THE POLITICAL ECONOMY OF PUBLIC SECTOR WAGE-SETTING IN GERMANY AND ITALY

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Setting the Scene

The chance to write this brief contribution stems from the invitation that I received to attend the Villa Vigoni conference. The general topic of the conference revolves around discrepancies in the German and Italian responses to the multiple crises affecting Europe.

Specifically, the subject matter of this paper pertains to the domain of public sector employment relations and wage policies in the European Economic and Monetary Union (EMU). The aim is to look at the political and institutional determinants of public sector wage policies in Germany and Italy over the period 1991-2015. In so doing, I ask the following interrelated questions: What were the political and institutional determinants of Germany and Italy's divergent public sector wage trajectories before the crisis? And, while Italy underwent severe post-crisis austerity measures which led to public sector wage deflation, why have public sector wages not risen consistently in Germany notwithstanding the budget surplus and low unemployment?

The empirical basis of the argument developed here is provided by research pursued in the context of my doctoral project at the *Max Planck Institute for the Study of Societies*, in Cologne. Besides the analysis of macroeconomic data and primary institutional sources, the essay draws on extensive fieldwork carried out in both countries. I have conducted interviews (24 in Germany and 17 in Italy) with key policy-makers in the top echelons of the Finance ministries, trade unions, associations for the representation of public employers (*TdL*[86] for Germany, and *ARAN*[87] for Italy), national courts of auditors (*Corte Dei Conti*) and academic/policy experts close to the field of interest.

In preview, the main argument of this paper is the following: while Germany pursued public sector wage restraint throughout the period 1994-2007, during the years 2002-2006, Italian public employers deliberately pursued a policy of public sector wage inflation for strategic political purposes. After the crisis, wage restraint in Italy was the result of unilaterally implemented wage cuts and freezes in the public sector. In Germany, wages are, instead, prevented from rocketing - notwithstanding favourable material conditions - by the peculiar structure of public sector wage-setting, which brings together rich and poor *Länder* (and municipalities) into a structured decisional process which produces a low wage equilibrium. In both the *TVöD* and *TV-L* contracts, wage increases have to be set as a lowest common denominator to take into consideration the ability of the poor *Länder* (in *TV-L*) and municipalities (*TVöD*) to pay. Italy, in contrast, experienced a pro-cyclical pattern of public sector wage inflation and restraint. During the good times of the Euro, public sector wages increased beyond macroeconomic fundamentals, driven by the political motivations of the "Southern *bloc*" (composed of the parties such as *Alleanza Nazionale* and *Unione Di Centro*) inside the Berlusconi-led centre-right coalition. The pattern of wage inflation had started to be reversed before the crisis occurred, when Tommaso Padoa-Schioppa was finance minister, under the centre-left coalition led by Romano Prodi in 2006-2007. Eventually, however, when the crisis unfolded, wage restraint was unilaterally imposed by the finance minister Giulio Tremonti in 2009 and was then continued by the subse-

86 TdL (*Tarifgemeinschaft deutscher Länder*) is the association of finance ministers of the German Laender in charge of negotiating public sector wage contracts.

87 ARAN (*Agenzia per la Rappresentanza Negoziale delle Pubbliche Amministrazioni*) is the Italian independent agency in charge of representing the government during negotiations with trade unions.

quent governments. Overall, Italy had seven years of wage freezes which substantially contributed to deflate its economy pro-cyclically.

In sum, discrepancies in public sector wage-setting in the two countries can be attributed to different institutional structures for the determination of public sector pay and interest representation. A system of soft fiscal constraints in Italy allows for the *political willingness* of sovereign employers *to pay* inflationary wages in good times. In Germany, instead, a system of hard fiscal constraints for sub-national governments precludes the pursuit of a policy of wage inflation. In the former country, the structure of public sector wage-setting leads to the politicisation of wage determination processes. In the latter, wage policy choices are constrained *ex ante* by the fiscal constitution of the state.

