HOW TO NOTES

How to Set Compensation for Government Employees

Céline Thévenot and Sébastien Walker

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How to Set Compensation for Government Employees

Céline Thévenot and Sébastien Walker
April 2024

Introduction and Main Messages

Spending on the compensation of employees (“the wage bill”) accounts for a significant share of government expenditure.[1] Total compensation spending is determined by compensation levels and the number of employees. This note focuses on aspects of compensation and is intended to complement the IMF Board Paper on Managing Government Compensation and Employment.[2] Main messages and guiding principles are as follows.

- **Government compensation-setting should be informed by the monitoring of trends in recruitment and retention and benchmarking against the private sector.** Unduly high compensation is an inefficient use of resources, while insufficient compensation can hinder efforts to recruit, retain, and motivate the workforce needed to deliver adequate public services. Analyzing these factors at a granular level, for example, by occupation or position, can help to identify specific challenges.
- **The bulk of compensation should come from base salaries.** Salary scales establish base salaries for given jobs, grades, and notches/steps. They ensure consistency, transparency, and equity in pay-setting, so that two similar employees performing similar work get paid similar amounts.
- **Non-salary elements of compensation (for example, allowances) can be used to differentiate compensation.** Non-salary components (such as allowances for night work or positions in remote areas) can allow for the differentiation of compensation according to various characteristics; however, they can complicate the compensation system, reduce transparency, and hinder employee mobility.
- **Caution is warranted when moving toward performance-related compensation.** In theory, compensation systems could be designed to incentivize performance. In practice, however, paying government employees according to performance or productivity is fraught with difficulties and has proven effective only in limited cases.

A good practice is regularly to review compensation systems to ensure consistency with these principles. Periodic reviews are a good way to ensure that pay structures or components that are not fit for purpose are reformed and those that appear necessary are introduced. Establishing pay commissions to conduct such reviews can be helpful, especially within the framework of a medium-term staffing strategy.

[1] In 2022, the global simple average for spending on compensation of employees as a share of total spending was about 26 percent.

[2] This discussion draws on experience from IMF Capacity Development (CD) work, previous IMF analysis, and the broader literature.

Box. Terminology

The words "compensation," "wage," and "salary" are not interchangeable. *Compensation* includes base (or basic) salaries and wages, allowances, performance-related bonuses, in-kind benefits, social contributions paid by the government as an employer, and any other benefit an individual receives *because* of their government employment.[*] *Wages* are paid on an hourly basis, and employees are typically eligible for overtime pay. *Salaries* are paid based on a theoretical number of hours worked during a pay period. Government employees are generally paid salaries rather than wages, although the difference between the two can be unclear in some countries.

This note is concerned with "*government* employees." According to the 2014 *Global Finance Statistics Manual* (*GFSM*), the *general government* is made up of the central government and sub-national governments (for example, states). The *public sector* comprises the general government and state-owned enterprises (SOEs), also known as public corporations. SOEs typically operate autonomously and set their own compensation, the details of which are generally outside of the scope of IMF staff analysis.[†] This note refers to "the government" where the level of government is undetermined and to the individuals on its payroll as "government employees" (or "personnel" or "workers").[‡]

[*] This usage differs somewhat from that in the 2014 *Global Finance Statistics Manual* (*GFSM*), which includes allowances, bonuses, and various other payments under "Wages and salaries." However, the expenditure policy lens of the analysis in this note requires a finer distinction between the various components of compensation.
[†] This note is also relevant to pay-setting in SOEs, although their pay systems are often more similar to those of the private sector.
[‡] This note is concerned with individuals directly employed by the government, which includes contractual employees, but excludes personnel paid by private companies to which functions are outsourced.

Determining the Right Levels of Compensation

Government compensation systems should be designed to recruit, retain, and motivate qualified personnel to provide public services. The role of governments is to provide public services—from security and the rule of law to social services (social protection, education, and healthcare)—with some variations in public preferences across countries. Delivering adequate public services requires sufficient personnel, both in number and in terms of skills, knowledge, and experience. The compensation of government employees should be considered as the price of the labor input into public service delivery.

