Using Severance To Facilitate Liquidation: How the World Bank Can Help

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INTRODUCTION

Although the size of the private sector in the transition economies of Eastern Europe and Central Asia has increased greatly in the past few years, a significant number of enterprises remain in the public sector (World Bank 1996c). Many of these enterprises are suitable candidates for future privatization. Others, including nonproducing mines, enterprises in sectors where the relevant country does not have a comparative advantage, and some munitions firms, might never be suitable for privatization. For example, Kudat et al. (1996, 63) suggest that the falling demand for coal will make major reductions in mining employment necessary in Russia and note that some loss-making mines need to be closed. Enterprises that cannot be privatized will have to be liquidated and their assets sold. Although closing loss-making enterprises will be beneficial in the medium term, the immediate loss of jobs will be wrenching. It will be especially problematic in one-company towns and areas that already suffer from high unemployment.

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

LIQUIDATION AND PRIVATIZATION

Under some circumstances, severance packages might be appropriate for enterprises due for privatization but there are several complicated issues concerning timing and design (see Box 1). Enterprises that can be privatized should be privatized rather than liquidated. If these firms prove unviable, their new owners will be responsible for liquidation.

Identifying Firms for Liquidation

The first challenge is how to identify those firms that are suitable for liquidation, and of those firms, which are suitable candidates for (Bank-financed) severance packages.[1] In some, cases identification of candidates for liquidation might be simple; for example, nonproductive mines that have exhausted their resources or firms in obsolete industries (e.g., some munitions firms) are probably good candidates for liquidation. On the other hand, some enterprises would never be candidates for liquidation; for example, it would be difficult to liquidate power companies or water utilities under any circumstance (even if they were failed privatization candidates or had participated in isolation programs).

Another group of candidates for liquidation are companies that had been included in previous privatization programs but had failed to find private sector buyers. In some cases, these enterprises might be restructured while remaining in the public sector and then privatized at a later date. However, an attempt to restructure prior to privatization can increase the likelihood of asset stripping, damage to creditors, and further subsidies.

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BOX 1

Should Workers Be Offered Severance Pay Prior to Privatization?

Although the focus of this paper is on severance pay for workers in enterprises due for liquidation, severance is also an issue for overstaffed public enterprises due for privatization. In a distortion-free world, where public managers have the same goals and information as private managers, it is irrelevant whether restructuring precedes or follows privatization. Costs associated with restructuring, realized before the enterprise is privatized, will be reflected in higher prices.

There are, however, reasons why it might be appropriate to restructure enterprises prior to privatization:

LABOR LAWS Private and public enterprises might be bound by different labor laws. For example, Fiszbein (1992) notes that Sri Lankan labor law makes laying off workers more costly for private employers than for the government. In similar cases, laying off workers prior to privatization might be attractive. (Although, in the medium term, this kind of distortion should be fixed by reforming labor laws, any large-scale reform will probably take time and might increase the political opposition to privatization.)

VALUATION If restructuring costs are high, the maximum price that private companies or individuals are willing to pay might be negative. In practice, governments might find it politically difficult to accept negative prices for even insolvent enterprises. In these, cases some restructuring might be necessary for political rather than economic reasons.

SENSITIVITY The new private owners might be wary about restructuring immediately after purchasing an enterprise due to politically sensitive layoffs and adverse effects on worker morale. They might also be concerned that the government might change the rules regarding layoffs or restructuring after the enterprise has been privatized. Laying off workers might be one way of demonstrating the government's commitment to reform (World Bank 1995).

Of course, there are equally convincing reasons why governments should privatize without restructuring. For example, the new private owners are almost certainly in a better position to assess their labor needs than the former public owners. If the wrong employees are laid off prior to privatization, the private owner will be forced to rehire those workers and the cost of severance will not be reflected in a higher privatization price (Rama 1997). Rama (1997) also notes that severance packets might be more generous when designed by the public sector.[7] Empirical work on privatization in Mexico suggests that the increase in the price paid for the privatized enterprise does not, in general, justify the cost of labor restructuring (Lopez-de-Silanes 1996). For these reasons, large severance programs are probably more appropriate in cases where firms are destined for liquidation.[8]

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7 Rama (1997) notes that case studies confirm that this is true in proactive (Galal et al. 1994).

