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LABOUR RETRENCHMENT IN A PRIVATIZATION PROGRAMME: THE SRI LANKAN EXPERIENCE*

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Abstract: This paper looks at the Sri Lankan labour retrenchment experience during privatization. The experience is traced by looking at how three key issues have been resolved, namely; (i) voluntary versus involuntary retrenchment; (ii) using a compensation package as a safety net; and (iii) pre-versus post-privatization retrenchment. It is shown that: (i) a voluntary retiring scheme cannot always be restricted in its application to redundant labour and thus it tends to suffer from the adverse selection problem; (ii) a fixed compensation package appears to be better than a flexible compensation package, especially if trade unions are characterized by rent seeking behaviour and compensation packages are downward rigid; and (iii) pre-privatization retrenchment may not be the best option for every state-owned enterprise because it ignores the post-privatization restructuring options. It is argued that the retrenchment experience met with serious problems in resolving all three issues, mainly because of the inflexibility in the Sri Lankan labour market and inadequate design of the retrenchment programmes.

Introduction

There is now a sizeable body of literature on various aspects of privatization. Many country experiences with privatization have also been documented in such literature (see, for instance, Kikeri, *et al.*, 1994). The case studies of developing countries have shed light on issues related to privatization, such as efficiency effects, fiscal effects, and so on, and enriched the knowledge regarding the implementation of privatization in various countries over the years. However, labour retrenchment in the context of privatization has received little attention.

In most developing countries until about the early 1980s the State was considered as the "engine of growth". There was a proliferation of

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state-owned enterprises (SOEs) in the industrial, agriculture and service sectors and many of them were run on a non-profit basis. Most SOEs recruited labour far in excess of their requirements in the belief that one of their tasks was to create employment. Recruitment was also based on political patronage in many instances. Once recruited, the surplus labour had to be carried even if it adversely affected the economic viability of the SOE. Thus, redundancy was a common phenomenon in the SOEs. Privatization of SOEs implied that retrenchment of surplus labour was a possibility. Due to this fear, Trade Unions which represented the interests of labour have not always seen privatization positively.

Retrenchment of labour from SOEs is not an easy exercise. Politically or socially motivated laws (e.g., labour laws protecting workers from being dismissed) and bureaucratic constraints (e.g., with respect to hiring) in developing countries make it difficult for SOEs to adjust their labour force to a socially or privately efficient level. Further, trade unions and other worker organizations often promote work rules of various types to induce work safety and job security (Svejnar and Terrell, 1991: 13). All these factors aggravate the problem of redundancies especially when there is a decline in demand for labour in the firm. Thus labour retrenchment in a privatization exercise cannot be executed without taking these factors into consideration.

A retrenchment exercise is associated with significant social as well as political costs. Retrenchment causes the individual worker to suffer various social costs, such as, the need to relocate geographically, learn new skills, face high search costs in finding alternative employment and suffer psychological costs of unemployment. The envisaged reforms may also cause considerable shifts in income and wealth, causing significant political costs in terms of welfare losses. In these circumstances, compensating retrenched workers can spread the temporary burden of reform across the economy thus preserving social peace during transition, which is essential for new supply responses to emerge in the economy (Diwan, 1992). In other words, retrenchment has to be associated with a compensation package if the socio-political cost of restructuring is to be minimized.

A compensation package or a 'redundancy payment' or a 'safety net' for workers in the context of privatization refers to a temporary monetary or/and non-monetary assistance that once-and-for-all compensates a worker for losses incurred during privatization as opposed to a broader social security scheme. An effective compensation package is one that minimizes the welfare losses to labour and also minimizes financial cost to the provider (the government or the private sector owner, depending on who is offering the compensation package), while minimizing social and political unrest in the labour market. In other words, it is a package that is acceptable both to the employer and the employees.

Sri Lanka provides a good case study of labour retrenchment and designing a compensation package in a privatization programme because of the complexities inherent in the labour market with deep seated political, social and economic bearings. Until 1977, the Sri Lankan economy was tightly controlled and inward-looking, characterized by slow growth and high welfare achievements (see, for instance, Athukorala and Jayasuriya, 1994). In 1977, the Sri Lankan economy was liberalized mainly in the areas of trade, financial and commodity markets. Despite two decades of experience with liberalization, the labour market still remains rigid with liberalization-related reforms making little in-roads into the labour market. The trade union movement in the country remains highly politicized and rigid employment-security oriented labour legislation govern the labour market (Gunatilake and Kelegama, 1997).

Roughly one fourth of the labour force in Sri Lanka is in the regulated sector that is governed by legislation that was enacted to suit the needs of the inward-looking regime of the pre-1977 period. The Sri Lankan trade union movement was born through and under the aegis of political parties in the early 1930s before solidarity on occupational lines had hardened and spontaneous demand for organization had developed among workers. As a result of these peculiar initial conditions, the majority of the trade unions look to the backing and mediation of the respective political party to win their demands (Gunatilake and Kelegama, 1997).

Reciprocal links between political parties and trade unions have tended to transform union leaders into agents and representatives of their affiliated parties. As a result, the objective of the political party has assumed priority over the objectives of the mass of workers whom they claim to represent. Thus, the majority of workers are involuntarily drawn into industrial disputes initiated by their leaders whose real agenda relates to the political interests of the Party he/she represents rather than improving the welfare of workers in the establishment. Thus, when a compensation payment package is introduced at the time of restructuring a SOE, it is the union leaders that determine whether it is acceptable to the workers or not. Since the package affects all employees in the firm, irrespective of grades or union membership, there is consensus among trade unions in the firm on the bargaining position. As the trade unions always bargain for a better deal, the workers feel that even if the package is acceptable to them it is better to support the trade union for an even better package through collective bargaining.

These complexities in the Sri Lankan labour market meant that most theoretical recommendations on labour retrenchment (e.g., Diwan 1992, World Bank 1995) are not necessarily practical. There are three issues that have been subject to much debate in recent times. The first concerns the nature of the retrenchment exercise: should it be voluntary or involuntary? Several countries such as Brazil, Yugoslavia, Ghana, amongst others, have pursued the former option (Svejnar and Terrell 1991). Multilateral donors also seem to support voluntary retirement (Rama, 1997). However, even when the government's resolve to implement a voluntary retirement scheme is strong, certain constraints in the labour market may lead to unintended consequences.

The second issue concerns compensation. It is accompanied by a host of queries: (i) what is an 'optimal' compensation package? Is it dependent solely upon the worker characteristics that are used in the design of such a package or is it influenced more by trade union bargaining power to the extent that laborious desk-work in calculating the 'theoretically optimal' package is rendered useless? (ii) Should the package be administratively fixed or be flexible (varying on a case by case basis, depending on the company)? (iii) The final issue is the timing of the retrenchment exercise: should it be *before* privatization or *after* privatization? The experience in several countries seem to lean towards the former (Diwan, 1992). However, there may be cases where pre-privatization retrenchment will be less-than an optimal solution in a dynamic environment where structural changes in the company differ considerably after privatization.

