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Labor Redundancies and Privatization

What should governments do?

Sunita Kikeri

When state-owned enterprises preparing for privatization have very high levels of redundant workers and when social safety nets and redundancy provisions in labor laws are inadequate or lacking, the political and social implications of layoffs mean that the government should be involved in the design and funding of special programs to deal with unemployment and labor unrest. This Note reviews the main elements of such programs—severance and retirement benefits, retraining and redeployment support, employee share ownership schemes, and, importantly, mechanisms to ensure labor consultation and participation. (Many of these components are supported in World Bank operations—see box 1.) In many countries these programs need to go hand-in-hand with reforms to expand private labor markets: removing obstacles to job creation, ending restrictions on hiring and firing, and eliminating taxes that raise the cost of labor.

BOX 1 WORLD BANK SUPPORT FOR LABOR ADJUSTMENT IN PRIVATIZATION

Since 1990 the World Bank has supported labor adjustment in privatization and enterprise restructuring in about fifty operations around the world. The main elements of Bank support:

- Technical assistance to governments to help:
  - Develop staff inventories and profiles.
  - Identify staffing needs.
  - Develop severance and retirement packages.
  - Analyze labor market characteristics and needs.
  - Redeploy workers through active labor market programs.
  - Design employee share ownership schemes.
  - Establish consultative mechanisms.
  - Prepare communications programs.
- Direct financing for severance payments in investment operations provided that such financing results in improved productivity of the sector and enterprise and that social mitigation measures are put in place (the first such operation was Brazil Railways, where the Bank project financed half the costs of the severance program).
- Poverty alleviation programs such as social funds to provide compensatory assistance, advice and training, placement services, and credit for self-employment. Such funds are typically targeted to the poor, but they have been used for state enterprise workers in cases of extreme economic distress or where large-scale redundancies occur in concentrated areas (as in the case of mining in Bolivia and Peru).

Selling state-owned enterprises with the labor force intact is not an option for firms and industries that have large numbers of redundant workers or difficult labor relations at the time of privatization.[1] Attempts to do so on the grounds that private investors both are better equipped than the government to judge the level and kind of skills needed and have greater incentives to minimize severance costs and adverse selection (where the best workers are the first to leave) have proved risky. Where union opposition is high, private investors, wary of taking on the political burden of carrying out large-scale layoffs, are reluctant to bid and the process slows down. Moreover, when investors have to absorb large labor liabilities, they discount the sale price accordingly, leading to lower sale revenues and potential public allegations that assets are being sold cheaply. Alternatively, they demand government subsidies to cover the cost of the liabilities, thus subverting one of the original goals of privatization. Leaving large-scale downsizing to new private owners may also create social problems, particularly where weak severance laws and social safety nets reduce protection for workers and where, in the absence of alternative job opportunities, redundant workers take months or even years to get new jobs.

In large, troubled enterprises, therefore, the government has an important role to play in the restructuring process. The extent and nature of its role vary from case to case, however. In Argentina, for example, where surplus staff and strong unions were a major source of inefficiencies, the state-owned steel, railway, and energy firms undertook major employment cuts prior to privatization. The railway company reduced employment by close to 80,000 in three years. Similarly, in Brazil more than 18,000 of the nearly 40,000 railway workers were retired or became redundant before the systems were concessioned. Prior restructuring was undertaken not just to improve the prospects for sale but also to overcome labor opposition and ensure that the social consequences of layoffs were properly addressed. In some cases, though, to minimize the risk of delays and to ensure that the right levels and mix of skills are retained, governments have stayed away from a direct role in restructuring, instead making the policy decision to grant private investors full flexibility to select the workforce from the existing pool according to need, with the government assuming responsibility for dealing with residual workers, or to transfer all staff to the investor but with the flexibility to make adjustments as needed. Such an approach was used in Argentina's Buenos Aires water concession, where the concessionaire took on all 7,400 or so employees and then reduced the workforce through a voluntary retirement program by nearly 50 percent within six months after the start of operations. Severance benefits were financed jointly by the new private company and the government.

Specific approaches to redundancies are bound to vary from one country and enterprise to the next, depending on local circumstances. But redundancy programs typically include four main components.

Severance and retirement benefits

Particularly in countries where the need to placate labor is strong or labor legislation prohibits outright layoffs, governments have provided severance and early retirement incentives to encourage voluntary departures, the most common form of downsizing. The size of the benefits varies considerably between countries and between enterprises within a country, depending on the legal and contractual obligations and the strength of labor unions in negotiations. Payments range from about eighteen months' salary (Brazil railways) to two and sometimes three years' salary (Argentina, Bangladesh).

Severance and retirement incentives buy labor support and allow privatization and its benefits to happen and, in the absence of unemployment insurance systems, mitigate the social impact of layoffs. The financial and economic returns are also high, with short payback periods and increases in the marginal productivity of redundant staff redeployed to productive activities elsewhere in the economy. But if poorly designed, they can become costly and difficult to finance, and thus stall the process. In Pakistan, for example, an agreement with the unions

resulted in a package equivalent to five months' pay for each year of service, while in Ghana and Tanzania the absence of overall guidelines for the government sector resulted in extremely generous severance packages negotiated at the enterprise level that neither the governments nor the firms could afford. If an overly generous package is offered to all workers, there is the added risk of adverse selection; in the rail and steel industries in Argentina, for example, the across-the-board offer led to the loss of key staff, hurting the performance of the newly privatized firms.

