Summary for non-specialists
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Government wages and labour market outcomes

The government wage bill represents a significant share of total public expenditures. Given its relevance, developments of government wages are likely to produce significant effects on the whole labour market, public finances and the overall economy. This paper looks at government wage formation, its outcomes, and interlinkages and interactions between government wages and the labour market.

A proper understanding of the interactions between government wages and labour market conditions for the private sector is currently of high relevance in the EU, as a number of Member States are facing the challenge of redressing public finances, while at the same time rebalancing their economies, and dealing with rising unemployment.

The aim of the paper is three-fold. First, it discusses the peculiarities of the objectives and constraints of the government as an employer and describes government wage formation across EU countries, looking at the main features of existing institutional settings and arrangements, the actors involved, and established practices. This is essential to better understand not only wage outcomes in the government sector, but also the scope for adjustment in the wage bill and the potential for and mechanism of wage spill-overs to the private sector.

Second, it compares the level of public wages with those in the private sector. The analysis aims at identifying the possible existence of "wage premia", which are not explained by skills or other individual characteristics. As compared with existing analyses, the aim is to estimate wage premia for all EU countries in years for which survey data are available both before and after the crisis, and to discuss cross-country differences in wage premia in light of relevant country characteristics.

Third, the paper analyses the dynamic interactions between government and private wages. Short-term interactions are estimated by means of a structural VAR for all EU countries for which sufficiently long time series are available. Compared with existing analyses, the advantage is that dynamic interactions are analysed across the EU for time series comprising the post-crisis period. In addition, the long-term relation between manufacturing and government wage levels is analysed across a panel of EU countries in a co-integration framework. Results are discussed with reference to country-level structural and institutional characteristics that may influence the dynamic interactions between wages in the government and the export sector.

Wage settings in the government sector vary significantly from one country to the other along several dimensions, including the presence, scope and breadth of collective bargaining, the degree of centralization, the rights of governments and the modes of representation, and union density. A key distinction is between countries where government wages are set mostly by legislative action and those where they are set by collective bargaining.

As concerns outcomes, it is found that compensations in the public sector are normally higher than in the private sector even after controlling for the composition of employment, which in the public

sector is characterised by the incidence of highly skilled employees. Simple correlation analysis indicates that the public wage premium tends to be higher in countries where employment protection legislation is strict and the government employs a small share of the labour force.
The dynamic analysis confirms that private wages respond to changes in government wages possibly also because of second-round effects via inflation, but openness to trade raises the resilience of private sector wages to shocks originating in the government sector.

As spillovers originating from strong dynamics in government wages have been mentioned amongst the drivers of competitiveness losses prior to the crisis, attention is specifically devoted to possible spillovers to the manufacturing sector analysed by means of a co-integration framework, which allows assessing long-run effects on wage levels. The results indicate that manufacturing and government wages indeed share a strong long-run relation and that this is much stronger in countries where the government employs a large share of employed people. Government wage setting modalities also play a role. It is found that where government wages are set through collective bargaining, manufacturing wages are related to government wages but they are also more tightly linked with productivity, which suggests that bargaining outcomes are closer to the market than unilateral decision by the government.

Most European countries have been recently engaged in an effort to cut government wage bills either by imposing freezes to wages or cuts or retrenchment of specific indemnities and benefits or a block to the turnover. The evidence is that, with the crisis, government wages have taken a completely different trajectory compared with the previous decade, growing at much slower pace than manufacturing wages, especially during fiscal adjustment episodes. Simple correlation analysis indicates that manufacturing and government wage growth are correlated in periods of fiscal stress only when the government sector is relatively large.