retirement age, but there may be a lump-sum incentive payment at the time of early retirement. At Brazil's RFFSA, for example, the company continued to pay the employer's and employees' contributions to the national social insurance system for workers who took early retirement (for a maximum of five years, or until the worker reached age 55). In addition, the worker received six months' salary during the first six months after early retirement.

There are several cases where governments have been so generous in their pension arrangements that the plans led either to excessive long-term liabilities on government or to the departure of too many staff through early retirement. Essentially these are cases where the implementing agencies have solved their immediate problem by transferring the financial obligations either to the new owner or to a future government. Examples include Sri Lanka Telecom (Salih 2000), Chile Rail, and a similar case in Australia's rail sector where too many employees took early retirement and had to be rehired later under contract.

Incentives for Voluntary Departure

Even where severance payments are the core element of voluntary departure plans, some compensation for past pension contributions may also be necessary. This can be a lump-sum payment or an obligation to pay a pension in the future, or a mix of the two. In general, the objective is to make plans as simple as possible, although complexities may arise if there are several classes of employees, different pension schemes, and different incentives required for different groups of workers.

An alternative to providing early retirement that may better target incentives to specific groups of workers or may entail lower costs is to make retroactive changes to eligibility and vesting rules. These rules, which are often very specific to the pension plan, can significantly affect the incentives and motivations for workers accepting early retirement or voluntary departure.

Eligibility rules can be based on age or based on years of contribution or service. For example, only workers over the age of 60 may be eligible to retire, or only workers who have a minimum of 20 years of contribution to the pension plan can qualify for early retirement.

Work force restructuring can result in amendments to the rules of the plan. In the case of PPI in Côte d'Ivoire rail, negotiations with unions resulted in the years of work required for pension eligibility being reduced from 20 to 15 years. This enabled a larger portion of the work force to depart or be separated while still preserving the right to future benefits without the expense of paying out immediate benefits.

Vesting rules in pension plans are often based on years of service; for example, until workers have accrued five years of service they cannot receive full

Implementing agencies should avoid the temptation to offer generous benefits today.

benefits. Like eligibility rules, vesting rules and conventions can influence workers' decisions and their willingness to adopt early retirement. Although there is a trend to more immediate vesting, many plans still have long vesting periods. Vesting rules can act as a disincentive to workers leaving voluntarily.

The vesting arrangements may also need to be considered as part of the total compensation package. For example, if the principle to be used in downsizing is last-in/first-out, the redundancy package may have to take account of forgone pension contributions because the affected employees are unlikely to have fully vested benefits.

The details of these rules can significantly affect workers' benefits. For example, in the electricity restructuring and privatization in Orissa, India, the former Orissa State Electricity Board (OSEB) included employees who had been deputed from government service. As for the Grid Corporation of Orissa (GRIDCO), when the board was unbundled and restructured into generation, transmission and distribution companies, the eligibility rules were less beneficial for these deputees than for OSEB employees. Specifically, OSEB employees had their years of service in OSEB carried over to count toward a GRIDCO pension, whereas former government employees had to have worked for 10 years *within* GRIDCO before becoming eligible for a GRIDCO pension (Ray 2001).

Future Pension Design

Eligibility and vesting rules require careful scrutiny.

A successful privatization will usually require restructuring the pension scheme to take account of the different concerns of workers, investors, and government and to align the new pension arrangements with the long-term requirements of a privatized enterprise. This section sets out the key considerations and potential alternatives in designing and implementing pension arrangements, including consideration of incentives to attract and retain workers, the level and pattern (cash flow) of expenses, and strategies for funding and investment.

Whatever options are chosen for resolving existing pension liabilities, the pension scheme will be an important aspect of the operation of the restructured entity. Should the implementing agency set terms for future pension schemes, which would become a condition of the PPI contract? In general, that should be avoided as far as possible, and the PPI investor should have discretion to determine pensions arrangements within statutory requirements. The way in which pensions are restructured will affect how investors value an enterprise and assess its long-term viability. Providing investors with the widest array of choices and flexibility will therefore greatly enhance the attractiveness of an entity for privatization.

The extent to which this is possible will depend, however, on the nature and difficulty of negotiations among the work force, trade unions, and government. The Lufthansa Airlines pension review, for example, required agreement between the government and the company; and when British Coal was privatized, bidders were required to accept a new pension plan (see box 5.16).

If the implementing agency is negotiating a future pension plan, it is essential to consider carefully such issues as the following:

Box 5.16: British Coal—Negotiated Pension Agreements

When the United Kingdom privatized its coal industry, past benefits accrued (and the consequential liabilities for funding) remained the responsibility of the government. Investors bidding for the coal mines were, however, required to participate in a new pension arrangement that had been negotiated previously between the government and stakeholders, including the employees (trade unions). This was an accumulation plan but the investors had no say over the contribution rate. The new plan was only open to retained workers who had been members of the old (closed) defined-benefit schemes. New employees engaged by the investor after privatization were able to participate in a third, completely new, plan that the employer established.

Source: Adam Smith Institute, personal communication; DTI 1993.

- **Legal compliance:** The plan should be consistent with legislation. For example, some countries require that one contribution rate apply to all participants in order to qualify for specific tax benefits, and some do not permit the employee contribution to exceed that of the employer.
- **Plan viability:** Legislation may provide that staff transfers to a new employer after privatization should be on "no less generous" terms and conditions. That may present a challenge for PPI if it leads to demands, for example, that PPI investors provide or maintain financially unsustainable pension arrangements. Other matters such as deemed length of service are also important—in this case because of its effect on workers' pension rights and benefits.
- **Plan type and contribution rate:** Most PPI investors (but few trade unions) would want to see new plans structured as defined-contribution rather than defined-benefit arrangements because defined-contribution plans make financial risk borne by the sponsor more readily determinable and predictable. The decision about plan type will depend on the joint assessment of financial risk and labor incentives as discussed below. Depending on the prevailing employment conditions in the country, an employer contribution rate of 5 to 10 percent of average wages should be sufficient to provide a generous plan by the standards of a developing or transition economy. A further 5 percent contributed by the employee should generally replace a significant portion of wages for long-term workers with a typical life expectancy of 10 to 15 years after retirement.
- **Consistency with other plans and national systems:** Care must be taken to ensure that any prospective pension arrangement does not set unwelcome precedents for other public sector schemes or enterprises. Will the plan lead to accelerating demands among workers in similar industries? Is it consistent with the purposes and scope of a pending or anticipated reform of a national pension system?

If the implementing agency will be involved in restructuring the pension plan, this is a checklist of some key issues.

Work Force Management and Incentives

Pensions are generally the largest element of compensation arrangements beyond the payment of wages and salaries. Although the average cost will be between 5 percent and 15 percent of a total compensation package, depending on the nature of the pension design and age of the worker, pension costs easily can exceed the wage bill for certain workers. That makes the design of the pension program on a going-forward basis a major issue in work force management.

There are essentially two main issues here: (1) the nature of the pension and (2) the level of benefits or generosity. Contemplating the replacement of an existing pension program will need to take into consideration both the potential effects of a change in expectations and an objective assessment of the future needs of the organization. Concerns about retaining key workers or limiting the adverse effects of difficult labor negotiations may significantly limit the movement toward what might otherwise be an appropriate design.

The basic decision of benefit design is the choice between a defined-contribution and a defined-benefit system. This is a question of matching the attributes of design to the requirements of the enterprise and the work force. Some of the key characteristics of each type are listed below.

Defined-contribution plan:

- Value is proportional to wages, with no differentiation by age.
- Is highly portable; workers take accounts with them.
- Offers greater flexibility in payout timing and options.
- Is easily transparent; workers can readily determine value.
- Financial risk is held by the worker.

Defined-benefit plan:

- Relative value of benefit usually increases with age.
- Has potentially large costs for early leavers.
- Offers little access to benefits before retirement.
- Value is hard to measure.
- Offers less financial risk for workers.

These characteristics make each type of pension appropriate for different work force management objectives.

Defined-contribution plan:

- Is attractive to younger workers with short tenure expectations
- Is effective in attracting scarce skills in mobile labor markets
- Is more effective in wage-competitive markets
- Has greater association with risk takers.

Defined-benefit plan:

- Is an effective retention tool for older workers and senior managers
- Is an effective means of protecting investments in training
- Is less attractive to young workers with highly marketable skills
- Is less conducive to competition in compensation
- Is associated with stability and risk aversion.

There are various potential combinations of the two basic designs that can merge aspects of any of those characteristics. One approach that is gaining acceptance in a variety of settings is a hybrid design in which workers are credited with a fixed amount in an individual account that accumulates with investment earnings during the working years. At an established retirement age, this account is converted into a monthly benefit. These types of arrangements may enable an enterprise to achieve many of the advantages of a defined-contribution pension in attracting workers and providing significant incentives to retain valued workers who are in their high-productivity later years of employment. The most important point is to recognize that neither model has any particular inherent advantage but rather a set of characteristics that should be aligned with anticipated needs.

Anticipated Expenses and Cash Flow

The two models also impose differing financial aspects that must be consistent with the objectives and constraints of the ongoing enterprise. In the aggregate, if the generosity of the pension is the same, both models should entail a similar present value of costs. The timing and pattern of costs, however, may be significantly different. The capacity of an enterprise to meet the cash flow demands of the short term may be an extremely important consideration in selecting a pension design.

Defined-contribution pensions involve constant and predictable cash flow demands. With workers' accounts usually credited with actual investment earnings, sponsors are not exposed to volatility in financial markets. Defined-benefit pensions involve the sponsor committing to a future expense that may vary significantly, depending on employment patterns or the earnings on any assets set aside to fund the plan. Although this arrangement may defer cash flow demands to a later date, those demands are typically far more volatile in their cost and cash flow requirements. If there is a requirement or effort to prefund these demands, poor investment performance may impose future expense shocks and changes in assumed interest rates may make annual funding requirements extremely volatile. The differences are as follows.

Defined-contribution plan:

- Has level annual expenses
- Is predictable as a proportion of the wage bill
- Has early and constant cash flow demands
- Offers low risk to the sponsor.

Defined-benefit plan:

- Has variable expense and cash flow

- Potentially defers the cost to later years
- Has exposure to financial market and interest rate risk
- Has potential to produce future cash flow shocks.

Funding and Investments

Decisions will also have to be made regarding a strategy to fund future pension benefits. In a few cases strategy may be dictated by law, although in most circumstances involving privatization there is not likely to be a legal and regulatory framework for pensions that imposes significant requirements. Defined-contribution pensions generally involve payment of the full pension expense during the period in which the commitment is made. Individual accounts should be established for each participating worker, and sponsors will have to take a significant responsibility to ensure the integrity of the funds through oversight and periodic auditing.

The most challenging issues are likely to be decisions about the investment of the funds, whether these decisions are to be made by the sponsor or whether a limited menu of choices will be provided to workers individually. In nearly all circumstances the level of development of capital markets and the lack of financial literacy among workers will require that any assets be held in very safe, professionally managed portfolios that are professionally managed. In countries that have developed a system of licensed pension funds as part of a broader reform (as will be discussed in the following section) this should be a relatively simple choice. In other circumstances, sponsoring entities will likely need to choose an asset manager and establish portfolio limits.

Defined-benefit pensions, however, require far more complex decisions. The sponsor will have to decide the extent to which there is a capacity to set aside funds in advance. Funding defined-benefit pensions on a PAYGO basis may move expense and cash flow patterns into the future but can expose sponsors to untenable risks in circumstances where the benefit formulas create rapidly accelerating or volatile pension expenses. Factors such as unanticipated patterns in wage growth, inflation, or the future need to restructure the work force may create large and unexpected pension costs. It is therefore advisable for the sponsor of a defined-benefit arrangement to estimate pension expenses as they accrue (using the services of a professional actuary) and to fund them on an ongoing basis. These actions will prevent the build-up of unsustainable liabilities that can drive otherwise profitable enterprises into insolvency if not properly managed.

Funding for future pension expenses should be separated from the other activities of the sponsor and managed in accordance with a predetermined and disciplined investment strategy. This result is best accomplished through the services of professional asset managers but will necessitate the formulation of a general strategy. Developing this strategy is usually an area in which engaging the services of competent consultants is advisable. A well-formulated investment strategy can mean the difference between a successful pension restructuring and one that exposes the enterprise to enormous financial risks in the future. Success in this regard is nearly always a process of balancing expense against potential risks.

Some common strategic approaches involve the following:

- **Intermediated financial products:** In circumstances where there is a reasonably well-developed market, all of the financial risk of a defined-benefit pension can be managed through the purchase of investment products. This strategy will increase the cost but remove risk by purchasing intermediated products such as investments with fixed returns or, if available, a series of annuity contracts in which an insurance company agrees to pay out benefits in return for a preset fee.
- **Government-issued or -guaranteed bonds:** Government debt is generally safe but provides very low returns. Investment of pen-

Defined-benefit plans present a greater challenge than do defined-contribution plans.

sion funds in government debt is often risk free and politically desirable, but it will do little to diminish costs over the long run.

- **Asset-liability matching:** Pension funds commonly try to manage risks by purchasing investments whose value moves opposite any changes in liabilities. This strategy is sometimes called "immunization" or "duration matching." It is a process that recognizes that the value of defined-benefit obligations is very sensitive to interest rates and seeks to purchase investments such as long-term bonds that will increase in value as a result of the same factors that might increase the level of future liabilities. These types of approaches are complex to administer but can significantly limit future exposure.

