ADB

TECHNICAL NOTE

Labor Issues in Public Enterprise Restructuring

Asian Development Bank

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The views expressed in this paper are those of the author and do not necessarily reflect the views and policies of the Asian Development Bank or its Board of Governors or the governments they represent. William Morrison, International Director of the Adam Smith International, conceptualized and wrote this Technical Note. The overall supervision was provided by Antero Vahapassi, former Senior Social Development Specialist of the Gender, Social Development and Civil Society Division, Regional and Sustainable Development Department (RSDD), with the help of his colleagues Sonomi Tanaka and Sri Wening Handayani. Marife Principe and Ma. Victoria Mabugat assisted in the publication. Jay Maclean edited the document while RSDD's Knowledge Management Center proofread its contents and managed its production. This paper also benefited from the valuable comments received from Armin Bauer, Daan Boom, and Axel Weber.

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ABBREVIATIONS

ADB	-	Asian Development Bank
IDA	-	Industrial Disputes Act
ILO	-	International Labour Organization
NCAER	-	National Council for Applied Economic Research
PPI	-	private participation in infrastructure
PSU	-	public sector undertaking
SOE	-	state-owned enterprise
VRS	-	voluntary redundancy scheme

In this publication, “$” refers to US dollars.

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ABSTRACT

This technical note discusses the impacts of public enterprise restructuring on workers, especially in the case of privatization of state-owned enterprises and private participation in infrastructure services (PPI). While it is widely accepted that privatization and PPI bring benefits at the macro level and to consumers, labor reductions in privatized enterprise are a reality. However, international experience has shown that more often these reforms are undertaken without adequate planning and support of parallel reforms to mitigate negative impacts on labor. A labor adjustment program has to be developed and implemented to address issues of redundant or surplus labor as well as take actions to mitigate the negative impacts of the reforms. Often labor adjustment programs are handled as two components: voluntary retirement schemes and social safety net. The note describes steps for developing and managing a labor adjustment program for privatization and PPI. It concludes, however, that labor issues arising from these reforms are complex and challenging and there is no single approach to address these concerns. Moreover, with clear objectives, careful planning, and adequate resources, labor issues resulting from enterprise and infrastructure policy reforms can be handled effectively. The note aims to guide the Asian Development Bank, its consultants, and the partners in its developing member countries in designing and implementing effective labor adjustment programs.

I. INTRODUCTION

1. This technical note has been prepared for staff of the Asian Development Bank (ADB) as a guide to the impacts that enterprise and infrastructure reforms have on labor, and approaches to mitigate those impacts. The note aims to guide ADB staff on the design and management of labor adjustment programs so as to inform their engagement with government, representatives of organized labor, and consultants on this key issue.

2. This note also focuses on reforms to state-owned enterprises and infrastructure firms, notably privatization and private participation in infrastructure (PPI), which are the types of reform that ADB supports.

3. The associated social, economic, and political impacts of these reforms on labor are considered with a view to explaining the need for labor programs to complement and underpin the reforms. International experience has shown that too often enterprise reforms are undertaken without adequate planning for and support of parallel reforms to mitigate the negative impacts on labor. A case study on the practice of voluntary redundancy schemes (VRSs) in India is included (Annex).

4. The note provides guidance for ADB staff on approaches to the design and implementation of effective labor programs in general and labor adjustment in particular, and links them to the four main phases of ADB's operational cycle. Additional information can be found in two key publications:

- ADB. 2006a. *Labor Issues in Enterprise Restructuring and Infrastructure Reform*. Manila.
- World Bank. 2003. *Labor Issues in Infrastructure Reform - A Toolkit*. Washington, DC.[1]

5. The following important background reading on labor adjustment can be downloaded from the World Bank website:[2]

- *Toolkit: Labor Issues in Infrastructure Reform* (Adam Smith International)
- *Privatization and Labor: What Happens to Workers When Governments Divest?* by Sunita Kikeri (1998)
- *Public Sector Downsizing: An Introduction*, by Martin Rama (1999)
- *An Overview of Labor Markets World-Wide: Key Trends and Major Policy Issues*, by Gordon Betcherman (2002)
- *Mitigating the Social Impact of Privatization and Enterprise Restructuring*, by David Fretwell (2002)

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1 Available: http://rru.worldbank.org/Themes/Privatization/.
2 Available: http://rru.worldbank.org/Discussions/Topics/Topic38.aspx.

II. WHY LABOR IS AN ISSUE: CONTEXTUAL ISSUES

6. The starting point for this note is to provide an insight into why labor is so often an issue that donors and their counterparts in government have to consider when designing programs for restructuring, especially programs of privatization or PPI.

A. Privatization and PPI

7. Privatization has been a worldwide trend since the 1980s. In the first wave, privatization focused largely on industrial and financial firms, especially in competitive sectors.

8. Infrastructure privatization followed in the second wave from the late 1980s and peaked in the late 1990s. There has been a recent slowdown in infrastructure privatization, coupled with some high-profile project cancellations.

9. The third wave, in social sectors and some formerly core government administrative services, started a few years ago and is still underway.

10. Through privatization and associated reforms, governments seek to become more efficient in running enterprises, both in terms of cost and quality of services. They achieve this by allocating risk better and absorbing untapped sources of private capital, technology, and know-how.

11. Privatization covers a wide range of approaches—from asset sales to initial public offerings—and requires technical expertise to determine and implement the method most suited to the particular transaction. Successful privatization programs require strong political leadership, clear policies with robust institutions, decision-making frameworks to give legal authority to those responsible for program implementation, and delegation to appropriate levels of government.

B. Privatization/PPI and Labor

12. Privatization and PPI take place in a changing global context that affects all businesses and national economies. While most countries and stakeholders—although by no means all—accept that privatization and PPI bring benefits at the macro level and to consumers, widespread concern regarding the impact of these reforms on workers, their families, and the communities in which they live remains.

13. As a result, public service workers and their unions often distrust PPI and privatization, fearing that it will have negative effects on employment numbers, pay, terms and conditions, and relationships with management. Set against a background in which many state-owned enterprises (SOEs) have provided their staff with employment security, and terms and conditions much better than those enjoyed by equivalent workers in the private sector, such anxieties are understandable. Moreover, a range of documented examples show that some of these fears are well grounded.

14. Labor reductions in privatized enterprise are a reality. Workers and unions have, therefore, generally opposed privatization, making a concession, contracting, and other forms of PPI. And it is not only union leaders who believe that privatization has had a negative impact on labor and, more broadly, on income and wealth distribution. According to a recent study, such

beliefs are growing and becoming more widespread (see Inter-American Development Bank 2002 and Box 1).

15. As a general rule, people tend to remember the short-term human cost of reforms without necessarily seeing or understanding the medium-term gains of the reforms in the more abstract terms of improved productivity or competitiveness. This can be a significant barrier to reform.

16. The evidence often supports this perception and ADB and other donors are increasingly mindful of this situation, although much depends on the initial condition of the enterprises. In some cases, workers have gained from privatization because new investments and dynamic expansion have resulted in new job creation at the enterprise or sectoral level, and because productivity improvements have led to better terms and conditions of service. Moreover, workers are also consumers and their households benefit from improvements in access and services.

Box 1: Popular Perceptions of Private Participation in Infrastructure and Enterprise Reform

At the heart of much of the criticism is a perception that privatization has been unfair—hurting the poor, the disenfranchised, and in some cases beleaguered workers, and benefiting the already rich, powerful, and privileged. Privatization is seen as throwing large numbers of people out of work or forcing them to accept jobs with lower pay, less security, and fewer benefits; as raising the prices of goods and services sold; as providing opportunities to enrich the agile and corrupt; and generally making the rich richer and the poor poorer.

The complaint is that even if privatization contributes to improved efficiency and financial performance (and some contest this as well), it has a negative effect on the distribution of wealth, income, and political power.

The negative perception is widespread and growing: 63% of people surveyed in 2001 in 17 countries of Latin America disagreed or strongly disagreed with the statement, "The privatization of state companies has been beneficial...." The extent of disagreement was much greater than in 2000 (57%) or 1998 (43%). Over 60% of Sri Lankans interviewed in 2000 opposed privatization of the country's remaining state-owned firms. It would not be hard to find other expressions of popular dissatisfaction with privatization, of a similar magnitude, from the transition countries in general and Russia in particular.

Source: Birdsall and Nellis 2002, p. 2.

17. It is important to note that PPI and privatization are not necessarily the only cause of increased poverty and other adverse effects on labor. Any counterfactual assessment of the impact of PPI/privatization on labor must take account of levels of labor adjustment that would have taken place anyway, perhaps as a result of new technology or structural change in the economy through a shift to services.

18. The impact that new technologies have had on labor-intensive industries is a case in point. The impact of industrialization of the British textile industry on Indian weavers and textile workers is a famous historical example. Recent examples can be found in many sectors; the example of ports is instructive (Box 2).

19. Overall, the impact of PPI/privatization on labor is more varied and nuanced than the stereotypes suggested. But it is critical that ADB staff, when considering support to a privatization or PPI program, recognize from the outset that workers and their representatives

have real concerns about PPI/privatization. These concerns are well founded and most of the general public in most countries will be sympathetic toward them. If these concerns are not addressed, they can and do lead to the delay of much-needed reforms and can have deep political consequences.

Box 2: Technology Drives Down Employment in Ports

In a review of the impacts of technology on ocean shipping, Talley (1999) reported that the increased use of containers, coupled with new cargo-handling techniques and work practices, led to a significant decrease in demand for port labor. Huge job losses resulted, ranging from 40% to 60% in many countries. In the United Kingdom, dock jobs fell from 80,000 in 1967 to 11,400 in 1986 and by another 44% between 1989 and 1992. In France, work rule reforms introduced in 1992 led to employment declines of 66% at six major ports. In Australia, waterfront reforms introduced in 1989 led to a 40% reduction in stevedore labor over a 2-year period.

20. Whatever types of reforms are adopted, experience shows that PPI and broader privatization programs can proceed smoothly if efforts are made to deal with labor issues early in the reform process. Early attention is needed to

- assure workers that measures are being taken to compensate them for losses and to mitigate the social impact of adjustment;
- ensure fairness and transparency in the treatment of workers and, thus, help build wider support for the process;
- clarify labor liabilities and approaches to attract private investors; and
- facilitate reforms and improve enterprise performance, including better and more reliable services, less fiscal drain, investment in new infrastructure, and faster economic growth.

