Box 10

GOVERNMENT WAGE DEVELOPMENTS IN THE EURO AREA

The development of government sector wages in euro area countries is an important factor behind the evolution of total economy wages, unit labour costs and inflation. This is evident from the fact that the government sector wage bill, in terms of compensation of general government employees in the euro area, averaged more than 20% of total economy compensation of employees in the period 1999-2006 (see last column in the table below), with some variation across euro area countries.[1] Thus, wage negotiations and employment developments in the government sector and their potential spillover effects on other sectors of the economy may have a marked impact on unit labour costs and inflationary pressures (incl. via changes in administered prices)[2] in the euro area as a whole, as well as on the cost and price competitiveness of individual euro area countries. Against this background, this box examines the dynamic behaviour of government wages in the euro area and their evolution vis-à-vis private sector wages.

Since the inception of EMU, total compensation of government and private employees in the euro area has risen at broadly similar rates.[3] Although the situation differs notably across euro area countries, for the euro area as a whole the increase in total compensation of government employees has remained below that of nominal GDP. This implies that the share of government wage expenditure relative to GDP has fallen over time, in line with the decline in the income share of total economy and private sector wages in the euro area.

By contrast, compensation per individual employee rose significantly faster in the government sector than in the private sector over the period 1999-2006, reflecting the different evolution of employment in both sectors. While these developments have varied considerably across euro area countries, in several of them government wages per employee rose faster than private sector wages per employee. This phenomenon is related to a number of factors, including

1 Attention should be drawn to some methodological caveats surrounding the measurement and cross-country comparability of government compensation of employees and government employment. Some of the observed differences in the behaviour of these two fiscal variables among euro area countries are related to institutional issues, such as differences in the organisation of the public sector. For example, in countries where hospitals are owned and managed directly by the government (either general, regional or local) the related healthcare costs appear in the government accounts as salaries paid directly to employees, as well as purchases of medicines and other inputs. By contrast, in countries where hospitals are managed by the private sector or a public corporation classified as being outside the general government, the costs borne by the government will show up under other public expenditure categories. This difference in the organisation of the provision of services may thus lead to different assessments of government wage developments, although the underlying economic transactions may indeed be very similar.

2 See May 2007 ECB Monthly Bulletin Box "Measuring and assessing the impact of administered prices on HICP inflation", pages 38-41.

3 Private sector compensation of employees is calculated as total economy compensation of employees minus government sector compensation of employees. Private sector compensation per employee is calculated as private sector compensation of employees divided by the number of private employees (total economy employees minus government employees minus self-employees).

Compensation per employee in the government sector and private sector in the euro area

	% growth in nominal terms, 1999-2006						Share of compensation of government employees in total comp. of employees, average 1999-2006 (%)
	Compensation of government employees	Compensation per government employee	Compensation of private employees	Compensation per private employee	Memorandum items		
					GDP	HICP inflation	
Euro area	**27.5**	**21.6**	**27.0**	**14.7**	**31.0**	**16.3**	**21.4**
Belgium	33.6	25.3	27.4	18.8	32.0	15.9	23.3
Germany	0.5	8.3	9.0	7.5	15.2	11.7	14.9
Ireland	131.7	67.0	84.7	42.2	92.1	28.0	22.5
Greece	74.0	64.9	66.3	44.7	68.8	26.3	35.5
Spain	56.0	22.1	57.8	12.2	67.8	25.4	20.8
France	27.1	20.4	31.8	23.0	29.9	14.7	25.6
Italy	36.7	33.8	36.0	14.8	30.8	18.3	26.8
Luxembourg	59.8	34.6	64.3	43.7	66.6	22.7	16.7
Netherlands	37.6	24.8	27.8	26.2	35.3	19.5	19.4
Austria	3.7	16.0	23.8	15.8	28.1	13.7	19.6
Portugal	39.3	25.3	44.5	31.9	33.4	24.0	28.2
Finland	36.2	28.2	36.5	28.0	35.8	11.6	27.7

Source: OECD Economic Outlook database, December 2006 issue. Missing government employment data for Germany, Greece and Austria has been taken from the June 2006 issue.
Notes: The euro area aggregate excludes Slovenia, as it was not part of the euro area in the period covered. The concept of total compensation of employees in the government sector is in line with ESA 95. For statistical issues regarding the definition of government epmployment, see the OECD publication "Measuring public employment in OECD countries: sources, methods and results", OECD, 1997. In view of differences with alternative data sources, OECD government employment figures for a number of countries (in particular Spain, Greece and Portugal) have to be taken with caution.

differences in the prevailing types of wage contract in the public and private sectors, the skill composition of employees in both sectors, the relative scarcity of workers, the prevalence of part-time and temporary work arrangements and, last but not least, the strength of constraints on government budgets versus the pressure from market competition in the private sector.