Pensions: Implementation Steps

This section outlines key implementation steps for pensions in PPI. There are three main steps:

1. Making information available to bidders
2. Ensuring adequate funds and administrative capacity
3. Obtaining technical support.

Making Pension Information Available to Bidders

The data room is a managed facility provided during the PPI transaction for bidders to examine supplementary, bulky, or detailed information. Bidding documents or the data room should provide information on:

- Relevant laws and collective bargaining agreements
- Details of existing pension plans, including plan rules; certificates of asset property titles; asset valuations; estimates of unfunded liabilities, including key assumptions; and estimates of arrears
- Any restatement of net pension assets and liabilities in the accounts of the infrastructure enterprise, adjusted if appropriate to bring them into line with international accounting standards
- Proposed pension system reforms
- The obligations of the PPI investor under the country's labor code and related legislation, as well as any specific pension plan rules.

Ensuring Adequate Funds and Administrative Capacity

Large-scale early retirement programs can present a challenge for pension plan administrators. First, finance must be found to meet any gaps in the plan funds. Potential sources of finance are essentially similar to those outlined in module 1 of the Toolkit. Second, the administrative capacity to process the applications or to manage a new pension scheme must be considered. For example:

- In Brazil's railway privatization, the early retirement process allowed a period of six months in which the workers' net salary continued to be paid while the appropriate paperwork was being processed by the National Social Security Agency (INSS). If payment was not ready within the six-month period, the railway company would continue to pay the net salary, but in the form of an interest-free loan to be reimbursed by the retired employee after the date of his or her actual retirement (Estache, Schmitt de Azevedo, and Sydenstricker 2000).
- In Mozambique workers in the port and railway company were members of the pension system for public sector employees. Workers to be transferred to the new private sector concession managers were to have their pensions immediately transferred to the INSS plan, but this did not happen because the public sector pension system was insolvent. Without the transfer of funds the INSS

could not enroll workers and the new private concessionaires could not contribute the employers' share. The backlog of cases reached 4,000 workers.

- In India, the Pension Trust Fund for Orissa's electricity sector was split among the four privatized distribution companies and the transmission company. There were, however, significant delays in establishing the distribution company trust funds, "due to the inability of the unions/associations to elect the employee's representatives" (Ray 2001, p. 33).

Together with the specialist consultant, the implementing agency will need to take the following actions:

- Consult with the relevant pension authorities to identify what is realistically possible in terms of payment processes. To reach accurate conclusions, the agency will have to assess the need for specialist inputs from pension consultants, identify specific decisions required from government or trustees, assess the available administrative capacity to handle large numbers of early retirement programs, identify secure payment arrangements, and develop procedures to verify that correct payments are made to the correct employees.
- Consider whether some type of technical assistance or training investment may be necessary for new trustees or supervisory board members.

Obtaining Technical Support

Throughout the pension process the implementing agency will benefit from the recruitment of independent pension or actuarial advice for three reasons:

1. **Assessment and valuation of the pension scheme:** This enables the implementing agency to alert ministers and other decision-makers to the fiscal impact of any decisions on pensions and to the potential impact on proceeds from PPI.
2. **Help in negotiations with trustees, workers, and other stakeholders.**
3. **Opportunity to give investors as much information as possible in bidding documents and data room:** This will help PPI investors conduct their own due diligence of pension issues more quickly.

Box 5.17 gives one illustration of how actuarial advisers need to work with the infrastructure enterprise, pension plan trustees, and the implementing agency. The CD-ROM that accompanies this Toolkit provides outline terms of reference for the engagement of a specialist consultant for a specific PPI transaction. It also offers a job description and draft advertisement for the position of long-term pension adviser who might support a PPI office through a number of PPI transactions.

Terms of reference
Job description for a long-term pension adviser.

Tools (on the CD-ROM)

Terms of reference for a pension review

Glossary of pension terms

Frequently asked questions about pensions

Job description for a long-term pension adviser

Additional Material (on the CD-ROM)

de Ferranti, David, Guillermo E. Perry, Indermit S. Gill, and Francisco H. G. Ferreira. 2000. "Helping Workers Deal with the Risk of Unemployment." Chapter 6 in *Securing Our Future in a Global Economy*. Latin American and Caribbean Studies. Washington, D.C.: World Bank. (Provides an overview of income support programs that have been used in Latin America, including severance pay, public works programs, training programs, and unemployment insurance.)

Ray, Pranabesh. 2001. "HR Issues in Private Participation in Infrastructure: A Case Study of

Box 5.17: South America—Working with Trustees and Pension Advisers

Description of the Pension Problems

In one South American country, employees in two mining companies and the mines holding company contributed to one pension plan. The privatization strategy was to offer the mines separately and close the holding company, and an early question was whether there needed to be separate pension plans. The pension scheme actuaries advised that there were cost benefits to continuing with one shared pension plan, including lower actuarial, audit, and trustee fees, although they recognized that company control of pension plans was important and any cross-subsidization was undesirable. Cross-subsidization could arise not only through one firm having problems with pension contributions but also with differing age and gender profiles and with different earnings levels and retirement ages between the two companies.

Significant practical problems emerged in trying to assess the pension plan's assets and liabilities. One of the fund's major investment assets, a property investment, would be difficult to sell. Moreover, the pension trustees had not perfected title to this property. When actuarial advisers looked at liabilities, they found that they could not value the current pension liability because the company had failed to provide the data on employees necessary to carry out the valuation. Moreover, the previous valuation six years earlier recorded a significant liability, and the mine companies' actuaries had then recommended an increase in pension contributions, which the companies had not implemented. According to the pension plan, this represented a liability of the company although it was not recorded as such in the company's accounts. In addition to these two liabilities, the increasingly poor financial position of the mines had resulted in their inability to pay pension payroll contributions to the pension administrators, which represented a further liability.

The unions wanted employees to be paid full redundancy payments before privatization, but also wanted all pension rights transferred and not liquidated. The pension plan rules, however, indicated that only the trustees could make this decision—not unions or the government—and that employees also had the choice of opting out.

Inflation had eroded the value of many pensions, which had been reasonable when first awarded, and many pensioners were now below the national poverty line. Fear of criticism arising from such payments might deter an international investor from taking over the pension program.

How the Problems Were Resolved

Earlier privatizations in the country had tackled pensions through pension scheme liquidation or negotiated handover (such as the transfer of an existing plan to an insurance company) that occurred at the same time the new investors created a new pension plan. Under liquidation, existing pensioners received an annuity, whereas others received lump-sum payouts calculated by the actuaries or deferred pensions. For the mining companies, however, the problems of selling a major asset—the commercial property—made liquidation an unattractive option.

On the advice of the actuaries, the government chose not to create three separate pension plans but to establish a notional separation that removed any cross-subsidization while enabling the plan to continue owning assets in common. The title of the pension scheme to the commercial property was undisputed and government—working with trustees—took steps to perfect the title.

The actuaries advised that the existing pension provisions, particularly for those on very low pensions, could be ring-fenced and responsibility for payment transferred to an insurance company, although this would result in workers losing medical benefits that were then being paid by the company.

The government engaged additional financial and accounting help to identify missing personnel data required by the actuaries, who then updated the valuation. In its information memorandum for investors the government stated that both the backlog of payments to the pension scheme and the increases recommended by the actuaries were company liabilities that investors were to take on, but that any actuarial deficit (that is, the uncertain financial liabilities) would be settled by government through future contributions or settled with the investor at the time of payment.

The government made available the services of the pension scheme actuary to prospective bidders who required clarification on pension liabilities during the bidding period.

Source: Adam Smith Institute, personal communication.

Orissa Power Reforms." PPIAF case study. World Bank, Washington, D.C. (Includes discussion of the treatment of pension issues in one PPI transaction—electricity reform in Orissa.)

Sin, Yvonne. 2003. "Pension Reform Options Simulation Tool Kit—PROST." World Bank, Washington, D.C. (A presentation introducing the World Bank's PROST methodology; helpful to illustrate the inputs that are needed to review very large or national pension systems.)

Web sites

Rapid Response: http://rru.worldbank.org. (The site is a gateway to a range of information on infrastrucuture, privatization, and private sector development policies.)

World Bank: www.worldbank.org. (Use the site's search engine to locate information about pensions and specialist sources of information.)

World Bank Institute (WBI): www.worldbank.org/wbi/. (The WBI is the training arm of the World Bank and provides courses on—among other topics—pension reform. For example, see: www.worldbank.org/wbi/pensions/courses/february2003/presentations.html.)

Other Material and Sources

Bateman, Hazel, Geoffrey Kingston, and John Pigott. 2001. *Forced Savings: Mandating Private Retirement Incomes*. Cambridge: Cambridge University Press. (A general introduction to pension policies.)

OECD (Organisation for Economic Co-operation and Development). 1999. *Privatisation, Capital Market Development and Pension Systems Reform*. Proceedings of the OECD Advisory Group on Privatisation, Thirteenth Plenary Session. September 21–22. Paris. (Various papers, see www.oecd.org.)

Vives, Antonio. 1999. "Pension Funds in Infrastructure: Regulations and Instrument Design." Technical Study IFM–119. Inter-American Development Bank, Washington, D.C. (Considers the potential for pension funds to contribute to infrastructure development)

REDEPLOYMENT SUPPORT

Redeployment support aims to help displaced workers reenter the job market or become self-employed. Redeployment programs are politically and socially valuable, providing a tangible demonstration of government's commitment to helping workers. But program design and implementation has to be considered carefully to ensure the cost-effectiveness and efficiency of such programs.

Redeployment support aims to facilitate restructuring of the enterprise, the sector, or the economy and to shorten and alleviate the period of unemployment and income loss experienced by displaced workers. It is an active rather than passive labor market policy response. This section summarizes the key types of redeployment support and the broad lessons emerging from international experience.

The main types of redeployment support are:

- **Prelayoff advice and counseling,** which—in addition to advice on separation and on services and support open to the displaced worker—may include elements of trauma, financial, and life counseling.
- **Job-search assistance,** which can include placement help (employment intermediation) to match workers with opportunities in the job market, time off for job search prior to termination of employment, and help in building skills and confidence to find a new job (interview skills, personal skill assessment, writing job applications, job clubs).
- **Training,** which may include retraining and skill upgrading so that displaced workers can find new paid employment elsewhere, and training in small business, microenterprise, or livelihoods to help them create self-employment and incomes.
- **Employee enterprise,** through which the resources and facilities of the PPI enterprise are used to create jobs for displaced workers by contracting out services needed by the enterprise to newly separated workers or by

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There are five main types of redeployment support.

setting up a range of facilities from simple workspaces to more sophisticated business incubators.

- **Efforts to create jobs** by looking to local government, nongovernmental organizations (NGOs), and community self-help groups, alone or in coalition, to develop employment opportunities at a local level. These can include large-scale, labor-intensive public works programs, local community activities, or small enterprise development projects.

How have redeployment programs worked in practice? The evidence shows mixed results. Reviews of retraining and other active labor market programs (mainly in the industrial countries of the OECD) found limited impacts (Dar and Gill 1995, 1998; Dar and Tzannatos 1999; Fay 1996). These findings are summarized in table 5.7. The evaluations revealed that retraining programs were generally no more effective than job-search help in increasing either reemployment probabilities or postintervention earnings, and they were between two and four times more expensive than job-search assistance.

Although many evaluations have focused on OECD experiences, the few evaluations of active labor market programs in developing countries also show mixed results, given the capacity, funding, and infrastructure constraints that many developing countries face. For example, Mexico's PROBECAT program, which was enrolling half a million workers a year, may have had no effect on the employability of trainees (Wodon and Minowa 2001). Similarly, Tanzania's redeployment program for more than 60,000 retrenched civil servants had no effect on employability, although the combination of counseling and training helped improve subsequent earnings (Blomquist 2002).

Wodon and Minowa 2001.

Redeployment programs, however, play an important political and social role in the labor restructuring process. When designed properly they can also be economically beneficial in moving unproductive workers to more productive sectors of the economy. The experience provides several general lessons in developing such programs:

- Implementing agencies should avoid overselling the programs, especially where jobs are scarce. In such cases, economic and labor market policies that generate sustainable economic growth and job creation are key in offering the best long-term prospects for displaced workers.
- Although national programs have had mixed results, there are opportunities for the implementing agency to design and implement more targeted redeployment programs that tackle the specific needs of workers from the PPI enterprise or scheme. Examples include rail privatization in Poland, where redeployment and retraining were integral components of the labor program.

  Link to the Web site of the Polish rail redeployment service: www.kaaz.pkp.pl/en/kaaz.html.

- Setting up a redeployment program takes time and is institutionally intensive. An evaluation of Brazil's federal railway redeployment program noted that the main problems came from underestimating the time it was going to take to agree on the strategy to implement the training and the outplacement programs (Estache, Schmitt de Azevedo, and Sydenstricker 2000). One outcome was that the training program was not put in place until some months after workers were separated, and many workers had already moved on. Early interventions are beneficial to workers. Experience in industrial and transition countries indicates that displaced workers are better help while they are still employed than after they have been unemployed for several months (Hansen 2001).
- Appropriate incentives for participants and service providers are important. Making training more demand-driven through the use of vouchers and other such mechanisms

Evaluations of large, active labor market programs conducted in OECD countries have shown mixed results.