21. The International Labour Organization (ILO) has approved a series of conventions and recommendations and other tools that provide guidance for policy makers and protection for workers in the case of enterprise restructuring. These are designed to prevent or minimize the negative impacts of economic and labor market changes on workers and their families. Many countries have ratified the conventions, which can help provide the starting point for negotiations.

C. Needs of Labor Restructuring

22. Often protected from competition and subsidized by their public sector owners, SOEs frequently employ more people than required for efficiency, pay wages, and benefits that are higher than their counterparts in the private sector, and have large, unfunded pension liabilities. These factors have led to lower labor productivity and higher labor costs than private investors can accept.

1. Overstaffing

23. Historically, many infrastructure and other state-owned companies have employed more workers than they needed to deliver services efficiently and effectively. This was because the public sector often was seen as a vehicle for creating jobs in the absence of a private sector, partly for reasons of patronage and partly for meeting developmental or social objectives.

Subject to weak performance incentives and to "soft" budget constraints, public sector managers often were also able to avoid dealing with the difficult restructuring and adjustment issues that private sector managers most likely would have been forced to tackle.

24. As a result, many infrastructure firms have excess manpower. For example, many African water utilities employ more than 10 employees per 1,000 connections, compared with typically 2.5–5 employees per 1,000 elsewhere in the world (World Bank 2001a). Loss-making long-haul carrier Air India had a staff-to-aircraft ratio of 663 in 2000, compared with ratios of 170–340 in various Southeast Asian carriers: Singapore Airlines, Thai Airways, Malaysian Airlines, and Cathay Pacific (India, Disinvestment Commission). In the 1960s, Brazil's federal railways had a staff strength of 160,000, which came down to 42,000 before the privatization transaction began and was further reduced after privatization. In Argentina, the corresponding staff decrease for the railways was from 92,000 to 18,600.

2. Labor Contracts and the Public Sector Wage Premium

25. The nature of the labor contracts that have governed the relationship between workers, enterprise, and state are also often in need of reform or modification. Labor contracts create acceptable terms and conditions of employment, including the health, safety, or social well-being of the workforce, and may have been negotiated many years previously. Some labor contracts and practices, however, may cause an enterprise to operate in less productive ways or at a higher cost than is required. For instance, public sector employees are often paid better than their private sector counterparts, particularly at the lower skill levels, and often receive tangible and intangible benefits—such as job security, seniority rights, special pension arrangements, subsidized housing, and health and educational services—that private firms do not provide. (Assaad 1997; Panizza 1998). All these factors have led to a public sector wage premium in many countries (Box 3).

Box 3: Evidence of a Public Sector Wage Premium

No doubt some groups of public employees are underpaid. The fact that governments have to offer very generous terms to persuade workers to leave voluntarily, however, suggests that the workers place high value on continued public employment. Even though salaries themselves may be low, the overall employment package of benefits as well as terms and conditions may be attractive to workers—and better than they might expect from the private sector. Several country studies have revealed evidence of a public sector wage premium. Some examples follow.

- Assaad (1997) found a public sector wage premium in Egypt, particularly for public enterprise workers, who earned on average 20–28% more than other government workers. The wage premium, plus nonwage benefits equivalent to approximately 85% of wages, explained the attractiveness of public sector employment and the long lists of applicants for jobs in the civil service and state enterprises.
- Bales and Rama (2002) concluded that state enterprise workers in Viet Nam were overpaid by about 20% relative to comparable private sector workers. (Their findings were based on measurable earnings and benefits alone, and took no account of better job security, more generous pensions, more flexibility in work, or lowered effort levels.)
- Analysis by Bhorat and Liou (2002) in South Africa indicated that wages of state-enterprise workers were about 21% higher than those of comparable private sector workers.

26. As industries and technology change and as firms are exposed to increased competition, change often becomes necessary and greater flexibility in working practices may be needed. These changes may involve market-based and merit-based remuneration systems, greater flexibility in the use and allocation of labor, and more flexible hiring and firing practices. Usually both employers and employees recognize that changes will be inevitable and so negotiation and revision are important aspects of labor contracts. The process of gaining agreement on change may, however, be a challenge.

3. Pension Liabilities

27. Large pension liabilities can threaten the viability of a PPI transaction or privatization program. Many infrastructure enterprises have large accumulated pension liabilities that have been promised to and earned by current workers under different pension arrangements. Many pension programs are operated on a largely unfunded or "pay-as-you-go" 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. As a result, many firms have a large liability for future benefits that are not accounted for and for which funds have not been set aside.

28. Unfunded pension liabilities and other pension issues can present a significant challenge for infrastructure privatization in particular. Such liabilities, which are legally enforceable obligations, can be substantial and their settlement can become a major issue during PPI/privatization because investors may be reluctant to take over an entity until those liabilities are resolved.

D. Labor Impacts of Privatization and PPI

29. Evidence shows that diverse labor impacts arise from PPI and privatization. More job losses have occurred in infrastructure enterprises than those resulting from privatization in general, and workforce reductions of 50% or more are common.

30. The greatest impact has been in those sectors where demand is declining because of competition from other modes (e.g., railways), and in sectors with long traditions of overstaffing (e.g., ports).

31. Job losses have been significantly lower and, in some cases, negligible in sectors where demand is rising (for example, telecommunications) or where there is demand for expansion of the network (e.g., water and sanitation).

32. In sum, the evidence shows a wide range of experiences with respect to PPI’s and privatization’s impact on labor, depending on the initial conditions at the country and enterprise levels. PPI/privatization can bring benefits to workers through retained jobs, higher pay, and new job creation as a result of new investments and dynamic expansion. But large employment losses can and do occur, particularly as infrastructure sectors and enterprises are reformed, regardless of whether PPI is involved.

III. DEVELOPING LABOR PROGRAMS FOR PRIVATIZATION AND PPI

33. A labor adjustment program is a series of activities and interventions—usually by government—that seeks first to address issues of redundant or surplus labor by downsizing and adjustment and then to take actions to mitigate the negative impacts of those activities and interventions (Box 4). Often labor programs are handled as two components: voluntary retirement schemes and social safety net programs.

Box 4: Characteristics of a Labor Adjustment Program

- Government-led program to help mitigate the negative consequences of enterprise reforms
- Can be linked to
  - privatization of state-owned enterprises,
  - sector-wide adjustment (public and private enterprises), or
  - infrastructure reform/private participation in infrastructure.
- Several components:
  - voluntary retirement scheme—the costliest part, including severance and pension payments;
  - worker pre- and post-restructuring counseling;
  - training/retraining/development of livelihood skills; and
  - other benefits.

A. Managing a State-owned Enterprise (SOE) Program

34. Before starting a restructuring program, the applicability of relevant ILO conventions should be known. ILO conventions that are applicable in the case of enterprise restructuring include conventions 158, 119, 166, 67, 102 on income security and minimum standards of social security.[3] In addition, a number of ILO recommendations, including human resources development, are relevant and should be reviewed to benefit from them.[4]

35. The starting point for restructuring is preparing a plan for managing the SOE program. Box 5 summarizes the plan for a restructuring program from the State of Kerala (India). What is important in the example in Box 5 is political commitment, capacity building of restructuring agencies, proper situation analyses, consensus building among stakeholders, and transparency.

36. After the preparatory planning work, the labor program can proceed in five steps:

- ensuring that objectives are clear and communicated,
- assessing the size and scope of the labor restructuring,
- developing strategies/options for labor restructuring,
- setting up the key components of a labor program, and
- managing the restructuring process.

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[3] More details on these conventions may be found on the ILO website: (www.ilo.org/ilolex/english/convdisp1.htm) or directly contacting the departments in charge.

[4] Further information is available at www.ilo.org/ilolex/english/recdisp1.htm.

Box 5: Plan for Managing a State-owned Enterprise Program (Critical Path) in Kerala, India[a]

- Policy statement and commitment from the Government on the strategic objectives of public enterprise reforms and their contribution as a means to national development.
- Establishment of enterprise reform agency (in Kerala, the Enterprises Reforms Committee and Restructuring and Internal Audit Board).
- Review of the enabling environment: market conditions and legal, institutional, and policy-making capacities.
- Assessment of private sector, institutional, and economic capacity for strengthening.
- Liaison for building consensus among all parties and stakeholders (such as management, trade unions, and chambers of commerce).
- Finalization of a comprehensive reform strategy and capacity building for implementation.
- A mid-stage review of the whole process and coordination with relevant ministries, government, private sector agencies, and donors.
- Preparation for public information campaign.
- Preparation of enterprise-level restructuring plans and Government decision.
- Implementation of decisions for each enterprise for the following alternatives:
  a. continuation under state ownership;
  b. immediate divestiture "as-is," e.g., privatization;
  c. restructuring as state-private joint venture, e.g., as public-private partnership intervention;
  d. restructuring (labor rationalization and one-time settlement of liabilities) and then divestiture or staff buyouts; or
  e. gradual, phasing out/closure of nonviable units with social safety net program for employees.

[a] Adopted from Gillibrand, M., and K. Padmakumar. 2005. Bridging the Gap Between Policies and Outcomes. *The Resurgence*, Inaugural Issue April–June. Government of Kerala.

B. Step One: Ensuring Objectives are Clear and Communicated

37. Workforce reduction is rarely an objective in and of itself. Rather, the objectives of labor restructuring are better defined in terms of the developmental, economic, and social goals sought from PPI or from enterprise reforms more broadly.

38. Objectives may be short term and urgent (for example, reducing operating costs), medium term (improved services to consumers and business), or long term (improved competitiveness in the sector).

39. In cases where stakeholder opposition is high, communicating these objectives is particularly important. If the objectives are not credible, or are vague, or poorly articulated, the Government will have more difficulty securing the support and resources needed for labor adjustment.

40. It would be expected—where ADB support is being provided—that ADB expertise can and should be deployed in ensuring that the objectives of the reform are clearly and logically articulated by government. ADB should offer this support as early as possible in the operational cycle, drawing on the economic, communications, and sector expertise of ADB staff and

consultants. Such support will make it easier to make the case for labor adjustment further down the line.

C. Step Two: Assessing the Size and Scope of Labor Restructuring

41. Whether the focus of the reforms is a whole state enterprise sector or an individual infrastructure enterprise, the second step by government and a supporting donor, such as ADB, is to estimate the extent of labor restructuring needed.

