FISCAL AFFAIRS

Special Series on Fiscal Policies to Respond to COVID-19

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Issues When Cutting Government Pay to Help Reshuffle Spending in a Crisis[1]

Governments around the world are experiencing large losses in revenues at a time when spending needs are at an all-time high, including for urgent measures to support households and firms. A lack of fiscal space, especially in countries that entered the current crisis with weak fiscal and external buffers and high public debt, imply that countries may need to rely on some form of expenditure reshuffling to facilitate their response to urgent spending needs. In this context, several countries have already introduced—or are considering—nominal pay cuts for some groups of government employees. The objective of this note is to help policymakers pursuing this policy as a temporary emergency measure in the current COVID-19 crisis on the issues that would need to take into account, rather than to assess the adequacy of the measure at hand. These issues include (i) the progressivity and coverage of the envisaged nominal pay cuts; (ii) the economic impact of savings from these cuts and how they relate to the need to reshuffle spending; and (iii) the importance to adhere to transparency and accountability standards. Finally, it sheds light on the need for a clear public communications campaign, with consistent messaging, including to outline the need for such measures and pave the way for their reversal.

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The need for emergency measures to respond to the COVID-19 crisis has led to a scramble to find both the right measures and a way to finance them. Goverments around the globe are facing significant financing requirements for rolling-out emergency policy actions across different sectors (including the health sector for the containment, mitigation, and treatment of the pandemia) and to support households and firms. At the same time, governments are facing rapidly declining tax revenues. In some countries, preexisting high levels of public debt and binding borrowing constraints limit their responses, leading policymakers to look for emergency financing, including reshuffling spending to meet urgent needs.

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Reducing the compensation of government employees has often been an important part of the policy response during previous crisis episodes. In past episodes of government wage bill consolidation, fiscal adjustments have been achieved primarily through the adjustment of wage levels rather than through employment reductions (Figure 1). The potential contribution of reductions in compensation to creating fiscal space is due to several reasons.

- ***The relatively large share of the government wage bill in total spending:*** The government wage bill typically accounts for a large share of total public spending, and thus, often constitutes a key component of fiscal consolidation strategies in response to economic crises. On average, spending on the wage bill absorbs around one-fifth of total spending, and ranges between 24.5 percent in advanced economies to around 27 percent in emerging and developing economies.[2] This said, there is a lot of variation in the wage bill size across countries, reflecting differences in compensation and size of the workforce.
- ***The scope for a relatively quick process in both their design and implementation*****:** This is particularly useful in the current context where the government is seeking to finance swift policy measures as part of its response to a crisis. Generally, reforms aimed at reducing the wage bill encompass different types of measures—including those focused on compensation, employment, and institutional framework—to help deliver deep and sustainable wage bill adjustments. The reform strategy is country specific. For instance, adjusting compensation may not be an option—for instance, for countries that recently underwent prolonged wage freezes or where the public-private wage premium is initially small, non-existent, or negative. Also, not all measures of the wage reform toolkit can yield quick fiscal relief. For example, unlike adjustments to wage levels, other measures as attrition and wage management measures (e.g., performance-related pay) could help bring more sustainable reductions, but they tend to take time to design and implement and may require up-front expenditures (e.g., severance pay).
- ***The relatively less contentious political economy context, relative to employment measures:*** While both compensation cuts and employment separation (for instance, by non-renewing temporal contracts) can provide short-term decreases in government wage spending, the former helps retain the link between employees and the government, which is important given the temporary nature of the expenditure reshuffling in the context of the COVID-19.
- ***The fact that in many countries there is a public wage premium, which widens during downturns:*** Unlike private sector employees, government employees in many countries enjoy employment protections and earn around 10 percent more than their private-sector peers with similar skill mix (IMF, 2016).[3] This wage premium tends to decline during upturns, but increases significantly during economic downturns, as government wages do not decrease unlike private wages (IMF, 2016).[4] From this perspective of equity, nominal wage cuts—especially in this current context of this crisis—could well be motivated by the need for social solidarity and burden sharing in the short-term.[5]

Several countries are currently considering to introduce pay cuts as part of the reshuffling of their expenditures during the current crisis. Paraguay has recently announced that it will be implementing wage

[2] For more details, see IMF (2016).