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Table 5.7: Summary of Active Labor Market Program Evaluation Results

Program	Appears to help	Comments
Job-search assistance/ employment services (19 evaluations)	Adult unemployed workers generally when economic conditions are improving; women may benefit more	Relatively more cost-effective than other labor market interventions (such as training), mainly because of the lower cost; youth usually do not benefit; difficulty lies in deciding who needs help in order to minimize dead-weight loss.
Training of long-term unemployed workers (28 evaluations)	Women and other disadvantaged groups	No more effective than job-search assistance in increasing reemployment probabilities and post-intervention earnings, and is 2 to 4 times more costly.
Retraining in the case of mass layoffs (12 evaluations)	Little positive impact—mainly when economy is doing better	No more effective than job-search assistance and significantly more expensive; rate of return on these programs is usually negative.
Training for youth (7 evaluations)	No positive impact	Employment and earnings prospects are not improved as a result of the training; taking costs into account, the real rate of return of these programs is negative.
Employment/wage subsidies (22 evaluations)	Long-term unemployed workers by providing a means of entry into the labor force	High dead-weight and substitution effects; impact analysis shows treatment group does not do well compared with control; sometimes used by firms as a permanent subsidy program.
Public works programs (17 evaluations)	Severely disadvantaged groups by providing temporary employment and a safety net	Long-term employment prospects are not helped; program participants are less likely to be employed in a normal job and they earn less than do individuals in the control group; not cost-effective if the objective is to get people into gainful employment.
Microenterprise development programs (15 evaluations)	Relatively older groups and more educated workers	Very low take-up among the unemployed; significant failure rate of small businesses; high dead-weight and displacement effects; high costs; cost-benefit analysis is rarely conducted but sometimes shows costs to the unemployment insurance budget to be higher than for the control group; administratively intensive.

Note: Based on evidence from around 100 evaluations of active labor market programs, mostly in OECD countries—mainly, Canada, Germany, Sweden, the United Kingdom, and the United States—but with some examples from transition and developing countries such as the Czech Republic, Hungary, Poland, and Turkey. Most of the evaluations were undertaken recently, during the 1990s.

Source: Dar and Tzannatos 1999.

There are limits to what can be achieved by redeployment alone—economic policies that generate sustainable economic growth will offer the best prospects for displaced workers in the medium term.

is one way to improve the effectiveness of the programs. Another is encouraging the involvement of NGOs and private providers through the use of performance-based contracts for the delivery of services.

Many developing countries face challenges in putting in place effective redeployment programs. In many countries training is still supplied by state-run agencies that lack resources, market orientation, and institutional capacity. Private sector training providers are few or weak. Moreover, employees themselves often have little faith that training will improve skills and help them find alternative job opportunities, particularly when unemployment is high. All of those factors need to be taken into account in the design and implementation of redeployment programs.

Good program design demands attention to the details of selection and incentives mechanisms.

Design and Implementation of Redeployment Programs

This section sets out the key steps in designing and implementing a redeployment program tailored to the circumstances of the PPI plan.

Step 1: Define Objectives

Before proposing redeployment support as part of a labor program, implementing agencies must be clear about the rationale for it. Potentially there are three objectives:

- From an *economic standpoint,* the objective is to facilitate the shift of unproductive workers to more productive activities elsewhere in the economy.
- From a *social standpoint,* the objective is to help workers acquire the necessary skills to become reemployed or self-employed.
- From a *political standpoint,* redeployment programs are intended to build public support for restructuring by signaling to citizens, communities, and labor representatives that those responsible for restructuring are ready and willing to help those who need and want help (Fretwell 2002). Such programs help make difficult reforms acceptable to workers and other stakeholders. In India, for example, trade unions supported the retraining elements of the National Renewal Fund (NRF) and welcomed this as a measure to offset the social costs of enterprise adjustment and reform (and they were subsequently very critical when the NRF funded mostly severance payments and little training).

In the right circumstances, redeployment programs can have important objectives. When those objectives have been clearly defined, the main challenge is to improve the effectiveness of redeployment programs.

Step 2: Conduct Preparatory Surveys

Three types of surveys are typically needed early in the program to help inform its design. They are:

1. **A survey of employees,** including the skills, capabilities, and expressed redeployment needs of workers
2. **A survey of the labor market itself,** including areas of supply and demand
3. **A survey of potential redeployment service providers,** including the types and capacity of existing public and private providers.

These three surveys could be carried out separately, but in practice the findings of each will inform the design of the redeployment program and close coordination is thus required. Outline terms of reference for the various surveys are provided in the accompanying CD-ROM.

Terms of reference for surveys of the labor market, workers, and potential redeployment providers.

Employee Surveys

Employee surveys provide a descriptive profile of the work force and help the implementing agency to:

- Understand the profile of workers in the enterprise
- Identify the most vulnerable groups
- Monitor and challenge proposals from redeployment service providers based on a factual information base
- Provide a baseline for subsequent monitoring and evaluation.

The survey can build on, but is different from, the staff and skills audits described in module 7. Those audits focus on the needs of the enterprise, whereas the worker survey focuses on the needs of workers who will lose their jobs (see, for example, box 5.18). The worker survey can also overlap with the stakeholder analysis needed for planning communications and consultation (see module 6). Stakeholder analysis might be usefully scheduled at the same time as the worker survey.

The worker survey can include:

- Assessing the likely plans of employees—what proportion will retire permanently, or return to their home towns or villages, or be

Redeployment has economic, social, and political benefits.

Box 5.18: Brazil Rail—Worker Surveys in a Labor Study

To minimize the social cost of layoffs, Brazil's federal railway, RFFSA, had to have a good understanding of the profile of its employees. A detailed study was carried out as part of the preparation for World Bank support. A detailed analysis of the characteristics of each regional labor market and the outplacement opportunities for each excess worker was conducted. The study covered the employee's age, experience, and education level, compared with similar characteristics in the regional labor market where the redundant employees would have to compete for a new job.

The study revealed that the two main characteristics of Brazil's labor market are (a) the modest qualifications of its labor force and (b) its capacity to generate jobs of poor quality. The poor qualifications of the country's labor force reflect the low level of formal schooling and the low quality of basic education. Professional training is not entirely effective, even for the most educated workers. Moreover, training on the job is often not sufficient because of the high turnover in the labor market. There are frequent short spells of unemployment. In many cases these spells result in lower wages when workers return to the market. There is also an increasing trend toward switching from the status of employee to that of independent businessperson.

In spite of some similarities, such as the low level of education, the profile of RFFSA's employees differed from the rest of labor market. The average rail worker was about 41 years old, had about 18 years of service with the same company, did not have much education, and had few or excessively specialized skills. The average worker in the general labor market is at least 6 years younger. RFFSA's workers were paid between 10 and 30 percent more than the average worker in the respective labor market.

The emerging concern was then that without some assistance, many of the rail workers declared redundant were likely to find it difficult to compete in the labor market in the short run. Even if these workers did manage to reenter the market, they were likely to be paid less. The view at that time was that what was needed was enough training to reduce the cost imposed by specialized job experience and the lack of formal education. A team of advisers from various training institutions was convened by RFFSA to prepare a menu of options from which affected employees could choose, and to design training packages that would meet the employees' needs.

Source: Estache, Schmitt de Azevedo, and Sydenstricker 2000.

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A redeployment program study is essential, and needs to cover three aspects:

- **The labor market itself**
- **Redeployment service providers**
- **The characteristics of displaced workers.**

willing to migrate to find alternative incomes?

- Developing descriptive profiles of the workers being retrenched through individual interviews and focus-group discussions. These meetings can provide a description of different groups of workers that bring to life—for decisionmakers—the risk profiles, key concerns, and challenges faced by different groups. (Box 5.19 describes such risk profiles.)
- Assessing worker preferences in terms of severance packages (one-time lump-sum payments, phased payments, or salary continuation).
- Learning from the experiences of other workers, perhaps in other sectors, who have recently retired or been retrenched.

The outcomes of the survey can help in designing the scope of the labor program. Those at highest risk are unlikely to find jobs quickly and will benefit from job-creation activities (public works, support for small enterprise, and community programs) as well as access to income support. Those with the most skills and highest level of mobility may benefit more from job-search assistance skills upgrading or retraining.

Worker surveys are an important input into the design and implementation of redeployment programs and must be designed with considerable care. An example of such a survey is included on the CD-ROM that accompanies this Tookit. Design, implementation, and analysis of the survey can be subcontracted out to national consultants or to academic or policy institutions.

Can the survey of workers be scheduled at about the same time as a stakeholder analysis?

Box 5.19: Ukraine—Profiles of Displaced Coal Mine Workers

Level One—Highest Risk

A woman, alone with children, with 70 percent or more of the family income derived from mine wages, is in level one. People like this are clearly the most at risk of losing everything.

Example: L. N. is 35 years old and has lived in the community all her life. She has two school-age daughters. Her ex-husband moved away and provides no child support. She has worked in the mine five years as an unskilled aboveground worker and earns US$32 a month in total family income, all of which comes from the mine. Her job will be one of the first to go and is not considered to be transferable to another mine. She is very worried about how she will take care of her children.

Level Two—High Risk

Other aboveground workers make up this category. As a general observation, aboveground workers are considered a highly vulnerable group of workers, not possessing particularly transferable skills. All female staff work aboveground, and 83 percent of the total number of aboveground workers (1,389) are women; 17 percent (285) are men.

Example: V. C. is 60 years old and has lived 60 years in this community. She has worked 30 years in the same mine. She currently works above ground in the stockyard in an unskilled position. She and her husband have a monthly family income of $64, which includes their pensions. Their family income is closely tied to the mine, and it will be cut in half, to about $1 a day, when the mine closes. She is frightened when she thinks about it closing. No one will hire her.

Level Three—At Risk

Underground workers in the engineering and other professions form this group. They are the highest-risk group of the underground workers.

Example: V. G. is a 40-year-old man who has worked 25 years in the mine. He is an electrician under ground and earns $64 a month to support his wife and two school-age children. He is totally dependent on the mine. His wife is unemployed, and 100 percent of the family monthly income derives from the mine. He has no savings and worries that the mine closing is going to be a disaster for his family.

Level Four—At Risk but Mobile

Underground skilled workers (face miners, drifters, timbers/fitters, and coal transport workers) have the best chance of adjusting to mine closure. They are potentially the most in demand for their skills and hence the most mobile.

Example: O. Z., 38, has worked under ground in the mine for 19 years, most recently handling explosives. Seventy-five percent of his family income derives from the mine. His wife earns $18 a month working in the hospital, and he is worried about the future for his two sons. Where will they work? He has lived in the same community his whole life and does not want to leave for another job. His skills considerably improve his chances of getting a new job.

Source: World Bank 1996b.

Labor Market Survey

The supply and demand for labor and skills relevant to the workers leaving the infrastructure enterprise will form the core of the labor market survey. The survey typically would include assessments of:

- The capacity of the labor market to provide new formal jobs through estimates of job creation, job destruction, and labor turnover in the economy
- Trends in formal and informal employment and areas of job growth and decline
- Alternative employment opportunities, including levels of wages and benefits and any trends
- Probability of finding formal and informal sector employment
- Patterns of employment in the private sector, including changing hiring practices and skill requirements
- Any barriers to entry into and exit from formal employment.

The labor market survey needs to consider both the formal job market and the informal sector because the latter is often a major source of employment. In South American and Caribbean countries, for example, the informal sector represents typically one-third to one-half of the work force (Freije 2001).

Labor market surveys should not be seen as a one-time exercise. Follow-up studies on a periodic basis can detect trends and changes in the labor market, fill in any gaps in understanding, and improve the quality, relevance, and targeting of redeployment activities.

Survey of Redeployment Service Providers

A survey of service providers is the third important source of information in the development of a redeployment program. The main objectives of the survey are to:

- Identify the full range of available service providers, including public and private ones and NGOs, as well as smaller organizations that are often invisible (see box 5.20).
- Identify the types of programs they offer and any gaps in services.
- Assess their capacity to deliver such services. Where there are shortages of service providers, the implementing agency may need to design the program so that service providers from outside the region are invited to provide services in partnership with local providers, or so that incentives to develop the market are provided through instruments such as vouchers (see Steel 2003).

  Steel 2003.
- Assess the performance of service providers in placing recipients or trainees in jobs. This can help determine appropriate performance measures to be included within performance contracts for service providers.

Step 3: Identify the Main Components of the Program

Counseling, training, and job search lie at the core of most redeployment programs (figure 5.2). Job creation, community approaches, public works, and employee enterprise are supplementary elements that can be appropriate in some circumstances.

Box 5.20: Tanzania—"Invisible" Service Providers

Despite the hostile environment for private enterprise in the 1970s, the commercial district of Dar es Salaam still hosted many small, private business service providers—bookkeepers and accountants, forwarding and courier agencies, marketing agents, and business training establishments. These small businesses seemed to be invisible to the donor agencies and to the government, both of whom preferred to set up high-profile central promotion facilities. Yet these microfirms were operating as profitable commercial businesses; they understood the market and the business environment. To the outside observer it seemed that the small accounting offices, for example—stimulated by increased demand and with some technical help—could be the seeds of future accountancy, business advice, and consultant service firms. But they had to compete with donor-financed facilities working out of expensively staffed and equipped offices and providing free services. Fortunately for them, the local knowledge and the marketing efforts of these state-sponsored bureaus were weak, so the local service suppliers were not seriously damaged and largely retained their traditional "invisible" customers. It was an opportunity wasted, however, because these existing fledgling service firms themselves would have benefited from advice, training, and incentives to upgrade so as to contribute to enterprise growth and improved governance.

Source: Phillips 2000.