To contain the risk of excessive payouts and to minimize adverse selection, the best strategy is to identify the activities and the workers to be separated and to target the severance offer only to workers already identified as redundant (through benchmarking studies, for example) rather than to all employees. Tailoring the severance package to worker characteristics (such as seniority or education) also helps induce the right self-selection and contain costs. A recent World Bank study of forty-one public sector retrenchments shows that moving away from standardized severance packages linked to wage and past years of service to packages more closely linked to the future earnings potential of workers based on such characteristics can reduce costs by 20 percent or more (Rama forthcoming).

Voluntary departure programs, particularly early retirement, can accelerate pension liabilities and aggravate the problems of already strained social security systems, so it is important to synchronize these programs with broader pension reforms. Where enterprise pension funds are insolvent, employees might be discouraged from taking early retirement because of fears that they will not receive regular pension payments. As part of the privatization process, therefore, some countries are looking at the option of creating independent, privately managed pension funds that would be capitalized through contributions from the enterprise, employees, and government (through sale of assets or employee stock option plans, for example) and allow payments to employees taking early retirement.

Retraining and redeployment support

Governments have often combined severance packages with retraining and redeployment support (counseling, job search assistance, small business support) to help laid-off workers reenter the labor market or become self-employed. Systematic evaluations are lacking in developing countries, but anecdotal evidence shows that retraining programs in particular often founder because of timing delays, weak institutional capacity, and low education levels. In Bangladesh, Brazil, and India, for example, the demand for retraining was far lower than expected (with less than a 20 percent take-up rate), and most surplus employees had left their jobs well before the retraining programs became operational. But if properly designed, retraining can have important social and economic benefits by ensuring that workers with several remaining years of productive life are equipped with the right skills to become gainfully employed elsewhere in the economy. Better results can be achieved by ensuring that retraining is demand-driven, not supply-driven (for example, by giving workers a choice between training and severance and building in a cost-sharing element), that it is targeted to those for whom it is most cost-effective, and that nongovernmental and private institutions are involved in the delivery of services.

One way to redeploy redundant workers is to help them set up cooperatives or small businesses to subcontract with the newly privatized company for activities previously carried out by the state entity (for some types of jobs service contracting improves performance incentives). In Guinea, for example, the privatized water management company (Société d'Exploitation des Eaux de Guinée, or SEEG) helped the 250 or so laid-off workers establish cooperatives to provide such services as new connections, canal maintenance, and landscaping. About twenty small enterprises have been formed, all of which subcontract with SEEG. In Argentina the privatized oil company entered into about 200 service contracts involving some 5,300 former employees. But putting this approach into place and ensuring that employees can compete effectively

with other service providers requires the provision of support services, including business incubators, training for business start-up, access to initial working capital, and technical support in preparing bids and contracts. Such support should be temporary to ensure that competition is not crowded out. In regions or towns where a state enterprise dominates the economy, contracting, retraining, and job search assistance are not enough. Broader regional development programs involving self-employment and enterprise development support—as well as temporary public works and subsidized private sector employment programs—are important.

Employee share schemes

To build labor support, many governments have reserved shares (ranging anywhere from 3 to 20 percent) for employees in privatized firms, often at discounted prices and with special financing arrangements. Such programs have produced large financial gains for employees thanks to rapid share appreciation resulting from the investment and management changes implemented by the new owners. In Bolivia, for example, employees in all the major transactions realized capital gains of more than 80 percent in a matter of months. In addition to financial gains, ownership gives employees a direct stake in the performance of the company and so has helped improve labor relations and labor productivity. Financing share ownership schemes is the major concern in developing countries. Chile successfully overcame this concern by allowing workers to use their end-of-service benefits to invest in the share scheme, with the guarantee that the value of the shares would not fall below their entitled benefits at the time of retirement. As a result, in many of the enterprises more than 80 percent of employees participated in the program.

Consultation and participation

Often labor unions and workers are not opposed to the concept of privatization—many recognize that reforms are inevitable and that the time for change has come. But the lack of information on what happens to workers combined with the lack of involvement in the process exacerbates fears and opposition. As a matter of routine, efforts should be made to establish early dialogue with workers and unions to inform them about the goals of privatization, the costs and benefits, the timing and method of privatization, the social safety net being put in place, the regulatory arrangements being developed to protect consumer welfare, and the incentive programs for employees, such as share ownership schemes. Such efforts have been particularly successful when combined with a broader public information campaign to ensure that the general public understands the costs of maintaining inefficient enterprises and the benefits of privatization. Countries with strong and active labor unions, such as Argentina and South Africa, have gone a step further and involved labor in implementation as well. Such a participatory approach may slow the process, but in a highly politicized environment it may be crucial in obtaining labor support and allowing privatization—and the broader economywide gains from privatization—to happen.

This Note is based on Sunita Kikeri, *Privatization and Labor: What Happens to Workers When Governments Divest?* (World Bank Technical Paper 396, Washington, D.C., 1998).

[1] Governments have privatized many state enterprises with the labor force intact. Redundancy problems did not arise either because increasing competition had led the firms to make prior labor adjustments or because private investors expecting new investments and dynamic expansion were willing to take the existing labor force and deal with surpluses through natural attrition and early retirement. Indeed, in a number of cases employment levels increased after privatization. In these cases workers have generally benefited from significantly higher wages (with 40 to 60 percent increases), improved training, and capital gains from share ownership schemes. See Narjess Boubakri and Jean-Claude Cosset, "Privatization in Developing Countries" (Viewpoint 156), Ben A. Petrazzini, "Competition in Telecoms—Implications for Universal Service and Employment" (Viewpoint 96), and William L. Megginson, Robert C. Nash, and Matthias van Randenborgh, "The Privatization Dividend" (Viewpoint 68).

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