



# We Need a Wage Policy for the Public Sector<sup>1</sup>

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## Public wages influence private wages

Wages in the public sector of B&H recorded an average growth of 10% in 2006 and 2007 and reached the whole 26% in 2008. These wage increases took place in the light of favorable fiscal developments, primarily due to the introduction of VAT in 2006 and strong growth of private consumption. In the 2007 Progress Report for B&H, the European Commission observed the following: „The 2007 budget execution at different levels of government shows continuing increases in public-sector wages...“.

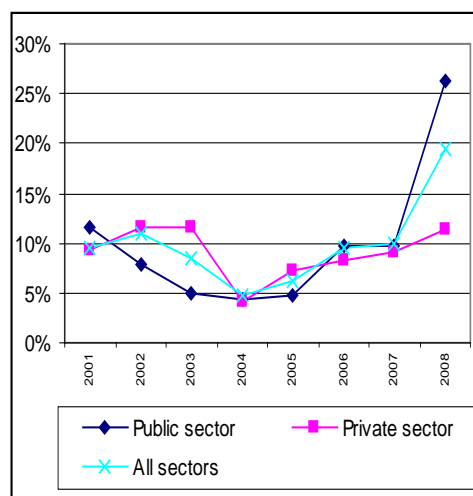
The average wage for total B&H economy also recorded a strong growth of 9% and 10% in 2006 and 2007 respectively and 19% in 2008. One reason for this is that the public sector accounts for roughly one third of total formal employment in Bosnia and Herzegovina and hence every increase in the public sector is immediately reflected in the average wage of total economy. This is why the wage setting in the public sector has a large potential to affect wages in other parts of the labor market (see Figure 1).

However, the wage negotiating in the public sector can be driven by factors different from those in the private sector due to political aspects of decision making in this process. Within that meaning, in countries where the public sector holds a significant share of employment, the government can become *de facto* a leader for the wage setting in the whole economy.

Indeed, public sector wage agreements often have strong signaling and spillover effects on the private sector wages. That this is also the case in B&H has been confirmed by previous studies (for example World Bank, 2005). This creates a potential problem because decisions of the government in this respect are not completely guided by the issues of efficiency and competitiveness as it is the case with the private sector.

## Wages - key policy instrument for B&H

A situation in which the growth of wages in an economy outpaces the productivity growth for a longer period of time normally leads to a fall in external competitiveness and to reduced job creation. This is why the European Commission and the European Central Bank pay special attention to development of these indicators in the EU member countries (see 2008 Convergence Reports from European Commission and European Central Bank).



**Figure 1. Public wages exploded in 2008**  
Increase of average wage, in percent (yoy)  
Source: Author's calculations based on data from the Republic of Srpska and Federation Statistical offices

## Summary

The period 2006 - 2008 has been marked by high growth of wages in the B&H public sector. National and local elections and favorable fiscal developments in this period have stimulated the governments to meet the requests of trade unions in this respect. Consequently, the level of average wage in the B&H public sector is today significantly higher than what it used to be in other CEE countries at the same level of development. These wage increases spilled over to the rest of the labor market driving up wages in the whole economy. Although higher wages have improved the living standard of those who are employed, they have undermined the competitive position of domestic companies and worked against the pressing need to reduce the B&H's unemployment rate and the current account deficit. Opening up and reducing barriers to trade, the process which has been supported by B&H policymakers, implies also accepting a direct price competition where wages play a vital role. A sustainable wage policy for B&H requires that public sector must stop setting the pace of the wage growth for the whole economy. A proposed way to do this is to bring the public wage levels in line with comparable positions in the private sector and link their further growth to the growth of private sector wages. The global economic crisis that had spread over the Europe in the last quarter of 2008 warrants an immediate policy action in this respect. The previous surge of public wages had been associated with a global economic boom that has ended with a "hard landing". A reduction of wages in the public sector is now necessary as it would relieve the pressure from the tightening fiscal revenues and would signal to the private sector that there is room for necessary wage and price adjustments. If this does not take place, the adjustment will take place through higher number of layoffs and company bankruptcies. Therefore, an impact of the external shock on domestic economy is inevitable but the manner of absorbing the shock depends on a policy chosen. A no-policy-change scenario leads to further deterioration of internal and external position of B&H and potentially endangers the stability of the financial system.

<sup>1</sup> This policy brief is based on the policy study "Wages in the B&H Public Sector: Hurting the Economy?" by Ognjen Djukic, produced under the Policy Development Fellowship Program of the Open Society Fund Bosnia and Herzegovina.

The mechanism through which wages affect international competitiveness and job creation is fairly simple. If wages grow faster than productivity, the cost of labor per unit of output increases and puts upward pressure on inflation. Domestic inflation rates higher than those of competitor countries lead to weakening of price competitiveness and, eventually, export performance. The impact of high wages on employment works through reductions in demand for labor induced by decelerated economic growth. But high wages can also cause lower labor demand through workings of other mechanisms such as the substitution effect between labor and capital. When labor is relatively expensive, the investments are made more in capital intensive sectors and less in those that are labor intensive.

Having in mind that unemployment and trade deficit probably represent two major economic imbalances of B&H economy, the issue of appropriate wage setting warrants the highest degree of attention. Moreover, the currency board arrangement in B&H has removed the exchange rate policy from the table of economic policy instruments leaving the wages as the most important mechanism for adjusting the international competitive position of B&H.