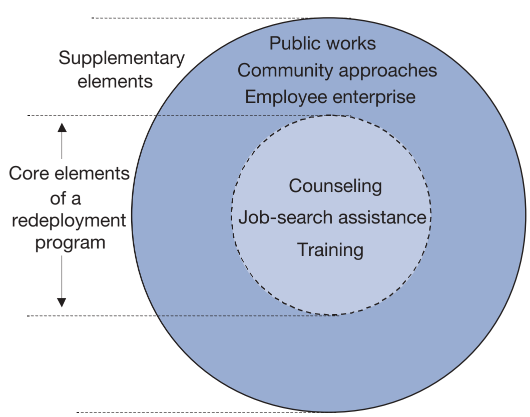

Figure 5.2: Core and Supplementary Elements

The labor market study should analyze both the informal and formal sectors.

There is no one best model for redeployment programs. Country-specific and enterprise-level circumstances influence the types of redeployment components that are selected. Every situation will be unique, but some guidelines for when various redeployment measures are most likely to be appropriate are set out in table 5.8.

Step 4: Design Appropriate Incentives

Poorly designed redeployment programs may have little economic effect. To improve economic benefits, redeployment activities need to be structured in a way that creates appropriate incentives for workers and service providers alike.

Weaknesses in the provision of training are common. The implementing agency will need to assess these as part of the labor market study.

An example comes from Chile, where training for displaced workers is provided through the National Training and Employment Service (SENCE), part of the Ministry of Labor and Social Security. More than 1,700 training providers to the program are registered, including private firms, municipalities, or universities. Funds for training are awarded through competitive bidding (publicly tendered) among providers, and must include commitment from private firms for a three-month apprenticeship for trainees. The program design helps ensure a degree of training relevance because both firms and training providers have incentives for monitoring quality (Freije 2001).

Table 5.9 summarizes incentive mechanisms that the implementing agency could adopt in a redeployment program. These are mechanisms for selecting the recipients of redeployment assistance and performance incentives for public or private service providers.

There is no one best model.

Specific incentives that can be adopted include avoiding or reducing stipend payments to employees who attend activities; cost-sharing by participants (especially for such services as training), including through vouchers; and performance-based contracts for service providers.

Avoiding Stipends

Many programs offer generous stipends to workers who attend the training programs. Although stipends encourage attendance—and hence high levels of activity rates are reported by training providers—they can significantly distort participation in redeployment plans. Several such plans have high dropout levels. Workers attend the courses while they have no other income, but as soon as they get a job they leave.

Increasingly, plans are moving to no or minimal stipends:

- In Trinidad and Tobago, training programs run by SERVOL (an NGO primarily working with poor youth) only provide training with a small stipend that is set low enough to prevent participants from dropping out of formal education and enrolling merely for the stipend.
- In India (Orissa and Andhra Pradesh), stipends for workers made redundant by the privatization program are kept at low levels.
- In Brazil's rail privatization, a postprogram review proposed that at least part of the stipend should have been paid when training had been completed.

It is sometimes argued that the stipends given during training are social protection transfers. If this is a major issue for a large PPI scheme, then other mechanisms for targeting vulnerable workers and providing a social safety net need to be considered, such as a public works scheme or a broader social fund program.

Cost Sharing and Vouchers

One approach to making programs more effective is to introduce some element of cost sharing. Giving workers a choice between obtaining training or getting the equivalent amount in cash as part of severance pay is one way. Making a small deduction or charge for training is another, but this can chase away the poorest workers. A compromise approach is to offer free training for the poorest workers—for example, those with severance compensation below a defined amount—and then establish a sliding scale of (still modest) charges for other workers.

Another mechanism is the use of vouchers (either free or at some cost) to allow workers to select their own programs. Vouchers have been used as a

Table 5.8: What Works Best When?

Activity	When it is most appropriate or likely to work best	When it is unlikely to work well
Counseling and prelayoff support	• Can be effective as a mechanism to provide information to workers if delivered efficiently, and on time (that is, before severance). • Is useful as a screening mechanism to identify workers most likely to demand and benefit from training or other support. • Works best where unemployment is frictional (that is, there are job vacancies but workers face information gaps) rather than structural (that is, workers lack the skills or live in the wrong places to fill existing vacancies) or where there is a lack of labor demand (that is, too few job vacancies).	• Is conducted too late (that is, after workers have left the enterprise). • Is not supplemented by other redeployment services.
Job-search assistance/ placement/ employment information exchange services	• Works best where unemployment is frictional rather than the result of skill mismatch between workers and vacancies or a lack of labor demand. • Country is large and job opportunities are available for workers with existing skills in other regions. • Public employment service is trusted by workers and employers and offers effective employment intermediation services. • Government has deregulated to allow the private sector also to provide placement services (with costs funded by the employer to prevent potential abuses of workers). • There is a local tradition of worker migration, nationally or internationally.	• Informal economy dominates. • Economy is depressed and formal work opportunities are few. • Country is small and private, and informal networks (that is, friends, family) are the most important sources of job information. • Public employment services (PES) are weak, highly decentralized, and have little capacity to provide a national labor information exchange. • Workers don't trust PES (perhaps because they also monitor unemployment benefit fraud). • Employers don't trust PES (perhaps because they also regulate labor standards). • Private sector placement and intermediation services are still illegal or excessively regulated.
Skills-based retraining/skills upgrading for employment	• Economy is growing reasonably fast and employers are hiring, but displaced workers lack appropriate skills. • There is a local tradition of worker migration, nationally or internationally.	• Formal sector job opportunities are limited. • Workers are illiterate or have a very limited skill base on which to upgrade. • There are barriers to entry into employment (regulations on demarcation of jobs).

(*Table continues on the following page.*)

MODULE 5

Table 5.8 (continued)

Activity	When it is most appropriate or likely to work best	When it is unlikely to work well
Training for self-employment	• Economy is diversifying or undergoing rapid structural shift to services (e.g., in transition economies, India, and China). • New entry into small business is relatively easy, and economies are substantially deregulated. • There are personal networks that can provide capital and support for entrepreneurs.	• Economy is stagnant or in recession; the formal sector is moribund and not providing work for the informal sector. • Economy is highly regulated, with excessive red tape that restricts small business and microenterprise start-ups. • Strong culture of the public sector remains; workers expect "guarantees from government" for new businesses.
Employee enterprise	• PPI schemes have potential to contract out services (such as meter reading, construction, facilities maintenance, infrastructure maintenance, and minor works). • PPI schemes have managers committed to developing a flexible work force and helping contractors succeed.	• Country has strong laws or tax disincentives against contracted labor. • Strongly negative attitude exists toward subcontractors by management or trade unions. • Continuing underemployment within the PPI enterprise conflicts with plans to contract out services to former employees. • PPI operators have no effective disciplinary control over rent-seeking contractual practices.
Community-based programs	• There is a history of civil society institutions (including trade unions) that can propose and manage local demand-driven projects. • Decentralized local and municipal governments are effective, capable, and trusted. • Formal sector employment opportunities are weak.	• There is profound conflict among ethnic groups, factions, or interest groups. • Initiatives can be captured by vested interest groups.
Public works programs	• There have been massive layoffs, with significant numbers of workers needing a temporary safety net rather than a "trampoline." • Formal and informal economy and income opportunities are both weak. • Vulnerable groups or regions can be identified and resources targeted there. • Activities are demand-led by local communities and NGOs. • Self-targeting is possible though rationing support to the poorest and most vulnerable people (e.g., through low wages, queuing).	• Political interference and patronage systems lead to excessive spending and misdirected support (that is, not to the poorest people). • National minimum wage is relatively high and can't be reduced. • Government regulations will not allow self-targeting of the poorest people through low payments (e.g., there is a mandatory minimum wage).

Table 5.9: Mechanisms and Incentives for Redeployment

Activity	Selection mechanisms for displaced workers	Performance incentives for service providers
Counseling	• No active selection required; should reach all workers and spouses	• Performance bonus to contractor if counseling reaches above a minimum percentage of workers
Job-search assistance/ placement/ employment information exchange services	• No active selection required; should be open to all workers or • Self-selection by payment of a minimum fee (cash or voucher)	• Competitive bidding for job-search assistance • Placement agency gets bonus for every worker still in job after, for example, 3 months
Skill-based retraining/skill upgrading for employment	• Counseling as a means of screening and matching workers with courses to improve the impact and relevance of the training • Self-selection by payment of a minimum fee (cash or voucher)	• Competitive bidding, plus quality control criteria for program accreditation of training institutions • Penalties imposed on training agency for dropouts (monitored by independent auditor)
Training for self-employment	• Counseling as a means of screening and matching workers with courses to improve the impact and relevance of the training • Self-selection by payment of a minimum fee (cash or voucher)	• Competitive bidding, plus quality control criteria for program accreditation of training institutions • Bonus for training agency for every worker still in job after, for example, 1 year (according to monitoring program)
Employee enterprise	• Active selection on the basis of objective appraisals of the business plans • Active selection by managers of incubator or managed workspace	• Commercially oriented enterprise, incubator, or managed workspace receives revenue benefits from successful cases
Community-based programs	• Self-selection of possible community projects, as proposed by community • Active selection of projects on the basis of (a) cost-benefit ratio and (b) social or poverty impact • High levels of transparency in the community on the amounts and use of funds; independent auditing	• Staged payments for activities • Transparency and audits
Public works programs	• Active targeting of vulnerable groups and geographic regions/locations • Self-selection of the poorest displaced workers through mechanisms such as low pay (perhaps below minimum wage) and enforced queuing	• Performance-based contracts for services (e.g., transportation and supply of materials)

tool for obtaining training and business development services in Ecuador, Paraguay, and Peru. The experiences of these projects are relatively well documented (see, for example, Bothelo and Goldmark 2000; Goldmark and Fitzgerald 2001; and Goldmark, Bothelo, and de Andrade Orozco 2001). Other examples are:

- A pilot program for the use of training vouchers was launched in the Republic of Korea in 1998 (Betcherman and others 2000a, 2000b), and vouchers were proposed for training redundant workers in the Ukraine coal mines (World Bank 1996c).
- Tanzania's Civil Service Redeployment Program has used vouchers for both counseling and training of some 63,000 retrenched employees (Blomquist 2002.

  Blomquist 2002.
- In Kenya a project to stimulate demand and supply for training and business development services for the self-employed, microenterprises, and small businesses used a voucher mechanism. The demand-driven approach led to most training being provided by small-scale, but more experienced, private sector master craftsmen. It also helped expand, diversify, and customize the supply of training, and helped link the savings and credit associations of microentrepreneurs with microfinance institutions (see Steel 2003).

Vouchers help shift from such a supply-driven approach dominated by the training providers to one in which the clients (displaced workers) have the power to select services relevant to their needs (see figure 5.3). Experience with vouchers, however, is relatively recent. Although initial evaluations of programs are promising, there is insufficient evidence to recommend widespread use. Nonetheless, they do address some of the fundamental deficiencies in training provision. A voucher program tightly targeted at displaced workers has a number of potential advantages over other types of voucher schemes in that:

- The client group is well defined.
- Concerns about distortion of the market are less significant because funding for any type of redeployment training will distort the market for redeployment and training services.
- There is less concern over the sustainability of the program—it ends when the last group of workers has passed through it.
- Self-selection occurs when there is a charge for the voucher because workers who do not intend to use it do not buy it. In the Kenya project a charge of 10 percent was made. Even so, about 37,000 vouchers were issued and 32,000 persons trained.
- The voucher could be traded within families (using identification cards, ration cards, and the like to identify the trainee). This will answer a common request among older retrenched workers to have a younger family member trained in their place.

The problems that the implementing agency will face regarding vouchers are likely to be linked to administration and to the training institutions rather than to participants. For example:

- Programs may be complex and costly to administer.
- There may be a shortage of training providers willing to participate (although the introduction of vouchers can help to improve the supply of training providers).
- There can be attempts at fraud or collusion between trainers and workers to share revenues among themselves. That risk can be tackled through a combination of independent auditing (random checks of attendance at training courses, postcourse interviews with trainees), regular monitoring of performance, and annual or biennial competitive rebidding of the contracts for training.