42. A systematic assessment of the workforce enables the Government and its implementing agency to

- determine the scope and nature of labor needs and likely costs,
- enter into more informed negotiations and discussions with trade unions and labor representatives,
- reduce the risk of service disruption or operational difficulties through the loss of skilled workers,
- improve targeting in any labor restructuring program, and
- ensure fairness and transparency of the process.

43. The principal objective of a staffing assessment is to determine existing levels and types of staff and compare those with what are needed. To that end, the assessment should address the following questions:

- How many staff are there in the sector/enterprise, and how does that compare with required numbers based on efficiency criteria?
- How can surplus staff be identified, and where are they located in the enterprise/sector?
- Are there any particular skills or categories of workers that are scarce?
- Will future market or operational changes place some skills in more demand than others?
- Are there particular categories of staff or key individuals who must be retained—perhaps because their experiences are critical to the continued operation of the enterprise?
- Is there an early understanding of the likely extent of labor restructuring?

44. The government and its implementing agencies can use the following tools to address the above questions:

- staff audits or personnel inventories,
- benchmarking (Box 6), and
- workforce analysis.

Box 6: ADB and Benchmarking

The Asian Development Bank (ADB) has financed two issues of the *Water Utilities Data Book*, which provide valuable materials on the Asia and Pacific region and have provided support for benchmarking in particular areas, e.g., the Pacific Water Benchmarking Study (Delana 2002).

Benchmarking, in combination with staff audits and workforce analysis, can guide decisions on levels of redundancy, avoidance of adverse selection and other aspects of the labor adjustment strategy. Critically they provide hard data on which government can base—and if necessary defend—decisions.

Before the government of an ADB-partner country finalizes the scope and nature of its PPI/privatization program, ADB should advocate or provide technical assistance to assist the government understand the likely size and scope of labor restructuring.[a]

[a] Draft terms of reference for consultants to undertake a staff scoping study that covers aspects of staff audit, benchmarking, and workforce analysis prepared by Adam Smith International can be downloaded from module three of the labor tool kit: http://rru.worldbank.org/Toolkits/Labor/.

D. Step Three: Developing Strategies/Options for Labor Restructuring

45. Once the overall objectives of the reforms in question have been clarified and data on the overall scope of likely labor restructuring exist, it is time to turn to the specific options and strategies of the labor restructuring associated with the reforms.

46. The key strategic questions in considering available restructuring options are:

- Who should undertake labor restructuring, government or investors?
- What options are available for dealing with restructuring?

47. The primary strategic decision is whether labor restructuring should be carried out by the government prior to PPI, or whether such restructuring should be left to the private sector after the PPI transaction is completed. There is no single best approach and countries have followed different paths, depending on the timetable and urgency of PPI/privatization, the nature of the labor issues at the enterprise level, and the existing legal framework. There are three options:

- leaving restructuring entirely to the private sector,
- leaving restructuring entirely to the government, or
- adopting a mixed approach.

1. Leaving Restructuring Entirely to the Private Sector

48. The option of leaving labor restructuring entirely to the private sector is based on the ground that private investors are generally in a better position to judge the level of employment and kind of skills needed. This option can work for companies in which earlier labor adjustments have largely tackled any problems of overstaffing. In these circumstances, to transfer responsibility for restructuring to the private sector is possible.

49. But, particularly in the case of infrastructure enterprises with high levels of overstaffing and difficult labor relations, leaving restructuring entirely to private investors may not be a viable

option. Leaving large-scale restructuring to the new private investors may also create social problems, especially where weak severance laws and social safety nets reduce welfare protection for workers.

50. ADB staff should highlight the political and social risks of leaving restructuring to the private sector.

2. Restructuring by the Government

51. For the above reasons, labor restructuring in large, troubled infrastructure enterprises or across whole state-owned sectors is often seen as a government responsibility, on the grounds that government involvement is needed to

- resolve potential labor conflicts and minimize the burden of politically sensitive restructuring measures on private buyers;
- ensure that the social consequences of labor force reductions are properly addressed, particularly in ensuring payment of severance obligations and development of other social safety measures; and
- increase the attractiveness of the enterprise and, thus, the feasibility of PPI/privatization. Government-led downsizing is also one of the few prior restructuring activities that are likely to improve the price that investors will pay for state-owned assets.[5]

52. Government-led labor restructuring has its own risks and disadvantages, however, particularly in terms of cost and adverse selection. Governments can be more generous than the private sector in setting compensation payments, leading to overpayment and issues of cost and sustainability of severance payments. Moreover, poor targeting techniques can lead to the loss of the better, most skilled, and most valuable workers during the course of labor restructuring. In the worst cases, workers who took the packages have been rehired, which has created incentives for the best and most skilled workers to accept severance (knowing that they can be employed or rehired easily) and led to the inefficient use of scarce public funds.

3. Mixed Approach to Labor Restructuring

53. To minimize the risks of overpayment and adverse selection, some governments have stayed away from a direct role in restructuring and have adopted a mixed approach. In some cases, they have made the policy decision to grant private investors full flexibility to select the workforce from the existing pool of workers according to need, while the government assumes responsibility for developing the labor program beforehand and for dealing with residual workers.[6]

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5 The strategy of leaving restructuring to the government has been adopted in a number of cases. In Argentina, for example, where surplus staff and strong unions were major sources of inefficiencies, the railway and energy enterprises undertook major employment cuts prior to private participation in infrastructure. The railway company reduced employment by close to 80,000 over several 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.

6 Such an approach was used in Argentina's gas company, where employee restructuring was left to the new private investors, who were allowed to select employees; the Government provided incentives and a social safety net for displaced workers.

4. Options for Dealing with Restructuring

54. There are several options for dealing with large-scale labor restructuring. The options can be divided into three broad groups:

- **"Soft" options**. These options do not introduce elements of incentive or compulsion but rely on the application and enforcement of existing workplace regulations. They include hiring freezes, payroll management, and the transfer of staff to other government departments.
- **Restructuring the Workplace.** Options in this group generally fall short of voluntary or involuntary departure and include such measures as administrative leave, job sharing, part-time work, and, in some cases, the shedding of noncore businesses.
- **Retirement and Redundancy**. These steps can involve
  - voluntary departure options that provide incentives for people to leave, either through an early retirement program or the provision of generous severance packages. Acceptance of these options is not forced (although in cases where worker's future prospects are very poor, workers may feel that they have little choice); or
  - compulsory redundancy options, where workers are required to leave employment without their consent.

55. Figure 1 illustrates the full range of choices available to government in workforce restructuring.

56. Factors that influence the choice of options include the extent and level of labor surplus, existing labor legislation, and the role of unions. Moreover, these restructuring options are not mutually exclusive; in practice, they can be used in sequence or combined with one another.

57. Soft options and workplace restructuring are generally most appropriate for a managed process of workforce restructuring and downsizing, or in special circumstances, such as transition economies where rapid, large-scale downsizing is not politically or socially feasible. In general, these approaches may work in the adjustment period prior to PPI or privatization, but in heavily overstaffed enterprises in urgent need of reform, such measures alone are not likely to be sufficient.

58. Where high levels of surplus labor and reforms are urgent, more drastic measures have been required. The most commonly used options in this regard are early retirement and voluntary departure programs. Particularly in countries with strong labor unions and weak social safety nets, as well as those where labor legislation prohibits outright layoffs, governments have resorted to voluntary departure programs by providing severance pay packages that have generally exceeded legally mandated requirements. The size of the payments has varied widely among countries and among enterprises, depending on legal and contractual obligations and the strength of labor unions.[7]

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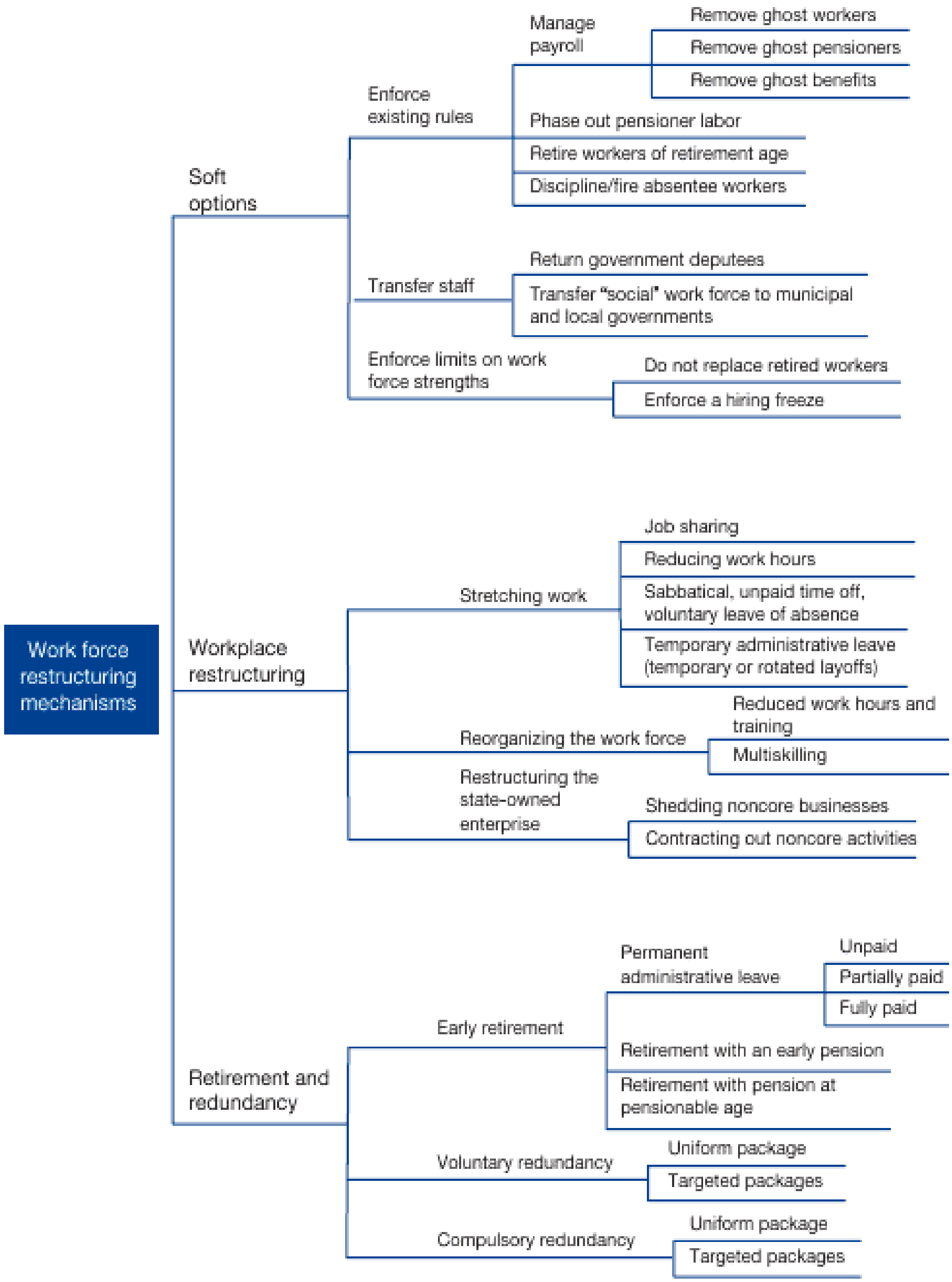
[7] A detailed case study on voluntary redundancy programs in India is presented in Annex.

