

Government Payroll: Harsh Truths and Policy Dilemmas

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Government payroll has become a main topic in the public debate on consolidation of public finances. This commentary presents the dimensions and characteristics of the problem and analyses alternative policy scenarios.

1. Review of the situation over time

As shown in Figure 1, historically, the average wage in the public is higher than the one in the private sector. However, the percentage difference between the wages in the two sectors remains constant (around 40% –50%) since 1991, with a slight downward trend in recent years. In other words, it is incorrect to claim that the rate of growth of wages in the public sector has always been, or have recently become, higher than that in the private sector of the economy. As shown in Figure 2 public sector wages as a percentage of government spending and GDP are stable over time, as is the percentage of public employees in the labour force.

Therefore, the extravagance of the government payroll is not new but a long-lasting problem of the economy and its relative size has not increased, although its importance is accentuated, in recent years due to the economic crisis.

Figure 1: Average wage (euro, 2009)

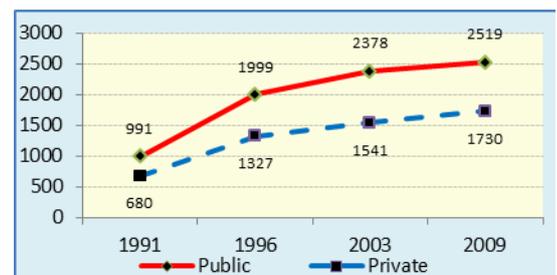
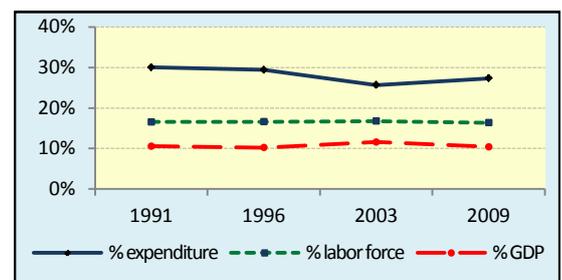


Figure 2: Government payroll as % of public expenditure and GDP, and public sector employees as % of labor force



Abstract

This commentary argues that not only the size but also the structure of the government payroll is not aligned with the fundamentals of the Cyprus economy. The appropriate correction implies decreasing the salaries and wages of public sector employees at low rather than high payment scales. This, combined with the fact that public sector employees have strong trade union power, poses serious dilemmas. Is Cyprus ready to accept large short-term adjustment costs for even greater but long-term economic gains? Can reforms that are considered socially unjust but increase productivity and enhance long-term fiscal stability be combined with social policy measures to dampen their effect on inequality? For how long can the Cypriot economy continue to ignore basic economic principles and operate below its potential in order to avoid painful reforms?

* The results reported in this Commentary are based on quantitative analysis carried out at the Centre of Economic Research by Alexandros Polycarpou and Adamos Andreou.



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2. Pay differences between private and public sector

The remuneration of employees in the private sector of the economy tends to be equal to their productivity. If it is higher the company will close. If it is lower the company will increase its profits by recruiting more employees up to the point where the remuneration is equal to the productivity. Thus, wages and salaries in the private sector can be used as a reference point to assess how overpaid or underpaid public employees are.

In Table 1, column (A) shows the percentage difference of the average salary between public and private sector employees by occupational group.¹ Column (B) of the table shows the same difference, after having removed differences attributed to the level of education and the age of employees in the two sectors. Based on these data it is clear that:

- salaries are on average 43% (or 27% after taking into account differences in education and age) higher in the public than the private sector,
- teachers and low-skilled workers in the public sector (unskilled workers, service and sales workers, technicians, clerks etc) are the most overpaid occupations, and
- the employees of the public sector high up in the salary scales (managers, senior officials and other professionals) are not, in general, paid more than employees in the corresponding occupations in the private sector.