Performance Contracts

More demand-driven programs can also be encouraged, without the complexity of vouchers, through

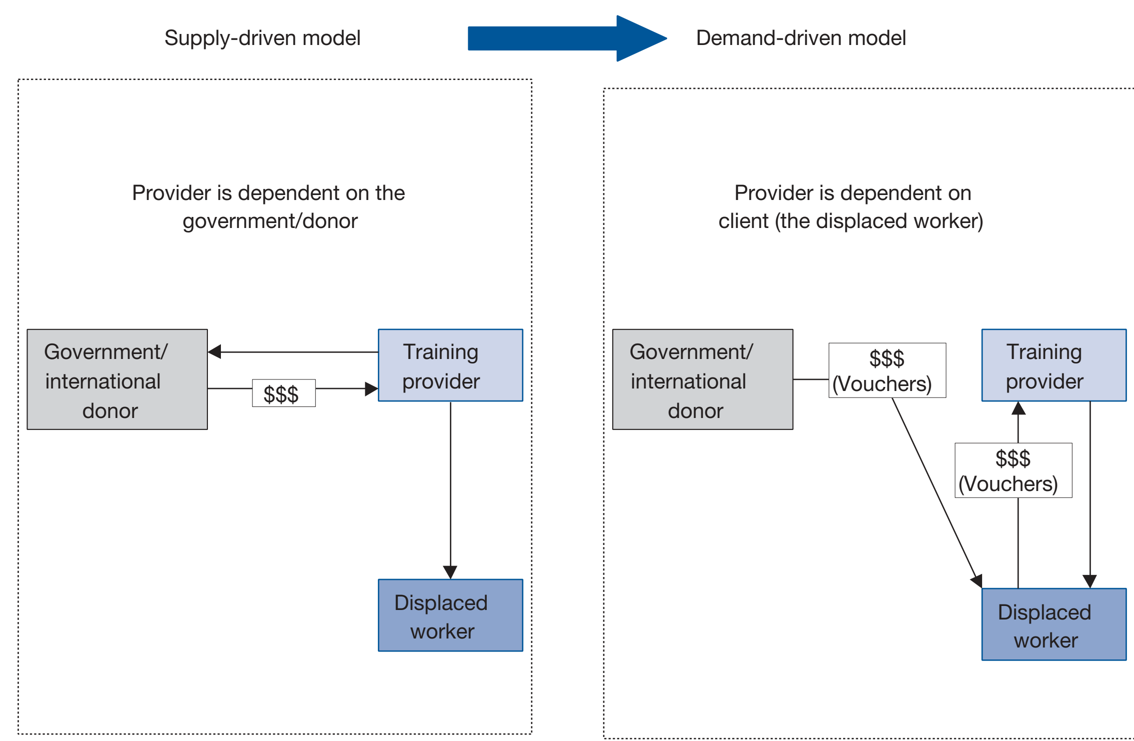

Figure 5.3: Moving from Supply-Driven to Demand-Driven Training

Source: Adapted from Goldmark, Botelho, and Orozco 2001 (annex 2).

Vouchers for training may be particularly relevant for redeployment programs.

transparent, competitive procurement, regular retendering, and performance-related contracts for suppliers. In Turkey's privatization program, for example, negotiated job placement rates were required in the contracts of service providers (at minimum levels of 10 percent for counseling and job placement services and 60 percent for retraining).

The reporting and publication of performance data can also support performance contracts. If potential program recipients gain access to good information on all training providers and performance measures (including numbers of other workers selecting the course, dropout percentages, quality ratings by former students, and success rates in redeployment), they are likely to move to programs that are both relevant and appropriate for them.

Step 5: Set up a Redeployment Team

When the redeployment program has been designed, a key step is to put in place a team to implement the program. The main tasks are to:

- Agree on the institutional home for the redeployment program. There are various options: one is to place the team in the implementing agency; another is to have a group such as the ministry of labor run the program. In either case, implementation of the actual program is generally subcontracted to private sector or nongovernmental institutions.
- Obtain the necessary expertise. The manager of the PPI implementing agency will have many other tasks and will need to delegate redeployment and severance matters to a labor specialist. (See the Toolkit CD-ROM for an outline job description for a labor specialist.)

  Terms of reference for a labor redeployment specialist.

- Advertise in well-known national newspapers to obtain a prequalified list of potential contractors who can subsequently be invited to bid for redeployment services. Private sec-

Experience with vouchers is relatively new.

tor providers, autonomous public organizations, and NGOs will be eligible and should be able to demonstrate minimum capabilities (that is, prior experience and track record, financial resources, in-house staff, and staff qualifications).

Workers need honest, transparent information on the quality and performance of courses.

- Consider working with other government agencies to establish a rapid response facility. These facilities usually comprise an early warning system to predict the timing of large retrenchments, prelayoff advice, and the rapid mobilization and coordination of supporting public services (see Hansen 2001). Experiences in industrial countries have been adapted in some developing and transition countries; for example:
  - Canada's Industrial Adjustment Services provided on request on-site, rapid response redeployment services, following the announcement of plant closings or layoffs. A committee, made up of management and labor representatives, funded by government and the company, organized job-search assistance for redundant workers. This approach was developed and adapted for use in Egypt.
  - The U.S. Department of Labor has promoted a rapid response facility with a dislocated worker unit in every state. A national directory of private sector consultants and service providers is available to enable state governments to quickly draw in expertise in counseling, retraining, and job search (see www.dolea.gov/layoff). Variations on this approach have been developed in Romania, where the approach is used as part of a national program to offset the effects of job loss arising from transition (see http://lrp.digi.ro/eng/), and in Hungary (see lgi.osi.hu/resources/practices/pdf/labor1.pdf).

Labor funds can be a vehicle for a mix of government and donor initiatives directed at creating employment and supporting redeployment.

Links to the Web sites of redeployment and rapid response units in:

- The United States
- Romania
- Hungary.

Social funds are more poverty focused, but can also support active labor market and social safety net initiatives.

Step 6: Develop Cost Estimates and Funding Arrangements

In addition to program activities, funding will need to cover the costs of:

- Administering the program, including the costs of labor experts, counselors, and the like
- Monitoring program progress and overall gross effects on workers
- Evaluation of the net impact at the end of the program.

These funds should be linked to the overall timetables for PPI and severance because there is little point in releasing funds for a labor program before basic approvals for PPI have been received.

The accompanying CD-ROM provides a spreadsheet to help develop cost estimates for program activities.

Spreadsheet (covering counseling, training activities) to develop cost estimates for the redeployment program.

Redeployment programs can be implemented and funded through national-level labor or unemployment funds, as has been common in Eastern Europe and Central Asia. These funds are typically financed on a discretionary basis from the state budget, often with the support of loans from donors and international financial institutions. The primary objective of these funds is to enable activities that help unemployed people get back into gainful employment. Where such funds do not exist, or where they serve a different purpose than what is required at the PPI level, separate arrangements can be made in which monies are channeled directly to the PPI implementing agency or to the group that is directly responsible for the redeployment program.

Social funds have also been used in some cases. Social funds are special-purpose, public sector arrangements designed to mobilize resources to alleviate poverty. Social funds differ from labor funds in that they are more directly concerned with poverty reduction and income support rather than employment generation. Their activities may, however, support displaced workers, particularly in regions of acute unemployment or in single-industry towns. Social fund activities are generally demand driven. Social funds do not directly implement social safety net programs, but rather solicit, evaluate, finance, and then monitor projects proposed and undertaken by private contractors, NGOs, or other groups. Social funds can attract substantial donor financing.

In the context of retrenched workers, social funds may serve a range of active labor market programs, such as retraining, microenterprise loans, and public works programs, in addition to social and welfare services. In 1985 Bolivia established the world's first Emergency Social Fund to help miners who lost their jobs because of economic adjustment (see box 5.21). It proved so successful that it became the model for Bolivia's Social Investment Fund set up in 1990 to finance long-term development of the country's social services and to deal with the more intransigent problem of endemic poverty.

Further advice on the design and implementation of social funds is available from the World Bank at www.worldbank.org/socialfunds.

WWW World Bank "gateway" for advice on social funds.

Step 7: Identify and Commission Service Providers

The implementing agency's office does not need to provide services directly, and many services can be contracted out. Terms of reference and contracts should include performance-based payment mechanisms to encourage performance, with clear performance measures and reporting requirements. This enables the program to be outcome driven (for example, by number of workers employed or number of workers with increased incomes) rather than numbers driven (for example, by number of workers counseled or number of workers who attended training courses).

Other measures to improve the quality of service provision are to:

Box 5.21: Bolivia—The Emergency Social Fund

In Bolivia the state mining corporation reduced its staff from about 28,000 in August 1985 to fewer than 6,000 by the end of 1986. The World Bank supported an emergency fund to help redeploy the miners. The Emergency Social Fund (ESF) was set up as a temporary fund to finance a large number of small-scale, labor-intensive subprojects in infrastructure (housing, schools, road improvements, erosion, flood control, and irrigation works), as well as technical assistance and extension programs.

The ESF illustrates some of the benefits of public works programs. The greatest benefits from participating in the program were received by those who would have been least well-off without it. Although the subprojects originally were intended to employ mostly miners, only 15–20 percent of them were employed under the ESF. Studies showed that although a number of miners moved rapidly to new jobs, others were reluctant to participate in ESF projects because the pay was low. The subprojects' ex post rates of return were generally positive and contributed substantially to reducing the social cost of adjustment after the economic crisis of the mid-1980s.

Sources: Mathieu 1996; Newman, Jorgensen, and Pradhan 1991.

If rapid response facilities are in place or are being developed, the implementing agency might usefully build these into the overall design of the redeployment program.

- Introduce open competition into the provision of services, and ensure transparency in the process of selection and award.
- Provide for pilots or phased programs so that the initial performance of service providers can be checked, as well as the relevance of the activity. These help deal with the inevitable uncertainty as to what will work best. Pilot activities can then be tested, monitored, reviewed—ideally by independent specialists—and then rejected, amended, or expanded.
- Conduct regular progress reviews that are linked to incentive mechanisms, such as regular competitive bidding for services.
- Engage independent auditors and monitors to review and evaluate the service providers.

Step 8: Monitor and Evaluate the Program

Module 7 sets out monitoring and evaluation processes in some detail and describes a range of performance monitoring measures. The implementing agency's key tasks here are to:

- Set up formal monitoring arrangements (again using independent contractors if possible) to provide regular reports on training and other services, and conduct follow-up surveys and focus groups to assess how redundancy is affecting individuals, families, and communities.
- Measure against performance indicators, such as numbers of other workers selecting the course, dropout percentages, quality ratings by former students, success rates in redeployment (see O'Leary 1995).
- Put performance and monitoring reports into the public domain so that workers can make more informed decisions on which services and providers are appropriate for their needs. This is important because, until training starts, neither the trainee nor the implementing agency has any real idea how good (or bad) the quality of training will be, especially if there are few redeployment service providers with prior experience in the country.
- Include short-term tracer studies on the impact of training on workers. This can help identify weaknesses in program activities. For example, if a training activity is only preparing workers for (perhaps nonexistent) formal jobs, ignoring the informal sector and self-employment, then it may have very limited success.
- Adapt the program in the light of performance findings.
- Provide for an independent net impact evaluation and then redesign as needed.

Counseling

Counseling is the first, and minimum, level of support that the implementing agency can put into place to help displaced workers. There are many types of counseling. Although cost-effective, counseling is often neglected.

Types of Counseling

The content of worker counseling can include:

- **Trauma counseling:** Job loss is a clear case of potential trauma in the lives of workers, and one component of the counseling process is to provide support and assistance to those who are particularly distressed by the event. Redeployment counselors may lack these skills and there is scope for involving NGOs with skills in these areas.
- **Financial counseling:** This is particularly important because severance may be the largest sum of money a worker receives in his or her life. Counseling can help people make prudent investment decisions by providing advice on:
  - How severance has been calculated.
  - Options for investing money (choices and risks).
  - Investing in self-employment. Experience shows that many recipients of severance pay assume (wrongly) that they need to invest large amounts to start a business, when in practice a more cautious "start small and test the market" approach may be needed.
  - The need to protect severance pay from fraudulent investment schemes set up to exploit the sudden increase in liquidity in a community where many people are receiving severance payments.
  - Helping prepare workers (particularly in rural communities) for the sudden arrival of large numbers of "extended family" seeking to benefit from the perceived windfall.
- **Counseling on job opportunities,** redeployment, and training services provides infor-

mation to workers on how to find new jobs and other income-earning opportunities, as well as how to access redeployment services (training, small business support, placement, and job-search services). There is some evaluation evidence (for example, Blomquist 2002) that counseling plus training are more effective than training alone.

Timing, Location, and Frequency of Counseling

Counseling can start when the first announcements have been made to workers about potential retrenchment. Two phases can be identified:

- **Prelayoff counseling,** which will focus on:
  - Providing accurate information to workers and their families on severance programs, possible training opportunities, the timing of activities, selection procedures, and treatment of staff housing, among other things. This helps improve workers' decisionmaking and avoids damaging rumors.
  - Establishing facilities for counseling (and job-search assistance), which may be located within the workplace or in a separate facility that workers can easily access.
- **Postlayoff counseling:** Counseling during this phase can become more intensive but should not distract the worker from his or her own job-hunting efforts.

The workplace is often the best location for counseling, particularly for early interventions and prelayoff counseling. Improving employee accessibility to information about training opportunities is key. Information can be made available at various locations:

- In the premises of the utility or PPI plan (easiest for workers and the most cost-effective location for initial counseling)
- In temporary rented accommodations (useful where the redeployment program needs to distance itself from difficult separation process)
- Through mobile visits (for counseling or training of smaller groups)
- At job fairs or meetings; in the community, using facilities of training institutions, local government, or other partners; at traditional meeting places; or in workers' homes.

Materials provided for workers should be in their own language. If many workers are illiterate, redeployment programs need to make more use of radio, video, group meetings, and means for providing information via other people in the community who meet workers face to face (for example, health workers or workplace "peer counselors").

How much counseling is required? Intuitively, a single session is unlikely to be sufficient to help workers dealing with significant job-loss trauma or challenges in finding new income. In India practical experience with national and state-level schemes has found that repeated visits are necessary.

Designing an Effective Counseling Program

Counseling before and after severance is a relatively low-cost measure. Hess (1997) estimated counseling costs on the order of US$100 per worker. In practice the costs have been significantly lower. In state-level programs in India counseling costs have been estimated at about US$10 per retired worker, equivalent to about 10 percent of the cost of training delivered to each worker. The Toolkit's CD-ROM contains a sample spreadsheet that facilitates the calculation of the costs of setting up a counseling program.

Spreadsheet for estimating the costs of counseling.