Figure 1: Mechanisms for Labor Restructuring



59. The choice of strategies and options open to the implementing agency is often constrained by existing legislation. An early task, and one that ADB is well placed to support or facilitate, is to review the legal framework for dealing with labor issues to determine the available options.

60. In summary, the choice of approaches to use depends on the circumstances at the enterprise and country levels, in particular:

- amount of accumulated surplus labor,
- legal framework,
- nature of labor relations, and
- presence of established procedures and practices for handling restructuring.

E. Step Four: Setting Up the Key Components of a Labor Program

61. If the government and its implementing agencies will be required to look at workforce restructuring approaches that include redundancy—whether forced or voluntary—a labor program to minimize any adverse affects of redundancy will be needed.

62. Such labor programs typically have four main components: (i) severance payments, (ii) pension payments, (iii) retraining and redeployment support, and (iv) employee share ownership plans. In India, these labor programs are often characterized as being of two parts: a VRS, which is the pay-off that workers receive for leaving their employment; and a social safety net program to assist displaced workers to return to employment.

1. Severance Payments

63. In the absence of unemployment insurance and other social security arrangements in many of ADB's developing member countries, severance packages are typically the primary source of income support during the transition period to alternative employment. As such, they are a central element in any labor program.

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

- Statutory end-of-service payments, the levels of which are usually set out in legislation. Statutory payments can include notice period or payments in lieu thereof; termination benefits; gratuity or pension benefits; earned leave; and payment of salary or wage arrears.
- Compensation for enterprise-level benefits, which are payments to retrenched workers for benefits as set out in the rules for each enterprise or as part of a formal collective bargaining agreement. These benefits can include housing, medical, education, and other welfare services; access to loans, perhaps at preferential rates; and subsidized or free food, equipment (e.g., telephones), or services (such as electricity supply).
- Ex gratia severance payments beyond statutory requirements, which are usually key elements of voluntary departure programs.

65. A severance package has a number of elements.[8] Each may be determined by different legislation, regulations, rules, or agreements. The design and implementation of severance payments are among the more challenging areas of labor restructuring. Four main issues typically arise: setting severance levels, developing targeting and selection mechanisms, choosing between a uniform approach and a case-by-case approach, and financing severance packages.

a. Severance Levels

66. For the reasons outlined above, many governments have resorted to voluntary departure programs by providing severance payments that exceed legally mandated requirements. The size of the payments has varied widely among countries and enterprises, depending on legal and contractual obligations, the negotiating strength of labor unions, and precedents.

67. In some cases, there may be an established severance arrangement; in others, the existing scheme may not be considered sufficient or there simply is none, and a new scheme may be needed. Usually, severance plans are based on a multiple of years of service and salary, taking into account legal or contractual obligations and, in some cases, prior experiences or precedents in the state enterprise sector more broadly. Such formulas are easy for managers to use and are widespread in both the public and private sectors. International experience has shown that severance formulas have generally ranged from 1 to 3 months of salary per year of service, with a typical average payment of 1.5 months per year of service.

68. In developing a severance scheme, the main challenge lies in devising severance payments that are both attractive for workers and financially affordable and sustainable. Severance has to be attractive enough for workers to leave voluntarily. At the same time, governments cannot afford to overpay because overpayment leads to problems of cost and financing and to problems of adverse selection. The advantages and disadvantages are summarized in Box 7.

Box 7: Standard Severance Formulas: Advantages and Disadvantages

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 easily imported; thus, managers in a hurry may simply copy formulas from another country or enterprise. • Can substitute for analysis of actual needs.

69. In practice, overpayment has often occurred because generous payments are seen to be politically and socially attractive. In Pakistan, for example, an agreement with the unions resulted in a package equivalent to 5 months' pay for each year of service, which neither the government nor the firms could afford to pay and which subsequently led to delays in implementation. If an overly generous package is offered to all workers, there is the added risk

8 For a detailed recent case study on issues relating to a severance package in Nepal, see the report at: www.nepalnews.com.np/contents/englishmonthly/businessage/2003/dec/cover.htm.

of adverse selection. In the rail sector in Argentina, for example, the across-the-board offer led to the loss of key staff, which hurt the performance of the newly privatized firm.[9]

70. The loss-based severance method is more a complement to an existing method than a purely alternative severance method. Its advantages are that it serves as a benchmark to assess possible overpayment, helps induce the right self-selection, and helps contain costs. The approach[10] aims to

- identify the factors that contribute to earnings loss after retrenchment. In several studies, women's earning losses have been greater than those of men;
- use estimations of earnings functions, based on data from national household statistics, and compare workers' existing incomes with alternative private sector income sources; and
- create a specific formula to calculate the welfare losses that then can be used to determine the compensation each worker will receive.

b. Targeting and Selection

71. Another way to avoid adverse selection, reduce the risk of rehiring, and contain costs is to identify the work activities and subsequently the workforce cadres to be separated, and then to target the severance offer only to workers whose jobs have been identified as redundant (for example, through benchmarking studies or functional analysis), rather than to offer severance to all employees.

72. Other ways to improve targeting and selection include

- giving managers the right to refuse an application for voluntary departure;
- using objective and independent methods of employee selection (standardized service records, assessment committees with independent members);
- obtaining contractual commitments by workers to retire from public service as part of their exit arrangements;
- instituting penalties for the public enterprise in the event of rehiring;
- strengthening human resource management systems to enable better monitoring of staff recruitment and to avoid the rehiring of workers who were prior beneficiaries of voluntary departure or early retirement programs; and
- considering rehiring as an indicator of program failure and poor design.

c. Uniform or Case-by-case Approach?

73. Where ADB is engaging with government about starting a program of workforce restructuring across a number of infrastructure enterprises or organizations, a critical decision arises. Should ADB advise government to adopt a single uniform approach to compensation

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[9] There is considerable evidence from an evaluation of downsizing programs that adverse selection can result in the rehiring of workers who have received compensation payments, which leads to problems of moral hazard and inefficient use of scarce public funds (e.g., Haltiwanger and Singh 1999).

[10] The approach has been piloted in Guinea-Bissau, Madagascar, and Tanzania, and is described in Chong and Rama (2000). The data requirements and methodological issues are covered in detail in Module 5 of the World Bank's *Labour Issues in Infrastructure Toolkit*: http://rru.worldbank.org/Toolkits/Labor/.

that will apply to all enterprises, or should severance packages be negotiated on a case-by-case basis?

74. A uniform approach may be preferable where there are strong trade unions and where a series of case-by-case negotiations can result in very high costs to government. Such an approach would avoid a situation where each new award raises the minimum severance level for the next negotiations and creates a ratchet effect that leads to increasingly higher severance levels that eventually become unsustainable.

d. Financing Severance

75. Work on securing financial commitments must start early and ADB staff should look to engage with the government on funding schemes from the six sources of funds for severance programs.

- **The Government Budget.** Government revenues can be used to finance restructuring programs, although these may be insufficient when countries are faced with large-scale severance programs.
- **Disposal of Assets.** An enterprise that has acquired non-related assets over the years can dispose of them through asset sales or privatization, and the revenues generated from the sales can be allocated to meeting the costs of downsizing. Problems can arise, however, if:
  - government rules prevent disposal receipts from being retained by the enterprise, requiring instead that they be allocated to the general treasury account. This is normally the case where the enterprise is a departmental (civil service) organization, but there may be more autonomy where the enterprise is a public corporation or a company;
  - the assets are illiquid or difficult to sell, or the market for assets is (temporarily) depressed. This will lead to a timing delay in sales, or reduced proceeds if the implementing agency implements a "fire-sale" of assets at cheap prices; or
  - there are legal issues, such as a prior charge on the assets by creditors or uncertainty of title.
- **Privatization Revenues.** Some countries have sequenced the sale of valuable enterprises first to build up adequate funds from initial proceeds to finance the labor adjustment and other costs of more difficult transactions.
- **Bonds, Loans, and Grants.** Governments can issue government bonds, and some profitable enterprises may take commercial loans to finance the costs of workforce restructuring. Many governments, however, look to loans or grants from multilateral institutions and bilateral donors as potential sources of funds.

2. Pension Arrangements

76. Some of the more complex issues in PPI and privatization arise from the way pension arrangements are addressed. A poorly conceived pension strategy can make an otherwise viable transaction effort untenable. The cost of past obligations or future commitments of an existing pension scheme is commonly among the more significant considerations in determining potential investors' willingness to participate in a privatization program or PPI initiative.

77. Many workers in SOEs are eligible for pensions. Public sector employees often benefit from generous pension schemes that may far exceed those available to private sector workers,

especially in developing and transition economies where pensions of any type are often unavailable to the majority of the workforce. The value of pension benefits can be the largest single component of the compensation package for many workers and the only form of "savings" accessible to them. The current and future costs of sustaining these arrangements, however, are often so great that the way in which they are structured and financed becomes a key factor in whether an enterprise is financially viable over the long term.

78. Pensions also represent a potentially powerful tool for restructuring labor. They may be an effective means to lower labor costs through early retirement or voluntary separation and a powerful incentive to attract and retain highly skilled or essential workers.