The objective of this paper is to see how the Sri Lankan retrenchment programme on privatization responded to the three contentious issues stated above. Since privatization of SOEs was pursued aggressively in Sri Lanka around 1989, the focus would be mainly on the retrenchment experience corresponding to the post-1989 period (i.e., 1989-1997). Undoubtedly, there are many other issues related to this topic, but the discussion will be restricted to the three selected areas.[1]

Conceptual Issues

Theoretically, a worker is redundant if his/her marginal productivity is below the received wage. However, measuring redundancy and identifying workers who are redundant is a difficult task (Fiszbein, 1992, Mundle, 1994, and others). Redundancy incurs a loss equivalent to the 'excess' wage paid, on redundant workers. The conventional wisdom is that purging excess labour from such firms, *ceteris paribus*, may be vital in improving financial viability and in attracting private equity.

Voluntary versus Involuntary Retrenchment

The first issue in regard to labour retrenchment is whether it should be conducted on a involuntary basis or voluntary basis. In other words, whether retrenchment should be forced on the workers or whether they

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[1]Some other issues that could be covered under this topic are : the actual benefits that an enterprise obtains as a result of retrenchment, other options available to deal with overstaffing (part-time labour, letting the work force decline through attrition), the effects of retrenchment on unemployment, etc.

should be given the option to use their discretion on leaving. Mandatory retrenchment is theoretically appealing because it suggests that the 'correct' amount of workers of the 'correct' type can be retrenched, leaving the firm with an optimal work force. However, there are two main constraints in this approach. First, identifying the redundant workers is not always easy since accurate information on worker productivity is often not available in sectors such as trade or services where output is not clearly measurable. Second, labour laws, political costs and trade union opposition may prevent mandatory retrenchment.

Another problem with forced retrenchment is that workers retrenched may be identified by prospective employers as low productive workers. Being retrenched implicitly signals that they had been redundant workers of 'low quality'. It may be that their skills are obsolete or that they are shirkers and are therefore redundant. Thus, forced retrenchment may create substantial resentment in a labour market that has a history of being employee-friendly.

The alternative is to offer a package attractive enough to entice voluntary retirement. However, even attractive voluntary retirement schemes (VRS or 'golden hand-shakes' as they are sometimes termed) may fail to remove *all* of the redundant labour. Conversely, it may be 'over attractive', removing *more* workers than optimal. Another serious problem is that the package might attract the 'wrong' type of workers. The latter encompasses the problem of 'adverse selection', where the better workers take up the package and leave the company (Diwan, 1992). Better workers have a higher probability of finding alternative employment sooner (since they may have more marketable skills, greater capacity to learn new skills, etc.) adding to lower opportunity costs of losing the job compared to 'low quality' (high rent) workers. In effect, voluntary retirement may well leave the firm with the non-optimal composition of workers.

Diwan (1992) has argued that the problem of adverse selection in voluntary retirement can be restricted by indexing the compensation calculation based on worker characteristics (skills, productivity, etc.), i.e., VRS could be offered only to those workers who have been identified as being in excess. Such solutions however, are in practice not feasible due to imperfect information on worker characteristics. It may also stir considerable trade union opposition and be subject to charges of discrimination.

VRS also suffers from the 'free rider' problem, i.e., the workers remaining in the firm may benefit more by the exit of some. In other words, the exit of some workers will raise the value of current jobs. This calls for the increase in the size of the compensation package for exiting labour for giving up the extra gains in the job. The increase leads to an above target compensation and wasteful compensation. Diwan (1992) argues that this problem could be solved by reducing the wages of the remaining workers. However, when wages are rigid downwards and when trade unions are strong, this would be practically impossible.

Despite these problems in VRS, institutions like the World Bank have argued that VRS are 'good investments'. In fact, in accordance with this thinking, the World Bank has decided to reclassify monies loaned for such purposes as 'investment' loans. The World Bank argues that investment in downsizing can foster efficiency gains and growth that more than compensates for the up-front cost of paying-off workers to leave (Robbins, 1995). In early 1996, the World Bank's operational rules were modified in order to allow lending for compensation related to VRS (Rama, 1997: 1-2).

Many of the severance packages recently implemented in developed and developing countries have been of the voluntary type. In Europe, most of the large restructuring firms offered VRS (large firms with strong unions used voluntary packages, while small firms with weak unions used involuntary schemes-- Galenson, 1989). In the U.S. large corporations usually lay-off workers using VRS, presumably to avoid legal problems related to discrimination (Lawrence, 1988).

Compensation Package: Safety Net for Labour

The second issue in the context of labour retrenchment in privatization is the accompanying compensation package or safety net. A compensation package can have both a monetary component in the form of a financial compensation package and a non-monetary component in the form of a retraining, redeployment, and relocation scheme.

For many workers, the monetary component of the compensation package may be more important than the non-monetary component. The monetary component of the compensation package is normally equated with the worker's opportunity cost of leaving employment (which however does not totally reflect welfare losses incurred). The opportunity cost equals the discounted present value of a worker's expected lifetime income loss resulting from job loss. In other words, an effective monetary package should make the worker indifferent between leaving employment and staying on (Fiszbein 1992, Diwan, 1992, for a more theoretical exposition). If not, an overgenerous package may encourage too many workers than required to leave, and a sub-optimal package may not be successful in removing the required amount of labour.

On the part of the financier of the retrenchment monetary package, an optimal package is one that incurs the least possible financial costs and the least trade union, social and political resistance. Even these two objectives tend to pull in opposite directions (in a financial sense) and it is necessary to strike a balance between them. Further, if it is retrenchment on a voluntary basis that the financier is aiming at, the package should be able to attract the optimal number and type of workers in surplus.

Designing an optimal monetary package is by no means an easy task, and is not the intention of the present study.[2] In short, designing involves estimating future income streams and depends on a multitude of factors such as current wage, skill level, age, employability, opportunities for promotions, and experience. Calculating an 'effective' monetary package for workers in general is a much more arduous task, since workers are heterogeneous in characteristics, and will thus have varying opportunity costs. Hence an important issue

[2] For details on designing an optimal compensation package, see Diwan (1992), Fiszbein (1992) and Robbins (1995).

is deciding which parameters should be included in designing a monetary package and how it should be weighted.[3]

Non monetary compensation often encompasses the broader social aim of minimizing worker dislocation and offering the worker security in the medium and long term. Such safety nets include retraining, assistance in developing entrepreneurial skills, developing a strategy for the fast reallocation of labour, etc. Most often, governments consider the need for a non-monetary safety net to accompany a monetary safety net to minimize resistance to retrenchment from trade unions (see, for instance, ILO, 1996).

