PUBLIC SECTOR WAGE DYNAMICS - WHEN AND HOW MUCH PUBLIC WAGES SHOULD RISE

Highlights:

- This policy brief examines how public-sector wage adjustments should be timed and sized, stressing productivity, fiscal sustainability and spillovers to the private sector.
- As Paul Krugman famously stated, “Productivity isn’t everything, but in the long run it’s almost everything.” In the public sector, productivity is not measured by profits, but by the efficiency and effectiveness of service delivery.
- We propose a four-pillar model to guide public wage growth based on:
    - Productivity Index (macro + micro indicators).
    - Customer Satisfaction Index (service quality and user feedback).
    - Budgetary Capacity Index (fiscal space and cyclical position).
    - Governance & Transparency Index (accountability, alignment with strategy).
- Public wage policy must balance productivity, service quality, labor-market spillovers and fiscal limits; a transparent, index-based approach that combines productivity, satisfaction, fiscal capacity and governance will produce more sustainable wage outcomes.

The calibration of public sector wages is a critical lever of fiscal policy, with far-reaching consequences for labor market dynamics. Globally, these wages account for a substantial share of government spending-averaging around 8% of GDP (World Bank, 2021) and directly influence the quality of public services, civil servant motivation, and national economic competitiveness.

Determining the appropriate timing and scale of wage adjustments in the public sector requires nuanced analysis. Research by the European Central Bank (Afonso & Gomes, 2008) underscores the interconnectedness between public and private sector labor markets. Their empirical model reveals:

- A **1% increase** in public sector wages triggers a 0.1% rise in private sector wages.
- A **1 percentage point** increase in public sector employment leads to a 0.45% increase in private sector wages.

These findings highlight that public sector wage policies do not operate in isolation. They influence the private sector wage trajectories, employment levels, and aggregate demand through

both public consumption and final consumption channels. If wage growth outpaces productivity gains, it can exert downward pressure on private sector wages and employment, erode competitiveness, and fuel inflationary trends. To assess whether wage increases are economically justified, productivity metrics are essential.

The most widely accepted formula-endorsed by institutions such as the World Bank and IMF is:

Labor Productivity = Gross Domestic Product / Total Number of Employees (Hours)

This ratio serves as a foundational indicator of economic efficiency, capturing the average economic value generated per worker annually.

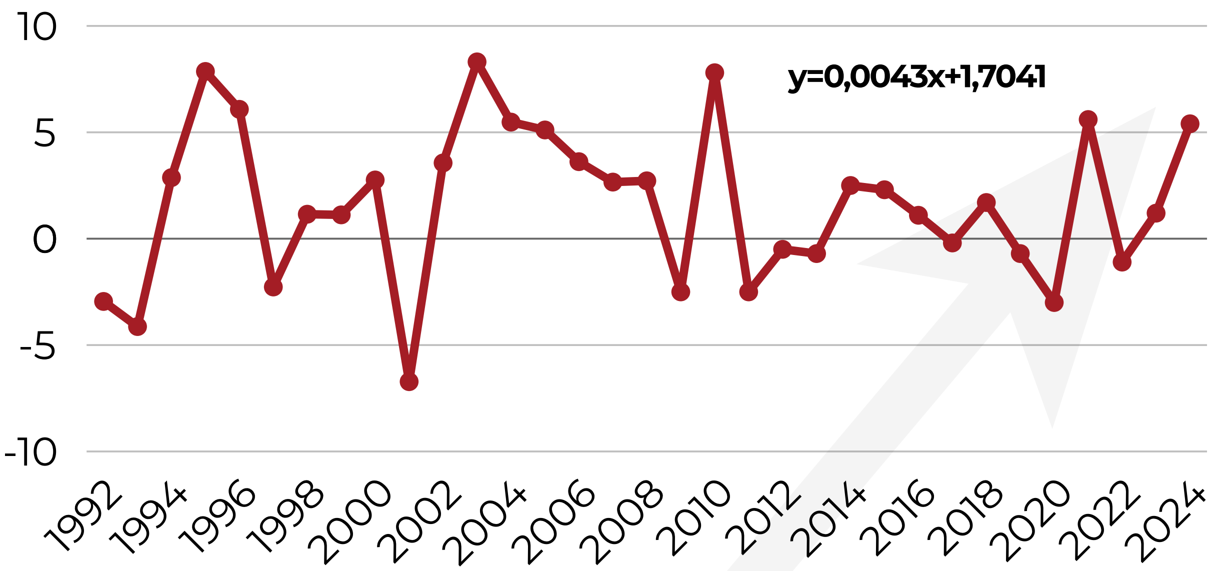

Table 1: Productivity 1991 – 2024

Source: Author's calculations based on data from the World Bank and the State Statistical Office.