79. The implementing agency and supporting donor must address three closely related but distinct matters in dealing with pension issues in PPI:

- Measuring and resolving existing pension commitments that have accrued to date in a manner perceived to be reasonable, fair, and financially viable.
- Using pensions in the process of labor restructuring through limited windows for early retirement or voluntary departure.
- Restructuring pension arrangements in a way that makes them consistent with the future requirements and financial sustainability of the enterprise.

80. Each of those issues is complex and their resolution depends on the specific type of pension scheme in place. The issues must also be addressed in ways that satisfy the differing interests of employees, the prospective investor, and the government.[11]

3. Redeployment Programs

81. Many governments have supplemented severance and pension packages with redeployment support to help workers regain productive incomes—whether through formal employment, self-employment, or informal livelihood activities. ADB has some experience of supporting such programs and many other donors have supported redeployment programs throughout the developing world.

82. Such programs also offer an additional incentive to encourage voluntary departures and help win support for politically difficult restructuring. They are aimed at facilitating the shift of economically unproductive workers from infrastructure sectors to more productive sectors of the economy. Redeployment is a tool of active labor market policy.

83. In some cases, redeployment programs have been developed explicitly for PPI or privatization-affected employees; in others, redeployment support is provided as part of broader active labor market programs for the unemployed. Such programs differ from passive labor market programs that act more as a safety net for the most vulnerable people.

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[11] See *World Bank Labor Toolkit*, Module 5. A separate ADB technical note on Pension Reform and ADB Interventions is also available (ADB 2006b).

84. The five main types of redeployment support are:

- **Counseling**, which should take place before and after the restructuring, and might include elements on career, trauma, financial, and life counseling, in addition to advice on services and support open to the displaced workers.
- **Job search assistance**, which can include placement assistance (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 (through personal skill assessments, coaching, and job clubs).
- **Training**, which may have different areas of focus, such as retraining and developing new skills in workers so that they can find new paid employment elsewhere; or training in small business, microenterprise, or livelihoods to help displaced workers find self-employment and incomes.
- **Employee enterprise**, whereby opportunities and facilities are provided by the government or the PPI enterprise to enable employees to set up their own businesses. These facilities and supports include contracting out services by the enterprise to newly separated workers; simple workspace facilities (sheds, garages, and small offices); and business incubators where workspace facilities are supported by business advice, shared facilities (fax and photocopier), and a degree of mentoring.
- **Community-based approaches**, which look to local government, nongovernment organizations, and community self-help groups, alone or in coalition, to develop employment opportunities at the local level. These can include public works programs that provide temporary employment opportunities through large-scale, labor-intensive projects.

85. However, on the whole, redeployment programs have had mixed results. Most evaluations have focused on the experience of industrialized countries. These experiences generally show that retraining programs resulted in modest gains in reemployment probabilities, but wage changes were negligible or negative. The same evaluations found that the costs of retraining are two to four times higher than job search assistance but are no more effective. By contrast, placement and counseling efforts tend to show positive results and are generally more cost effective. Especially important is pre- and post-restructuring counseling where future livelihood options are discussed and advice given on how to safely invest or save compensation money. Without counseling, workers often spend or lose the lump-sum money quickly, thus increasing their likelihood of falling into poverty.

86. Nonetheless, emerging experiences from a wider range of circumstances can inform the design and implementation of redeployment programs and help workers with several remaining years of productive life to acquire gainful new livelihoods. At the program level, effectiveness can be improved in several ways:

- Ensure that redeployment services are driven by demand rather than by supply. This can be done by giving workers a choice between training and severance, and by building in a cost-sharing element through the use of vouchers and other instruments.
- Target services to workers for whom such services are most cost effective, in particular, younger workers with basic educational levels and skills, and who are most likely to improve their labor market outcomes from retraining. Effective targeting

requires that a survey of workers be undertaken as a preparatory step to obtain a clear profile of worker characteristics and needs.

- Develop a good understanding of the labor market that workers will be entering. This requires a labor market survey as early as possible. Proper labor market information is critical for setting up training and employment-support programs that are relevant to workers' opportunities and needs.
- Be aware of the types of services, programs, and institutions that are available to deliver services. This requires a survey of existing training and other labor market infrastructure to determine the capacities of service providers.
- Develop good counseling and advisory services to help match workers to appropriate and relevant retraining and other programs.
- Bring in a wide range of institutions, including nongovernment and private institutions, to foster competition and efficiency in the delivery of services, and use performance-based contracting arrangements where possible to improve incentives and efficiency.
- Give workers access to information on the performance of training and other service providers so that they can better select courses and services (and at the same time make the program more demand driven).
- Provide redeployment support to help workers set up their own small businesses instead of merely equipping them with skills for jobs in the formal sector—jobs that tend to be limited.

87. The *World Bank's Labor Toolkit* (World Bank 2003) provides detailed guidance on key steps involved in designing and implementing redeployment programs.

4. Employee-share Ownership Plans

88. Share transfers are best seen as an addition to, rather than a substitute for, voluntary departure or early retirement. In workforce restructuring, employee-share ownership plans can be used as a form of compensation to displaced workers, as part of an incentive or reward package to workers who remain, and as the basis for management employee buyouts or employee buyouts of units of the enterprise.

89. In addition to financial gains from such arrangements, ownership programs can help give employees a direct stake in the performance of the company and, thus, help improve labor relations and labor productivity.

F. Step Five: Managing the Restructuring Process

90. Experience shows that labor restructuring can proceed smoothly if stakeholders are involved and good communication mechanisms are in place. The fears and concerns of workers can be significantly reduced when explicit efforts are made to inform them about the objectives, timing, and methods of PPI and privatization, as well as the packages and incentives that will be developed to minimize the social impact. To ensure a smooth process, governments also need to define implementation arrangements and create the capacity to carry out labor programs, as mentioned earlier.

1. Communications: Engaging with Stakeholders

91. Privatization is almost everywhere a highly controversial process that various stakeholders, including labor, oppose. Labor opposition can be greater for infrastructure enterprises than for other SOEs because

- high levels of downsizing are often needed;
- high levels of investment are required, and the involvement of foreign investors is likely;
- PPI may coincide with tariff increases and rebalancing, particularly in sectors where the service is seen by some stakeholders as a "right" (for example, water); and
- infrastructure services are essential, and organized labor has some degree of power to disrupt those services through industrial action.

92. The historical lack of labor involvement in the process has been a further contributing factor. Although there is a trend toward more openness, some governments are still reluctant to engage earlier and more openly with stakeholders.

93. Three of the most common concerns for governments are:

- Stakeholder participation might delay PPI/privatization. Just as workers may be fearful of job loss, government officials may fear that engaging with stockholders can lead to delays, particularly at the start of the process where there are no ready answers.
- The very process of engaging stakeholders can raise workers' expectations, which officials may not be able to meet (for example, on the scope of consultation or on levels of severance). If, for example, the government consults trade unions on the process of labor adjustment in PPI/privatization, the government may fear that trade unions will reject that consultation and demand that the policy of PPI/privatization itself be challenged.
- There is a lack of specialist skills, tools, and experience in government to engage with confidence on labor issues.

94. Those concerns have some validity in experience. But experience also shows that failure to involve stakeholders can have significant costs, can fuel conflict and suspicion, and can further delay PPI/privatization or lead to problems down the line. Instead, a well-managed process involving stakeholders can facilitate PPI/privatization. Equally important, it can encourage adaptation of labor and working practices to local circumstances and improve outcomes. If properly planned and managed, the involvement of stakeholders can play an important role in strengthening the fairness, transparency, and accountability of the PPI/privatization process.

95. As with many of the more technically demanding aspects of labor adjustment, stakeholder communication is an area where ADB and other donors might look to provide technical support and assistance to governments.[12]

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[12] See ADB (2006a), the most recent publication on participation and communication.

96. For any PPI/privatization scheme, there are generally five principal groups of stakeholders:

- **Employees**. Employees can be classified by, for example, status (temporary, permanent, and contract); age; skill; cadre (management, skilled, or manual); gender; and ethnicity. The concerns of different groups and the likely impact of workforce restructuring on them may vary, and a better understanding of their concerns can therefore influence and improve not only the design and content of communication programs for workers, but also the design of the labor programs themselves.
- **Unions**. Trade unions are important stakeholders and can influence the restructuring process, but government may face challenges in engaging with them. Like governments, unions may lack the capacity to engage effectively. Some unions do not want to be seen as cooperating with employers, whereas others may oppose government policy on PPI/privatization as a whole. Consultation may be made difficult by the number of unions involved. For example, discussions on port reform in Sri Lanka involved 19 unions, and in the power sector in the Indian state of Orissa, employees were represented by 43 trade unions and federations. In some circumstances, national and international federations are important parties, both in terms of capacity building for local unions in developing countries and of entering into general framework agreements at the national or even international levels.
- **Government**. As is true among employees and unions, there are different groups within government itself. The key ministries involved are likely to be the relevant sector ministry, the ministry of finance or economic planning, and the ministry or agency responsible for privatization. Other ministries, including those of social protection, labor, justice, and local government, also have a role. Understanding the different roles—and frequently competing interests—of these different factions in government is important in making sure that labor programs are carried out effectively.
- **Investors**. Investors, whether foreign or domestic, often only enter into the discussions at the transaction stage. As a result, their specific concerns may not be heard during much of the restructuring process. Earlier involvement of investors allows their interests to be taken into account and balanced with those of other stakeholders. Such involvement can take place through consultation meetings with investors, better communication of relevant policy papers, and early scheduling of prequalification.
- **Customers**. Consumers and other users of infrastructure services have a direct stake in the broader reform process. Opinion polls and attitude surveys are valuable sources for developing an understanding of what people think. In general, however, customers want reliable services they can afford, which means they have an indirect interest in the capacity and productivity of the workforce producing them. Conversely, workers are also consumers and so they have a broader stake in the process as well.

2. Implementation Arrangements

97. There are two major requirements for a successful labor restructuring program:

- clear implementation arrangements, and
- capacity to undertake the various aspects of the program.

98. For privatization programs or major PPI transactions, this usually means the creation of some institutional capacity to handle the labor program. Arrangements vary among countries, but common institutional homes for this institutional capacity are the national- or state-level privatization agency; the relevant sectoral or line ministry; the PPI enterprise itself; the central ministry of finance, economics, or planning; or special units set up to support sector or individual enterprise reforms.