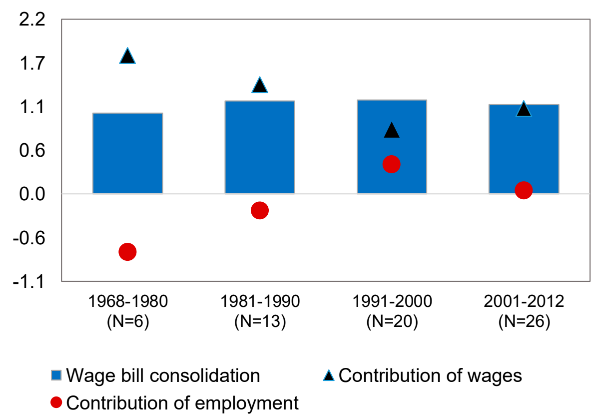
[3] According to IMF (2016) the average public sector wage premium is estimated at 10.1 percent, ranging from 5.4 percent in advanced economies, 11.7 percent in emerging markets, and 12.8 percent in low-income developing countries.

[4] According to IMF (2016), public wages tend to exhibit downward rigidity during economic downturns but are flexible and increase with private wages during economic upturns.

[5] In the same spirit of solidarity, Tunisia has recently established a solidarity solidarity fund ("Fond de Solidarité") for grants from the Tunisian population (including public sector employees) as a way to share the burden of the crisis.

cuts of 10 and 20 percent for public employees whose salaries exceed five and ten times the minimum wage respectively.[6] Uruguay has also announced that the salaries of better-paid public officials will be reduced by up to 20 percent with the savings directed to the newly established Coronavirus Fund.[7] San Marino announced a reduction in public sector pay to help finance the spending needs in the health sector. Governments in Albania, Brazil, and Rwanda are also considering cuts.[8] Other governments, such as Burkina Faso, have announced mandatory actions to donate portions of the salaries of some employees to finance the response to the crisis, while countries such as Belize and Costa Rica have suspended all planned incremental salary increases.[9] During past crises requiring significant fiscal consolidation, countries have also resorted to wage measures (IMF 2016). These include: (a) The Netherlands in the context of the reforms of the 1980s; (b) France, Greece, Ireland, and Portugal, among others, in the context of the Great Recession and Financial Crisis (GRF) of 2008–2009; and (c) Honduras during the 2013–2015 fiscal consolidation period.

Figure 1. Contribution of Employment and Wages to Government Wage Bill Consolidation (in percent of GDP)



Source: IMF 2016.
Note: Wage bill consolidation episodes are identified as two-year periods in which the government wage-bill-to-GDP ratio decreases in each year and the cumulative decline is at least 0.5 percent of GDP.

While temporary pay cuts can help address urgent spending needs where fiscal space is limited, they should be carefully designed and implemented to yield the expected savings and avoid unintended consequences. Governments considering such measures should ensure that they are designed to be:

- ***Progressive (with reductions varying with compensation levels):*** Although wages—or more generally, compensation, where allowances are numerous—in the government sector are typically compressed across skill-levels compared to the private sector, and those at more senior positions can face a negative wage premium compared to the private sector, the greater job stability for public employees calls for solidarity with private sector employees facing job losses and significant cuts in income.[10] Solidarity and equity considerations point to the need for more highly-paid public employees taking on a higher share of the

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[6] See https://www.aa.com.tr/en/americas/paraguay-to-cut-public-sector-wages-over-covid-19/1785779.

[7] See IMF Policy Tracker and https://www.telesurenglish.net/news/Uruguay-lacalle-implements-economic-measures-facing-covid-19-20200327-0003.html.

[8] See IMF Policy Tracker.

[9] See IMF Policy Tracker.

[10] Given the temporary nature of this measure, retaining skilled staff is less of a concern, in particular, given the tight employment conditions in the private sector.

burden. Lower-paid public employees could be fully shielded from any compensation cuts to avoid inadvertently creating poverty.

