Element 7: Contemplating enhancement and compensation measures

Poverty and social impact analysis is undertaken to maximize welfare gains, in particular for the poor, by influencing the design of a policy reform. To the extent that there are losers from the reform, PSIA can inform policy design leading to choices that minimize the number of losers or the extent of adverse impacts. Better understanding of adverse impacts can also inform the design of appropriate compensation mechanisms, if needed. This component of the PSIA is informed by the analysis and tools laid out in the previous section. This analytical work can provide potential options to limit the negative impacts on the welfare of the poor or other groups. In addition, finding the appropriate solution, or set of solutions, also often necessitates substantial discussion and debate by key stakeholders, in particular consultation with those affected to test whether the proposed compensation measures can feasibly be implemented. In short, if the ex-ante poverty and social impact analysis shows that a proposed reform will have short-term adverse impacts on the living standards of the poor or other groups, it is critical that the analyst address the following considerations.

Consider alternative design

The design of reform may be improved by including enhancement or mitigation measures, or by different sequencing of public actions. First, one may opt to proceed with the implementation of a reform as planned, but with a subsidization arrangement to protect the poor or others adversely affected by the policy. For example, a water tariff increase associated with utility reform may be designed to protect those who consume relatively small quantities of water by incorporating a subsidy mechanism.[27] Often contextual information and consultations are required to select the most appropriate type of mechanism to best fit specific country circumstance and implementation capacity. Alternatively, analysis of an electrical utility reform may determine access to be the main constraint for the poor, resulting in the design of subsidized grid connection fees for targeted poor communities.[28] In fiscal reform, key staple goods that make up the bulk of consumption for the poor may be exempted from taxation.[29]

Second, the policy set may need to be expanded beyond the core policy measures (driven by the problem diagnosis) to include complementary measures. For example, if "behind the border" bottlenecks (such as barriers to entry in the domestic transport sector) reduce the benefits of trade liberalization accruing to intended beneficiaries, taking measures to address those constraints will be critical to achieving expected welfare gains. Similarly, it will be essential to understand and address the factors that constrain the poor or other target groups from benefiting from market reforms—for example, lack of assets (land, credit, electricity grid connection) or of capabilities (price information, market access). Micro-econometric analysis as well as qualitative analysis can assist in identifying the type of complementary measures that might be necessary.

Third, it is important to carefully consider sequencing. For example, shutting down a commodity board can eliminate monopsony and subsidized inputs at the same time. If critical inputs are likely to be unavailable or prohibitively expensive for vulnerable farmers in certain locations, PSIA might suggest that the government first take action to drop barriers to entry or encourage private merchants to pursue untapped markets *before* it dismantles the commodity board. Also, sustainability of the reform process can be enhanced with quick wins among key stakeholders to build support for reform. For example, new resources for mining safety in Russia were used to persuade the unions of the need for reform.

Consider direct compensatory mechanisms

When adverse impacts of reform are unavoidable, considerations driving the decision to compensate losers may be based on: (a) poverty grounds (especially if some of the poor lose in the short run and the objective of the policy is poverty reduction); (b) equity grounds (especially if groups that have traditionally been the poorest and most vulnerable lose ground to those with greater economic security); or (c) political economy grounds (especially if the losers have the capacity to organize and threaten either the sustainability of reform or survival of the government).

Careful consideration is required in the design of compensatory schemes—to ensure appropriate targeting of intended beneficiaries and cost effectiveness, and to avoid perverse or distortionary incentive schemes that might compromise implementation of the intended policy (see box 12). It is also important to calculate the cost of compensation, and consider it relative to the expected benefits of reform. In terms of costs, the compensation scheme itself (for example, a large retrenchment or social program) will have fiscal costs that, depending on magnitude, can have indirect impacts on fiscal stability, prices, and the economy. Moreover, there is an opportunity cost, as any compensation scheme will use resources that would otherwise have been spent elsewhere.[30]

Consider delay or suspension

If the findings of PSIA suggest that the short-to-long-term benefit of the best-designed policy intervention does not exceed the short-term (or long-term) costs of mitigating or compensating the poor, or that other important groups might suffer irreversible losses, then consideration could be given to delaying the reform (that is, resequencing) or abandoning or suspending implementation of the policy.

Box 12. Labor Downsizing and the Design of Compensation Packages in Vietnam

The issue of labor downsizing and the design of compensation packages have been analyzed ex ante in the context of Vietnam by Martin Rama (2001). Proposed reforms included a major downsizing operation involving the liquidation, divestiture, or restructuring of approximately 6,000 state-owned enterprises, resulting in unemployment of roughly 5 percent of the Vietnamese labor force or 450,000 workers. In anticipation of the massive layoffs a special compensation package was developed which amounted to two months of salary per year of service plus a substantial cash training allowance. This package was a result of policy debates around simulations generated by Rama using DOSE (Downsizing Options Simulation Exercise). The simulation computed "acceptance rates" for alternative severance packages, based on the characteristics of individual workers.

The acceptance rate is defined as the fraction of the workers for whom the separation package would exceed the present value of the estimated loss from job separation. Rama found that a formula based solely on earnings history had a consistently higher acceptance rate for men, while women found a uniform lump-sum compensation more attractive. Based on these simulations, the government of Vietnam picked a separation package that involved a sizeable lump-sum component in the form of the training allowance in order to ensure that female workers would not be unduly penalized by the layoffs.