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Public sector layoffs, severance pay, and inflation in the small open economy

Edward F. Buffie*

Department of Economics, Wylie Hall 105, Indiana University, Bloomington, IN 47405, United States

A B S T R A C T

Because severance pay is worth 2–5 years of wages in many LDCs, public sector layoffs increase the fiscal deficit in the short run. Nevertheless, generous severance pay is not as serious a macro-economic problem as generally thought. In the case where the fiscal deficit is financed by printing money, inflation is continuously lower under plausible conditions. When the government can borrow in world capital markets and layoffs reduce the present-value wage bill, there exists a sequence of bond sales and subsequent redemptions that guarantees continuously lower inflation. This result does not hold, however, if the reform lacks credibility.

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1. Introduction

Public sector overstaffing in developing countries has lowered productivity, increased the fiscal deficit and inflation, worsened the distribution of income, and contributed to balance of payments problems. Consequently, structural adjustment programs often call for deep employment cuts in the civil service and at state-owned enterprises. This is especially true of adjustment programs in Sub-Saharan Africa. Ghana, Sierre Leone, Uganda, Kenya, Tanzania, and Zambia reduced civil service employment by 20–50% in the nineties (Harvey, 1996; Sahn et al., 1997; African Development Bank, 2005); Guinea and Gambia went even further, eliminating one-fourth of *all* public sector jobs (Jabara, 1994; Mills and Sahn, 1996).

The long-run benefits of lower inflation, higher productivity, and a better distribution of income add up to a powerful case for reform. There is a catch, however: under existing contracts, retrenched workers in many LDCs are entitled to severance pay worth 2–5 years of wages (see Table 1). Because severance pay is so generous, the wage bill increases sharply before it starts to decline. Policy makers

* Tel.: +1 812 855 9566; fax: +1 812 855 3736.

E-mail address: ebuffie@indiana.edu

fear therefore that employment cuts will lead to higher fiscal deficits and higher inflation in the short run. This has slowed the pace of reform to a crawl in many countries. Surveying the scene in the Middle East and North Africa, Page (2001) observes that “financial incentives for voluntary redundancy such as severance pay... have not been widely used due to fiscal constraints” (p. 72); hence governments are unlikely to “undertake more active labor redundancy policies [until] increased tax revenues from rising income will permit greater fiscal space” (p. 73). In a similar vein, Helbling (1999) argues that civil service reform may threaten macroeconomic stability if its short-term costs are not paid for by a temporary tax surcharge. Recently the World Bank amended its operational rules to allow lending for severance pay. The new rules were adopted for the express purpose of loosening the fiscal constraint in public sector restructuring programs (Rama, 1999). Nevertheless, fiscal concerns still inhibit reform (African Development Bank, 2005) and “cost-benefit” assessments in the literature still tend to be highly ambiguous, e.g.: “The voluntary approach to reductions—especially paying workers to leave—... is now broadly supported by IFIs (International Financial Institutions). But the costs of needed severance pay and other safety-net enhancements—early retirements, counseling, retraining—may be greater than the financial and economic benefits” (Cook and Murphy, 2002, pp. 7–8).

I argue in this paper that generous severance pay is not as great a macroeconomic problem as generally thought provided layoffs are credible (i.e., expected to be permanent). Severance pay three times the annual wage is certainly a severe fiscal shock. But the shock is strictly temporary. Forward-looking agents realize that the fiscal deficit and inflation will be lower in the future. Due to the deflationary pull of the fundamentals, the outcome is uncertain even when severance pay is financed entirely by printing money. Much depends on the trajectory of the wage bill and the sensitivity of money demand to its future return, but there is no general presumption that inflation increases in the short run. I demonstrate that inflation is *continuously* lower when the interest-elasticity of money demand is slightly above .50 and the ratio of severance pay to the annual wage is less than the reciprocal of the nominal interest rate, a number on the order of 2–6 in most LDCs. And if the interest-elasticity is significantly higher, severance pay can be obscenely generous without endangering price

Table 1

Ratio of severance pay to the annual wage in various LDCs.

Senegal, 1990–2000	3–5
Ghana, 1986–1989	4.3
1989–1995	>4.3 ^a
Kenya, 1990s	3.3
Mali, 1990s	4.0
Zambia, 2000–2007	10
Sierra Leone, 1990s	2.0
Egypt, 1996–1997	3.0
Guinea-Bissau, 1990s	9.6
Africa, 1990s	5.2 ^b
Ecuador, 1990s	2.3
Bangladesh, 1990s	3.1
India, 1993–1994	14.3 ^c
Argentina, 1990–1994	2.0 ^d
Peru, 1990s	2.4
Average in the 1990s for 37 LDCs ^e	2.05/3.0

Sources: Tait Davis (1991), Rouis (1994), Kikeri (1997), Rama (1999), Rama and MacIsaac (1999), Gupta et al. (1999), Haltiwanger and Singh (1999), Thurlow and Wobst (2004), and African Development Bank (2005).

^a 52 months of wages plus early payment of retirement benefits.

^b Ratio is inflated by inclusion of programs that used part of the fiscal saving from layoffs to increase real public sector wages.

^c For state-owned textile firms.

^d For railways, telecommunications, and steel companies.

^e 2.05 is the figure implied by Haltiwanger and Singh's (1999) calculation that, at a discount rate of 10%, it takes 2.27 years on average before the financial saving from lowering the wage bill equals total outlays on retrenchment. But Haltiwanger and Singh's figure (i) includes some programs that paid little or nothing to retrenched workers and (ii) excludes programs that generated a present-value loss (i.e., programs that did not have a finite breakeven period). The higher value 3 reflects an arbitrary guess that adjustment for these factors would increase the average payback period by 50%.

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