Design and Implementation Practices for Wage Subsidies during COVID-19

Draft Note[1]

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The objective of this note is to discuss key design features of wage subsidies schemes in the context of COVID-19. Wage subsidies amidst the health crisis are aimed at reducing layoffs, by helping firms to reduce costs and avoid severance pay, and helping workers to receive some support during the crisis. Many of the design considerations are thus different from regular wage subsidies.

Most COVID-19 response programs essentially pay a certain proportion of a worker's salary or a given (most often fixed across the board) amount of money per month for 2-3 months per worker (given uncertainty, schemes may or may not be extended beyond this period). That said, there is significant variation in the details of the programs, based on countries' fiscal space, the impact of the crisis, and countries' economic structure and political economy.

Against this backdrop, the following principals can be useful when designing a new wage subsidy scheme to mitigate the social and economic COVID-19 impact:

1. ***Coverage***. In most advanced countries, given the larger fiscal space and given the nature of the crisis and containment measures (e.g. mandated lockdowns across the economy), subsidies often have not targeted specific sectors—they have been largely broad-based. In most countries, subsidies have also covered all registered workers in all registered firms. In contrast, countries with more limited fiscal space and more clear-cut sector impacts tend to target specific sectors: Indonesia focused on manufacturing workers that earn below a threshold; in the Western Balkans, countries target firms by size. Key decisions are:
   a. **Which sectors to cover?** This will depend on the nature of the crisis and containment measures in the country. In some sectors, firms may be mandated to close so subsidies here make sense; if the firms in the sector are open, but demand is low, subsidies may also be justified (although probably with different parameters). Some sectors may be booming (supermarkets, pharmaceuticals, for example) and may not need the support. Some countries aim to focus on sectors that are the hardest hit, employ lots of people, and are strategic. It is critical that the selection of sectors is transparent. Moreover, some sectors may need longer support than others, potentially through different policy instruments, depending on how the crisis evolves.
   b. **Do you target specific firms within sectors or not?** Most (advanced) countries covered all firms within sectors. Many others have focused on micro and small enterprises (MSMEs) such as several Western Balkan countries or the Dominican Republic. There is a clear rationale to target MSMEs given that they have less liquidity and face larger constraints to access external finance. But there is also an argument to support large firms with many employees or have a critical impact on the rest of the economy through value chains, as the objective of the wage subsidies is to avoid workers being fired and also maintaining key economic structures—such as value chains—working. The other question on targeting firms is whether to focus on firms that are "financially viable" or not. The argument here is that you do not want subsidies going to firms that do not have a

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sustainable business model. While this makes sense in more "normal" times, due to the depth of this crisis, the need for a quick response, and difficulties to gauge and enforce financial viability criteria, especially in developing countries, this is probably better avoided in the current juncture. Moreover, the nature of the COVID-19 shock and containment measures is that most of the firms within an affected sector are being hit. In Austria and Germany, for example, short-term wage subsidies during the global financial crisis targeted firms that had experienced a specific shortfall in revenues/profits, but both countries abandoned these conditions in the current crisis. That said, as the depth of the health crisis ebbs, and the scheme ends, any follow-up support scheme may give more consideration to the viability of the firm.

c. **<u>All workers or not?</u>** Most countries cover all (formal) workers within the firms they support. Some exceptions are Italy and Norway where the support is for furlough workers/workers temporarily laid-off; in the Czech Republic, the subsidies are only for quarantined workers; in Indonesia and Kenya, tax exemptions are only for workers in manufacturing that earn below a certain amount. There are more differences across countries, however, in the amount of subsidy per worker (see below). Again, this choice will depend on how the crisis is manifesting itself in the country and on whether governments can trust any reporting on who is working and who is not, and on the reported level of earnings. Generally speaking, and when data infrastructure is limited, broad-based support appears more adequate given the nature of the shock.

2. **<u>Type of the subsidy</u>?** The wage subsidy can take the form of reductions in social security contributions, income taxes, and/or actual wage subsidies. Most countries have done the latter—paying part of the salary—in some countries also including paying the contribution to social security. Given the depth of the crisis and the objective to avoid layoffs, just exempting workers or firms from paying social security contributions or income taxes is unlikely to be sufficient. These can be helpful later at the margin, however, when the objective is to encourage new hiring during the recovery phase.

3. **<u>How much of the salary shall be covered?</u>** Some countries impose a maximum amount of funds they give each firm, but this is not necessary if the objective is to support workers and a fixed amount per worker is distributed. In advanced countries, wage subsidies typically cover between 60-80 percent of worker salaries, including a maximum amount per worker (a cap). In some of the advanced countries, they also have a sliding scale where they pay a higher proportion of the salary for the low-income workers and a lower proportion to higher earners, up to a maximum. Such schemes make sense if there is fiscal space but still not enough to pay a fixed proportion of salaries to everyone. In some countries, the subsidies are paid only for the proportion of hours *not* worked (at the firm or remotely) such as in Germany and Austria. But this requires a robust system for reporting number of hours worked which is very difficult to enforce in many settings. In developing countries, is may be more practical and less costly to pay everyone a certain percentage of the minimum wage. There is a lot of variation across developing countries in how these schemes ae being implemented, depending on fiscal space and the level of minimum wage. Serbia and the Dominican Republic are paying the equivalent of 50 percent of the minimum wage; Poland 40 percent. The key is to ensure that all workers take home a minimum amount that is sufficient to cover basic expenses, that workers keep their employment relationship, and that firms do not need to fire workers and pay severance. If fiscal space is an issue, and there are not enough resources to cover that basic minimum for

everyone, then countries may exclude workers with earnings above a certain amount (but still include them in the overall employment conditions for firms). The size of the subsidy, however, critically depends also on the conditions imposed on firms and country specific labor regulation as highlighted below (5.b).

