

# Public sector downsizing

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# Contents of the presentation

- » The context
- » A mixed record
- » Adverse selection
- » Losses from separation
- » Compensation packages
- » Training and assistance programs
- » Returns to downsizing

# The context

- Labor retrenchment is increasingly used as an ingredient of economic reform
- It is seen as the only durable fix for recalcitrant budget deficits
- Since 1996 the World Bank can lend for severance pay in state-owned enterprises
- Since 2002 it can lend for severance pay in the civil service
- If the World Bank does not lend, other donors and multilateral agencies will

# Usual problems

- Downsizing operations are often implemented in a rush (especially when facing large budget deficits)
- Separation packages are often copied from other operations, and their formulas are ad hoc
- Some separated workers are under compensated, others get “golden handshakes”
- The composition of “stayers” and “leavers” is often discovered after the operation is carried out
- The liabilities created by early retirement programs are seldom evaluated
- While financial returns to the operation may be known, economic returns are seldom assessed

## A mixed record

A survey of 41 downsizing operations supported by the World Bank in the early 1990s shows that:

- Most operations display high financial returns (the average payback period is about two years)
- But 40 percent of the operations display some re-hiring (substantial in 20 percent of the cases)
- For each dollar spent on workers compensation, two dollars were spent on enhancing safety nets

# Adverse selection

- Voluntary separation packages are more attractive to productive workers
- In some cases, no downsizing can be preferable to a “wrong” downsizing
- The optimal mechanism is a “menu” of offers, but how to implement this in practice?
- Some kind of targeting is needed before offering voluntary separation packages

# Losses from separation

They include loss in earnings, in tangible benefits (housing, pension, etc.) and in intangible benefits (job security, lower effort, etc.)

Three approaches to estimate the loss: before-versus-after, in-versus-out and stayers-versus-leavers

These approaches show that the “size” of the loss varies considerably across countries, and with the characteristics of public sector workers

## Some frequent patterns

- Those with more education tend to lose less, in relative terms
- Those who have spent more time in the public sector lose more on an annual basis
- But they may lose less in a long-term perspective, because they are denied fewer years of service
- Women tend to experience a larger drop in earnings and benefits, but not in well-being

# A practical strategy to predict losses

- Use household survey data to estimate potential earnings and tangible benefits out of the public sector
- Focus on those who could gain by leaving to estimate the value of intangible benefits
- Adjust observed earnings and tangible benefits by the estimated value of intangible benefits
- Subtract potential earnings out of the public sector to assess the annual loss from separation
- Compute the present value of this loss for all the years until retirement age

# Designing a compensation package

- Each severance pay formula leads to a specific amount of compensation per public sector worker
- This compensation can be compared to the losses computed using household survey data
- If compensation is higher than the loss, the public sector worker would not feel penalized to leave
- Some packages are better than others in terms of their cost, fraction of workers satisfied, or the composition of stayers and leavers

# The severance pay formula

- The “best” formula may not look too different from formulas used elsewhere
- For instance, it may pay  $A$  years of salary, or  $B$  months of salary per year of service
- But the choice of  $A$  and  $B$  is not arbitrary
- Small changes to  $A$  and  $B$  can actually modify the downsizing outcomes quite radically

# Political considerations

- In the end, the choice of a compensation package is a political decision
- But technical work on the “best” compensation package can provide a useful benchmark
- A related issue is whether separated public sector workers should be “fully” compensated
- As they are seldom poor, even after retrenchment, full compensation is hard to justify
- But it might be necessary for political reasons

# Re-training and assistance programs

- Government resources can be used to offset the loss from separation (as in severance pay)
- Or they can be used to reduce the magnitude of the loss (as in re-training or placement programs)
- The effectiveness of re-training and placement programs appears to be quite limited
- Separated workers should be allowed to choose their own mix of compensation and re-training

# A practical approach to re-training

## 1. Before downsizing:

- Tender for re-training services, open to all
- Chosen providers present their services
- Workers learn the assistance they are entitled to

## 2. At downsizing:

- Workers choose their re-training providers (if any)
- The cost is deducted from the assistance

# Returns to downsizing

- Downsizing and investment operations are similar: large upfront costs with potential long-term benefits
- Therefore, the ex-ante assessment of these operations should be similar too.
- The ex-ante assessment involves a comparison of costs and long-term benefits
- But benefits from the perspective of the downsized unit, or of society as a whole?

# Financial versus economic returns

- Public sector over-staffing is only one among several distortions:
  - “Wrong” pay schedules in the public sector
  - Transfers to or from the budget
  - Relocation costs and externalities
- Correcting only one distortion does not necessarily increase efficiency
- Financial returns do not take these other distortions into account; economic returns do

# Financial returns

## 1. Costs:

- Severance pay packages
- Re-training and assistance programs
- Liabilities from early retirement

## 2. Benefits:

- Savings in terms of salaries

Typically benefits largely exceed costs

# Economic returns

## Labor reallocation

Are separated workers more or less productive out of the public sector? Depends on extent of adverse selection and on labor market conditions

## Reduced taxation

If taxes did were not distortionary, financial returns would only entail redistribution. The output effect of reduced taxation depends on the marginal tax burden