The dynamic behaviour of government wages is of particular interest when analysing aggregate economic fluctuations. Recent evidence supports the conclusion that government wage spending, compensation per employee and employment have typically moved in a pro-cyclical manner (with one/two-year lags) in the euro area and in euro area countries over the last 30 years.[4] This is consistent with a political economy view of the behaviour of public wages, whereby governments find it harder in favourable economic conditions to resist pressures to raise employment, wages and thus wage expenditure. Similarly, in an economic downturn, government wage expenditure appears to be one of the tools for discretionary tightening, in order to limit deficit increases.

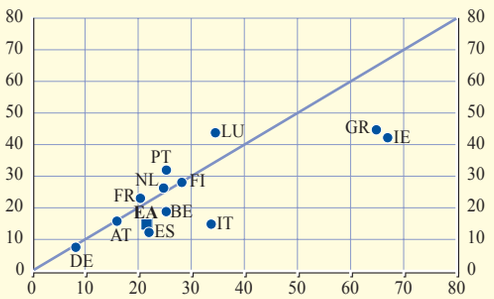
In order to assess the impact of government wage developments on the economy, it is also important to consider the potential spillover effects between public and private sector wages. Over the period 1999-2006 a positive correlation was evident between government sector and private sector wages per employee in euro area countries (Chart A). Also over the long term, euro area compensation per employee in the government and private sectors followed similar trends, with government wages rising more slowly in the 1980s and faster since the mid-1990s (Chart B).

4 See A. Lamo, J. J. Pérez and L. Schuknecht, "The cyclicality of consumption, wages and employment of the public sector in the euro area", ECB Working Paper No 757, May 2007.

Chart A Compensation per employee in the government sector and private sector in the euro area

(Nominal percentage growth rates, 1999-2006)

x-axis: compensation per employee, government sector
y-axis: compensation per employee, private sector

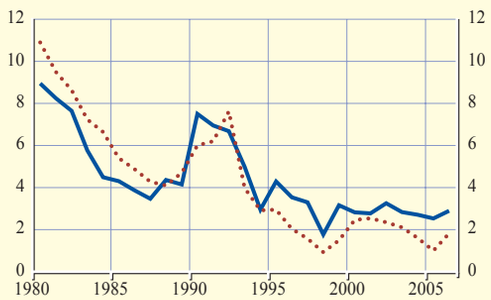


Source: See table in this box.
Note: The euro area aggregate excludes Slovenia, as it was not part of the euro area in the period covered.

Chart B Euro area compensation per employee, 1980-2006

(Annual average nominal percentage growth rates)

government sector
private sector



Source: See table in this box.
Note: The euro area aggregate excludes Slovenia.

However, this correlation pattern does not indicate the direction of causality and it is therefore not possible to conclude whether public sector wages lead or follow private sector wage developments. From a theoretical standpoint, both a leader and a follower role for public wages are possible, and the empirical relationship is likely to depend on country-specific circumstances. In this regard, the size of the government and thus the weight of government employment in the national labour market may play an important role. The larger the public sector wage bill, the higher the potential impact of government wage agreements on wage changes in the private sector and on the aggregate wage level of the economy. This would tend to raise the likelihood of a leader role for public wages. The limited empirical evidence provided by the academic literature in this regard seems to suggest a (weak) leader role for private sector wages in some industrial countries. However, in the case of the euro area, the fact that government wages rose faster than private sector wages in the period 1999-2006 might provide some anecdotal evidence that public sector wages at least did not have a follower role in this period. By contrast, in the 1980s, when many euro area countries were faced with the need to curb large government deficits, wage and employment restraint in the public sector may have set the stage for wage moderation in the private sector.

The findings reported above on the pro-cyclicality of public wages and employment, and the contribution of government wages to total economy wage developments in the euro area call for particular prudence on the part of governments in the current cyclical upturn. Any departure from earlier plans to maintain public wage and employment restraint risks fuelling aggregate demand pressures, burdening government budgets with additional spending commitments that will carry over into the next downswing, and could even trigger additional wage pressures in the private sector. Public wage policies in the euro area countries thus have an important signalling role in the current economic situation and play an important part in supporting the single monetary policy in maintaining price stability as well as in dealing with unwarranted wage and inflation differentials in EMU.