4. **Can wage subsidies schemes be used to encourage formalization of workers?** In some contexts, formal firms often hire many workers informally. Depending on the country context, there may be space to include a version of the subsidy also for "new" reported hires (recognizing that some of them may just be conversions from informal to formal); for example, by reducing firms' contributions to social security temporarily or providing a fixed subsidy to the wage of new reported hires. Such a scheme is of course more suitable when the share of informal workers in formal firms is considered significant.

5. **Conditions (imposed on firms).** This may be the most critical and overlooked design element.

    a. **Maintaining employment?** Most schemes impose strict limits on firing workers which makes sense, especially if subsidies are generous. Conditions can be done mainly in two ways: (i) by maintaining overall levels of employment compared to a baseline; that is, firms can still fire and hire individual workers, but the overall employment level is to be maintained; (ii) by prohibiting any firing of labor all together. While the first preserves flexibility of firms, it may be more difficult to enforce. If the subsidy is less generous, countries often apply softer versions of the employment conditions (e.g., countries cannot reduce employment by more than a specific percentage of the overall employment level).

    b. **Do firms need to pay the uncovered part of worker salaries?** In the cases where wage subsidies do not cover most of the individual wages (for example, when you pay a fixed percentage of the minimum wage to all workers), countries often require firms to pay part of the uncovered individual salaries, up to a certain amount or the rest of the full salary. In fact, many countries have legal limits on how much and how long wages can be "lowered" for workers (and also on the conditions that allow for this). For example, if the government provides a wage subsidy that is equivalent to 30 percent of the salary of the workers, then the firm may be required to pay the other 70 percent. While such a condition can be introduced as the severity of the crisis passes, such a condition in the depth of the crisis can be detrimental and undermine the effectiveness of crisis response since participating firms may still run out of cashflow very quickly and be forced to lay off workers due to the low share of mandatory salaries cover by the subsidy. In addition, especially for higher-earners, it is also reasonable for workers to share part of the burden if they are not having to work, will have some savings associated with transportation costs for example, and they benefit from maintaining an employment relationship. Specifically, in lockdown sectors where firms are closed or operating with very limited capacity or revenue flows, this can be a death sentence for the firm (the opposite of one of the main goals of the policy). Such a situation needs to be avoided—it is thus critical to account for a country's specific legal framework and clarify such issues within the countries social dialogue.

    c. **When should the subsidy become effective?** In many countries, before the firm receives the subsidy, it needs to have given workers their paid vacation days for the year. Again, countries must already have a registry of vacation days to impose such conditions. Firms are likely to have already applied such a condition in this crisis anyhow.

6. **Legal framework.** The legal framework can bring limitations that will impact the design of the wage subsidy (see 5.b). A couple of critical aspects: (i) how flexible are wage adjustments; and (ii) whether workers can be furloughed or not. Depending on the context, the objective may be to pay workers to be able to stay home.

7. **Duration.** A wage subsidy scheme during this crisis needs to be time-bound because subsidies are expensive, and the longer they last, the more distortive they are (encouraging too few hours worked for too many months). Most countries have announced time-bound wage subsidies for 2-3 months, at least to start with. The key is that a scheme designed with the principles and objectives described here, is adequate for the depth of this crisis in which economic activity in some sectors has come almost to a halt— and the aim is pay workers to stay home to contain the spread of the virus.

8. **Delivery mechanism.**

    a. **Firms or workers?** In most countries in this crisis, the wage subsidy is per worker but channeled through the firm which then pays out the subsidy. Some countries are handing out the subsidy directly to the workers as there may be concerns that firms do not pass it on; however, this is more difficult to implement, and authorities would still need to check if the firms follow the employment conditions. Moreover, countries can put in place a system through which workers know whether their employer is receiving subsidies, the amount, and whether the firm registered a worker for the subsidy.

    b. **Data requirements.** Governments need to have databases that cover firms, their employees, and, depending on the design, also individual wages. Most countries use tax data or social security databases, from which they can set a baseline from a couple of months before the crisis to define employment levels for firms. Ideally, governments also have the banking information of firms so that transfers can be disbursed quickly. To make the transfers directly to the workers, the Government would need bank information for each individual.

    c. **Application and release of funds.** Speed is of the essence. If the scheme takes too long to pay out, it is ineffective. To speed up the process, in more advanced countries firms are being required to apply online . In Germany, for example, firms receive the money within two days of their application. The government then checks the information against its databases and it reserves the right to claw back resources if there was an error, by creating a future tax liability (for example, if the firm requested higher subsidies than it is entitled to, given its number of workers or salary levels). Rather than paying monthly, some countries have paid the amount to the firm as a lump-sum for the two-three months program.

    d. **Communication.** It is very important from the start to explain the scheme clearly and have mechanisms in place to respond to firms' questions. This is especially important if there can be delays in getting the money out so that firms and workers can be assured that the support is coming.

9. **Transparency, social dialogue, and grievance mechanism.** The effectiveness of wage subsidies depends on clear and transparent rules, timely discussions with and full information provided to employers and workers. This includes having effective mechanisms for firms or workers to complain, if needed; for example, governments provide a website where workers

can enter their ID number to check if the firm is receiving subsidies, whether they are registered and how much they should receive.