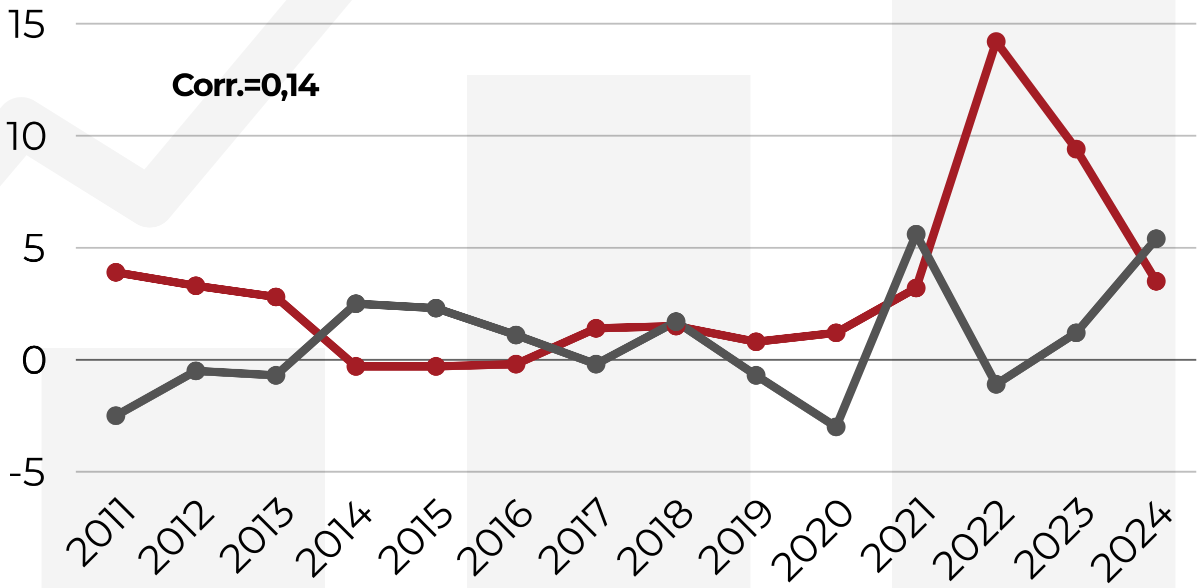

Table 2: Wage growth and productivity

Source: Author's calculations based on data from the World Bank and the State Statistical Office.

Public Sector Wage Growth and Productivity in Macedonia: A Framework for Sustainable Policy

Graph 1 illustrates the trajectory of labor productivity in the Republic of Macedonia from 1991 to the present, while **Graph 2** compares this with the evolution of gross wages from 2011 onward.

The analysis reveals a negative correlation coefficient of -0.14 between gross wage growth and productivity growth during the observed period. This suggests that, on average, when productivity rises, gross wages tend to grow more slowly-or even decline-and vice versa.

However, when a one-year time lag is introduced, the correlation coefficient shifts to +0.3, indicating a delayed but positive relationship between productivity gains and wage growth.

While this is a simplified analysis based on limited data, and cannot yield definitive statistical conclusions, it does point to several important implications:

- Wage growth may be driven by factors unrelated to productivity, such as political decisions, adjustments to the minimum wage, or inflationary pressures.
- Periods of rapid administrative wage increases can coincide with stagnant or declining productivity, raising concerns about fiscal sustainability and economic competitiveness.
- Public sector wage policies are often shaped by election cycles or fiscal expansions, rather than improvements in service efficiency.

Productivity as a Foundation for Wage Policy

As Paul Krugman famously stated, “Productivity isn’t everything, but in the long run it’s almost everything.” In the public sector, productivity is not measured by profits, but by the efficiency and effectiveness of service delivery.

The World Bank notes that the public sector accounts for 38% of formal employment globally, and 39% of tertiary-educated workers are employed in public institutions (World Bank, 2021)—making it a cornerstone of national productivity.

Yet, measuring productivity in the public sector presents methodological challenges. Many public services lack market transactions, and their outputs are collective, complex, and often have delayed effects (Somani, 2021). Traditional metrics such as "executed budget" or "number of cases completed" may not accurately capture the true value of labor.

Nonetheless, productivity should not be overlooked. The IMF recommends using a mix of microeconomic and macroeconomic indicators—such as completed processes, user satisfaction,
and comparative costs—to build a more nuanced picture of public sector efficiency (IMF, 2023).

Wage growth should be anchored in these indicators, even if partial, to avoid automatic or populist budget decisions.

Citizen Satisfaction as a Corrective Mechanism

Public sector wages should reflect not only input metrics (e.g., costs), but also output indicators-particularly the quality and perception of services. The World Bank emphasizes the distinction between "performance" (outcomes) and "productivity" (efficiency). In the public sector, performance is often linked to citizen satisfaction, transparency, and service accessibility

For instance, if a social welfare agency reduces claim processing times, improves communication channels, and boosts user satisfaction, this signals improved performance. In such cases, wage increases may be justified as a reward for enhanced service value.

However, the public sector also wields significant bargaining power-especially through unions-which can result in wage premiums that are not necessarily tied to efficiency. To mitigate inflationary risks without corresponding productivity gains, service satisfaction should
be integrated into wage growth formulas.

Budgetary Constraints and the Economic Cycle

The third pillar of sound wage policy is fiscal realism. During economic expansions, when budget revenues are strong, moderate wage growth may be feasible-provided it does not create long-term fiscal imbalances. The IMF warns that public sector wages are fiscally rigid, meaning they are difficult to reduce without triggering social or political repercussions (IMF, 2023). Conversely, during economic stagnation, wage growth should not be frozen. Moderate increases can help sustain morale, retain talent, and stabilize household consumption. The World Bank highlights that even small gains in public sector efficiency can unlock substantial fiscal space (Somani, 2021)—a critical consideration in the post-pandemic recovery phase.

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Toward an Integrated Wage Growth Model

Based on the analysis, we propose a four-pillar framework for public sector wage growth:

- **Productivity Index:** Combines macro and micro indicators, including completed tasks, cost per service, and user satisfaction.
- **Customer Satisfaction Index:** Derived from citizen feedback and service quality surveys.
- **Budgetary Capacity Index:** Reflects fiscal space, economic cycle, and long-term sustainability.
- **Governance and Transparency Index:** Tracks institutional accountability, responsiveness, and alignment with strategic goals.

With construction of a transparent wages growth model, public wage growth will be more appropriate and acceptable for the public administration, government and the private sector.