Occupational group:	(A)	(B)
Managers, Senior Officials	14%	-20%
Teachers	116%	107%
Other Professionals	12%	13%
Technicians, Associates	30%	21%
Clerks, Cashiers	30%	31%
Service and Sales workers	41%	57%
Skilled workers	22%	18%
Unskilled workers	45%	79%
Total	43%	27%

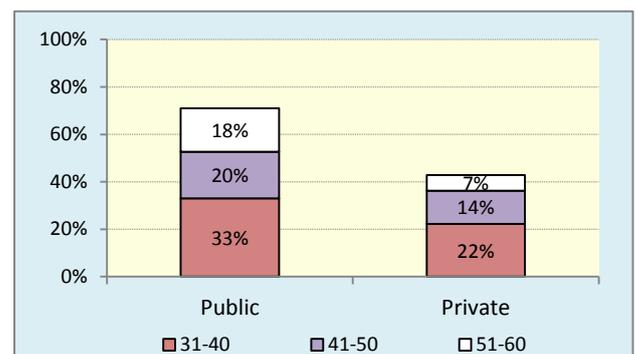
Based on the above, the recipe for correcting the government payroll is to reduce the salary scales, but not at the same rate for all employees. In particular, a reduction of the high scales is not appropriate because this will intensify the distortions of the government payroll with negative consequences on productivity not only in the public but also in the private sector, due to the expansion of the distortion in the whole labour market. This recipe, of course, is not in line with social justice. Therefore, the need for reform of the government payroll creates a dilemma for the government:

- promote what is commonly understood as social justice with measures that reduce income inequality among the high and low-ranked public employees but increase labour market distortions, reduce the productivity of the economy and increase fiscal instability; or
- implement measures that are seen to be ‘socially unjust’, in the sense that they increase the gap between the high and low-paid public employees and may cause social tension, but improve the productivity of the economy and strengthen fiscal stability.

3. Effect of age and education

The automatic wage and salary increase with age is one reason why pay in the public is higher than the private sector. This can be seen by comparing the two histograms in Figure 3, which show the percentage increase in remuneration for public and private sector employees by age group. Evidently, the difference of the average remuneration of workers aged 26–30 and 51–60 years is 71% in the public and 40% in the private sector.

Figure 3: Effect of age on remuneration (with reference to individuals aged 26–30 years)



¹ Computed with data drawn from the Family Expenditure Survey 2009 (conducted by the Statistical Service).

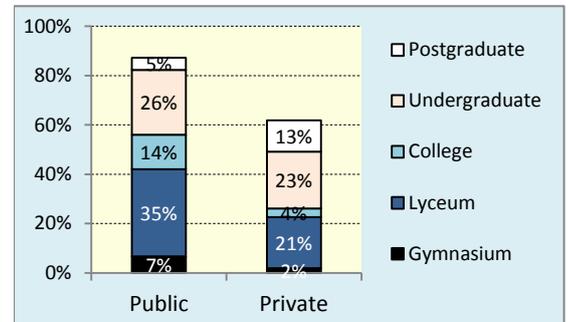
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Education is also distorting pay differences between the public and private sector. As shown in Figure 4, high school (Lyceum) diploma increases remuneration by, on average, 14% more in the public than the private sector. Also, a college degree increases remuneration by 10% more in the public than in the private sector. In contrast, postgraduate education has higher returns in the private (13%) than in the public (5%) sector.²

The above reflect the fact that the public sector rewards the formal qualifications rather than the ability of employees. For example, all university degrees are recognised as equal regardless of the grade and the quality of the educational institution from which they were awarded. Also, the small difference in remuneration between undergraduate and postgraduate degree holders reflects the fact that many PhD and MSc/MA holders are appointed to positions that do not require postgraduate qualifications.

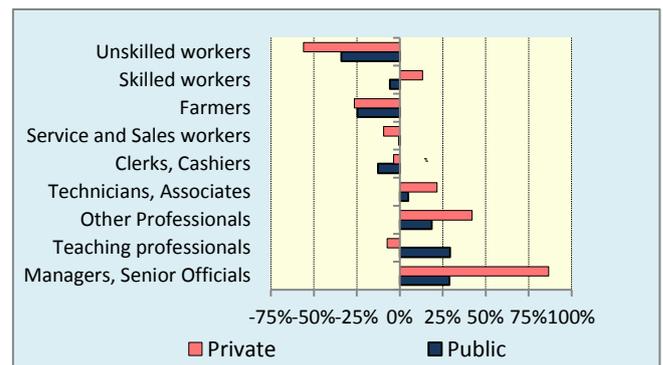
Figure 4: Effect of education on remuneration (compared to up-to-elementary education)



4. Pay differences within sectors

The automatic salary increases and the automatic cost of living adjustment (COLA) received by all public employees, together with the fact that the main criterion for promotion in the public sector is experience, depress pay differentials. This is shown in Figure 5, where the percentage difference between the average salary of each occupational category and the average remuneration of individuals (of similar age and education level) is presented. In the private sector unskilled workers of a given age and education have an average pay of nearly 56% below the average remuneration in the private sector as a whole. In the public sector, the corresponding difference is 34%. The same applies and at the other side of the pay distribution: directors and senior officers of a given age and education in the public sector have, on average, remuneration of just 29% higher than the average remuneration of the public sector as a whole. On the other hand, directors and senior officers employed in the private sector have an average remuneration of 87% higher than the average remuneration of the private sector as a whole.