It should be noted however, that the *type* of compensation package that is offered to the worker depends on the objectives of the employer. For example, if the State sector retrenches, it normally considers that a non-monetary package should accompany a monetary package. The private sector on the other hand, will be more inclined to offer only a direct monetary package. Both sectors may also offer shares of the company to workers, either due to liquidity constraints in financing monetary compensation, or in order to broad-base share ownership. Shares are offered in normal practice to remaining employees (as a sweetener to secure their support for the divestiture), but there can be cases where shares are also included in the monetary component of the package to address the 'free rider' problem.

Therefore the most effective package, would be one that strikes the best balance between motives and constraints of the worker and the employer. In other words, it is one that minimises welfare losses of the worker, whilst minimising trade union and political costs.

The third significant issue is whether the monetary compensation formula should be fixed (across-the-board) or flexible (varying case-by-case). Although a fixed scheme has the advantage of

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[3] Since different workers will be characterized in general by different rents, a uniform severance offer that does not hurt the high-rent workers too much will allow the low rent workers to increase their pay-offs. This overpayment may be eliminated if severance offers could be made worker-specific and tailored to compensate each worker according to his/her losses. This can be achieved with some type of indexation, but in practice worker types cannot be observed with precision.

being simple and easy to administer, the World Bank (1995:90) argues that administratively fixed payments are too high in most countries. This is not a problem if wages are flexible because employers will reduce wages to off-set high costs of dismissal. But flexible wage systems are almost impossible to find. Therefore the World Bank suggests that a flexible formula that varies across firms, and negotiated between workers and employers of respective firms is the "ideal". Especially when it is financially infeasible for a firm to bear the cost of a fixed compensation formula, it seems better to negotiate with the workers and pay them a lower amount.

Supporters of the fixed formula warn against flexible formulas on the grounds of arbitrariness of different packages for different firms (Fiszbein, 1992). The use of a flexible formula is criticized for several reasons. First, it encourages competitive rent seeking by the parties involved and the arbitrator (such as a Labour Commissioner). The arbitrator may grant approval to certain packages under the influence of sectional interests. Second, the 'efficiency' aspect of compensation packages may be violated. Different payments by different firms will militate against the principle of just compensation of workers on the basis of opportunity cost. In other words, the principle underlying the payment of compensation that the worker should be indifferent towards voluntarily retiring and continuing employment, may be violated. Thus, there could be demands from workers for the most attractive package rather than one that covers opportunity cost. Third, there is a significant uncertainty cost associated with the duration of the determination of the compensation package.[4] Such periods of uncertainty encourage pressure groups to become active. Alternatively, in the absence of a consistent policy, there is danger of a negotiating game which creates a snowballing effect on redundancy compensation packages.

Pre versus Post-Privatization Retrenchment

Another key issue is whether retrenchment should take place before privatization or after privatization; whether it should be the

[4] Normally, in a developing country, the Labour Commissioner takes at least six months to determine the compensation package.

government (the owner of the SOE) or the private sector buyer (new owner) that should retrench the excess labour. On this issue it is essential to focus on whether the workers targeted and retrenched *before* privatization (in number and in composition) are the same, had retrenchment been done *after* privatization. Ideally, the choice of "who" is retrenched and "how many" are retrenched under both scenarios should be "dynamically consistent" (Cukierman, 1992).

The issue of dynamic consistency is often ignored in labour retrenchment because labour is viewed in isolation vis-a-vis other structural changes that occur in an enterprise as a consequence of privatization. For example, the private sector buyer may significantly restructure the enterprise by altering techniques of production, down sizing or upgrading capital, introducing new product lines, and closing down some of the old. As a result, what was considered as the optimal size and composition of the labour force before privatization may change considerably after privatization. Hence, workers targeted and retrenched before privatization will be non-optimal in quality and quantity after privatization, thus compromising the very purpose of shedding labour.

The second issue regarding the pre-and-post privatization retrenchment debate arises from asymmetries in retrenchment costs faced by the two sectors, that might lead to rent seeking by the party with informational advantage.[5] Asymmetries may arise from varying political and legal costs. SOEs, for instance, face a large political cost when retrenching workers. Such political costs are particularly acute when high unemployment prevails in the rest of the economy. The presence of high unemployment usually leads to longer search periods for retrenched workers due to congestion effects (Rama, 1994). This reduces the probability of finding a new job immediately and increases the psychological and search costs of the retrenched worker. Thus, there could be higher opposition to being laid off. Similarly, the private sector may face higher legal costs if the

[5] In a world of correct information where both the seller of the SOE and potential buyer have no informational advantage on the optimal size or composition of the work force, the question of pre-or post-privatization retrenchment does not arise. Dynamic inconsistency, for instance, will not occur under perfect information.

legal constraints it faces are different from those faced by the public sector. The private sector may also lack the informational advantage in regard to worker, union and labour relations and may encounter serious problems and these will be exacerbated if trade unions have political links.[6]

The crux of the matter then, is that both the SOE and the potential buyer face differing costs depending on the economic, political, legal and industrial environment. Hence, the solution to the problem of cost asymmetries evolves from a detailed cost-benefit analysis weighing the two options. This is not an easy task.

The Sri Lankan Experience

The Sri Lankan privatization experience has been discussed extensively in the existing literature (see, Jayawardena, 1993; and Kelegama, 1993, 1995, 1997a and 1997 b, and others). Labour redundancies were a common phenomenon in most SOEs in Sri Lanka during the late 1980s. It was caused by two factors. First, and most importantly, SOEs were largely *overstaffed* because employment had been given under political patronage and as a last resort to fulfilling the State's objective of reducing unemployment. Recruitment was easiest in the semi-skilled and unskilled tiers -- where most opportunities of disbursal of patronage prevailed -- and thus, not surprisingly, surplus labour was most common in the grades of labourers, minor staff, clerical and other allied grades rather than at the management and executive grades, and grades requiring skilled labour.[7]

Second, worker redundancy was common in SOEs because the work ethos that prevailed was not one that generated high worker productivity. Since the profit motive was not the main drive in a public enterprise, implementing efficient corporate management and productivity enhancement techniques were not high on the SOE

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[6] This may be the case especially if the new owner is from a foreign country.
[7] See, for example , the management study done on the Distilleries Corporation as cited in the GOSL (1987 : 22).