The implications of this argument for comparative political economy (CPE) are manifold. Contrary to what is usually believed (Hancké 2013; Höpner and Lutter 2014; Johnston 2016; Johnston and Hancke 2009; Johnston, Hancke, and Pant 2014), wage restraint in the German public sector is *not* due to effective/defective inter-sectoral wage co-ordination imposed by the export sector upon sheltered sector wage-setters (Di Carlo 2018). Nor was or is it pursued to protect export price competitiveness in the interests of an "hegemonic social coalition" between employers and skilled labour in the export industries (Baccaro and Benassi 2016; Baccaro and Pontusson 2016; Hassel 2014). Public sector wage-setting is, first and foremost, a public finance problem. It involves state actors located at different levels of the public administration, representing heterogenous institutional interests (very diverse from those of the German export industry). Furthermore, public sector wage policies do not come uncontested. Studying the *politics of fiscal policy* teaches us that significant conflicts can emerge inside the sovereign employers bloc: for example, between finance ministers with diverse vested interests across different state levels (as in Germany) or between politicians (who make promises) and the finance ministers of their governing coalition (who have to pay for them). CPE research interested in studying public sector wage-setting should, instead, look at the institutional constellation shaping processes of public sector wage-setting proper and stop understanding the working of the public sector solely as a function of export-sector interests. This constellation, I posit, is composed of three key elements; first, the structure of the *public administration* determines the distribution of *administrative competencies* among the layers of the public administration – and therefore the distribution of personnel costs; second, the structure of the *taxation system* determines the *ability to pay* of sovereign employers located at the different levels of the public administration; and, third, the characteristics of *public sector employment relations* determine legal rights and the structure and modes of interest representation.

The remainder of this paper is organised as follows; Section 1 engages with the problem of public sector wage divergence in the EMU; Section 2 provides a summary of the German case study, while Section 3 deals with the Italian one. Due to space constraints, I will skip a thorough review of the literature[88] and provide only stylised accounts of the case studies.

1. The Problem of Divergent Public Sector Wage-setting in the EMU

Joining the EMU entails losses of national sovereignty *vis-à-vis* the policy tools available for the macroeconomic stabilisation of the economy (De Grauwe 2016). Of the four standard policy tools available for the control of the economy (Scharpf 1991), monetary policy is delegated to a supranational independent central bank; fiscal policy is *de jure* constrained by national and supranational Fiscal Compacts, while exchange rates are relinquished. In this scenario, wage policies remain the most important pillar of macroeconomic policy-making for domestic social partners in the EMU.

88 For a more detailed discussion on public sector wage setting in the German context, see Di Carlo (2018) and Keller (2011).

While private sector wage policies are often beyond the remit of governmental authorities (e.g., *Tarifautonomie* in Germany), public sector wage policies are of particular interest, given that their implementation necessarily coincides with the fiscal stance of the sovereign employers in charge of earmarking fiscal resources for wage contracts. Thus, looking at public sector wage trajectories is a fundamental way of looking at the fiscal trajectories of governments. Public sector wage-setting matters in the EMU, both with regard to the co-ordination of the fiscal policies of euro Member States, but also, and especially so, for the impact that wage inflation can have on macroeconomic imbalances *via* divergent unit labour costs (ULC) and price inflation[89] (Baccaro and Tober 2017; Hancké 2013; Johnston, Hancke, and Pant 2014).

From the perspective of the EMU's macroeconomic regime - an economic system rooted in price stability - relatively stable ULC inflation is required in order to avoid structural divergence of Members' price inflation in the medium to long run. The trade imbalances to which this divergence leads can, in fact, no longer be absorbed through adjustable exchange rates (Carlin and Soskice 2014, Ch. 12).

In this context, the European Commission had adopted what is understood as the *Golden Rule of Wage Bargaining*[90] as the formal policy guideline for national social partners: wage-setting is to be based upon the European Central Bank's (ECB) inflation target plus average productivity in the economy. Given the absence of pan-European wage co-ordination, this was meant to engineer a virtuous interaction between national wage policies and the supranational monetary policy and, at the same time, avoid inflation differentials and the rise of macroeconomic imbalances in the monetary union. In an abstract world, three types of wage policies are thus available to national public sector wage-setters.