Counseling is relatively low cost, but that does not always mean it will be effective. The implementing agency can improve effectiveness if:

- There is rapid mobilization of counseling services. In some cases workers may disperse to their homes very soon after severance so it is essential to deliver counseling advice before that happens. For the implementing agency this means that operating budgets, recruiting and training of counseling staff,

Severance payments may be the largest amount of money that workers ever receive. Providing prudent financial advice is a critical part of counseling.

Training and counseling services can be contracted out to separate independent agencies.

and counseling materials all need to be in place well before workers start leaving the enterprise. A minimum of six months is ideally needed prior to the formal announcement of retrenchment so as to coordinate all the resources (staff, materials) necessary to set up a counseling program for a major work force restructuring program.

- There is early attention to building capacity in counseling. The implementing agency can address this by:
  - Contracting a training provider. Counseling is an underdeveloped skill in many developing countries, and the implementing agency may need to look to NGOs with experience in disaster counseling, conflict resolution, and negotiation for "training the trainers."
  - Using competitive bidding mechanisms to identify a range of potential service providers from government agencies, NGOs, and the private sector.
  - Recruiting and training local counselors. Some programs have successfully selected young college graduates as counselors for privatization redeployment programs. Local counselors have the advantage that they come from the same communities as the workers; and their local sensitivities and language skills mean that they can be quickly effective when they have had induction training.
  - Using peer counselors—that is, other employees from within the workplace.
- There is rapid feedback from counseling, gathered by actively seeking out the view of the counselors in the field, not just their managers. Implementing agency managers should attend some counseling sessions and listen to the counselors as they share their experiences. The best feedback on the real problems that workers face will come from those closest to the work—from workers and counselors and not from office managers.
- There is some degree of independence of the counseling service so that the advice is not compromised. This means:
  - Keeping counselors independent of tasks that are properly the work of the utility/PPI enterprise managers—for example, the announcement of layoffs or the selection of workers for redundancy. Counselors should be associated with helping the worker, not with the retrenchment process itself.
  - Ensuring that counselors are as independent as possible from the training program. Where counseling and training are combined, there is a risk that counselors become sales agents for the training programs and push workers to inappropriate courses simply to boost the numbers of "trained" workers.

Job-Search Assistance

Job-search assistance can be valuable because it helps identify and match workers' skills to available job opportunities. Job-search efforts generally show positive results and, when targeted, can be cost-effective.

Employment Services

The purpose of job-search assistance (or outplacement) is to reduce the time and transaction costs that displaced workers would otherwise incur in trying to find new employment. There is evidence that job-search help works, at least in situations where the formal labor market is active:

> *The intervention that seems to work best—at the lowest cost—is job search assistance (sometimes combined with other labor market measures) (Fay 1996, reviewing active labor market programs in OECD states).*

Public employment services in particular have served as brokers matching jobs with job seekers, traditionally through physical centers (employment "exchanges"). Internet technology is also being used in some countries (box 5.22).

In a comprehensive review of active labor market programs, Dar and Tzannatos (1999) concluded that evidence suggested job-search assistance could have positive effects and is usually cost effective compared with other active labor market programs. Results, however, were linked to the labor market conditions—where overall unemployment is rising, job-search assistance has not had a positive impact.

Dar and Tzannatos 1999.

Assisting Job-Search Efforts

In industrial countries, a first phase of job-search assistance is often undertaken on the premises of the enterprise, and involves providing an outplacement center where workers can:

- Practice and be trained in job-search and interview techniques
- Share experience and gain employment ideas from other workers, perhaps through peer counselors, as members of a job club (see box 5.23), or from visits by other workers who have been made redundant earlier
- Receive other relevant counseling advice (financial, household planning, trauma, life, livelihood)
- Have access to information (books, brochures, video, presentations) on training courses, self-employment options, and other resources
- Have access to computers (where appropriate) for preparation of curriculum vitae and for searching Internet-based job prospects.

Another tool is the provision of an additional period of paid time during which workers continue to receive a salary but can use that time for job search. It can help both workers and managers:

- Workers have paid time to find new incomes.

Box 5.22: Job-Search Assistance—Using New Technology

Labor programs associated with the restructuring of both Brazilian and Polish railways made use of Internet technology to deliver information on severance and redeployment to displaced workers.

In Chile the National Training and Employment Service has developed a national electronic labor exchange—InfoEmpleo (see www.infoempleo.cl/)—that holds the résumés of job seekers and receives notice of more than 300 job vacancies a month. Similar programs exist in Korea ("Work-net" at http://www.work.go.kr/worknet/main.htm) and in the Philippines ("Phil-Jobnet" at phil-jobnet2.dole.gov.ph/pls/philjobnet/main).

In Andhra Pradesh, India, the state government's Social Safety Net Program established a Web site where workers who have been displaced as part of a series of enterprise closures and restructurings could post their résumés. Some workers found employment overseas through this mechanism, via a private sector placement agency in Chennai that had accessed the Web site.

Source: Adam Smith Institute, personal communication.

Counseling is an underdeveloped skill in many developing countries. Additional training may be necessary to develop enough counseling capacity for the redeployment program.

- Managers in the enterprise reduce any potential problems arising from disaffected workers in the workplace.

Rebuilding displaced workers' confidence is an important element of both counseling and job-search assistance.

Retraining

Retraining is often the biggest element of a redeployment program, and often the most costly. Retraining can be provided for both formal employment and self-employment. The record of such programs has been mixed. Retraining needs to be targeted and made demand driven if it is to be effective in cost and outcome.

Retraining for Employment

Retraining programs to facilitate formal sector employment are a common element in redeployment programs (box 5.24). Courses usually combine a mix of practical and theoretical training and include:

- Short-term (one to six months) vocation courses for unskilled and semiskilled work-

Box 5.23: What Happens in a Job Club?

A job club is a group of workers who meet regularly together as part of their job-search efforts. The job club may be supported by the implementing agency or by the public employment service. Members of the club can determine their main activities, which could include:

- Receiving job leads from potential employers and job-search agencies
- Sharing information about job openings
- Developing job-search strategies
- Preparing curriculum vitae or résumés and helping each other complete job applications
- Creating job-hunting teams for moral support and shared transportation
- Taking field trips to workplaces that may be hiring
- Practicing interviews, telephone skills, and telephone follow-up calls
- Listening to speakers or watching videos about different kinds of jobs
- Getting and sharing information about housing, legal aid, medical assistance, and other resources
- Sharing experiences—good and bad—and talking about how they feel about trying to get a job and the effects of unemployment on them and their families; planning and taking part in shared social events.

Source: Hansen 2001.

ers in areas such as taxi driving, basic carpentry, motor rewinding, dressmaking.

- Short-term technical courses for more skilled employees. For example, the growth in information technology services has prompted the popularity of computer training courses among more qualified workers redeployed from privatized SOEs in most Indian cities.

- In-service training and on-the-job training are particularly valuable. Often these provide mechanisms where workers can enhance or extend their skills through working as an "apprentice" to a skilled worker. In Kenya these were the most demanded

Box 5.24: Retraining—Chile's Program for Mine Workers

The Retraining Program for Displaced Workers is a pilot project organized recently by the government of Chile with the financial assistance of the Inter-American Development Bank Multilateral Investment Fund. The program is mainly designed for skilled adult workers displaced by industrial restructuring and technological progress. The program is currently focusing on the retraining of more than 1,000 redundant coal miners. The program managed by the Production Development Corporation includes subsidies for counseling, retraining, and employment intermediation services for displaced workers. The private agencies that provide these services are selected on the basis of competitive bidding and receive a maximum subsidy of approximately US$2,000 per reemployed worker. Enterprises that hire retrained workers receive a subsidy of approximately US$900 per worker. The retraining and reemployment program is part of a broader plan for industrial restructuring in the coal-mining region that offers a series of incentives for private investment in labor-intensive projects.

Source: Espinoza 1997.

training providers in a small-enterprise training program (Steel 2002). Training programs can work with employers to provide on-the-job training and a commitment to hire a proportion of trainees, perhaps in return for receipt of the worker's stipend. (This approach was used in the PROBECAT program in Chile.)

Generally, training costs are about US$200–$500 per worker in middle-income countries (see Fretwell 2002). In Brazil's rail restructuring, however, the average cost of training was about US$900 per worker, and similar costs were reported for group training in Hungary (O'Leary 1995). Uptake varies considerably but is generally relatively modest—typically 15 to 30 percent—and depends on labor market conditions, the relevance of the training, and the level of incentives (stipends) to workers.

Fretwell 2002

It should also be pointed out that governments may not want to offer redeployment and training, perhaps in circumstances where the broader reform goal is to reduce a culture of dependence on government for services, assistance, and subsidies. There may be a policy of offering a generous one-time severance package and encouraging a clean break between workers and government:

> *We don't want to offer redeployment and retraining. We have offered a generous separation package, and workers are leaving quietly. If we offer them retraining, they will then expect a job at the end of it, almost a government guarantee (adviser to prime minister's office, developing country).*

Retraining for Self-Employment

Most training for redundant workers has focused on training for jobs in the formal sector. In part this has reflected aspirations of government, implementing agencies, unions, and workers alike. But retraining for self-employment is also relevant, especially where formal jobs are scarce. Training for self-employment can address upgrading workers' skills for the "informal sector" of casual employment and trading, and is best linked to broader small- and medium-size enterprise support. Reasons to focus on the informal sector are that:

- Many displaced workers have little formal commercial or business experience. A common counseling experience is that newly displaced workers, flush with their severance payments, can have overly ambitious plans for becoming entrepreneurs. Encouraging workers to try out their business ideas and their aptitudes for business with very small, low-risk, informal trading activities is often more appropriate than their investing—and risking—most of their severance money in an untested business.
- The state may well provide barriers to entry to formal business.
- The informal sector can provide income opportunities that workers value (Maloney 2003), as well as a transition into other full-time employment or formal business.
- Workers are often already engaged in part-time self-employment (and their spouses are as well).
- Only a small proportion of displaced workers will have the aptitude for formal business. For example, a study of OECD and transition economies found that only around 5 percent of unemployed workers will choose to become self-employed (Van Adams and Wilson 1994).

From a policy perspective, support for self-employment is an approach that can stimulate labor demand without distorting other aspects of the economic reform process (through subsidies, for example). As with retraining for employment, programs to encourage self-employment also suffer from dead-weight loss effects and will benefit from measures to select participants. For example, an evaluation in Hungary and Poland, based on more than 5,500 follow-up interviews, indicated that many of those receiving financial and training assistance for self-employment would probably have gained reemployment without government help.

Employee Enterprise

Some governments have helped employees set up their own enterprises to contract services that were previously provided by the state enterprise, or set up workspaces and small business incubators.

Contracting out Services

Contracted-out services are one way to encourage employee enterprise and thus reduce unemployment among displaced workers. The enterprise awards limited-term, outsourced subcontracts to firms set up by former employees. Those new small businesses may then create jobs themselves.

Contracts are usually awarded with exclusivity periods for a relatively short period—typically no

Counselors should caution workers against overly ambitious or risky business start-ups.

more than two years—long enough to provide a secure environment for the new business to learn the disciplines required of private enterprise. The limited life of the contract provides an incentive to them to improve their performance and innovate in order to successfully bid competitively at the end of the contract. It also encourages them to devote time to finding new work and opportunities from other clients.

Contracting out also may be part of a wider strategy for restructuring of the enterprise. Ancillary functions (for example, catering, building and equipment maintenance) and core functions (such as revenue collection) can be separated from the main business and the services purchased from private providers. In cases where the private sector is still developing, there may be limited skills and capacity in the market to provide certain specialist services. These contracted-out services may contribute to overall employment but need not necessarily employ the redundant workers.

Examples of contracting out include:

- **Privatization of service units:** For example, in Mexico rail privatization the period 1990–95 saw the sale of various small factories and workshops that provided services to the railway. Many of the workers who left the company in that period joined the small factories as workers (López-Calva 2001). In Bolivia's railway, job losses in the privatized railway were partly offset by new jobs in maintenance contracting companies (Valdez 2002). Road reforms in a number of Sub-Saharan African countries have created new opportunities for road maintenance contractors (box 5.25).
- **Utility companies changing the skill mix, as they become more customer and service oriented:** For example, Telecommunications New Zealand (TNZ) concentrated its strengths on marketing and customer service, and outsourced many technical jobs. In a lot of cases, staff took early retirement or redundancy options before taking up positions with subcontractors who were called in to do the work (Ross and Bamber 1998).

Box 5.25: Malawi—Road Maintenance by Displaced Workers

Road maintenance in Malawi has been transformed from an activity managed by the (former) Department of Roads using government road gangs to one that is managed by a new Roads Authority, where the actual work is undertaken by private sector contractors. This change did not occur overnight, however, and there was a two-year interregnum between the old and the new management. During those 24 months, basic road maintenance was carried out through contracts issued to small contractors by the Department of Roads. In practice these were groups of retrenched workers formed around former charge hands and foremen who provided skills and continuity. It may have been somewhat messy, and undoubtedly that was a period of muddling through, but this approach did allow workers and the government time to adjust to the new regime and the new arrangements, and provided something of a safety net for workers who were displaced from regular government employment.

- **Redundant utility employees being offered guaranteed contracts to undertake work such as meter reading:** In the privatization of the Manila water supply, the two concessionaires agreed to give preferred-contractor status to a service cooperative of former employees for one year (Cruz 2001). In the privatization of Argentina's national oil company, about 5,000 retrenched employees received supplier contracts for up to two years for their approximately 200 newly formed businesses (Shaikh 1996).