agenda. On the part of the workers, they had little incentive to improve productivity levels especially since wages were linked to inflation rather than productivity. Further, workers were entitled to take 42 days leave annually, absenteeism was not heavily penalised and public holidays were high (Gunatilake and Kelegama, 1997). They also enjoyed a high sense of security and treated the public sector job as their *entitlement* rather than a position that had to be secured by efficient performance.[8]

Fiszbein (1992) estimated, the redundancy level in the SOEs in the State sector in Sri Lanka (excluding plantations), which employed roughly 120,000 people to be as high as 40-50 per cent in 1991. The level of redundancy in the Sri Lanka Transport Board was estimated at 6 employees per bus (the optimal ratio of employees per bus is estimated at 6.5 as compared to Sri Lanka's 13.1; the additional amount is thus considered as redundant labour (Svejnar and Terrel, 1991: 18). The problem of redundant labour was identified by the Presidential Commission Report on Privatization (see GOSL, 1987: 9-13). In order to comprehend the strategy that was suggested by the Presidential Commission to address the problem of labour redundancies it is essential to focus on the existing labour exit policy in Sri Lanka

One of the most important pieces of legislation that govern employment security in the labour market in Sri Lanka is the Termination of Employment Act (1971) (TEA). The TEA applies only to the private sector, and under its provisions an employer with 15 or more employees, wishing to terminate the services of an employee with one or more years of service on non-disciplinary grounds, is required to obtain the written consent of the employee or the approval of the Labour Commissioner. If the dismissal is approved, the Labour Commissioner would decide on the required compensation. It is a time consuming, cumbersome and costly procedure (Gunatilake and Kelegama, 1997).

[8] In Sri Lanka, employment in public service assures the worker a life-long income guarantee: a steady job until the time of retirement , and after that the transference to a pension programme.

The TEA however does not apply to Government. Owned Business Undertakings (GOBUs) or to SOEs.[9] This is because under the Sri Lankan legislation, a worker in a GOBU or SOE is not covered by any labour legislation but by the government Establishment Code. Thus the services of a worker of a SOE can be terminated without the specific permission of the Commissioner of Labour.[10] A worker of a GOBU or SOE once retrenched cannot go before a Labour Tribunal to get relief. Therefore, although it may appear paradoxical, workers are better protected by legislation in Sri Lanka after privatization than before.

There had been several attempts in the past to rectify the adverse implications of the TEA in order to create a more efficient labour exit policy. Given the highly politicized trade union structure in Sri Lanka, none of these attempts have been successful. Thus, the Commission may have considered it more prudent that the excess labour issue is fully dealt with before executing the privatization programme because, as mentioned, it was easier to do so under the existing legislation. It is apparently on the basis of this thinking that the Commission formulated its recommendations in handling the surplus labour issue. Its recommendations are summarized in Box 1.

[9] All nationalized private firms under the Business Acquisition Act of 1971 were categorized as Government-Owned Business Undertakings (GOBUs). Basically they were State-Owned Enterprises with a different name.

[10] The Public Corporations Act No. 22 states: 'All members, officers and servants of the Corporation shall be deemed to be public servants within the meaning and for the purposes of the Penal Code' (p.6). Under the retrenchment provision of the Industrial Dispute Act, if one months notice is given both to the Trade Unions and the Labour Commissioner, before the lapse of 3 months, retrenchment could be executed.

Box 1 : Recommendations made for handling labour issues during privatization

Retrench workers before privatization.

Do not conduct involuntary retrenchment of labour.

Compensation:

- Offer only a monetary compensation package, worked to a particular formula.

Provident Fund Benefits and Gratuity Rights:

- Enable employees, irrespective of age to withdraw due Provident Fund benefits on termination of employment due to privatization (Under normal law, a worker has to serve until retirement age to withdraw Employees' Provident Fund (EPF) benefits -- see Footnote 12). This recommendation was legalized subsequently, by the EPF Amendment Act No. 14 of 1990.
- Ensure that an employee does not forfeit his gratuity rights conse- quent to the change of employer. Thus, past service of the workers in SOEs (Public Corporations) are deemed service rendered to the new company that has taken over the business of the SOE. This recommendation was legalized subsequently, by the Payment of Gratuity (Amendment) Act, No. 41 of 1990

Identify surplus workers at each staff level and offer only these workers the option to retire.

- If workers not in surplus wish to leave, they will be entitled only to gratuity payment.

  Note: Under the Gratuity Act of 1983, all employees of state enterprises are entitled to gratuities, irrespective of whether they are leaving the service of the enterprise on or after its conversion into a public company. Gratuities are paid on the basis of previous service to the enterprise. The Attorney General and the Commissioner of Labour have both ruled that these gratuities are payable to all employees even if they are offered terms of employment under the new Company which are the same as, or superior to, those which they enjoyed under the State enterprise, and even if all the benefits that had accrued to them when they were in the service of the State enterprise are guaranteed to them after the conversion of the enterprise into a Public Company.

Source: GOSL (1987).

Subsequent to the Report, two Acts were passed in Parliament, and some amendments made to the laws governing provident fund and gratuity payment as suggested in the Report (see Box 1).[11] Neither of these Acts however mentioned labour issues apart from a brief reference in one of them (Section 3.2 (c), Act. No. 23, 1987), where it was stated that those employees not absorbed in the conversion shall be compensated on such terms as determined by the Cabinet of Ministers. Nor was there any proper discussion with the Department of Labour before this legislation was enacted. After conversion of a SOE under the 1987 Act No. 23 to a public company, the worker enjoys all the rights of a worker in the private sector (for example, payment of Employees' Provident Fund (EPF)[12], Employees' Trust Fund (ETF) [13], etc). There was also no reference to a non-monetary safety net in the subsequent legislation passed, perhaps because there was no reference to such a package in the Presidential Commission Report.

In order to conduct the pre-privatization retrenchment exercise (as well as general retrenchment in the administrative set up) a Committee headed by Bulumulla was appointed to design a monetary compensation package. In late November 1989, the "Report of the Committee on Payment of Compensation for Redundant Staff in Government Corporations and Statutory Boards" was submitted to the government. This came to be known as the Bulumulla Report and was accepted by the government.

A compensation package recommended by this report was offered at the very start of the privatization programme in early 1990 to retrench labour from SOEs. The Bulumulla formula was somewhat

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[11] The two Acts passed by Parliament in 1987 were: (a) Act No. 22 of 1987 which deals with the conversion of Government-Owned Business Undertakings (GOBU) into Public Corporations or Companies; and (b) Act No. 23 of 1987 that gives legal backing to the conversion of Public Corporations into Public Companies. These Acts facilitated the general privatization process.

[12] EPF is an institution created by the government in 1958 for the management of the provident fund. When an employee retires, the accumulated lump sum could be obtained. It is managed by the Labour Department and the Central Bank of Sri Lanka.