Starting from the Golden Rule:

WP= 1,9% + Δ avg. LP

Where:

WP = wage policy implemented

ECB inflation target = 1,9%

Δ Avg. LP = % change (yoy) in total labour productivity in the economy

Sovereign employers can then adopt three alternative types of wage policies:

i. Policy of wage inflation > Golden Rule

ii. Policy of wage restraint < Golden Rule

iii. Policy of the Golden Rule = Golden Rule

Ideally, in order to avoid a rise of macroeconomic imbalances, trajectories of nominal wages would have had to develop in line with national productivity rates and the supranational price target. Reality has proven different from theory. Panel *a* in Figure 1 shows the divergent trajectories of nominal wages in the public sectors of the EMU participants during the good times of the Euro. Three clusters can be observed. At the two opposite extremes, we find Germany (alone) pursuing a policy of remarkable public sector wage restraint and the so-called GIIPS[91] countries experiencing substantial public sector wage inflation. The core countries of the EMU, interestingly, have had wage developments almost perfectly in line with the Golden Rule.

Not surprisingly, public sector wage developments have mirrored quite faithfully the trajectory of real exchange rates (REER) (Figure 2) since the launch of the single currency. The connection between public sector wage inflation/restraint, REER appreciations/depreciations and current account imbalances is evident. Research has, in fact, shown that current account imbalances in the EMU had their root cause primarily in sheltered sector wage inflation (Baccaro and Tober 2017; Hancké 2013; Johnston, Hancke, and Pant 2014), of which the public sector constitutes the bulk.

On average, public sector employment in the

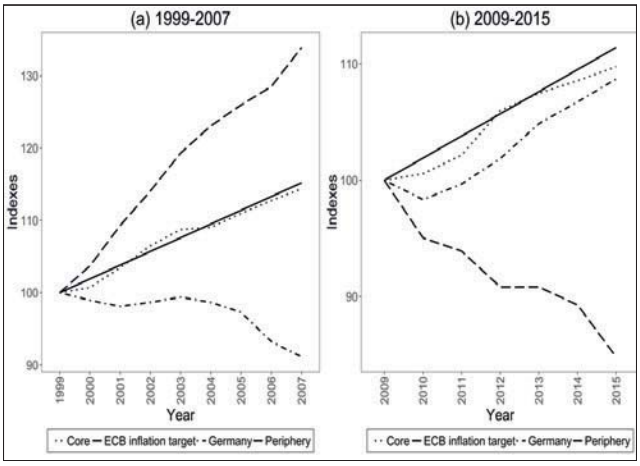
89 See Höpner and Lutter (2014) for a review of the empirical literature.

90 For a more detailed description, see Collignon (2009).

91 Greece, Ireland, Italy, Portugal, Spain.

EMU accounts for more than 15 per cent of total employment. The sovereign employers are the single biggest, political and economic, employers in every advanced economy. Since public wages are paid out of taxpayers' money, wage policy in the public sector cannot but be a subset of fiscal policy. With regards to the latter, studies by the European Central Bank (Holm-Hadulla et al. 2010, 4) also find that "government wage expenditure is subject to a pro-cyclical bias in most euro area countries and at the euro area aggregate level". A pro-cyclical policy of wage inflation in the public sector can thus lead to losses of REER competitiveness, underpin excessive imports, and contribute to an overall expansionary - pro-cyclical - fiscal stance in the economy. *Vice versa*, in hard times, public sector wages are hardly hit by the fiscal authorities.

Figure 1: Indexes* of hourly wages in the public sectors of EMU countries (1999-2015).



Source: EU KLEMS Growth and Productivity Accounts, September 2017 release.

*Indexes are discounted by labour productivity in the total economy. In (a), 1999=100. In (b), 2009=100.