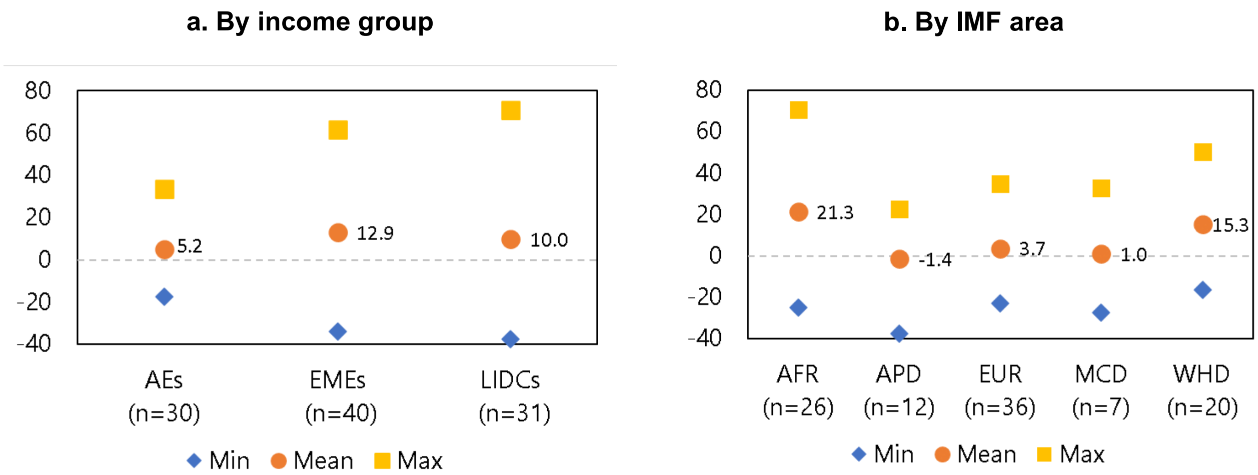
Trends in recruitment and retention are an essential input into determining compensation levels. To ensure government compensation remains competitive—both sufficient and not unduly generous—it is essential to monitor recruitment and retention metrics, such the number of (qualified) applicants per job opening, the rates of acceptance and rejection of job offers, and the number of and reasons for voluntary departures. The latter can be monitored through exit surveys.

Government compensation needs to be competitive with that of the private sector to recruit and retain personnel. An initial step to evaluate the competitiveness of government pay is to estimate the government-private sector compensation premium (also called the "wage premium" in common parlance), which is the average difference in compensation between the government sector and the private sector, statistically controlling for educational attainment and other individual characteristics.[3] Estimates of the premium vary widely across countries, with a greater dispersion and higher average premia in emerging market economies (EMEs) and low-income developing countries (LIDCs) than in advanced economies

[3] Estimation details can be found in Gupta and others (2016).

(AEs) (Figure 1). This premium provides a useful starting point for determining how government compensation compares with that of the private sector on average; however, more detailed analyses (for example, market studies) are necessary to compare broadly similar groups of jobs.

Figure 1. Government-Private Sector Compensation Premium, Latest Available Values
(Percent of private-sector compensation)



Source: IMF Government-Private Sector Compensation Premium Database and World Bank Worldwide Bureaucracy Indicators.
Note: These estimates cannot always distinguish between government and public-sector employees (see Introduction Box). Means are simple averages of country estimates for each group. The means and medians are very close for all country groups. A 12.9 percent compensation premium in EMEs, for instance, can be interpreted as indicating that government employees, on average, earn 12.9 percent more than in the private sector in EME countries (controlling for education and other individual characteristics). AEs = advanced economies; AFR = African Department; APD = Asia-Pacific Department; EMEs = emerging market economies; EUR = European Department; LIDCs = low-income developing countries; MCD = Middle East and Central Asia Department; WHD = Western Hemisphere Department.