[13] The ETF is another fund created by the government in 1980 where every employer is expected to deduct 3 per cent of the salary allowance of the employee and to remit to a fund managed by the Labour Department. The invested income of the fund is credited to the Employee's account. The employee gets the full amount at the time of termination of employment.

similar to the formula recommended by GOSL (1987). Normally, severance packages offer compensation based on the number of years of service (Booth and Chatterji, 1989). But the Bulumulla package offered compensation on both years of service and years denied service.[14] In accordance with the recommendation of GOSL (1987), for some SOEs, tiers of surplus labour were identified before introducing the voluntary retrenchment package.

The compensation packages have been financed in several ways. Some SOEs have sold land and assets (e.g., Building Materials Corporation) whilst some others have used sales proceeds from privatization. When there were delays in obtaining these sale proceeds, loans were obtained from the Treasury to settle the compensation payments. Where the SOEs were unable to bear the cost, the State stepped in by utilizing funds left aside for contingencies. Undoubtedly, the latter form of financing was a drain on the government budget. Surprisingly, there was no support from the World Bank -- the strongest advocate of VRS -- for compensation payments until late 1996.

If the new private owner was not satisfied with the number of people removed before privatization via the government's compensation package, he had the option of removing the additional labour by offering a compensation package of his choice with the concurrence of the Commissioner of Labour. Thus, both pre-and post-privatization retrenchment took place in Sri Lanka. During the pre-1995 privatizations, the ruling party had a strong influence over the dominant trade union at that time (Jathika Sevaka Sangamaya) and thus able to control its bargaining power vis-a-vis compensation packages (the historical political party-trade union nexus worked in the usual style). Repressive measures were taken against any labour uprising that was instigated by left-oriented trade unions.

[14] According to this package, workers would receive half a month's salary per year of employment (gratuity payment) and a compensation for "denied service" (the period between retrenchment and the worker's 55th birthday). The compensation is worked out according to the following formula: C= one month's salary * { (55-age) * (age/55) * (years of service /20) }. The formula reduces the amount of compensation offered with age. This reflects the adjustment for denial of service. There are variations in the Bulumulla package according to the ceiling in compensation offered.

The new political party that assumed office in mid-1994 severely criticized the privatization programme of the previous government, alleging that it was conducted in a non-transparent manner and encouraged "crony capitalism" (GOSL, 1995). The new regime was also committed to privatization but preferred to call it "public enterprise reform" The new government was more friendly towards labour and it had an overwhelming support of some of the leading trade unions in the country. Thus the government did not want to immediately engage in pre-privatization retrenchment and antoganize its support base. Thus, initially (in the year 1995) the policy was that no worker should lose his/her job as a result of privatization, but by 1996 when there was World Bank financial support for VRS, once again voluntary retirement was put into operation before privatization.

Voluntary versus Involuntary Retrenchment and the Patterns of Retrenchment in Sri Lanka

Retrenchment that took place during the early years of privatization were both voluntary and involuntary. There is sufficient evidence to indicate that when the government failed to remove the overstaffed labour (the number that the government had in mind) through a VRS, forced retrenchment was occasionally used as this was possible under the Establishment Code. The leading trade union at that time (Jathika Sevaka Sangamaya) resented this. Thus, on 1 May 1992, the President of Sri Lanka announced an employment guarantee for all public sector employees until they attain the age of 55. This made voluntariness in retrenchment the State policy and this put a stop to involuntary retrenchment by the State.

The number of people retrenched as a result of privatization up to July 1994 (before the change of government) is in dispute. There are highly divergent estimates. The Labour Department puts the figure at 18,000-20,000 whilst the Employers' Federation of Ceylon estimates it to be 35,000. On the other hand, the main public sector trade union, the Jathika Sevaka Sangamaya, claims that 50,000 of their members had been retrenched. The dispute over the number of retrenched workers is indicative of the haphazard way in which the government had conducted the retrenchment exercise, and the fact that involuntary retrenchment has taken place both before and after privatization (under private sector ownership).[15]

Given the unavailability of data, it is very difficult to find accurate information regarding the types of workers who had opted to retire. The majority who took the compensation packages were persons beyond the age of 45 (Weerakoon, 1992). However, the type of workers who opted to retire seem to have followed a bi-modal tendency: one type of workers were those who had a dire need for the money offered by the compensation package because of high indebtedness or some other personal reason such as a wedding in the family. These workers were often semi-skilled or unskilled and felt it was advantageous in the short-run to opt for the package and leave employment. Several such retrenched employees had claimed later that they have not found sustainable alternative sources of income. A survey done by the Sri Lanka Business Development Centre (SLBDC) in 1992, for instance, showed that most employees used compensation received to pay debts, rather than investing in income generating activity (Kelegama 1995).

The other set of workers were the more skilled type, such as engineers and mechanics, who could find jobs elsewhere relatively easily. Included in this set, were workers who faced a lesser degree of financial insecurity either because their spouses were employed or because they had personal wealth.[16] Thus, for some workers, compensation seemed a 'windfall' gain whilst many others were left worse-off with no sustainable source of income, a high psychological

[15] There was no specific number of employees targeted as in, for example, India (ILO, 1996). Involuntary retrenchments are executed very discreetly in stages and normally little is spoken about them. The Labour Department and other relevant government departments speak of their financial inability to monitor the process.

[16] For example, one worker intimated that both he and his wife opted to be retrenched from Ceylon Oxygen Ltd., in 1992 because the total compensation they jointly received amounted to around Rs. 1,000,000 (rather than the average Rs. 200,000 - 300,000 that most workers obtained during the period). This is because the package included the direct monetary compensation payable to workers in the executive grade, as well as shares of the company which rose in price from Rs. 10 to Rs. 152 per share within a few months of privatization, enabling the couple to obtain windfall gains. They invested the money in a house, which now affords a source of regular income since it has been rented out.

sense of dislocation, and high susceptibility to old-age poverty since their provident fund benefits had already been dissipated. The psychological sense of dislocation came about because the economy was not growing fast enough to create new employment opportunities for the new entrants to the labour market.

When voluntary retirement was used in the pre-privatization scenario, the government gave at least 3 months notice to workers to decide. In the post-privatization scenario, the workers were given only roughly 2-3 weeks by the new owners to decide whether they wanted to take the compensation package and leave. In some cases the deadline for the decision was extended indefinitely so that the workers could leave the firm whenever they wanted.[17] The firm terminated this provision when the number of workers were brought down to the level deemed optimal by the management.

Even when tiers of surplus labour were identified before putting VRS into operation, some workers maintained that this was discriminatory and that the option of voluntary retirement should be extended to all workers. However, the main opposition to targeting-tiers for retrenchment came from workers who were not targeted. Opposition came from the more skilled grade of workers who felt they could obtain windfall gains through the compensation packages, since they could find alternative jobs without much difficulty.