8 The issue of whether restructuring is worthwhile prior to privatization is discussed in greater detail in Kikeri (1997) and Rama (1997). A recent World Bank project in Venezuela noted that when the restructuring of public enterprises was not associated with either privatization or with liquidation, the restructuring usually failed to improve either the finances, productivity, or efficiency of the public enterprises (World Bank 1996b).

LIQUIDATION AND PRIVATIZATION

TO FOLLOW GOALS OTHER THAN PROFIT MAXIMIZATION, OR THE FIRM MIGHT SIMPLY HAVE BEEN POORLY MANAGED. For example, Sherif and Sooz (1993) describe the case of Misr Dairy, a state-owned Egyptian enterprise that produced dairy products. They noted that one of the reasons that the enterprise was nearly insolvent was that the holding company for food processing forced Misr Dairy to produce pasteurized milk and prevented it from concentrating on its fast-moving products like white cheese. In addition, when contracting services or goods from other suppliers, state-owned enterprises might be encouraged to favor other state-owned enterprises rather than using the lowest price provider. Rangathan (1987) noted that state-owned enterprises in India were required to give other state-owned enterprises a 10 percent price preference over private enterprises.

THE GOVERNMENT MIGHT PREVENT STATE-OWNED ENTERPRISES FROM LAYING OFF WORKERS OR FROM RESTRUCTURING FOR POLITICAL REASONS. World Bank (1995) notes that pressure from interest groups (e.g., labor unions) might mean that governments restrict layoffs in state-owned enterprises. Empirical evidence seems to support this assertion. Fiszbein (1992) estimated that over 50 percent of labor employed by some state-owned enterprises in Sri Lanka might be redundant despite the fact that there were no laws preventing the public sector from laying off workers. Pohl et al. (1997) find that privatized enterprises in several transition economies were far more likely to restructure than enterprises that remained in the public sector.

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their activities. World Bank financing of severance then might be most appropriate for firms that are nonviable but politically powerful.

A second reason that withering away might not be appropriate is that social safety nets are weak in many transition economies. For example, in a study of coal mines in Russia, Kudat et al. (1997) note that although Russia provides "extensive legal protection for unemployed workers" (p. 90), benefits are often unpaid and workers often do not know what benefits they are entitled to.[9] Although the most efficient reform in these cases might be reform of the social safety net, this approach might not be feasible in the near term. Large-scale restructuring of the social safety net might (i) prove too expensive in the near term, (ii) take too long, and (iii) increase political opposition to these programs (e.g., if reform reduces benefits for some recipients). In the near term, severance payments might be easier to implement than a complete overhaul of the social safety net.

Finally, the withering away process can be extremely slow. For example, Gray et al. (1996) found that, under the liquidation procedures defined by Hungarian bankruptcy law, only one out of fifty liquidations was completed within two years. Because this time period extends from the time that the firm entered bankruptcy proceedings (not from the time it became insolvent), it is reasonable to suppose that withering away could take many years. In the mean time, assets will be stripped by employees and the management, and debts will continue to grow.

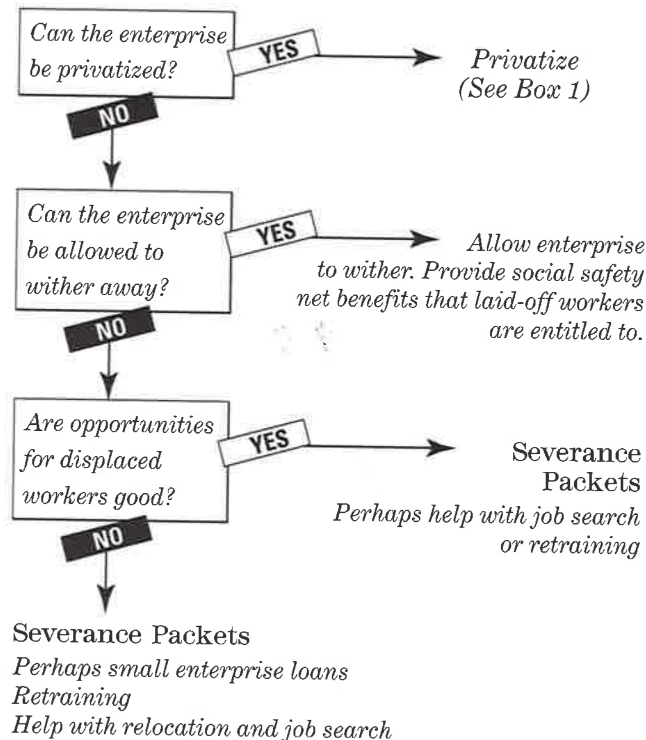
9 Workers laid off in connection with the reorganization or closure of an enterprise are entitled to 75% of their base salary for twelve weeks, 60% of their base salary for the next four months, and 40% of their base salary for an additional five months (Kudat et al. 1997, p.90). In comparison, qualified unemployed workers in the United States are generally entitled to between 50% and 70% of their pretax wage, up to the state-determined maximum, which varied between $175 in Missouri and $404 in Rhode Island in 1996, for a period of six months (Committee for Ways and Means 1996, p. 342). Workers in states with high unemployment rates can receive 50% of their state-determined benefit for an additional 13 weeks.

