Wage cuts are better than layoffs to combat covid crisis

The Centre should announce a 30% pay cut for everyone to deal with the economic crisis. This would spread the burden equitably, stop job losses and mitigate a collapse in demand

The human calamity due to corona has also led to an economic calamity. For brevity, I will call this e-corona. Based on macroeconomic principles, also applicable to India, this article makes a ground-zero policy suggestion. The finance minister should announce a reduction of 30% in wages and pensions for all government and quasi government employees for the remaining fiscal year, and recommend that private firms do the same.

Given my overall pro-market orientation, I hesitate to make such a sweeping recommendation. Justifying such a diktat calls for first explaining the macroeconomic distinction between relative and aggregate shocks. When car owners suddenly switch from petrol to electric vehicles, that is a relative shock. Total miles driven will not change much. But due to a lockdown, demand for all travel collapses; this is an aggregate shock.

We are undergoing a colossal aggregate shock—barring a huge surge in demand for corona-related medical goods and services, and shifts to more online purchases. How best to cope with this shock? In my opinion, the first line of defence should be to try to cut wages and simultaneously the prices of all services uniformly (all rents, pensions, educational fees, etc.)

Cutting wages is the first crucial step to take. This is because wages, when aggregated across different firms in the economy, comprise the bulk of costs. Unfortunately, this is easier said than done. Typically, firms do not cut wages, but lay off workers when demand falls. As John Maynard Keynes emphatically stressed in 1936 in his General Theory, money wages are rigid.

Over decades since then, copious ink has been spilt by economists, with diverse ideological perspectives and methodologies, trying to explain why. The most convincing answer is provided by the implicit contract approach of Arthur Okun, in his 1980 book Prices And Quantities. His unique micro-macro approach has been incorporated and partly applied to India in my book Applied Macroeconomics (2017, Sec 1.8, 3.4, 7.6).

Implicit contracts, and some explicit ones too, are deeply rooted in values of trust and fairness. Layoffs signal a clean decision by the firm. By contrast, worker(s) tend to construe wage cuts as depriving them of their dues. Do human resource manuals ever recommend it?

Money wages are sticky due to what Okun called the “invisible handshake" between workers and firms.

Such behaviour makes sense during a normal recession. When demand initially drops, workers are first benched, not dismissed. If that drop continues, then the layoffs start. Indeed, a small drop in demand can serve as a catalyst, and some justification also, for the firm to let go of those few perceived to be performing poorly, say up to 5-10% of all employees.

However, for a huge collapse in demand, it can be dangerously damaging for all concerned to function this way. After e-corona, firms can now easily justify a flat x% cut in wages for all. Most workers would welcome a large pay cut right now, if it comes with a reasonable guarantee of not getting laid off.

Based on the above considerations, the government should mandate a 30% across the board pay cut for the rest of this fiscal year, for all Central government and quasi central government employees. For the cut to have a beneficial macroeconomic impact, it should apply to all, since the bulk of wages are at the lower end (Group C and D employees). For workers as a whole, a 30% drop in wages is better than the same wage but with 30% layoffs.

By announcing a 30% cut in their salary and MP Local Area Development Scheme grants on 6 April, as a mark of solidarity, Parliament has set a good precedent. This is not just a good ethical decision, but also a good practical one. It can set the ball rolling for all others. Health and hospital workers should be exempt from any wage cut.

State governments should be requested to follow suit. Indeed, Kerala has taken the lead by announcing larger cuts along these lines. Private firms should be strongly encouraged, although not compelled, to follow. They likely will.

Worker resistance to such a big wage cut would be much less if accompanied by a similar reduction in their house rents. The government should announce that it is legally acceptable to reduce by 30% the payment for all contractual services, specifically rental payments and all educational fees, two items that loom large in most household budgets. Both tenants and landlords are better off with lower rents than with more defaults and evictions at the same rent.

All government pensions should be reduced by 30%, and private sector firms encouraged to follow. Interest payments on retirement savings, now yielding way above market rates, tax free, should ideally also be reduced.

Reducing wages will certainly not suffice to avert many layoffs now, but will distribute some of the burden more equitably. The far bigger issue, ignored by Keynes and almost all macroeconomists, is that when output is reduced, why not share the work by cutting average hours per worker instead of laying off some while the rest clock overtime hours and even get paid a premium for it? This trillion-dollar question, and the size, timing and allocations of a much-needed fiscal stimulus and direct cash transfers call for a separate discussion.

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