Considering total rewards to government employees, a somewhat negative compensation premium should generally be sufficient for government compensation to be competitive. Government employees tend to enjoy greater job and income security, more predictable working hours, and other nonmonetary benefits.[4] Unduly generous government pay risks crowding out private-sector employment (Alfonso and Gomes 2014). Therefore, the premium should generally be somewhat negative, for similar jobs, when the aim is to equalize total rewards (monetary and non-monetary) with those in the private sector. However, determining by how much compensation should differ between sectors requires consideration of a broad range of factors, notably trends in recruitment and retention. The compensation premium should, in principle, reflect all *monetary* benefits (including pension contributions, health insurance, and other fringe benefits), but these may not all be captured when the premium is estimated using household survey data. Therefore, the interpretation of the premium should consider any significant omissions in the data and whether these result in a greater underestimation of government- or private-sector pay for certain groups of employees; for instance, missing information about long-term incentives (such as stock options) may understate pay for some highly skilled private-sector professionals.

[4] Job security is an important benefit offered to government employees that helps to promote recruitment and retention objectives.

It is generally appropriate to compare government compensation with that of the *formal* private sector. Jobs in the formal economy are typically more similar to government jobs than those in the informal sector. However, when there is only a limited formal private sector, using the entire private sector as a comparator may be informative because the informal sector could also be a competitor for workers. Nevertheless, comparability issues may remain because of weaker compliance with tax and labor rules in the informal sector.[5]

Excessive pay compression can hinder the recruitment, retention, and motivation of highly skilled workers. Pay compression is the ratio of the highest to the lowest compensation levels. Recruiting, retaining, and motivating highly skilled workers may require relatively high levels of compensation to be competitive with prevailing compensation for these workers in the private sector (or in other countries, if "brain drain" is hindering government recruitment). This may notably be the case for occupations such as IT professionals[6] or lawyers. The same applies to senior managers, given the need for pay progression as employees are promoted to higher levels of responsibility. When pay is excessively compressed (the compression ratio is too low), a *positive* government-sector compensation premium *on average* may exist alongside a *negative* premium for *highly skilled employees*, especially when earnings inequality in the private sector is high. Pay compression can, for instance, be measured through the ratio of average compensation in the highest and lowest deciles. Using this measure, cross-country benchmarking can be performed using the World Bank Worldwide Bureaucracy Indicators (World Bank 2021). Another useful benchmark from the same database is to compare the compensation of similar occupations in different countries.

The following additional considerations matter when calibrating pay levels.

- *Fiscal space.* Resources allocated to government compensation are bound by the budget. Unduly generous compensation for government employees is a form of inefficient spending that can hinder other objectives. For instance, it may prevent governments from hiring enough employees to achieve public service delivery goals, crowd out spending on other inputs into public service delivery (for example, infrastructure or medical equipment), or lead to unnecessarily high (distortionary) taxation.

- *"Efficiency wages."* Arguments from "efficiency wages" for compensation above the market-clearing level may also apply to government employment. These arguments notably relate to ensuring adequate nutrition/living standards for workers, encouraging effort, keeping down turnover, and addressing adverse selection in recruitment (Yellen 1984).[7] For instance, government compensation was so low in The Gambia until 2022 that the lowest-paid employees were barely able to purchase food (IMF 2022 and Jallow 2021). Insufficient pay may lead government employees to take up one or more additional jobs ("moonlighting") to make ends meet, distracting them from their main job. If a minimum wage or salary exists in the private sector, it should also apply to the government sector.[8]

- *Corruption*. There is a significant negative relationship between government employees' compensation and corruption (Dimant and Tosato 2018). Increasing compensation can reduce

[5] Workers may also lack opportunities and seek to emigrate, in which case the competition for workers comes from other countries, but this would normally apply to both the government and private sectors.

[6] Country authorities (for example, Costa Rica and Moldova) have expressed concerns about difficulties in hiring IT professionals.

[7] Adverse selection in recruitment arises when job applicants' ability is imperfectly observable by the employer, and low pay levels risk attracting only low-ability applicants since ability is positively correlated with a worker's reservation wage.