Summary

When considering whether an enterprise is a suitable candidate for liquidation and severance, the first question is whether the enterprise can be privatized (see Figure 1). If the enterprise can be privatized, then it should be. Firms that cannot be privatized (because there are no willing buyers) should be liquidated. In some cases, the appropriate mechanism might be to simply allow the firm to wither away. When the firm cannot be allowed to simply wither away, severance packets should be offered to workers. In some situations, other services (i.e., training or small enterprise loans) should also be offered.

FIGURE 1

Should an Enterprise Be Liquidated or Privatized?



ISSUES IN DESIGNING SEVERANCE PACKAGES

Although there has been increased interest in the efficient funding of severance pay in the public sector, most recent research has focused on funding severance pay for civil servants or as a prelude to privatization (see the discussion in Box 1). This research has identified the following issues in the design of severance packages (Rama 1997):

THE PROGRAMS TEND TO BE VERY EXPENSIVE AND TO OVERCOMPENSATE LAID-OFF EMPLOYEES. Public sector severance packages have often been expensive and workers are more than compensated for the losses associated with retrenchment. This makes programs prohibitively expensive and because public employees are often relatively well paid, it is not an effective way to reduce poverty.

THE PROGRAMS OFTEN END UP ENCOURAGING THE MOST PRODUCTIVE WORKERS TO LEAVE. When workers are offered a generic severance package, the most productive workers are the ones most likely to take it. These workers are likely to be the hardest working and therefore, might lose the least if they had to move to the private sector. Rama (1997) argues that if private sector managers are better than public sector managers at monitoring effort, then the hard-working employees only suffer a financial loss, while lazy employees suffer both a financial loss and are forced to increase effort in the private sector.

WORKERS OFTEN ACCEPT SEVERANCE PACKAGES BUT ARE REHIRED AT A LATER DATE. Severance programs were often not targeted properly; as a result, irreplaceable workers were released. Productivity then falls and the laid-off workers have to be rehired. This means that public resources are simply transferred to workers, while no down-sizing is achieved. Although some packages explicitly forbid the rehiring of workers (Rama 1997), this restriction might also be costly if it leads to falling productivity or to the hiring of new workers with similar characteristics.

For the purposes of this paper, the last two issues do not apply because in liquidation, all workers are laid off and the enterprise is then closed.[10] However, the first issue remains pertinent: Overcompensating laid-off employees is neither efficient nor equitable.

Avoiding Overpayment

As Kikeri (1997) notes, government-funded severance packets often end up being relatively generous. Although this might not be considered an especially undesirable trait, Rama (1997) notes that public sector workers are often better off than the general public. Further, in a world of limited resources, overpayment to workers in one enterprise will restrict the number of insolvent enterprises that can be helped by any given program. In addition, there are several reasons to suspect that overpayment might be especially severe for the firms considered in this paper:

UNDER SOME SPECIFIC CIRCUMSTANCES, VOLUNTARY PROGRAMS THAT ALLOW WORKERS WITH THE LOWEST RETRENCHMENT COSTS TO SELF-SELECT INTO SEVERANCE PROGRAMS CAN BE CHEAPER (POLITICALLY FEASIBLE) THAN MANDATORY PROGRAMS (Diwan 1992). However, this is only true when a portion of workers leave. Because liquidation implies that all employees need to be laid off, and because it would be impossible for practical or political reasons to pay similar workers different amounts (in terms of seniority, wage level, or other observable characteristics), purely vol-