99. The legal and commercial skill sets required in privatization and PPI transactions are not generally found in government. ADB and other donors have a good record in establishing or supporting units/agencies of this sort and might consider offering technical assistance to partner governments in setting up and establishing these sorts of institutions.

100. Once the agency is created, the government will need to assemble a team for implementation. The implementing agency team will need to include labor experts for the labor restructuring program. The structure of the labor team depends on the size and scope of the labor program. In large PPI/privatization programs with a major labor component and where there is little capacity elsewhere in the government to deal with labor, a small labor unit may have to be created within the PPI/privatization agency. In smaller programs and where other groups in the government, such as the ministry of labor, have the required capability, it may be necessary to recruit an individual labor expert in the agency to coordinate implementation.

101. The labor unit (or individual expert) will be responsible for overall implementation, and the relevant tasks cover the full range of activities in the labor program:

- Completing the establishment of the labor unit, including the training and capacity building of any in-house staff.
- Securing funding (if this has not already been done).
- Commissioning early initial reviews (for example, legal reviews and assessments of the need for labor restructuring).
- Designing and enacting procedures for implementing voluntary redundancy, early retirement, and other actions.
- Ensuring that stakeholder engagement (consultation, communication, negotiation, and cooperation) takes place sufficiently early for all key stakeholders so that the process can be seen as both fair and legitimate.
- Coordinating with other existing government organizations that may already be involved in redeployment support and that must be brought into the process. These include the ministries of labor, trade, and industry and commerce; public employment offices; and finance authorities.
- Designing procedures for the approval, disbursement, monitoring, and auditing of severance funds.
- Designing and coordinating implementation of the redeployment (counseling and retraining) program for workers.
- Monitoring specialized contractors hired for the labor restructuring process.
- Commissioning monitoring and evaluation activities.

IV. CONCLUSIONS

102. There is no one approach to addressing labor issues in PPI/privatization or in similar restructuring interventions. Every country and every transaction is different. The approach depends much on the political, economic, and social conditions, as well as on the nature of the enterprise and the sector in which it operates.

103. Several general lessons emerge from international experience:

- Labor issues can and should be addressed early in the reform process. Labor issues are one of the more complex and politically challenging elements in PPI, and dealing with them early can help secure employee support and provide a social safety net. In general, ADB should engage representatives of labor from the beginning, such as during the preparation of the country strategy and programs—specifically in drafting the summary labor market assessment—to ensure timely and appropriate levels of understanding of the concerns of employees.
- Governments have an important role to play in the restructuring process in large, troubled enterprises. In cases with high levels of overstaffing or difficult labor relations, transferring infrastructure firms with the labor force intact is not an option because private investors are wary of taking on the burden of labor adjustments and employees are concerned that private investors may not provide an adequate social safety net.
- A mix of options can be used to deal with labor restructuring. One is redundancy. Other measures include voluntary departures and early retirement, correcting payroll errors (such as identifying ghost workers), freezing recruitment, enforcing retirement rules, removing barriers to employees' departure, and reducing costs of such staff substitutes as overtime and fee-paid workers.
- Voluntary departures are the most frequently used option. Such schemes are generally considered to be politically and socially attractive, but issues of affordability and adverse selection need to be considered in their design and implementation.
- Redeployment programs have yielded mixed results but, if properly targeted, can have social and economic benefits. Better results can be achieved by ensuring that retraining is driven by demand, that it is targeted to workers for whom it is most cost effective, and that nongovernment and private institutions are involved in the delivery of services.
- Funding for meeting the costs of labor adjustment must be secured early. Severance schemes often involve very substantial amounts of money and it is important to give workers credible assurances that the funding for making timely payments is in place.
- Early communication and consultation with labor are important. Such efforts help build understanding and support and assure workers that adequate arrangements are being made. Openness and transparency in decision making on labor issues are important confidence-building measures. The implementing agency should ensure that labor adjustment is seen as a fair process, even if job losses are inevitable.

104. These lessons taken together show that although labor issues are complex and challenging, they need not be an obstacle to PPI or privatization. With clear objectives, careful planning, and adequate resources, labor issues can be handled effectively while implementing government policy on enterprise and infrastructure reform.

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Annex

Case Study: Voluntary Redundancy Programs in India

I. Introduction

1. This paper provides an overview of the theory and practice of voluntary redundancy schemes (VRSs) in India. Through the 1990s, a number of Indian states developed VRSs for employees of public sector undertakings (PSUs).

2. As overstaffing is said to be one of the main contributory factors to the heavy losses of many PSUs, governments recognized that it was simply impossible to reform, restructure, or modernize PSUs without tackling the difficult question of staff reduction.

3. In the absence of a VRS, reform of PSUs is otherwise frustrated by the legal and procedural difficulties inherent in shedding labor in India as well as the political and ethical objections to dismissing people in a country where no effective system of social security exists.

4. Staff reduction through compulsory retrenchment[13] in PSUs is difficult:

- The enforcement of retrenchment is a cumbersome process. Although the Industrial Disputes Act (IDA) provides a statutory compensation for workers of 15 days pay for each year of continuous service, there are onerous requirements[14] on enterprises to submit detailed applications and rationales for retrenchment.[15]
- Employees and/or trade unions have a propensity to contest compulsory retrenchment in the courts, making the process very time consuming. Involvement of the courts greatly increases the cost and effort involved in pursuing retrenchment[16] and delays the reform of the enterprise, often by years.
- Decisions on employment in PSUs have been politicized. Attempts to drive through an aggressive program of large-scale retrenchment and enterprise reform[17] will face concerted political opposition. Reform may be technically possible, but politically uncertain.

5. In view of the difficulties caused by the IDA and the need for PSU reforms to be “sold” to a number of stakeholder groups, the specific objective of state-level VRS is to encourage

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[13] The Industrial Disputes Act defines retrenchment as “the termination by the employer of the service of a workman for any reason whatsoever, otherwise than as a punishment inflicted by way of disciplinary action, but does not include: voluntary retirement of the workman or retirement of the workman” (Industrial Disputes Act, 1947 para 2, inserted by Act 43 of 1953).

[14] See, for example, form S1 of the Orissa Rules, which includes a requirement to submit balance sheet, profit and loss accounts, and audit reports for the last 3 years, together with the application for retrenchment. For many public sector undertakings, there have been no audited accounts for many years, thus providing an immediate (albeit technical) basis for workers and their representatives to challenge the validity of the retrenchment action in the courts.

[15] The Budget Speech of 2001 proposes to increase the statutory compensation to 45 days, but to make the need for prior application to Government a requirement only for units of more than 1,000 workers.

[16] Even if an enterprise is defunct, the employer remains liable for salary and related costs. For the Government of Orissa which remains legally responsible for paying, these build up as significant arrears.

[17] Some of the opposition to enterprise reforms, such as privatization, arises because these reforms remove influence and power from the political and bureaucratic sphere, and decisions on enterprise investment are made on commercial grounds rather than for political, or rent seeking, reasons.

employees to leave their employment without recourse to expensive and time-consuming procedures.

6. Clearly, workers will only do so if the financial benefits on offer are greater than those available under the IDA, which provides a “floor” for any VRS. In addition, many VRSs can provide ex-employees with nonfinancial benefits in the form of a social safety net program of counseling and retraining to ease their exit from public sector employment.

7. The application of an effective VRS, hence facilitating PSU reform, has enabled state governments to address underlying budgetary and fiscal problems.

II. What Makes a Successful VRS? − The Theory

8. A successful VRS must “work” for both employees and employers alike.[18] In essence, the best measures of whether a VRS is a success are the willingness of employees to apply for it and the readiness of employers to continue to offer it. In theory at least, a successful VRS should have the following characteristics:

Attractiveness to Employees*.* The VRS must be attractive enough to encourage employees to apply. One can consider here

- *Financial Benefits:* At a minimum, any VRS must provide compensation greater than that offered through legal retrenchment, otherwise, why would anyone accept the VRS?
- *Nonfinancial Benefits:* These include access to counseling or retraining opportunities. In some large central public sector units,[19] the VRS has offered recipients continued access to medical facilities or preferential access to facilities.

Attractiveness to Employers. The VRS should be attractive for the employer (i.e., the government). To implement VRS, governments must make large one-off initial payments, but thereafter gain from reduced salary and staff-related bills in future years. Governments can assess the financial costs and benefits of a VRS in a similar way to the appraisal of an investment project. As with all projects, the key financial issues are the profile of the net cash flows (how fast is the payback?) and how to finance the initial investment.

Fairness and Consistency*.* The VRS must be seen to be fair and consistently applied; discriminating between groups of employees is risky. It will attract criticism and damage the VRS. If a government makes a special additional allowance for one PSU or one group of workers, this will quickly raise expectations and become the new norm. A VRS should not change frequently, so that someone taking a VRS today does not do better or worse than someone taking it later. The VRS should not have arbitrary changes and, as far as possible, the terms offered should be consistent across PSUs and over time.

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18 This section on the attributes of a successful VRS draws primarily on Adam Smith International research and design work 1997–2004 and practical experiences of implementation in several Indian states.

19 For example, the Steel Authority of India Ltd or Bharat Heavy Electrical Ltd offered continued medical facilities, while the Department of Telecommunications planned to offer STD/ISD booths to non-officer category employees who were accepting VRS. Reported by S.K. Goyal in *Privatisation in South Asia – Minimising Negative Social Effects through Restructuring* (ILO 2000).

Targeting. The VRS must allow targeting. PSU managers must be able to identify and decide which employees are to be offered VRS and which will be retained. The Indian Government's VRS is explicit in this regard. Consider two "real life" examples:

- In an enterprise that is being downsized, the ideal would be to retain the best staff to facilitate its privatization as a going concern.
- In an enterprise that is being closed and either the assets sold or the enterprise liquidated, some key staff (e.g., accountants, security staff) will be needed for some time to deal with bringing accounts up to date, dealing with queries on legal title, collecting any outstanding debts, and assisting in the sale of assets and liquidation of the enterprise.

Communication. The VRS must be well communicated. PSU managers must understand completely why the VRS is being offered and what its elements are. Otherwise, they will be unable to apply it at their PSUs. The terms of the VRS must be fully explained to employees,[20] if necessary more than once, so that they can make an informed choice. They must be given the opportunity to ask questions and must be answered fully and honestly.

