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NEW REPORT: Higher levels of public sector employment often lead to a reduction of employment in the private sector

A timely new report now published on IZA World of Labor finds that the expansion of public sector jobs leads to "crowding out" of private sector employment; when wages are relatively unresponsive to productivity differences, this can even increase unemployment

With Trump having just announced a hiring freeze on federal jobs a timely report by economist Vincenzo Caponi of the CREST-ENSAI, France looks at the effects of public sector employment on the economy. He summarizes recent research which finds that higher levels of public sector employment often lead to a reduction in private sector employment. The reason for this is that the public sector competes with the private sector for workers in the labor market, and this competition leads to the private sector losing workers to the public sector. A panel data analysis of OECD countries found that if a government hires one additional public sector employee it has a negative effect on private sector employment, reducing it by one and a half employees.

This effect is particularly strong when public sector wages are both higher and more rigid than private sector wages. For instance, one study shows that public sector employees in southern Italy are paid the same wages as their counterparts in the north, while private sector employees, due to the fact that productivity in the south is generally lower, face a wage gap of about 10%. There is evidence that about half of the unemployment gap between the south and the north of Italy can be explained by the role of the public sector. Were public sector wages in line with those of the private sector, that is, paid according to local productivity, the unemployment gap would be half of what it has been historically.

The public sector competes with the private sector for workers, and this competition can increase the tension in the wage bargaining process and, ultimately, the wages of workers in the private sector. This tension generates a crowding-out effect that brings workers from the private into the public sector. However, Caponi shows that in cases where public wages are responsive to productivity and adjust similarly to private wages, then the size of public employment acts as an automatic stabilizer, that is, it reduces the fluctuations of unemployment over the business cycle. Therefore the rules adopted by the public sector to determine the compensation of public employees are crucial in determining the overall effects of public employment.

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Notes for editors:

IZA World of Labor (http://wol.iza.org) is a global, freely available online resource that provides policy makers, academics, journalists, and researchers, with clear, concise and evidence-based knowledge on labor economics issues worldwide.

The site offers relevant and succinct information on topics including diversity, migration, minimum wage, youth unemployment, employment protection, development, education, gender balance, labor mobility and flexibility among others.

Established in 1998, the Institute of Labor Economics (www.iza.org) is an independent economic research institute focused on the analysis of global labour markets. Based in Bonn, it operates an international network of about 1,300 economists and researchers spanning more than 45 countries.