[8] This was not the case in France until 1998, for example. "Salaire minimum interprofessionel de croissance – Rapport du groupe d'experts," 2019.

corruption, but relying on this alone may require unrealistically large pay increases. Georgia, for instance, managed to reduce corruption through a multistep action plan including higher compensation (IMF 2019a). However, there are other drivers of corruption for government employees besides the level of compensation. Effective control and monitoring systems and appropriate enforcement are also necessary.

- *Political and social aspects*. Governments are often tempted to use government compensation (and employment) to achieve short-term political objectives or as a form social protection, notably as a countercyclical policy. However, compensation should be seen as the price of an input into public service delivery, and it is a poorly targeted and difficult-to-reverse form of social protection.

Length-of-tenure-related compensation increases are justifiable if they remain moderate. Government compensation systems often provide automatic compensation increases (typically through the base salary) linked to length of tenure, in addition to other increases such as cost-of-living adjustments and promotions. This note considers automatic increases to include those that are *de facto* automatic, such as theoretically performance-related increases, which are, in fact, granted to virtually everyone. Human capital theory suggests that knowledge and skills (and therefore productivity) increase with tenure. However, empirical studies suggest that as tenure lengthens, motivation decreases, leading to lower productivity (Ng and Feldman 2013). This argues for moderate length-of-tenure-related compensation increases to support retention as long as the positive effect on productivity is considered to outweigh the negative one. However, large or indefinite tenure-related pay increases are not advisable because they are unlikely to reflect productivity increases.[9] In addition, they lead to upward pressure on compensation spending (contributing to upward “wage drift”), which is difficult to manage as the workforce ages.

The ways in which compensation should respond to inflation depends on a country’s circumstances. Automatic indexation of pay to inflation is not generally advisable as it limits the government’s ability to adjust pay in line with trends in recruitment and retention or other considerations outlined previously. Indexation can also create fiscal challenges and make inflation more persistent (IMF 2023). If fiscal space permits, governments can still raise pay levels in line with inflation to preserve their employees’ purchasing power in the absence of formal indexation. However, if compensation levels are “too high,” they may need to rise by less than inflation (or not at all); if compensation levels are “too low,” they may need to rise by more than inflation.

Determining the Right Composition of Compensation

In addition to the levels of compensation, the composition of compensation matters. In most countries, government compensation comprises a base salary and some non-salary components (such as allowances and bonuses). About 60 percent of countries have a government compensation system featuring a base salary and one or more non-salary components (Gupta and others 2016; Figure 2). Non-salary components can make up a sizable proportion of total compensation: their share can range from about 25 percent of compensation spending to more than 90 percent (Figure 3).

[9] There is often a limit on the number of tenure-related salary increases permissible for government personnel. Promotions are a separate case because the employee normally takes on additional responsibilities.

Figure 2. Share of Countries by Pay Structure, Latest Available Values

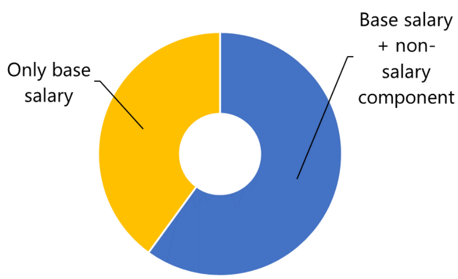
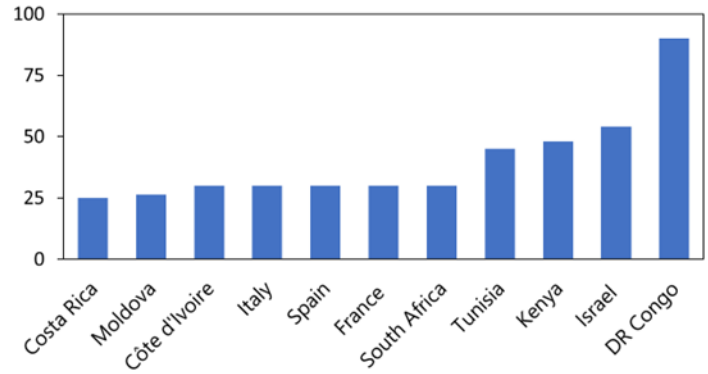


Figure 3. Non-Salary Share of Compensation in Selected Countries, Latest Available Values

(Percent)



Sources: IMF (2016), Moshonas (2019), and OECD (2021).