Management and Credibility. To be credible, the VRS must be well managed. The starting point is often a high level of mistrust by employees arising from past failures to manage the PSU properly. Not only must an employee understand the VRS and what is on offer but must also be confident that if an application is made, the full entitlements will be received and in a timely manner.[21]

Rehiring. The VRS must prevent rehiring. The so-called "revolving door" scenario, where VRS recipients are later reemployed in the same or a related enterprise, is a clear indicator of a failed VRS. There can be little point in a government promoting a VRS if employees who receive VRS from one PSU are simply rehired elsewhere in the public sector. Such a scheme could be open to abuse and collusion between employees and managers.

III. State-level Experience

9. In practice, VRS programs in India have been principally based on a formula (Figure 2). In the simplest schemes, the formula provides for increasing payments with seniority (years of service). Others adjust by taking into account years remaining.

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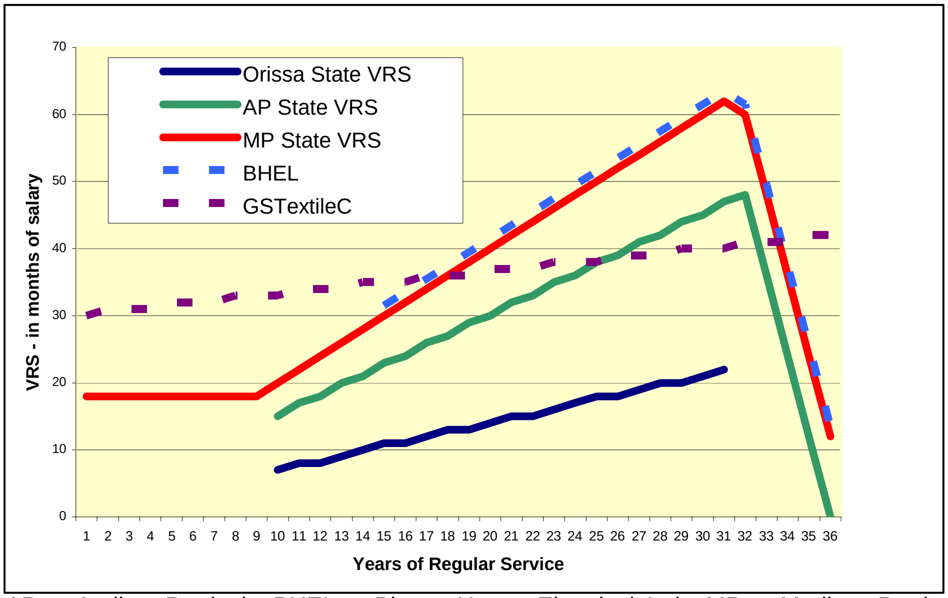
[20] Some legal judgements reinforce this point. In April 1998, the Bombay High Court ruled that employers could not withhold the details of VRSs to help ensure that employees can make an informed decision. In addition, the court ruled a mandatory 21-day period between the announcement of the scheme and acceptance of applications so that employees have a cooling-off period in which to think through, without undue time pressure, whether to accept it or not (Reported in the *Indian Express*, 5 May 1998).

[21] Experience suggests that a realistic period should be no more than 60 days, otherwise, workers may start to lose confidence in managing the VRS.

Figure 2: Comparison of Select Public and Private Sector VRSs in India
(Benefits in terms of months of salary vs. years of service)



AP = Andhra Pradesh, BHEL = Bharat Heavy Electrical Ltd., MP = Madhya Pradesh, VRS = voluntary redundancy scheme.
Source: Adam Smith International 2003.

10. A comparison of some relatively recent state-level schemes is presented in Appendix 1. In practice, the implementation of the formula depends on a range of eligibility and other conditions that are applied. In some cases (e.g., Orissa), there are restrictions on eligibility and, in others, a cap on total payments (e.g., Madhya Pradesh as set out in the Box below).

Box: Madhya Pradesh Severance Scheme

In 2002/03, Madhya Pradesh had a well-designed, uniform severance scheme. The scheme was generous (60 days per year of service) but capped at Rs500,000 (approximately $12,000). The scheme defined salary, for the purpose of severance, as the average of the last 10 months' salary, and provided a notice period of 1 month. In practice, this combination proved difficult to implement when dealing with larger numbers—e.g., more than 5,000 retrenched workers in the Madhya Pradesh state bus company. Delays in releasing funds and the short notice period meant that severance pay had to be recalculated constantly to the average.

Source: Adam Smith International.

11. In India, perceptible differences in VRS compensation exist between central and state government enterprises, and among states. Differences also exist between privatized enterprises and those that have been closed down. VRS payments on average per worker have been around Rs3 lakh[22] for central public enterprises and Rs1.6 lakh for state-level public enterprises.

[22] 1 lakh = Rs100,000.

12. There has been considerable variation in payments per worker (Table 1). Orissa is the state with lowest total compensation (Rs1.9 lakh per worker) and Central Government public enterprises have the highest (Rs6.9 lakh per worker).

13. One of the simplest comparisons between state programs is their worker payments in terms of the equivalent months of salary that the compensation represents. Workers receive total compensation packages equivalent to between 45 months (3.75 years) and 75 months (6.75 years) of salary (Table 1).

Table 1: Components of Total Redundancy Compensation by State
(Rupees)

	Andhra Pradesh	Uttar Pradesh	Madhya Pradesh	Orissa	Karnataka	Central Government
Provident fund	107,072	143,634	89,130	78,649	115,875	226,323
Gratuity	76,168	46,093	46,538	53,191	78,743	109,955
Pension	357	151	12	145	433	75
Leave encashment	27,392	24,062	23,991	11,783	17,139	20,911
Other benefits	10,078	22,146	21,454	10,101	11,289	1,346
VRS compensation	145,108	182,414	178,101	41,477	210,420	335,580
Total Compensation	**366,175**	**418,500**	**359,226**	**195,346**	**433,899**	**694,190**
Average monthly salary	7,486	7,616	6,038	4,329	5,771	10,968
Average VRS as months of salary	*19*	*24*	*29*	*10*	*36*	*31*
Average Total compensation as months of salary	*48*	*54*	*59*	*45*	*75*	*63*

Source: Derived from World Bank (India) Survey 2003.

14. This comparison allows judgments to be made both between states in India and with international experience. It confirms that the Orissa program is the least generous, but also suggests that the Karnataka program may be unusually generous.

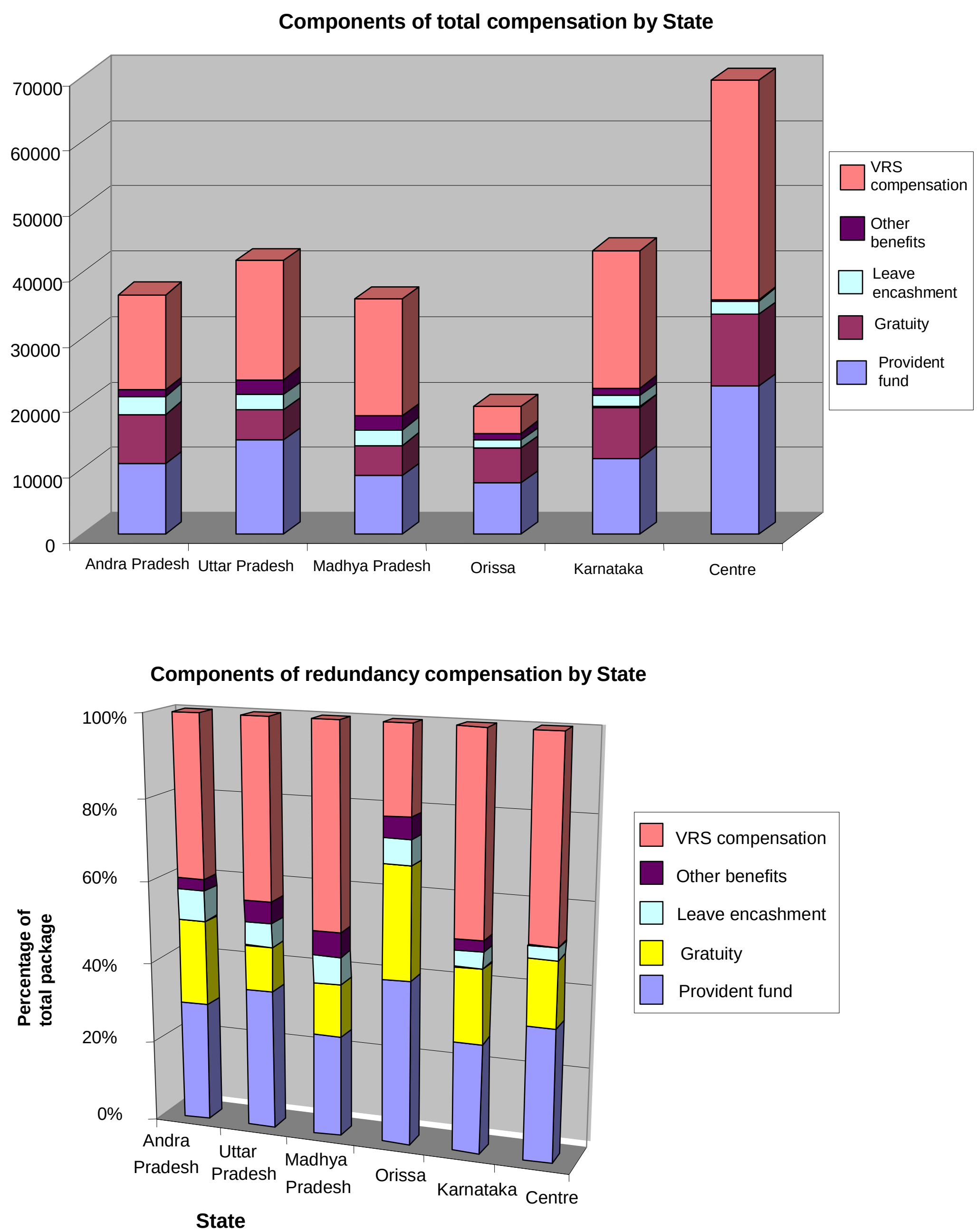
15. Comparisons in the graphs (see Figure 3) suggest that:

- Central Government public enterprise workers benefit from their high starting salary, particularly through the benefits when applied to the VRS formula and the gratuity formula; and
- workers in states with the least generous schemes (e.g., Orissa) receive a relatively high proportion of their overall compensation through statutory and contractual end of service benefits, such as gratuity and earned leave.