Hence identifying tiers of redundant labour for voluntary retirement was eventually dropped and across-the-board voluntary retirement was applied. This is why the problem of adverse selection (better workers leaving) was common in Sri Lanka's voluntary retirement process. The problem was exacerbated during pre-privatization retrenchment because SOEs were worried mainly about the number of people that left work, and not the type. For example, during the privatization process of the bus transport system, most of the workers who opted to take the package and left were mechanics, engineers, stenographers and other skilled employees (Kelegama, 1997a).

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[17] This was the case, for example, in a firm called United Motors.

Even where workers of an identified tier were subject to VRS, the problem of adverse selection could not be altogether avoided because the better workers within the tier opted to leave. It was difficult to screen the high quality workers from the low quality workers. Even where exams were held for this purpose, those workers who wanted to leave the firm performed in the exams very poorly.[18]

Compensation Package in Sri Lanka

As stated earlier, the compensation package offered was basically a monetary package. There was no non-monetary component to the overall compensation package. Basically, the compensation packages had a 'fixed component' (the pre-mature payment of the provident fund benefits and the gratuity payments -- see Box 1) and a 'variable component' comprising of monetary compensation. The variable component was the main component of the compensation package.

Estimates show that the fixed component (gratuity/provident fund benefits) amounted to around 15 to 35 per cent of total monetary compensation offered to the worker, and hence was a significant share of total compensation payable.[19] This provision therefore, was particularly attractive to privatized companies that had government managed provident funds, because when they opted to retrench workers after privatization, nearly a third of the cost of the overall compensation was borne by the government.

A fundamental problem however, with the provision to prematurely withdraw provident fund entitlements was that it contradicted the main objective of having provident funds, which is to offer an old-age social security scheme for workers. The changes to provident fund laws took away an employee's future consumption entitlement and gave it away for current consumption. As SLBDC(1992) shows, very few workers invested their compensation in any income generating avenue. In the context of the changing demographic

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[18] This was the case in the Airport & Aviation Authority at the secretarial level.

[19] In 1991, for instance, Rs. 120 million was paid by the ETF for about 25,000 workers retrenched by the privatization programme (The Island, 16 October 1991 : as cited in Kelegama 1993:66).

composition in Sri Lanka (i.e., the rapidly ageing population where the above 65 years old population is going to double within the next two decades -- De Silva, 1997) and the increasing likelihood of old-age poverty, this situation was quite disturbing.

About 3 privatizations during the 1990-1991 period used the Bulumulla package. As time passed, the workers resented the Bulumulla package and thus voluntary retirement using this package became difficult. This was due to: (a) the trade unions finding that the package was not upgraded for inflation in the economy; and (b) more attractive packages being offered at that time by the new private sector owners of the privatized companies as well as the existing private sector companies (e.g., Ceylon Tobacco).

When it came to the privatization of the Leather Products Corporation in mid-1991, the Trade Unions refused even to bargain on the Bulumulla package. Thus the government had to come to an agreement with the buyer to absorb the redundant labour. Once the corporation was privatized the new owner offered a compensation package to the workers that was more attractive than the Bulumulla package. However, since dismissals were involved, the terms of the compensation package had to be negotiated with the Labour Commissioner. After obtaining his approval the new owners were successful in retrenching some redundant labour through this new package. This package later became well known among other privatized firms and the government, and established its name as the Leather Products Company Formula (LPCF).[20]

A third formula was adopted in mid-1992 by the new private sector owners in the case of Lanka Ceramics Ltd, where the compensation package went up to Rs.300,000. This was a specific case because the employer concerned had sufficient funds to meet this

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[20] The LPCF is a maximum of 50 months salary subject to an upper limit of Rs. 2 1/2 lakhs in the case of Managerial Grades and Rs. 2 lakhs in the case of others. The formula found favour with the Trade Unions and it was subsequently applied for various privatization cases (e.g., BCC, 3 companies formed after the conversion, under the 1987 Act, of the Sri Lanka Sugar Corporation, and others). During 1991-1992, about six of the retrenchment exercises were conducted along the lines of this package.

liability. The compensation together with their EPF, ETF and Gratuity benefits would have secured an average worker a financial package of approximately Rs. 250,000 to 300,000 (see Table 1).

Fiszbein(1992) shows that the Bulumulla package 'under compensates' workers compared to the 'opportunity cost' based estimations made in his paper. He further shows that the LPCF 'over compensates' the workers. It is not the intention of this paper to examine the validity of these findings. Figure 1 shows the style of compensation by various packages that came into existence after the Bulumulla package.

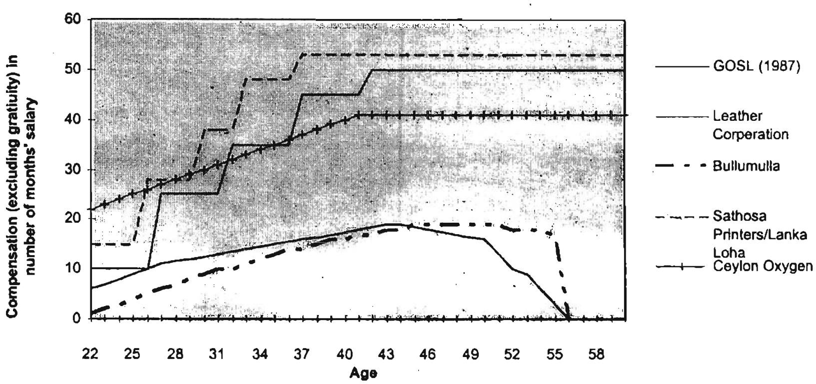
As seen in Figure 1 and Table 1, packages offered after the Bulumulla package, were much more generous. Fiszbein's optimal compensation package may fall somewhere in between the Bulumulla package and the LPCF; and various packages offered during the course of privatization have been more generous than Fiszbein's optimal compensation package. As different compensation packages were introduced, the variable component underwent various changes based on ad-hoc formulas and other add-ons according to trade union demands, such as payment for unutilised leave for the year, interest free repayment of all loans obtained from the company, using a base wage 30 per cent higher than the final wage paid to calculate compensation due, share gifting, etc. (See Table 1).