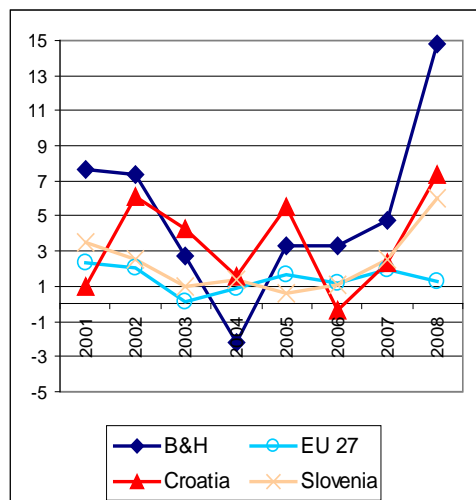
#### **B&H's competitiveness reduced**

A recent analysis of international data on wages<sup>2</sup> revealed that wages in B&H public sector have been unusually high by international standards. Moreover, the data suggests that the strong overall wage growth in the period 2006-2008 has undermined the B&H's competitive position in terms of price competitiveness measured by unit labor costs (see Figure 2).

#### **The global crisis demands immediate response**

So what are the implications of these findings in terms of adjustments to external shocks such as the global economic crisis that has contaminated the Europe in the last quarter of 2008? For B&H, the slowdown of global economic activity has caused a significant deterioration in exter-

<sup>2</sup> Ibid.



**Figure 2. Losing competitive edge**  
Change in unit labor costs, in percent (yoy)  
Source: Author's calculations based on data from statistical agencies and EUROSTAT

nal terms of trade due to a sharp fall in prices of B&H exports. This situation, coupled with currency devaluations in a number of CEE countries, exerts a strong downward pressure on domestic prices. In the presence of a currency board arrangement in B&H, the main remaining instrument for adjustment to such external shocks lies in the labor market. If wages are not able to respond to the new circumstances, this leads to increased company bankruptcies and layoffs of workers. Adjustment in this case works through reductions in employment and growth. If wages are more flexible, a slowdown or recession is than less pronounced. Furthermore, a stronger recession shock means also a stronger test for the currency board as the international reserves deteriorate due to a falling competitiveness and raising devaluation pressures.

#### **Policy recommendations**

The main policy recommendations can be summarized as follows:

- *Bring the public sector wage levels in line with comparable positions from the private sector.* The benchmarking of public wages to the private sector could be done by the government or economic-social councils whose role would be especially important



in determining the appropriate benchmarks for jobs that have no clear comparisons outside the public sector, e.g. army and police. In the benchmarking process, factors such as a greater level of security in the public sector and other benefits should be taken into account. The wage correction could be phased in gradually with an initial reduction at the level necessary to satisfy fiscal constraints and signal a policy change in the wage setting.

- *Link the further growth of wages in the public sector with the growth of the average wage in the private sector.* This will ensure that the same mistake does not take place again in times of economic booms and that over time public wages remain anchored and do not compete with the private sector.
- *Introduce these measures at the level of Fiscal Council.* This is important as it would remove a possibility of wage competition between different government levels and would provide the necessary coordinated implementation. The strong commitment of the Fiscal Council to long-term implementation of this policy would send an important signal that the overpayment in the public sector cannot be again expected. This would increase the attractiveness of the employment in the private sector and could help stimulate entrepreneurial activity.
- *Improve the quality of statistical information and reporting on wages.* According to the World Bank (2005) the official statistical data on wages are not representative as only a smaller share of companies (11% in 2004), mostly from the public sector, reports this data while the data submitted from the private sector might be biased downwards. The reliability of statistical data on wages under this policy option is highly important as it serves as primary basis for policy decisions.

A main caveat of this policy option is that it does not come without political costs. Social unrests and riots in countries that have recently tried to implement austerity measures (for example Ireland, Iceland, Hungary, Latvia, and Greece) illustrate this very well. However, not reacting now only postpones, but also aggravates, the problem. The first shy attempts of the RS Government in terms of 10% wage cuts for the public sector employees whose monthly salary exceeds 2000 KM is far from enough as it affects a small number of employees and creates little savings. This measure is also temporary in character as it further squeezes the already compressed wage spread in the public sector, which is not sustainable in the long run.

Therefore, an appropriate implementation of this policy requires substantial political will, which has probably contributed to the fact that a number of European governments, including B&H, have resorted to arrangements with the IMF trying to shift some of the pressure from their shoulders. At the time of conclusion of this policy brief, it seems that a good share of domestic policymakers still has not comprehended the significance of this problem (or have not cared) as the representatives of the Federation Parliament have made a decision to increase their salaries in January 2009, the representatives in the RS Parliament have not considered any reductions and the representatives in the B&H Parliament agreed only to withdraw their raise from the beginning of the 2009.

#### **Related resources**

Djukic, O. (2009). *Wages in the B&H Public Sector: Hurting the Economy*. Sarajevo: Open Society Fund Bosnia and Herzegovina.

Djukic, O. Vidovic, I. and Tutnjevic, M. (2008). Plate i produktivnost: konkurentnost BiH u međunarodnom kontekstu (Wages and Productivity: Competitiveness of B&H in International Context). *Nezaposlenost u BiH: (ne)efikasnost postojećeg tržišta rada*, 5-36. Banja Luka: NGO Gea.



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Ognjen Djukic is an economist involved in the fields of macroeconomics and development policies. For the last five years, he has worked at several advisory and executive posts in domestic and international institutions. Ognjen is a member of the NGO Gea, a center for research and studies, which promotes informed policy debate in the areas of economic development and employment in particular. Ognjen received his M.A. in Development Economics at the Williams College in Massachusetts. He was born in Banja Luka where he graduated at the Banja Luka Faculty of Economics. His professional interests include transition countries' macroeconomic imbalances, structural reforms and employment policies.

European Central Bank. (May 2008). *Convergence Report*.

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Kristic, I. (2007). *Sustainability of the Currency Board Arrangement in BiH*. Sarajevo: Bosnia and Herzegovina Economic Policy and Planning Unit.

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