16. How do VRS payments in India compare with international experience? Table 2 provides some comparisons, drawn from published sources and from a review of World Bank projects. Care is needed when making international comparisons to ensure that like-for-like alternatives are made. Many cases in Table 2 represent downsizing of large infrastructure enterprises whose restructuring was political and contested by unions and other groups. As such, they offer a useful comparison, given that disinvestment in India is also contested. There is considerable

variation; estimating a mean or median would be spurious. As a mid range, however, most programs are offering severance packages of perhaps 16–24 months' salary. Packages offering less than 10 months and more than 30 months are exceptional. In international terms then, the VRSs offered in Karnataka, Central Government public enterprises, and Madhya Pradesh appear overgenerous while that of Orissa is low.

Figure 3: Components of Compensation by State



Source: Derived from World Bank/NCAER Survey and Adam Smith International 2003.

Table 2: Severance Payments - International Comparisons

Country / Enterprise	Severance Package (months of salary)
Argentina - Steel & Railways	Equivalent to 24
Brazil	
- Banco do Brazil	Average equivalent to 13
- Banrisul Bank	Average equivalent to 10
- CEEE Power	Average equivalent to 25
- CRT Telecom	Average equivalent to 30
- Federal Railway	4–12
- Rio Grande do Sul Electricity	Capped at 15
Cape Verde - Privatization	20 if 15 years of service
Croatia - Rail	15
Guyana - Telephone & Telegraph	22
Lebanon - public sector	Maximum 10
Macedonia - Social Support Project	Equivalent of 12
Mozambique - Rail	Equivalent to around 24
Poland - Rail	24
Sri Lanka - Mahaweli Restructuring	Approx. 24–36
Togo - Public Enterprise Reform	Equivalent to 16
Tunisia - Rail	Capped at 30

Source: Labor and Disinvestment Survey and ASI Sources 2003.

17. These relative amounts do not, however, tell the whole story. In principle, a relatively generous program could be justified if it led to significant increases in the speed of enterprise restructuring. A 1- or 2-year delay in labor adjustment reform will itself have costs in terms of

- continued expenditure on staff-related costs;
- reduced privatization revenues. Indian circumstances are different but in Mexico, Lopez-de-Silanes (1997) found an increase of net privatization prices of 12% for every 10% reduction in the labor force (he also found a statistically significant positive impact from replacement of the chief executive of the enterprise); and
- delayed implementation of privatization or restructuring program due to opposition from organized labor.

18. Empirical evidence does not support the hypothesis that more generous payments necessarily allow faster restructuring. For example, Orissa and Madhya Pradesh formulated a VRS at around the same time (June 1998). By May 2002, however, Orissa, with its far less generous scheme, had retrenched more than 13,600 workers[23] whereas Madhya Pradesh, despite its somewhat overgenerous scheme, had retrenched around 6,000 workers by May 2001 (Adam Smith International research) and an estimated 8,500 by May 2002.

19. The Orissa experience appears to based on the fact that high proportions of SOE workers had not been paid for months or, in some cases, years. Many workers had given up all hope of receiving any money from their enterprises and were happy to receive some money given the state's parlous fiscal condition.

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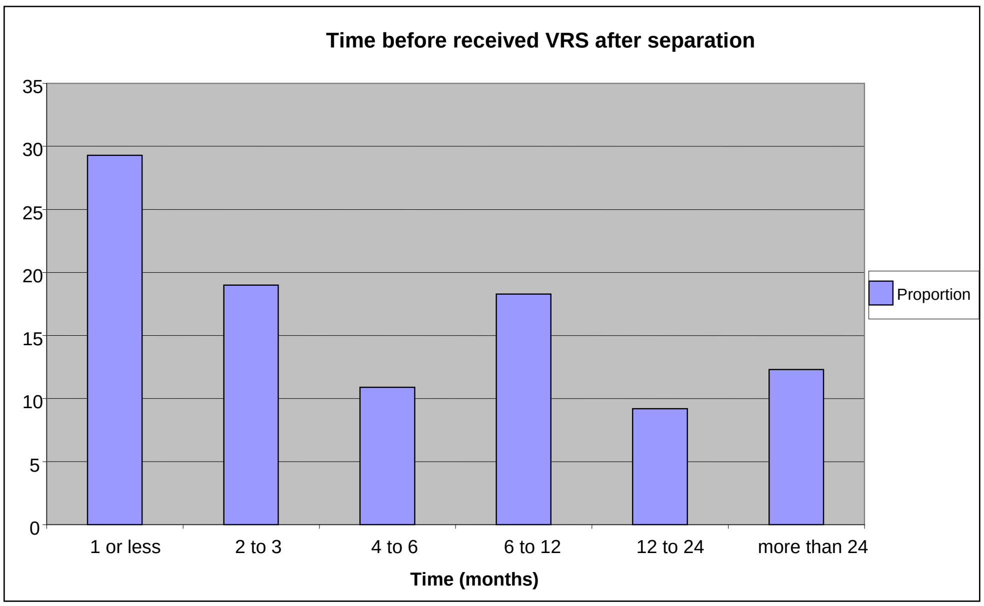
[23] Government of Orissa presentation at the 30 May 2002 World Bank Workshop on Public Enterprise Restructuring, New Delhi.

20. Legal factors can also be important in determining the pace and impact of public enterprise restructuring. For example, despite Karnataka's generous VRS, a court-based legal challenge, procedural bottlenecks, and resource constraints resulted in delays.[24]

21. The financial condition of the public enterprises in question also plays a role in the speed/success of a VRS. For example, in the case of Orissa, many enterprises were in acute financial distress and nonfunctioning well before their closure; few employees or unions challenged their closure through the courts. A donor-funded social safety net program was also established in Orissa some 3 years earlier than in Madhya Pradesh.

22. A 2003 World Bank-funded survey by the Council for National Applied Economic Research (NCAER) also indicated that workers preferred payment in a lump sum rather than installments. In part, this is because lump-sum payments allow workers to make one-time investments into property or interest-earning accounts and because of growing uncertainty in several states about governments' ability to pay (Figure 4).

Figure 4: Delays in Receiving Compensation
(Months)



VRS = voluntary redundancy scheme.
Source: Derived from World Bank/NCAER Survey 2003.

23. The Government of India and those states with a degree of fiscal stability are often willing and able to finance the costs of VRS. Unfortunately, procedural delays and sometimes temporary cash shortages can lead to delays in disbursing VRS funds to workers. As the NCAER research shows (Figure 3), these delays can be significant.

24. One unintended consequence of donor support may be that the specific accountability requirements for VRS payments lead to greater attention to on-time and full payment, and the reduction of procedural delays. This, together with the poor state of public enterprises, may help

[24] Government of Karnataka presentation at the 30 May 2002 World Bank Workshop on Public Enterprise Restructuring, New Delhi.

explain the relatively high numbers of workers accepting a VRS in Orissa, despite the unusually low level of VRS benefits on offer.

IV. Conclusion

25. There is limited empirical research to show how VRSs perform in practice.

26. No state-level VRS meets all theoretical criteria of a successful scheme, but those states that have sought to implement VRS programs with a degree of energy and consistency (i.e., Orissa and Andhra Pradesh) clearly have been able to progress in privatization and reforms faster than those states that have not.

27. States that have implemented schemes have largely met the key criteria of being both attractive to employees and to employers, but it is fair to say that most of these states have faced real problems with the operational and management aspects of the schemes.

Comparison of State-level VRSs

Characteristic/ State	Madhya Pradesh	Andhra Pradesh	Gujarat	Orissa	Uttar Pradesh
Order	Voluntary redundancy scheme VR-98, dated 19 August 1998	Government memo 1038/PE-I of 23 January 1996	Finance Department circular JNV 1699-1070-A of 12 April 1999	Resolution 1743/PE of 6 June 1998	Government Order 288/P.R.C./44-1/93-85/90) of 1993
Applicability	Government, local authorities, corporations, and undertakings owned or controlled by the State, joint ventures with more than 50% equity, grant-in-aid organizations, etc.	PEs under the Companies Act, co-op institutions, institutions under the Societies Registration Act, etc.	PEs in the process of downsizing	PEs	PEs with a view to reducing surplus manpower
Level of Ex-gratia Payment	Part A: (Workers who have completed 10 years): 2 months (60 days) of salary for each completed year of service or total salary for remaining period of service up to the date of superannuation, whichever is less Part B: (Workers with less than 10 years service): Terminal benefits plus 75% of salary for Year 1; 50% of salary for Year 2; and 25% of salary for Year 3	1.5 months (45 days) of salary for each completed year of service or monthly salary multiplied by the remaining years of service, whichever is less	35 days of salary for each completed year of service, added to 25 days of salary for each remaining year of service or monthly salary at the time of retrenchment, multiplied by the remaining months of service, whichever is less	21 days of salary for each completed year of service	45 days of salary per year of service or monthly salary at the time of retrenchment, multiplied by the balance months of service, whichever is less
Basis of Calculating Salary	Basic pay + dearness allowance (DA) + interim relief (IR)	Basic Pay + DA	Basic Pay + DA + house rental allowance	Basic Pay + DA + IR	n/a
Upper Limits on Compensation	5 lakh maximum for eligible workers	No upper limits mentioned	No upper limits mentioned	No upper limits mentioned	No upper limits mentioned
Lower Limits on Compensation	No lower limits mentioned	In the case of closure, minimum package of benefits of Rs30,000 for employees with less than 10 years of service (see Notice of Amendment 47538/PE of 26 August 1998)	No lower limits mentioned	No lower limits mentioned	No lower limits mentioned
Retirement Age	58	Not mentioned	Not mentioned	Not mentioned	Not mentioned
Eligible Persons	Part A: Workers with over 10 years of service Part B: Workers with less than 10 years of service	Workers with 10 years of service or having attained 40 years of age	Workers with 10 years of service or having attained 40 years of age	Workers with 10 years of service	Workers with 10 years of service or having attained 40 years of age

DA = dearness allowance, PE = public enterprise, IR = interim relief, VRS = voluntary redundancy scheme.
Source: ASIL Researches 2003

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