10 In practice, liquidation of insolvent firms often involves the privatization of a significant portion of assets as going concerns. Gray and Holle (1997b, p. 27) note "while privatization [in Poland] may be an important avenue for privatization, creditors are big losers. They are recovering very little from liquidation in our sample of firms." Gray et al. (1996) found similar results for liquidation procedures in Hungary. If some parts of the company remain viable after liquidation, the two other problems provide minor concerns. However, in general, as long as the new small private firms that develop with the SOE's capital do not put pressure on the banking system, the only concern is equity (i.e., some workers receiving payments but keeping their jobs).

untary programs could be very costly when all (or most) workers have to leave. The supposition is the following: Different workers have different reservation prices at which they would take severance over continued employment. If you are unable to pay different workers different amounts, and all workers have to agree to take the severance payment, then you will have to pay all workers the highest worker's reservation price.[11] If workers behave strategically, these problems will be exacerbated. However, in either case, some mandatory layoffs might be necessary to keep the program affordable.

THERE WILL BE SOME CASES WHERE IT MIGHT BE PREFERABLE TO ALLOW A FIRM TO WITHER AWAY RATHER THAN OFFER A SEVERANCE PACKAGES TO WORKERS. One such group would be enterprises in politically powerful sectors (perhaps due to strong unions). In these cases, the workers might be in an especially powerful bargaining position, making overpayment even more likely.

A FINAL CONCERN IS THAT WORLD BANK FINANCING MIGHT MAKE THE GOVERNMENT LESS WILLING TO BARGAIN WITH WORKERS. Providing the government with a softer budget constraint might make the government less willing to expend political capital taking on politically powerful enterprises or unions.

There are several steps that task managers might take to ensure that programs remain affordable. Rama (1997) notes that the usual procedure when compensating displaced workers — setting severance pay at the equivalent of several months or years of this wage — might actually worsen this problem. In particular, he suggests that because public sector pay tends to be flatter than private sector pay, a better practice might be to reduce the amount of compensation with the (public sector) wage level.[12] Another suggestion might be to base compensation on other easily observed characteristics (i.e., education level, sex, marital status, and number of dependents). Although the effects of some characteristics on welfare and earnings loss appear to differ between countries, Rama (1997) notes that the estimates of overpayment suggest that it would be less costly to produce and process the data required to tailor severance programs.[13] An additional point, suggested in World Bank guidelines, is that although task managers should expect negotiations between the government and workers (or unions), these negotiations should be carefully monitored and a firm grip should be kept on overall affordability. Finally, Bank guidelines note that there are four things task managers should be aware of: contractual obligations towards employees; applicable laws; prevailing labor market conditions; and the attitude and power of unions. Prevailing labor market conditions are vitally important: Workers who have little chance of finding a job without relocating (i.e., in one-company towns) might need greater compensation than workers in areas with relatively liquid labor markets. Similarly, workers with highly transferable skills will likely find it easier to find comparable jobs than workers with highly specialized skills.

In many cases, labor laws will prevent some of these compensation recommendations from being implemented (i.e., basing severance payments on some observable characteristics). Additionally, legislation might set a minimum level of legal compensation. However, in practice, even when there is a legal minimum, many workers are paid more than that amount. For example, Haltiwinger and Singh (1997) note that a retrenchment exercise in India paid twice the legally mandated level of severance pay, and a retrenchment program in Ghana paid two months of salary for

11 Suppose that there are two workers with reservation prices of $1 and $2. If you have to pay them the same severance packet, laying off one worker would cost $1 (the lower reservation price). However, laying off two workers would cost $4 (not $3) since you would have to pay BOTH workers $2.

12 In addition, Rama (1997) notes that this type of severance packet might also encourage the most skilled workers to leave the public sector.

13 For example, it would not be costly to survey workers and pay different amounts to different classes of employees. However, it would be important to design survey instruments carefully so as not to bias responses upwards.

every year served (exceeding the legal mandate of four months pay for most workers). Similarly, the World Bank (1996a) found that twice the legally mandated level of severance pay was paid in a public enterprise employee retrenchment program in Venezuela.