Figure 5: Pay differences within public and private sector



5. Effects from recent measures

The two packages of measures that have been decided for confronting the financial crisis include increases in contributions for public employees to the social security fund and the widows and orphans fund, as well as a special contribution. These measures, combined with the suspension of annual increments and COLA in the public sectors for two years, will work towards the reduction of the average difference between the salaries of public and private sector; but will not reduce various distortions of the government payroll analysed in this Commentary. On the contrary, the existing distortions of the government payroll will be aggravated by the fact that the rates of some contributions increase with the remuneration (special contribution and the increase of contribution rate to the widows and orphans fund). This, combined with the tax rate increase on incomes over 60,000 euro, will compress even more the differences between low and high paid public employees, a result that can be seen to promote 'social justice', but demote efficiency (optimal allocation of resources) and economic growth.

²The effect of education, as well as the effect of age at the previous diagram, is the marginal. It is estimated using ordinary least squared estimation and evaluated for the average value of the other characteristics which affect the wage rate.



6. Policy conclusions

The government payroll did not create the economic crisis in Cyprus; yet, the latter has helped expose the structural problems of the government payroll, which have been upheld for decades by unorthodox pay practices, such as automatic salary and wage increases (COLA, automatic annual pay increases, appointments / promotions based on seniority etc), political party interventions and excessive attention paid to the narrow interests of organised groups.

Reductions in public sector wages and salaries are necessary but not sufficient to confront the problems caused by the government payroll to the economy. These reductions need to vary between occupation, age, education and perhaps other characteristics, so as to take account of differences in the productivity of public employees, as measured by employee remuneration in the free market. The calculations in this Commentary are based on available statistics and may not be adequate for arriving at an exact measure of the required pay adjustments. However, it seems that – with the exception of teachers – the largest percentage reduction in remuneration should incur among workers who are at the lower end of the wage and salary scales.

The automatic pay increase practices mentioned above should be replaced with practices that reflect productivity. For example, the distribution of pay increases in each governmental department should be decided by an independent panel based on pre-defined measurable indicators of productivity; while the distribution of remuneration increases among the employees of the department should be decided internally by the department itself. This way each department, in order to receive a larger share of the pay increase, will reward more the employees with the highest productivity. This and other practices that generate incentives for higher productivity are essential for correcting the distortions of the government payroll. The problem is that their implementation will have gainers and losers, generating social tension. Therefore, whatever way is chosen to correct the distortions of the government payroll, it should be implemented in small steps and over a long-term period to ease the impact on (and response) of current public sector employees.

7. Epilogue

The financial crisis has highlighted the structural problems of the Cypriot economy and creates difficult dilemmas for the state.

- The government payroll can be reformed on the basis of principles of economic efficiency in order to increase the productivity of the public sector and alleviate its negative effects on the economy. This will improve the overall long-term prosperity of the country, but will have some short-term adjustment costs, as those facing the prospect of salary reduction are likely to firmly oppose the reform. Also, feelings of injustice are associated when measures affecting negatively the income of low-paid employees, regardless of the fact that many individuals among these employees do not earn their pay. Such feelings can lead to social disorder, especially when they threaten traditionally strong social groups.
- Alternatively, the government payroll can remain unchanged or change according to what is understood by politicians to be 'socially just'. In this case the public sector will continue to be inefficient, with all the negative economic consequences generated by the fact that the economy will be off the optimal growth path (operate below its potential). In this sense the economy will suffer long-run 'disequilibrium costs' that will impact on its capacity to confront crises and, eventually, its ability to avoid collapse. Yet, by doing what is seen to be 'socially just' avoids short-term adjustment costs likely to arise from resistance to change by those favoured by the status quo.

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