Table 1 : Types of Compensation Packages Offered in Sri Lanka

Company	Date of approval	Number of months salary					Other Additions	Maximum payable (Rs.)
		less than 5 years	5<10 years	10<15 years	15<20 years	more than 20 years		
Bulumulla Package*	1989-1991	Compensation = 1 months salary* (55-age)* (age/55)* (years of service/30)						
Leather Products	1991 July	10	25	35	45	50	-Gratuity/provident fund benefits	200,000
Ceylon Oxygen	1991 July	Compensation = Rs. 85,000+(monthly wage* number of years of service less than 20 years)					-Gratuity/provident fund benefits	250,000
		less than 5 years	5<10 years	10<15 years	15<20 years	more than 20 years		
B.C.C.	1991 September	12	25	35	45	50	-Gratuity/provident fund benefits	
Consolidated Exports and Trading Ceylon Oils and Fats	1992 March	12	25	35	45	50	-Gratuity/provident fund benefits	200,000
Lanka Fertiliser	1993 Feb.	12	25	35	45	50		min [250,000; (55-age)* monthly wage]
Kantale Sugar	1994 March	12	25	35	45	50	-Gratuity/provident fund benefits -Payment for unutilised leave for the year. -interest-free recovery of all loans obtained from the company.	Managerial grade:250000 Others:200,000
		less than 4 years	4<8 years	8<12 years	12<16 years	>16 years		
Sathosa Printers	1995 May	15	28	38	48	53	-Gratuity/provident fund benefits -Base wage used in the formula was 30% higher than the final wage paid.	Managerial grade:355000 Others:290,000
Lanka Loha Hardware	1997 May	15	28	38	48	53		350.000
GOSL (1997)	1997 January	Compensation = (1 months salary* years of service + 1.5 months salary* (55-age)* (age/55)* (years of service/30)					-Gratuity/provident fund benefits -Duty free import of buses/bus chassis of not less than 40 passenger capacity. -Agricultural tractors/trailers for transport of goods at the comcessionary duty free rate of 25% (as opposed to 35%).	Executives 130,000 Non-executive 100,000

Source: Various trade unions

Figure 1: Compensation packages (excluding gratuity) offered: 1989 -1996



Assumptions: Retirement age is 55, Age at joining the company is 22.
*In working out the compensation for Ceylon Oxygen, monthly wage was assumed to be Rs. 4000.

Source: Information obtained from various Trade Unions.

One clear trend in the average value of these compensation packages was that they increased in value over time (Table 2). What contributed to this increase? Part of it can be attributed to inflationary tendencies. However, even if the packages were weighted for inflation, a rising trend is visible. The other more important factor then, is that the bargaining power of trade unions has increased over time.

Table 2: Average Compensation (excluding gratuity) from 1987-1997

Year	Average Compensation (excluding gratuity) in number of months salary
1987	17.5
1989	16
1991	45
1993	45
1995	53
1997	53

Source: Official letters to the Trade Unions from the Labour Commissioner.

In late 1996, the government attempted to curb this rising trend in the value of the packages and recommended a uniform compensation to all SOEs shedding labour (PE Circular 114, GOSL, 1997). In design, this package was somewhat similar to its previous counterpart, the Bulumulla package. The maximum payable was Rs.100,000 for non-executives and Rs.130,000 for executives. However, the package included an extremely generous implicit add-on component amounting to roughly Rs.50,000-250,000. This add-on, as seen in Table 1 (under GOSL 1997), came from the benefit of being able to import certain types of vehicles duty-free or on a concessionary level of duty (one vehicle per employee). This provision was included with the intention of opening up avenues for self-employment amongst those who opted to retire.

This attempt by the post-1994 government was by and large futile. Very few SOEs offered the package (e.g., Paper Corporation). A majority of trade unions (including those of the Steel Corporation and Lanka Loha) vehemently opposed this package, and bargained aggressively for packages of a much higher value. So much so, that in the case of Lanka Loha, in 1997, the total compensation paid to some workers before privatization, soared to an all-time high of Rs. 500,000.

Trade union bargaining power may have strengthened over time partly because: (a) the economy was not growing fast enough to rapidly absorb retrenched labour, (b) unionists felt that welfare losses and uncertainty incurred due to retrenchment had increased over time, and (c) because they had become avid rent-seekers, exploiting the labour-friendly attitude of the post-1994 government.

A significant factor that contributes to the notion that the costs faced by workers are high, was the ad hoc and lackadaisical manner in which labour issues were handled during the early stages of privatization, and the lack of transparency in the privatization process itself (Kelegama, 1993 and 1997a). In particular, the failure of some privatization schemes have increased worker resentment to privatization.[21] The rent seeking powers of trade unions seem to have increased due to a probable rise in the marginal political cost of the new government that took over after 1994.[22]

The new liberalist tendency of a formerly socialist party for privatization was influenced mainly by the need for generating revenue, in particular to meet the demands of the escalating war. This policy stance was difficult for workers to reconcile with their expectations (Kelegama, 1997b). Trade Union bargaining power was also strengthened because the speed of privatization was important to the government for revenue reasons and to attract private investors through providing quick solutions to labour issues. Thus, on the part of the provider of the compensation package, the amount they have to finance in order to mitigate increasing trade union opposition and political costs has been higher.

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[21] For example, in three SOEs that were privatized during the pre-1995 period, over 1000 workers were adversely affected because the owners abandoned the firms due to lack of technical expertise and financial resources. In 1996, a Rehabilitation of Public Enterprises Act, No. 29 was enacted for the government to restructure the firms, make payments to the workers and re-privatize them within six months after the takeover (Kelegama, 1997b).

[22] During the post-1994 period, the ruling party -- which was a coalition -- had less influence over the dominant trade unions because of its earlier anti-privatization stance, and thus had little control over determining the compensation packages.

A key result that emerges from the discussion in this section is that even though a customized compensation package negotiated between workers and employers (i.e., varying across firms) may seem "ideal" (World Bank 1995:90), in Sri Lanka, compensation packages so formulated were downwardly rigid, and led to rent seeking. Moreover, in recent years, the increase in rent seeking activity led to the formulation of packages so attractive that more workers than targeted opted to leave the firm (e.g., Lanka Loha, Ceylon Steel Corporation, etc.).

Another lesson is that any estimation of compensation should take into account all components of the package. This will include premature gratuity payments, compensation based on a formula, as well as other add-ons to compensation such as share gifting. A rational worker considers the total value of the compensation receivable in deciding whether to stay or leave, and as such, it is incorrect to discuss only the formula-component of the compensation package.

When valuing the worth of shares in a compensation package, unusual problems can arise. One problem is that the nominal value of the share, at the time of privatization, can be largely underestimated, resulting in the retrenched workers enjoying windfall capital gains on the shares, once they are sold in the market after privatization. The converse is true for companies with low-yielding shares. The element of uncertainty involved in offering shares as part of the compensation, suggests that it may be best to avoid compensating retrenched workers with shares. Including shares in the compensation formula can also exacerbate the adverse selection problem, especially in better-performing firms. This is because employees in the upper-tiers of management, who often have better knowledge and information on share market proceedings, dealings and trends, tend to opt for the retrenchment package and leave the firm.