The base salary should be the primary component of compensation. The base salary is normally determined by a salary scale that defines pay levels for specific job roles, grades, and steps. Getting the pay level right for individual jobs and employees can generally be achieved through appropriate mappings to a salary scale (for example, assigning a new doctor to a higher salary level than a new teacher). A salary scale maintains consistency, transparency, equity, and visibility over future earnings. It is generally based on a job classification that ranks occupations based on skills, duties, supervisory responsibilities, and other characteristics, sometimes including education or previous experience (Shiavo-Campo 2018 and OECD 2021). Some countries have different salary scales for employees in different sectors (for example, many French-speaking countries and South Africa) while others have opted for a single salary scale (for example, Costa Rica and Moldova).

Salary scales provide visibility over earnings over time by imposing rules that determine the pace at which employees move through the scale. There are two ways of moving through the salary scale: passage of time (moving "across") and promotions (moving "up"). Movement through the salary scale allows compensation gradually to rise with tenure. Competitive promotions are a useful way of rewarding performance and maintaining motivation through career progression. They should be granted according to performance.[10] Transparency can be further promoted by publishing salary scales along with other compensation policies.

Non-salary components are sometimes used to increase pay when this could be achieved more transparently through salary scales. The following are examples of cases where adjusting the salary scale would be more appropriate than relying on allowances to meet policy objectives.

- *Rewarding scarce skills or senior positions.* If a government finds IT specialists difficult to recruit, it could consider increasing their base salaries by adjusting their salary grade range rather than introducing an "IT allowance" for these professionals (see Box 1). Some countries pay a "managerial allowance" to employees whose positions are inherently managerial and who could therefore be rewarded by a higher level on the salary scale.

[10] Shiavo-Campo (2018) cites the example of India, where promotions are linked to tenure, harming the motivation of employees.

- *Broad-based pay increases.* Base salary increases are often preferable to allowances or salary top-ups granted to a large majority of or all employees.[11] For instance, so-called 13th- (or even 14th-) month payments do not serve the purpose of differentiating pay and the same pay increase could be achieved more transparently through a higher (monthly) salary, especially in countries where such payments are not widespread in the private sector.

Box 1. Targeting Compensation Increases: Which Options for Which Policy Objective?

Table B1.1 maps options for increasing pay levels depending on policy objectives and discusses their advantages and drawbacks. Depending on the policy objectives and country circumstances (including fiscal space), authorities might opt for an across-the-board increase, a change in the compensation structure, or a targeted pay increase.

Table B1.1. Selected Channels to Increase Government Employee Compensation

Channel	Objectives	Advantages	Drawbacks
Type I - Across-the-board salary increase			
Percentage salary increase	Increase attractiveness of all gov't jobs; offset impact of inflation	Maintains existing salary differentials	Can be the costliest or contribute most to inflation pressures
Fixed amount salary increase	Increase purchasing power of the lowest-paid gov't employees	Progressive	Compresses the payscale (unless this is an objective)
Type II - Targeted salary increases			
Differentiated percentage increases (greater increases for higher grades)	Target positions with staffing challenges (e.g., highly skilled workers or certain sectors)	Decompresses the pay scale	Risk of "leakage" to positions without staffing challenges
Job regrading (shifting jobs to higher grades)		Best for targeting certain sectors/occupations	Legislation may be needed
Type III - Changes in compensation structure			
Increase speed of length-of-tenure-related salary progression	Improve retention	Encourages longer careers in government sector	Higher "wage drift" and faster growth in compensation spending
Change bonuses and allowances	Target the pay increase at specific criteria	Easiest to target based on narrow criteria (e.g., geography, task)	Risk of proliferation of bonuses and allowances; can be less transparent

Source: IMF staff.