Other Issues

Although severance pay might reduce labor opposition to reform, there are several additional problems that should be addressed. First, unemployment is high in many transition economies; it might be difficult for laid-off workers to find new jobs. As a result, training programs or small and medium enterprise (SME) loans might be appropriate in some countries.

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

When the enterprise due for liquidation is located in a major city, especially when unemployment is low, displaced workers might simply need help locating new jobs. However, in some transition countries, many money-losing enterprises are located in one-company towns. Unfortunately, there is little information about what other opportunities are available to persons in one-company towns. For example, if the enterprise being liquidated is already insolvent (and is no longer operating), many employees might have already developed other opportunities in either the informal or private sectors. There should be a high return to careful case studies that look at the availability of other employment opportunities and the demand for severance, retraining, and loans for small enterprise development in these one-company towns in Eastern Europe and Central Asia.

Although retraining programs might appear attractive, it should be noted that World Bank projects have had only marginal success with retraining in the past. For example, Rama and MacIsaac (1997) found that only 12 percent of laid-off employees from the Ecuadorian Central Bank took advantage of the retraining program offered to them. A World Bank study in Kenya found that although 53 percent of laid-off civil servants reported that the training programs were beneficial, few could specify what they found useful.[14] In addition, Kikeri (1997) notes that studies of displaced workers in OECD countries indicate that training programs have only mixed results. For these reasons, task managers should be cautious when planning these kinds of programs.

14 The study reported that many of the respondents thought that the interviewers were from Civil Service Reform Secretariat (CSRS) and that this might have biased responses upwards.

In this final section of the paper, we outline different Bank modalities that can be used to fund severance payments for employees of state-owned enterprises. Prior to 1996, World Bank loans were not used to fund payments directly, although technical assistance loans could be used to help in the design and implementation of severance payment programs. Counterpart funds generated by Bank loan proceeds could be used to fund severance payments to employees of state-owned enterprises and to civil servants directly.

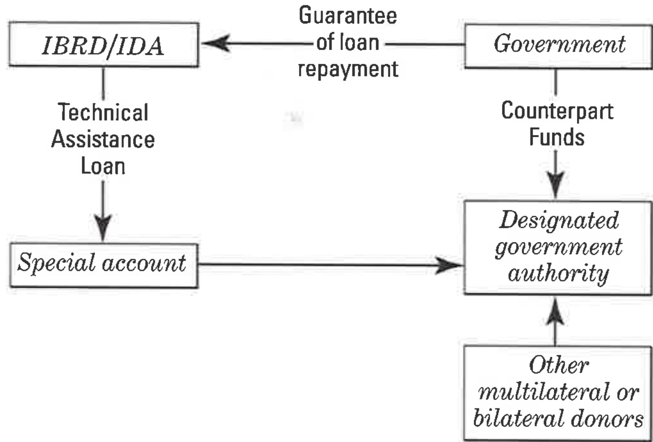
Since February 1996, direct investment lending for severance payments has been allowed but is generally more restrictive than the use of proceeds from the other types of loans. In particular, World Bank guidelines require the project to be justified by increased productivity in the enterprise or sector after restructuring or by related development activities (e.g., retraining of laid-off workers or environmental clean-up). The guidelines note that budgetary savings and closures of inefficient enterprises is **not** sufficient justification for this type of loan. For this reason, as noted in Rama (1997), lending for severance pay is not allowed when state-owned enterprises in a specific sector are not viable. Since the focus of this paper has been on liquidating inefficient enterprises, these stipulations make adjustment loans and technical assistance loans more appropriate in those cases where the loan is not specifically designed to improve **sectoral** performance (e.g., closing down inefficient or unproductive mines to boost the performance of the remaining mines).