  Cruz 2001 (a PPIAF case study).

- **Private sector contractors being required to give first right of refusal to displaced workers:** For example, following the introduction in 1992 of the Competitive Contracting Program, the city of Philadelphia, Pennsylvania (United States) implemented several programs designed to help public workers in the transition required by privatization and public–private competitions. The city created new job classifications and established a redeployment office to match the skills of displaced employees with position openings in other departments. It also gave displaced employees preferential consideration for other city jobs and required private contractors to give first right of refusal to affected city workers.

Special assistance and training in setting up a business can be offered because workers may not be familiar with all the requirements and principles of small business. The implementing agency can therefore engage specialist small-business development agencies to undertake a selection and training program for applicants for contracted-out schemes.

If successfully designed, such programs can win the support of workers. Trade unions may be opposed to contracting out, however, because of concerns about workers moving into so-called atypical employment and less formal contracts that offer less protection to the workers.

Making Employee Enterprise Work

Not all employees are suited to employee enterprise, and not all the new companies formed are likely to succeed. This is normal—many small business start-ups fail, although ones that receive professional support have a higher success rate.

The prospects of creating sustainable new employee enterprises can be improved by:

- Engaging business development advisers to screen and select employees with the aptitude to become small contractors
- Ensuring that the plan documentation and contracts are clear, comprehensive, and coherent so that workers can understand their choices, options, and risks
- Providing professional support to the selected employees through access to business start-up training and microenterprise training (with a minimum level of basic business training being mandatory)
- Reducing the costs of initial business start-up by providing free or low-cost access to sheds, garages, and simple industrial units, and allowing workers to keep and take the tools of their trade with them into their new enterprise
- Providing an initial period (one to two years) of guaranteed employment or exclusivity to allow the new enterprises to start up
- Reducing the risks that management or trade unions will renege on promises to support the use of contractors in the future, through contractual clauses agreeing not to compete unfairly with the new companies over a longer period (say, five years) and allowing (not restricting) the new companies to diversify and find other clients, and public memoranda of understanding or enterprise policies in favor of the outsourcing and contracting out of specified services.

Job-Creation Initiatives

In many transition and developing countries, a primary problem is the lack of demand for labor. Initiatives that help create jobs are valuable in many redeployment circumstances, but particularly in regions or monoindustrial towns with high levels of local unemployment. These initiatives include public works programs, support for small and medium-size enterprises, and local and community development planning and job-creation incentives for employers.

Public Works

Labor-intensive public works programs are mainly thought of as safety net programs to deal temporarily with large numbers of poor people in crisis. Public works programs can, however, be appropriate in PPI labor programs in regions where there is a particular mix of high and chronic levels of unemployment, lack of formal social safety nets, and large numbers of vulnerable workers.

Training for livelihoods or self-employment may be as important as, or more so, than training for jobs where the opportunities for new employment in the formal sector are poor.

Contracting out can favor redundant workers and offer opportunities for some to start their own small businesses.

Privatized service units can offer jobs to some redundant workers.

The pioneering Bolivian ESF had elements of public works programs within it and was initially intended to support redundant mine workers at a time when the economy was very weak (see box 5.21).

Well-integrated public works programs can combine safety net benefits with community action, productive investment, and a degree of encouragement for workers to engage in microenterprise (where elements of the public works are contracted out). Senegal's public works program, managed by AGETIP (Agence d'Exécution des Travaux d'Intérêt Public), is an example of a public works program that combines these objectives and has developed transparent, streamlined procedures (see box 5.26).

See www.worldbank.org/oed.

Box 5.26: Three-Point Checklist for Successful Public Works Programs

To make public works programs cost-effective, the implementing agency can check to see that:

1. They pay less than the prevailing market wage for unskilled manual labor in the program area. Restrictions on eligibility can be avoided by setting the wage rate at a very low level to ensure self-targeting (that is, only those in urgent need of a job take it, and as soon as they find better income opportunities they will leave the program).
2. The labor intensity of projects is higher than normal, although this may vary if the assets being created have real value for the poor in the area (for example, irrigation or road works that will benefit entire communities).
3. Where rationing of the public works scheme is required (for instance, where the demand for work exceeds the budget available at the [low] wage level), the program should be targeted at the areas with the most people disadvantaged by labor adjustment, as indicated by a credible poverty impact map.

Source: Adapted from Ravallion 1998.

Support for Small Business

Support for small business includes technical advice (business development services), microfinance, and managed workspaces and business incubators.

Detailed consideration of these types of support is beyond the scope of this Toolkit, but further sources of information on each of them is provided at the end of this section on redeployment.

Managed workspaces and incubators deserve special mention, however, because the assets of the PPI enterprise can be used to help workers start up a business in a relatively low-risk way by providing workspace and facilities. The principal difference between managed workspaces and incubators is that incubators try to bring together both physical space and technical assistance to start-up entrepreneurs in one location:

Workspaces and incubators can be set up independent of labor programs and may be wholly private or public–private partnerships. The best incubators are themselves profitable businesses, making their incomes from tenant rentals. The implementing agency, however, will principally be interested in looking at the existing assets held by the utility and infrastructure company and seeing how these may be used to benefit displaced workers.

British Coal Enterprise (BCE) is one of the early examples of this approach (see box 5.27). The BCE experience illustrates the value of very simple and basic managed workspaces. BCE workspace sites were often not attractive new buildings but converted former mine operation buildings. Some national and regional governments have invested in more substantial incubator facilities—some even moving toward high-tech science parks—but normally they have done so as part of a wider employment and economic development policy rather than as a strategy to deal with redeployment.

Worldwide there is much experience on the design and implementation of managed workspaces and business incubators. One source of information is the National Business Incubator Association.

The NBIA Web site is a source of information on incubators: www.nbia.org.

Box 5.27: British Coal—Responding to Mine Closure

The coal-mining industry presents a challenge when mine closure or work force reduction is required. The geological dictates of the industry mean that the closure of mines leads to the concentration of redundancy in a few areas. In 1981 there were 211 collieries in the United Kingdom, but this had shrunk to 17 by 2001. Over the same period the number of workers employed in the industry fell from 279,000 to fewer than 10,000. In response, in 1984 through the National Coal Board, the government established a public sector job-creation agency for the mining areas, British Coal Enterprise. BCE's charge was to facilitate the economic regeneration of coal-mining communities.

BCE focused on the delivery of practical initiatives intended to stimulate regeneration of the coal field areas led by the private sector. The three main activities were outplacement services, business funding, and workspace provision. These activities were intended to expand the prospects for the labor market by lowering the threshold for business entry and growth, and by promoting the development and expansion of skills.

The outplacement program helped about 60,000 miners through one-to-one counseling with career consultants, and help with résumé preparation and proactive job-search techniques. Some funding for retraining was also available from British Coal.

The business-funding program aimed to support fast-track financing. Loans of up to £25,000 were made available to start-ups and new businesses within coal-mining communities, and larger start-ups or expanding businesses were able to apply for larger venture capital investments of up to £250,000. In all cases only business plans with considerable promise of growth were funded—not microenterprises employing one or two people. In many cases these start-ups or expanding businesses also made use of BCE's managed workspace programs. BCE also managed £3 million from other sources.

A central feature of BCE's approach was to unite outplacement and funding by introducing managed workspaces or small-business incubators. BCE offered workshops and offices of various sizes and types, as well as such shared services as secretarial support, photocopying, and facsimile facilities. "Easy-in/easy-out" lease terms were designed to remove barriers to growth and diversification for the nascent businesses. The workspaces made use of former British Coal premises, redeveloping the existing infrastructure and so keeping the costs of conversion low.

In many cases the regeneration of existing facilities in derelict areas was the catalyst for increased local economic growth. BCE invested a total of £101 million during its existence (1984–96) in more than 5,000 enterprises—thereby generating some 54,624 jobs (an average of 11 jobs created per business). Overall, BCE estimated the investment cost per job created to be £1,384. About 56 percent of the jobs created were derived from business start-ups, and 44 percent from business expansions. The managed workshops operation led directly to the creation of some 16,200 jobs in more than 1,121 units, and itself became a viable commercial enterprise (that was subsequently privatized).

Source: Gore, Dabinett, and Breeze 2000; Tawney and Levitsky 2000.

Where there is chronic unemployment, both community approaches and public works can provide elements of active and passive labor market support.

Local and Community Economic Development and Job-Creation Incentives

Community-based approaches are those where communities—including local and municipal governments—participate in identifying, selecting, implementing, or monitoring programs designed to create employment or protect those who have lost jobs and incomes. The approach aims to build community partnerships to improve the business environment, strengthen the local economy, and create jobs for displaced workers. It also helps in rebuilding the economic foundation and increases citizen participation in local economic development efforts.

In some countries the employers remaining in the community have received incentives to create new jobs. For example, in Cape Verde vouchers were given to private employers to provide on-the-job training to employees retrenched as a result of privatization. The employers were reimbursed 40 percent of the salary of a retrenched worker for up to a period of six months (Kikeri 1998). In Poland loans at prevailing interest rates were made available to existing businesses to organize new employ-

Incubators can bring together workspace and business assistance in one location.

ment places for at least 24 months. And in Hungary, the employment fund gave grant aid to enterprises making investments that would employ long-term employed workers. This was, however, the most costly form of active labor program—about six times more expensive than individualized training or self-employment assistance in terms of cost per person reemployed (O'Leary 1995).

Simple buildings and facilities can be used very effectively as workspaces.

Typically, the implementing agency or other government representatives or contractor will help organize a broad-based community task force to conduct an economic assessment and planning effort "owned" by the community. Community leaders are invited to participate in a structured economic renewal program designed specifically to strengthen the local economy and create more employment and livelihood opportunities. Workshops are conducted over, for example, a six-month period, and residents learn the principles of local economic development and are taught how to assess their community's needs, write a local strategic plan, select and design projects, and begin implementing them. Community approaches may be complemented and financed by other programs, such as regional development initiatives, social funds, or labor funds.

Those approaches are particularly relevant where:

- The PPI plan produces significant employment effects on single-industry towns (for example, some ports).
- There is systemic and chronic unemployment in the region.
- There are opportunities that will benefit the community (for example, conversion of buildings into not-for-profit workspaces or public–private business incubators).
- The PPI plan leads to some resettlement of staff, perhaps because of the relocation or merger of operating units.

Tools (on the CD-ROM)

Terms of reference for a redeployment survey

Terms of reference: Turkey's Labor Assistance Group (privatization social support project)

Job description for a labor redeployment manager

Sample worker survey

Sample questionnaire for counseled workers

U.S. Department of Labor adjustment model

Monitoring and evaluation performance measures for job search assistance services

Additional material (on the CD-ROM)

Dar, Amit, and Indermit S. Gill. 1998. "Evaluating Retraining Programs in OECD Countries: Lessons Learned." *The World Bank Research Observer* 13(1)79–101.

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Web Sites

Committee of Donors for Small Enterprise Development: www.ilo.org/employment/sedonors. (The site provides access to guidelines on financial intermediaries and business development services for small enterprises.)

The European Database of Business Incubators: europa.eu.int/comm./enterprise/bi. (Site provides access to information on incubators in 28 European countries, case studies, benchmarking information, and a database of nearly 950 business incubators.)

International Labour Organisation's International Training Centre: www.itcilo.it (For courses on enterprise development.)

International Labour Organisation's Small Enterprise Development: www.ilo.org/dyn/empent/empent.portal?p_prog=S.

National Business Incubator Association: www.nbia.org. (This site provides information about the organization's publications on business incubation and about annual conferences. NBIA provides materials and experiences from developing as well as industrial countries.)

Polish Railway Retraining and Re-employment Agency: www.kaaz.pkp.pl/en/kaaz.html. (An exam-

ple of an implementing agency for a labor program.)

PPIAF: www.ppiaf.org. (Site provides access to other PPIAF toolkits, as well as information about PPIAF and how governments and other agencies can access PPIAF resources to accelerate privatization.)

U.S. Agency for International Development microenterprise site: www.usaidmicro.org. (Site includes papers on the use of vouchers in the delivery of small business development services.)

Webcast presentation on the voucher program in Kenya's small business development plan: www.worldbank.org/wbi/B-SPAN/sub_kenya_voucher.htm.

World Bank Social Funds site: www/worldbank.org/socialfunds.

World Bank: www.worldbank.org. (The site's search engine can be used to obtain the Bank's latest operational policies on involuntary resettlement.)

Other Material and Sources

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EMPLOYEE SHARE OWNERSHIP

Employee share ownership can be used as part of the PPI program, as an element of compensation, as an inducement to remain with the operation post-PPI, or as part of an employee buyout. This section outlines those potential roles.

Employee share ownership often has multiple goals, centered around:

- Concepts of redistribution through gain sharing of the wealth generated from the PPI enterprise.
- Reduction of the principal-agent problem (where managers behave in ways that hurt the interests of the firm and its owners). When workers and managers share in the profits of the firm there is likely to be closer alignment among the work force and managers and the owners of the enterprise (the shareholders).
- Reducing opposition to PPI by enlisting support from workers.

In work force restructuring, employee share ownership can be used in three ways:

1. As a form of compensation to displaced workers. Instead of cash, they can receive shares of the enterprise.

2. As part of a new incentive or reward package for workers who remain with the enterprise.
3. As the basis for management employee buyouts or employee buyouts of units of the enterprise.