Non-salary components should be used sparingly when there is a need for further compensation differentiation. There is a clearer case for differentiating pay through allowances for aspects affecting only a subset of employees in a given category. Most of the components of non-salary compensation can be grouped into five broad categories: labor market adjustment, job, task, commuting, and living cost (Figure 4). This rough classification can help when considering the appropriateness of non-salary compensation components. Non-salary components can be used to attract certain workers to underserved regions. It can also be a way of compensating for job-specific risks or hardship (for example, personnel sent to dangerous areas or made to work night shifts) or encouraging certain behaviors (for

[11] A caveat is that relying on non-salary compensation can be less costly. The base salary component can be linked to additional costs for future and sometimes current pensions and other entitlements. However, salary increases can be designed in such a way that their overall cost has the same net present value as a non-salary payment by factoring in these additional costs.

example, using public transit instead of driving). Finally, diplomats and other workers posted to foreign missions are often paid allowances to reflect the higher cost of living in a different country.

The compensation system can be undermined by excessive non-salary components. These can create a lack of transparency, inequities, and inefficiencies. A complex system of allowances and bonuses can hinder internal mobility and recruitment because both current employees and external applicants may struggle to estimate their compensation in a new position. Employees may even face a nominal pay cut if they change jobs within the government. The proliferation of non-salary components can lead to excessively complex compensation systems that are costly to administer. Over 60 different schemes have been identified in Ghana and 247 in Kenya, the latter accounting for 48 percent of total compensation spending in 2019 (Gupta and others 2016 and Kenya Salaries and Remuneration Commission 2021). Common funds (*fonds communs*) in Burkina Faso, used to pay bonuses out of fines and fees collected by numerous ministries, have been a particular source of opacity and inequity because their total value proved hard to determine. The 2019 budget reformed these bonuses, notably by capping them (IMF 2019b). In France, a reform aimed at streamlining most bonuses and allowances in the 2010s.[12] The non-salary compensation component now consists of a monthly allowance linked to job characteristics, expertise and hardship allowances, and a performance bonus.

Figure 4. Categorization of Non-Salary Components of Compensation and Examples

Labor market adjustment	Job-related	Task-related	Commuting cost	Living cost
• Regional attractivity	• Risk allowance	• Night work	• Public transit	• Diplomats

Source: Adapted from Kenya Salaries and Remuneration Commission (2021).

Non-salary components can easily proliferate. These components sometimes receive a lighter tax treatment, which encourages their use over that of higher base salaries; examples include 13th- and 14th-month payments in Costa Rica[13] and allowances in Eswatini. The cost of these non-salary components is then understated by the compensation budget, given the lower revenue resulting from such tax expenditures. Allowances can also be used to circumvent limits on base salaries. They are sometimes recorded under use of goods and services rather than compensation of employees—for instance "per diems" intended to cover additional personal costs arising from travel. These may become *de facto* income top-ups if paid for trips involving no additional personal costs, such as attending meetings in another government building without having to pay for transportation or food.[14] This can also harm productivity and efficiency if work practices are driven by financial incentives rather than business needs.

Non-salary components can become outdated or not serve their intended purposes. For instance, in Israel, the "car allowance" was revised because it disincentivized the use of public transportation (OECD 2021). In Chad, teachers receive a "chalk allowance," meant to compensate them for the hazard of breathing chalk dust, even if they are in administrative positions away from classrooms.

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[12] https://www.fonction-publique.gouv.fr/etre-agent-public/ma-remuneration/le-regime-indemnitaire-fixe

[13] The 13th- and 14th-month payments are respectively a Christmas bonus and the *salario escolar*, an allowance originally intended to help employees buy school supplies.

[14] For a discussion of possible misuse of per diems, see: Sabin and Vian 2012; Lindner 2013; U4 2013; U4 2009; and Vian and others 2012.

A good practice is regularly to review compensation systems to ensure their consistency and fitness for purpose. An excessive non-salary share of compensation can undermine the base salary structure and hinder the pay progression that would otherwise result from promotions. Regular planned reviews are a good way to ensure that pay components that have become inappropriate are reformed and those that appear necessary can be introduced. This is especially relevant if considered within a broader, medium-term strategy for government employment. Dedicated pay commissions can be useful institutions to conduct these reviews.