Technical Assistance Loans

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

FIGURE 2

Technical Assistance Loans



Civil Service Reform Secretariat (CSRS). This loan was not used to fund the VERS directly, although the Government of Kenya did provide counterpart funds for this purpose.[15]

Loans could be set up as in Figure 2. The government needs to designate some body to manage the severance program. It could (i) set up an agency to disburse the severance to displaced workers; (ii) designate management to an existing privatization cell or (iii) have existing social funds manage the program. It would then deposit counterpart funds in an account that could be accessed by the agency. Other multilateral or bilateral agencies could also deposit funds into this account to pay workers. The International Bank for Reconstruction and Development (or the International Development Agency) can then set up a special account in a commercial bank into which it deposits some portion of the technical assistance loan. The agency would then be responsible for using money in this account (subject to the agreement reached with IBRD or IDA and to World Bank guidelines). When that portion was used up, IBRD/IDA could deposit additional funds.

15 In addition, the Overseas Development Agency also provided a small share of the VERS funds.

BANK MODALITIES TO FUND SEVERANCE

FIGURE 3
Adjustment Loans

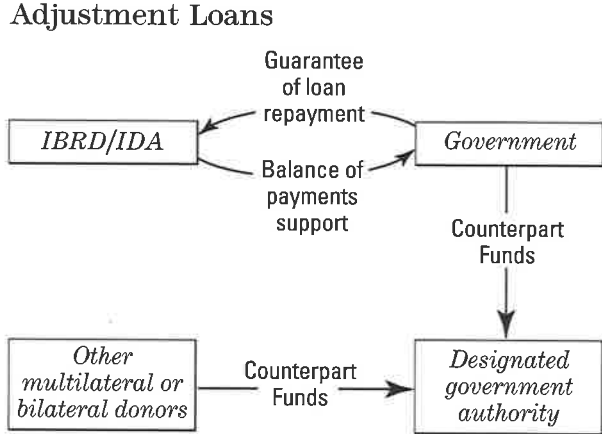
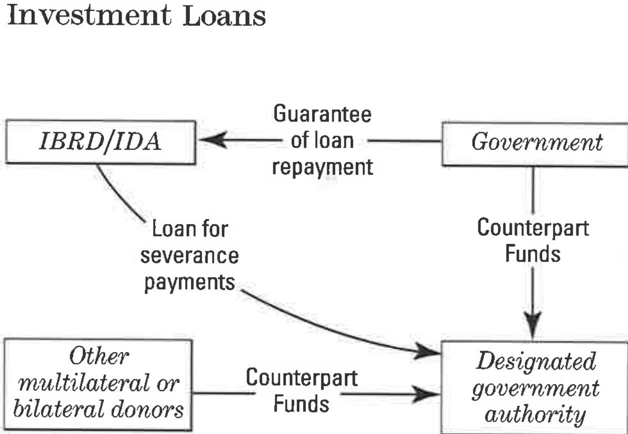


FIGURE 4
Investment Loans



Adjustment Loans with Counterpart Funds Provided By Government for Severance

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

Investment Loans

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

CONCLUSION

If nonproductive enterprises continue to operate, they will end up either being a drain on public finances (if they receive direct subsidies or tax exemptions) or they will threaten the stability of the banking sector (if they receive subsidized credit). Therefore, loss-making enterprises that cannot be privatized will have to be liquidated and their assets sold. Although this will be beneficial in the medium term, the immediate loss of jobs will be wrenching, especially in the one-company towns that are common in the former Soviet Union. Well-designed severance packages can help protect workers and reduce political opposition to the liquidation of nonproductive enterprises.

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

Recent World Bank research has identified three problems related to the design of severance packages for public employees: overpayment, adverse selection, and the rehiring of laid-off workers.[17] The last two problems, which revolve around making sure that nonproductive workers leave and productive workers stay, are not concerns when designing severance packages for firms due for liquidation, since all (or most) workers will need to be laid off. Overpayment, however, remains a potential problem and might be particularly serious when severance is financed by the World Bank. To avoid overpayment, task managers involved in World Bank projects should design packets that tailor severance payments to individual circumstances (i.e., marital status, education, and number of dependents) rather than to an equation (i.e., two months of the worker's final wage for each year of service), which tends to over-reward seniority. Task managers should closely monitor negotiations between workers and the government; [18] and it is crucial that task managers be aware of local labor market conditions, local labor laws, and contract provisions regarding lay-offs.

Supporting the liquidation of loss-making enterprises will help the development of the private sector, protect public finances, and will ensure long-term growth in the transition economies of Eastern Europe and Central Asia.

17 Rama (1997).

18 The first two points are discussed in Rama (1997).

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