Compensation Packages for Redundant Workers

As part of a compensation package, share transfers are probably best viewed as a supplement to, rather than a substitute for, severance or early retirement. This is true for three reasons:

1. As a social safety measure, share transfers are problematic because the benefits that workers receive will depend on movements in share prices. Those movements in turn depend on uncertain micro- and macroeconomic factors. Implementing agencies should exercise considerable caution if they wish to promote share ownership as a compensation mechanism; dramatic falls in share prices during 2001 are reminders of share price volatility. Although in the past some workers have done very well from shares, these successes have been in sectors—such as telecommunications—that have recorded very high levels of growth for a period. A strategy that provides a large proportion of workers' post-PPI compensation and safety net in the form of shares is too risky an investment strategy—particularly for older workers. Governments, however, have sometimes offered shares backed by a guarantee to workers.
2. Many developing countries have relatively weak institutional environments for their capital markets (that is, uncertain property rights, limited protection of minority shareholders, poor share registration and depository systems, and weak regulation and oversight). Combine that environment with a work force that has little experience of share ownership, and there are significant risks of governance failure and abuse.
3. If only a limited number of shares are available for allocation to employees, many managers would prefer to see those allocated to the remaining work force as a performance incentive rather than to departing workers.

Shares as an Incentive or Reward

The use of share transfers or discounts as an incentive to workers is a common feature of infrastructure PPI through privatization (see box 5.28). In an analysis of 630 privatizations of infrastructure, energy, and other enterprises, conducted by initial share offer in more than 59 countries, more than 90 percent of the transactions transferred shares to workers. On average 7.6 percent of the shares were sold to employees, often on favorable terms (Jones and others 1999). Data for the individual enterprises is available at http://facultystaff.ou.edu/M/William.L.Megginson-1/.

Some countries have established the concept or principle of employee share transfers in privatization laws. For example, Article 14(4) of Nepal's Privatization Act 1994 states that "His Majesty's Government shall make available to the workers and employees of an establishment which is to be privatized some of its shares free of cost or at a subsidized price." In Malawi the government encourages employees in privatized companies to buy shares in the form of an employee or management buyout. In such cases the privatization commission may offer a discount of 20 percent. In addition employees may be allowed to pay for their shares by deferred payment terms or through a privatization fund managed by the Investment and Development Bank of Malawi, as part of a financing agreement between that bank and the European Investment Bank. (The fund was so popular that the money originally allocated was exhausted within a few months.)

Employee Share Ownership Plans

An employee share ownership plan (ESOP) is a mechanism that enables and facilitates employee ownership in a company. As some of the examples

Box 5.28: Shares as Incentives in Infrastructure Privatization

Thailand power: Privatization of the Ratchaburi Electricity Generating Holding Public Company Ltd. provided for 45 percent of shares retained by Electricity Generating Authority of Thailand (EGAT), 40 percent of shares offered to the public through an initial public offering (IPO), and 15 percent offered to employees through an ESOP. The employees received shares at par value (10 baht/share) compared with the IPO price of 13 baht/share. The aggregate value of the shares offered to the EGAT employees was no greater than three times the monthly wage bill for all EGAT employees (Bhoocha-oom 2001).

Bolivia rail: In the concessioning of Bolivia's rail networks, the ministry decided to use share options as a means to minimize risk and promote share ownership among workers. To access the option, workers had to purchase one share at a preestablished book value share price of US$20. The option contract gave workers the right to buy shares owned by the state or by public shareholders at book value, up to a total of their social benefits (one monthly wage per year of work). The option could be exercised anytime during a period of one or two years after the closing of the transaction with the private operator (it varied among companies as a result of negotiations). However, after the opening of the economic envelopes (financial tenders), the offer for the newly issued shares in the case of the eastern network was only 4.6 percent above book value and for the Andean network it was 54.3 percent below book value. Therefore, most of the workers decided not to exercise their options to buy additional shares (Valdez 2001.

Italy's Enel: The first stage of privatization of Enel Spa, the publicly owned Italian electricity sector operator, took place in November 1999. Approximately one-third of the capital stock of the company was floated on the Milan and New York stock exchanges. The offer was well subscribed and included share requests to 70,302 of the company's employees (85 percent of the total group work force as of June 1999). In addition, the three main sectoral unions had promoted establishment of an association of employee shareholders (European Industrial Relations Observatory On-line [EIROnline]). Available at www.eiro.eurofound.ie/).

Chile airline and power: The second phase of Chile's privatization program included a program that offered low-risk share ownership. As a general rule, workers were offered 5 to 10 percent of the company's shares at a discounted price. To pay for the shares workers were allowed to borrow up to 50 percent of their severance pay, with the company promising to repurchase the shares at retirement at a value at least equal to the forgone severance payments. Therefore, employees could buy shares below market price with no cash outlay, with no risk of loss, and a potential for gain if the shares increased in value. The resulting enthusiasm among workers led, in some cases, to workers becoming the largest single shareholder group via personal borrowings used to expand their stake. This was the case in the privatization of LAN Chile (the airline), Metropolitan Chilectra, and the Steel Company of the Pacific (Gates and Saghir 1995). In privatizing ENDESA, the electricity holding company, broader-based share ownership was encouraged, and the government not only placed 30 percent of the shares on the local stock market for the general public but also reserved shares for the work force.

Mexico telecommunications: To win over employees to the privatization of Telmex, the government offered them eight-year loans on favorable terms from a government bank to enable them to purchase 4.4 percent of its class A shares for a total of US$324 million. The bank held the shares in trust to ensure payment of the loan. The strategy was beneficial for workers: by 1995 employees had gained some US$1 billion in increased share value (Tandon 1995, Wellenius and Stern 1994).

Ireland telecommunications and post: In July 1998, 11,000 employees were given a 14.9 percent stake in Telecom Eirann—Ireland's state-owned telecommunications company, through an ESOP, as part of an agreement that included 2,000 voluntary redundancies and changes to long-established working practices, and that was meant to help prepare the company for its subsequent privatization in 1999. Previous ESOPs in state enterprises (airline and electricity) had been limited to about 5 percent of the shareholding, but the 14.9 percent Telecom Eirann model set a precedent that was adopted for other infrastructure and utility firms, including the postal service, An Post EIROnline. Available at www.eiro.eurofound.ie/.

(*Box continues on the following page.*)

MODULE 5

Employee share ownership can be used as compensation, as an incentive, or as a means for the employees to purchase significant blocks of shares.

Box 5.28 (continued)

Argentina water: The Argentine government built workers' support for the Buenos Aires water concession by pledging to transfer to them 10 percent of shares in the new water company when the dividends paid to the government for these shares covered their book value (US$12 million) (Alcázar, Abdala, and Shirley 2000). Similar programs were adopted in other Argentine enterprises. In the case of Argentina Gas (GdE), however, given the size of GdE relative to the number of total employees, the government decided to give less than 10 percent of the shares; employees were offered 3 to 5 percent because of the large size of the company relative to the number of the employees (Shaikh 1996, p. 4).

Manila water: In the concessioning of MWSS the concession contract required that the concessionaire grant every regular employee an annual stock (share equity) purchase bonus equal to not less than the last basic monthly salary due that year until all of a block of 6 percent of shares set aside for employee share ownership was fully subscribed (Lazaro n.d.; Cruz 2001*)*

Senegal electricity: In 1999 10 percent of the shares were offered for sale to workers.

Kenya Airways: In the 1996 privatization of Kenya Airways, the Dutch airline KLM became the largest single strategic investor with a shareholding of 26 percent, but 3 percent of the airline was also reserved for staff at the float on the Nairobi Stock Exchange.

in box 5.28 illustrate, ESOPs now form part of the structure of privatization programs for infrastructure enterprises in developing countries. ESOPs are usually:

Shares transfers are best seen as an addition to, rather than a substitute for, voluntary departure or early retirement compensation plans.

- Structured as a separate legal entity (often a trust) that purchases shares held on behalf of the employees, with a defined mechanism that describes how shares are distributed.
- Designed to take advantage of national tax laws so that the plans are tax efficient both for employees and for the companies. For example, the ESOP for Kenya Airways privatization was structured as a unit trust for tax reasons (Megginson, privatization database).
- Established by the enterprise, which contributes either new shares of its own equity into the ESOP or cash to buy existing shares.

Establishing a formal ESOP is relatively complex (see box 5.29) and requires independent professional advice. Except in the case of employee or management employee buyouts of infrastructure units, ESOPS normally provide a level of ownership of 5 to 15 percent. Higher levels of ownership often entitle representation on the board, but this may deter investors if they believe that further labor adjustment is essential after PPI is settled.

Shares transfers are not the best mechanism for primary compensation to transferred workers because of the risk implicit in share ownership.

Additional Material (on the CD-ROM)

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Gates, Jeffrey R., and Jamal Saghir. 1995. "Employee Stock Ownership Plans (ESOPS): Objectives, Design Options and International Experience." World Bank CES Discussion Paper Series 112. Washington, D.C.

Ray, Pranabesh. 2001. "HR Issues in Private Participation in Infrastructure: A Case Study of Orissa." PPIAF case study. World Bank, Washington, D.C.

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Web Sites

Capital Ownership Group: www.capitalownership.org/. (This is the site of a think tank on ownership issues funded by the Ford Foundation.)

European Industrial Relations Observatory Online: www.eiro.eurofound.ie/. (This site monitors various

Shares are common incentives in privatization plans.

MODULE 5

Box 5.29: Checklist for Successful ESOPs

If some form of ESOP is to be established, here is a checklist of key issues that the implementing agency should ensure are being followed.

Participation Issues

- All employees should be able to participate, subject to a qualifying length of service such as 12 months.
- There should be no great discrepancy between management's stake and that of the rest of the work force.
- There should be similar voting rights.
- There should be similar dividend rights.
- Use of an employee trust aids flexibility and helps sustain the plan for the longer term.
- Transparency—particularly regarding the first allocation, where it is important that everyone knows broadly who is getting what.
- A "free share" allocation, even quite modest, is usually essential to get everyone in as a shareholder.
- Wages and other benefits (for example, pensions) should not be sacrificed for a share scheme.
- It is usual for employees leaving or retiring to have to sell their shares to the trust.
- The trust will be run by trustees and a balanced make-up of the trustees avoids its being dominated by any one faction—for example, two management representatives, two work force representatives, and one independent trustee agreed on by the other trustees would strike a good balance.

Management Issues

- The engagement of a specialist adviser, familiar with ESOPs, trust law, and taxation, will be essential.
- A participative style of management is adopted to make the best of the plan.
- Communicating with the work force before, during, and after the plan has been implemented is vital to gaining their initial and ongoing support, thereby creating the necessary long-term enthusiasm.
- Plans should be subject to full consultation with the work force.
- There is a need for culture change on both sides (that is, management and the work force), but it should be led by management.
- Employees need to understand the difference between their rights and duties as employees and their more limited rights as shareholders—an important part of the communications process, particularly around the time that the deal is completed.
- In all of the concerns about the work force, it is important to ensure that management has adequate incentives and that these arrangements are transparent. Often, an appropriate share option plan is one that allows employees to acquire additional shares when they achieve agreed targets, both corporate and individual, over, say, a three-year period.
- Management also still has the right to manage.

Structural and Technical Issues

- What is the source of the shares (existing government shares, newly issued shares)?
- What are the eligibility rules (how many shares to offer, when, and at what price)?
- What constitutes compliance with national legislation?
- Wages and conditions of employment should be kept separate from share ownership.
- Employee representatives (including trade unionists) should have access to independent professional advice about the plans.
- It is important to build in features that will promote the sustainability of the plan, such as leavers must sell their shares, use of trust.
- There is nothing wrong in principle with employees being asked to put their own money in—some employees will be more focused on their jobs if they have their own money at risk.
- For distribution of shares it is best to use tax-efficient share plans where available.
- Internal market: some of the work force will want to buy or sell some shares, and this is usually allowed in private companies, on a "matched" basis when the scheme has been running for a while.
- Depending on the size of the stake the employees have, they may be entitled to look at having a representative on the company's main board—as a rule of thumb, a holding in excess of 25 percent?
- If the ESOP is put in place before PPI, should the ESOP offer existing employees the possibility to cash in at the time of privatization or should it be structured as a long-term, performance-related incentive plan for the employees who best respond to the transition to private management? (The answer is probably both, and this will have implications for how the ESOP is eventually put in place.)

aspects of labor relations in Europe, including information on share ownership.)

National Center for Employee Ownership: www.nceo.org

Ohio Employee Ownership Center: http://dept.kent.edu/oeoc/AbouttheOEOC/AboutTheOEOC.htm. (This center, based at a university in the United States, has an international program.)

Rapid Response: http://rru.worldbank.org. (This site is a gateway to a range of information on infrastructure, privatization, and private sector development policies.)

William Megginson. http://faculty-staff.ou.edu/M/William.L.Megginson-1/ (This home page for Professor Megginson has a number of papers on privatization to download, as well as databases giving information on shares offered to employees in initial privatization public offerings, and longitudinal measures of share ownership in privatized enterprises worldwide.)

Other Material and Sources

Binns, David. No date. "Privatization through Employee Ownership: Learned From the International Experience." Available at cog.kent.edu/lib/Binns%20-%20Privatization%20Through%20Employee%20Ownership.htm.

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An ESOP eases employee share ownership. A common model is a trust with well-defined rules on share distribution, transfer, and buyback.

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May, Karen. 1998. "Conversion to Worker-Owned or Cooperative Businesses through Privatization: International Experience and the Case of Puerto Rico." Available at cog.kent.edu/lib/May.htm.