The Challenges Raised by Performance-Related Compensation

In theory, a compensation system that rewards performance could improve the quality of public services, but in practice, such systems rarely deliver against expectations. Following the private sector, where pay systems often reflect productivity, would imply that compensation for government employees should also bear some relation to performance. Since the early 1990s, many countries have introduced performance-related pay systems, with mixed results.

Performance-related pay can be awarded through higher increases in the base salary or through non-salary components (such as bonuses). A possible drawback of performance-related base salary increases is that they cannot be reversed (at least in nominal terms) if performance is not sustained. One-off performance bonuses are an alternative option, although they may lead employees to take a shorter-term view than with base salary increases, which are cumulative over time. Most OECD countries now have some form of performance assessment. Among these, 18 OECD countries use performance-related compensation in the form of bonuses and 21 in the form of performance-related base salary increases (OECD 2017 and OECD 2018). Denmark and Japan use performance-related compensation more extensively than other countries, through a combination of one-off bonuses and base salary increases, for up to 40 percent of an employee's base salary. South Korea also extensively links pay to performance and moved from a system rewarding seniority to a performance-based one.[15]

Designing a performance-related pay system requires (1) defining performance through clear and measurable objectives and (2) making decisions about how to link performance to pay and for whom. Several characteristics of government employment make it difficult to implement successful performance-related pay systems. Important issues to consider include:

- *Functional characteristics of a job.* Whether the workers are tasked with ensuring compliance with laws and regulations (tax collection agents, police officers, judges) or whether they are service providers (health and education workers) will not result in the same mechanisms to design incentives (Finan, Olken, and Pande 2017). The first group is more exposed to corruption because their job implies a tension between the objectives of the state and the individual citizen, which complicates performance-pay mechanisms. For instance, an experiment on tax collectors in Pakistan showed that implementing performance-based incentives in some areas was improving revenue collection but could also increase the magnitude of bribery (Khan, Khwaja, and Olken 2016).
- *Measure of performance based on outcomes or inputs*. Performance incentives may improve productivity for tasks with standardized delivery processes and easily verifiable outputs (Hasnain, Manning, and Pierskalla 2014; and World Bank 2021). However, measuring performance through

[15] Salaries and Remuneration Commission Act (2011) Principles of Pay Determination.

a narrow set of outcomes creates risks because employees may only focus on the measured responsibilities and neglect the others, resulting in a lower overall quality of service (Holmstrom and Milgrom 1987). Rewarding only easily observable outcomes (for example, students' grades) may lead to the neglect of difficult-to-observe outcomes (for example, students learning teamwork skills or civic values). Inputs (for example, hours of presence at the workplace) may provide a basic measure of performance. For instance, a teacher who does not come to school is necessarily not performing, and their pay can be withheld on grounds of absenteeism. However, even such basic input-related pay can be problematic in countries with inadequate sick leave and health care provision.

- *Measure of performance at the individual or collective level*. Performance-related pay systems may undermine teamwork if they are too closely related to individual performance. An experiment in Mexico found that education outcomes were greater when the incentives were offered jointly to students, teachers, and the school administration rather than to only one of these groups (Behrman, Parker, Todd, and Wolpin 2015).

In countries where performance-related compensation has been in place for long enough, studies report little evidence of higher government employee motivation or better quality of public services (The Work Foundation 2014). The OECD notes that few of its member countries have succeeded in designing an effective system of bonuses (OECD 2021). The complexity of performance assessments and the issue of multitasking are commonly reported difficulties. While measuring performance also presents challenges in the private sector, the profit-maximization motive points to reasonably objective metrics to assess performance that are less readily available in the government sector. Compensation systems also need to consider how to address poor performance. Since it is typically very difficult to dismiss underperforming government employees, withholding performance-related pay from underperformers may at least incentivize them to seek alternative employment. Experience with performance-related pay suggests keeping it to a modest share of the total compensation of government employees. A useful way to reward performance remains to link it to career progression through competitive promotions, which still requires a robust performance assessment framework.

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