- ***Targeted coverage (by excluding employees of priority sectors):*** It is important to exclude from the adjustment the salaries of public employees in some sectors regardless of their income level if, for example, they are involved, either directly or indirectly, in the response to the crisis. This includes employees in the health sector (e.g., doctors and nurses, emergency service workers, paramedics, among others). In most countries, first responders also include fire fighters, social workers, and security personnel (including the police).[11] Some employees in other sectors could also be exempted from the coverage of the cuts if they are deemed to be involved in the provision of services part of the critical response to the crisis. Depending on the country, this could include workers who are building and setting up health facilities, transportation sector workers who are ensuring that medications and equipment are being channeled to health facilities, postal service workers who are delivering merchandise that is deemed essential, and public employees who are directly involved in ensuring a well-functioning and stable food and medical supply chain.
- ***Temporary and consistent with the underlying legal and institutional framework (with clear exit strategies):*** Political and public support for cuts in compensation can be reinforced by emphasizing their temporary nature, including through legal assurances to that effect, and avoiding any perception that they reflect opportunistic behavior of policymakers to implement a longer-term reform agenda. Even if cuts are transitory in nature, it is crucial to ensure that they are consistent with the underlying legal framework to avoid future obligations in the form of wage arrears.[12] Base salaries and most other benefits (e.g., bonuses, 13th month salary and various allowances) are typically considered entitlements for civil servants and are thus well entrenched in the civil service statute. Likewise, it is important to ensure that the institutional framework is adequate for implementing the wage adjustment. Combining the wage cut with a temporary ceiling on wage bill could help deliver the expected fiscal savings through stregthening the link with fiscal planning and budget process.[13]

Support for pay cuts can be strengthened by providing assurances that the resulting fiscal space will help finance critical public spending. This requires full transparency on how the savings from the measures will be spent. Savings from the cuts can be used to support the financing of the required increase in health spending[14] to enable containment and mitigation, and to build resilience to the outbreak. They can also help finance a much-needed expansion of social spending—such as cash-transfer schemes to households that are most affected by the shock—or unemployment insurance (both in terms of coverage and benefit generosity), where applicable. Other expenditure policy measures that help keep firms alive and preserve employment in the private sector—such as wage subsidies—can also be effective and could potentially be considered, depending on country-specific circumstances.

Progressive and temporary cuts in the compensation of some public employees may have a positive impact on aggregate demand. While wage cut measures, as discussed in this note, are primarily aimed at addressing urgent fiscal financing needs, they may also help support aggregate demand. For instance, since savings from the measures will support the income of households who are most impacted by the COVID-19

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[11] As in many countries, health, security and education account for a large share of the government employees, savings will be reduced when excluding sectors from the reduction in compensation.

[12] Constitutional frameworks of some countries prescribe one branch of the government from imposing salary adjustments to another branch, in line with the principle of separation of powers.

[13] In the past, ceilings on the wage bill or employment numbers have been put in place in countries, which did not have them, as a crisis management mechanism to counterbalance more fundamental institutional weaknesses (IMF, 2016).

[14] See accompanying note “Managing the Impacts of the Coronavirus: Guidance on Health Spending Policies”.

crisis, this can lead to an increase in aggregate demand through private consumption, mostly due to the difference in the marginal propensity to consume between those subject to the wage cuts and those who receive the benefits financed by the cuts. The later may face liquidity constraints and are thus expected to spend any benefit they receive. This is consistent with findings in the literature suggesting that government spending is more effective in stimulating aggregate consumption demand when the share of liquidity constrained households in the economy is large (Galí, J. López-Salido, J.D. and Vallés, J., 2007).

Overall, a clear, consistent and timely public communications strategy as well as transparency and accountability in the use of public resources are crucial to ensure broad public trust and support during the crisis, and to effectively pave the way for an exit strategy and a removal of emergency temporary measures. At the current juncture, making clear that support measures to address the COVID-19 crisis are temporary could help manage expectations (IMF, 2020). Going forward, managing expectations may actually be key in designing policies to exit the crisis, as the ability of governments to mitigate the impact of the crisis fades. The potential impact of this crisis may well be larger and more persistent than can be addressed by temporary policy measures that are subject to the increasingly binding fiscal constraints facing countries. A strong communications strategy with consistent messaging across all components of the government can be an additional powerful tool available to governments to foster broad public support. An effective communications strategy must also ensure that messages delivered to the public are aligned with the interests of the different external stakeholders key for maintaining public support (Worley, Pasquier, and Canpolat 2018; Abdallah and others, 2019). This can also help to pave the way for an exit strategy and removal of temporary measures. Finally, transparency and public accountability are also essential to further reinforce a broad public support for the measures and to ensure that they achieve their intended objectives.

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