Pre-versus Post-Privatization Retrenchment in Sri Lanka

Why was pre-privatization labour retrenchment recommended by the Commission? It is not possible to obtain a clear answer to this from GOSL (1987) but, one can assume, as explained earlier, that this was first due to existing legislative impediments for post-privatization retrenchment, and second, the Commission may have felt that the labour-force had to be reduced in size in order to make the enterprises attractive to the private buyer and thereby obtain a higher revenue for the government.

What were the consequences of the pre-privatization retrenchment? The most evident problem was inconsistency in the number and type of workers retrenched. There is evidence that a number of privatized firms have re-hired workers with skills similar to those that left the company before privatization using the VRS (as in the bus transport sector, Steel Corporation, Lanka Loha, and others). The SOEs were worried mainly about the number of people that left work, rather than the type. The dynamic environment in which the firms operated have changed so much that the type of workers that left the firms became very essential for new operations.

In some cases, there have been post-privatization capital restructuring and production changes that meant that the type of workers needed before were not the ones after. For example, companies such as Kelani Tyres made considerable changes in its capital structure after privatization and even introduced new product lines. On the other hand, companies such as Milco changed their business focus from being a manufacturing company to a trading company, which in turn required different skills. Thus, it appears from the Sri Lankan experience that the question of who has to be retrenched at least in some SOEs, may be better solved by the companies *after* privatization.

In the event of pre-privatization retrenchment, the Sri Lankan experience shows that one way of avoiding the problem of dynamic inconsistency may be by privatizing through the 'negotiated sale of shares'. Under this method the prospective buyer is known in advance and therefore prospective changes to production techniques can also be known.[23] Bos (1994) argues that it is advisable to restructure an SOE after a suitable private sector buyer with the most enticing plan comes along, without rushing into immediate privatization.

[23] The privatization of Pugoda Textiles was done under this method.

Since dismissals after privatization were not specifically defined, the private sector did not hesitate sometimes to take the most effective and easiest route for labour retrenchment. The private sector owners found various methods to circumvent the law in order to get rid of some unwanted labour after privatization. In some cases, the post-privatization work environment was made very uncomfortable for some employees forcing them to leave. In some other cases, workers claim that false allegations were made against them, to permit uncompensated dismissal. A common charge is that of insubordination. As stated earlier, the TEA stipulates that the approval of the Labour Commissioner does not have to be sought under such disciplinary charges. An internal inquiry can be held and a worker can be dismissed. Of course, the worker has the right to appeal to the Labour Tribunal. However, many did not possess the legal and financial resources to go through with an appeal and this worked favourably for the employer.

Concluding Remarks

The paper has traced the Sri Lankan labour retrenchment experience during privatization by looking at three main issues, namely, (i) voluntary versus involuntary retrenchment; (ii) compensation package as a temporary safety net; and (iii) pre-versus post privatization retrenchment. All three areas were found to be fraught with problems during implementation.

One set of problems encountered stemmed from rigidities in the labour market. Rigid labour laws, for instance, led to private sector employers circumventing the law and effecting forced retrenchment. The inflexibility also increased costs of retrenchment to the private sector. This encouraged the government to adopt pre-privatization retrenchment leading to dynamic inconsistency in the number and amount of workers retrenched. This problem was aggravated by the adverse selection process inherent in the VRS. Minimizing this effect through applying VRS to tiers of redundant labour was not possible in the highly politicized labour market in the country.

The other main problem encountered during the retrenchment exercise pertained to providing a compensation package. In Sri Lanka, ad hoc monetary compensation packages were provided. The value of the packages were downwardly rigid, and rose nearly four-fold within a span of eight years due to increased rent seeking and bargaining by trade unions. Not only did this make retrenchment more expensive to the financiers, it also led to longer negotiation processes and triggered considerable industrial unrest.

It was also observed that the value of the packages were so attractive during recent times that more workers than targeted opted to accept the VRS during privatizations. This suggests that a fixed compensation package, developed after consultation with trade unions, may be more suitable for the Sri Lankan labour environment. A fixed formula may avoid the time consumption and the arbitrariness of ad hoc compensation packages. It may also reduce a firm's uncertainty regarding costs to be borne when retrenching workers.

The Sri Lankan retrenchment experience also shows that labour retrenchment should not be viewed in the context of privatization alone, but as part of the move to a market economy. Ad hoc retrenchment programmes that lack transparency, only increase information asymmetries and confusion, leading to a very uneven and inefficient public sector downsizing in a privatization programme.

In order to view labour retrenchment from the perspective of further liberalization of the economy, the focus should turn to labour market reform. In spite of two decades of experience with liberalization, labour market reform in Sri Lanka is a relatively untouched area. The labour market remains rigid and inflexible, with a market unfriendly exit policy. The poor sequencing of labour market reform with respect to the privatization programme and liberalization in general, contributed to the inefficient handling of the retrenchment programmes.

Why has labour market reform lagged? This is partly due to the colonial history of Sri Lanka which generated the perception that the workers were victims of exploitation and thus needed State support. Moreover, SOEs were promoted, *inter alia,* with the objective of generating employment and also a high degree of employment security was provided in accordance with the protectionist policies that Sri Lanka followed during the post-colonial period. Employment security was viewed as an instrument of guaranteeing income security to the employees in the absence of a State-sponsored social security system. After economic liberalization in 1977, several attempts to change legislation governing employment security ran into difficulties with the trade unions because they consider these as benefits secured after long fought battles. The political costs of reforming therefore were very high.

This situation however should be changed and labour market reform should receive priority if the privatization exercise is to be successful. Since initiating labour market reform has been difficult for the past 20 years due to peculiarities in the Sri Lankan labour market, the existing consensus for implementing privatization should be seen as an opportunity to initiate labour market reform. The question is how such reform is to be done, and how it is to be sub-sequenced given the socio-political and economic climate in the country. This is an issue that needs further study.

A key feature in such reform is that it should ensure that the exploitative labour relations of the past do not re-emerge. It should also include trade union reform. The success of the Thatcher government in U.K. in its privatization strategy was mainly due the enormous changes that were effected in the management of labour relations of SOEs in the run up to privatization. Privatization was devised as a means of delegating authority over wage and severance bargaining with the work force and trade unions, to the private sector and also as a means for the government to distance itself from bargaining with trade unions (Haskel and Szymanski, 1994).

All in all, the Sri Lankan experience shows that when the complexities of a labour market are taken into account, most theoretical recommendations on labour retrenchment make less sense in actual practice. However, even in a complex labour market, it is apparent that a retrenchment exercise would encounter less resistance if the economy is growing fast enough to absorb the retrenched labour from a privatization programme.

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