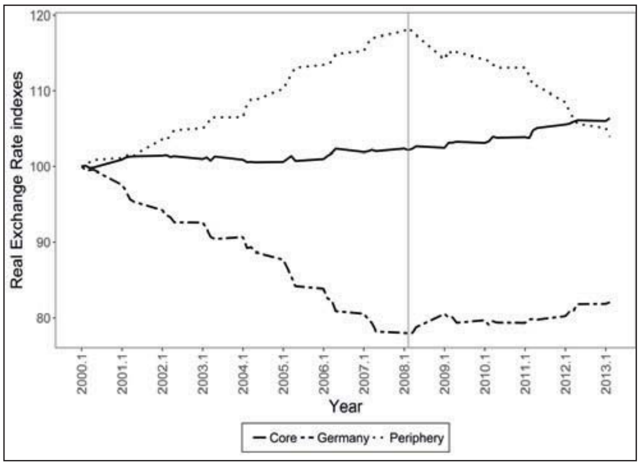
EMU Core = Austria, Belgium, Finland, France, The Netherlands.

EMU Periphery = Greece, Ireland, Italy, Portugal, Spain.

This is particularly evident when observing developments in public sector wages in the aftermath of the crisis. Panel *b* in Figure 1 shows the policies of public sector wage restraint pursued in the GIIPS countries after 2009. The countries which had undergone wage inflation in the good times of the single currency all experienced post-crisis restraint, as part of the harsh austerity measures which followed. Arguably, public sector wage-setting is the first and most accessible policy domain from which governments glean resources in hard times. Germany, in contrast, did not perform the eagerly awaited symmetric adjustment (Bibow 2012) through an expansionary public sector wage policy. It continued along the trajectory of moderate public sector wage increases inaugurated in the aftermath of re-unification (Di Carlo 2018; Keller 2016; 2014).

Thus, overall, the wage trajectories in the Italian and German public sectors develop asymmetrically in both good times (panel a) and hard times (panel b). In the first decade of the EMU, Italy experienced public sector wage inflation, while Germany pursued wage restraint. In hard times, Germany continued its pattern of moderate public sector wage increases (despite slightly expanding public sector employment in some sectors such as education and care), while Italy underwent remarkable wage restraint.

Figure 2: Real Effective Exchange Rates (REER) of EMU members (2000-2013), based upon unit labour costs (ULCs), weighted against 14 EU trading partners. Quarterly data (.1=1st quarter)



Source: Bruegel Datasets, REER for 178 countries, a new database (Latest update: June 6,2017).

EMU Core = Austria, Belgium, Finland, France, Netherlands.

EMU Periphery = Spain, Greece, Ireland, Italy, Portugal.

Notwithstanding the relevance of public sector wage policies for the smooth functioning of the single currency, very little research is available on the topic. The public sector has been neglected both by industrial relations scholars and the comparative political economists – not to mention scholars of European affairs.

In industrial relations, a set of works exists that studies the structures of public sector employment relations and patterns of institutional change (Bach and Bordogna 2016; 2013; L Bordogna, Dell'Aringa, and Della Rocca 1999; Keller 2016; 2011; Keller and Seifert 2015). These studies are highly informative, but remain mostly at a descriptive level. In CPE, the public sector has always been treated as a satellite of the export sector's interests.[92] The perspective adopted in these studies was always that of inter-sectoral wage co-ordination between the exposed sectors and the sheltered ones. Surprisingly enough, no attention was ever paid to the structure of the public administration, the role of the state as a sovereign employer (Hyman 2008; Traxler 1999), the characteristics of public sector employment relations or the fiscal constitution of the state. The study of public sector wage bargaining remains a neglected and misunderstood aspect in the discipline. The status quo in the literature is not satisfying and a clear-cut understanding of the political and institutional determinants of public sector wage setting in missing in both industrial relations and CPE.

92 Di Carlo (2018) provides a thorough literature review of this literature in the context of European CPE. It also provides an empirical falsification of the thesis according to which wage restraint in the German public sector is the result of export-sector-led pattern bargaining.

2. The Political Economy of Public Sector Wage Restraint in Germany: *die öffentlichen Kassen sind immer leer*

2.1 The 1990s: *blühende Landschaften* hit the EMU fiscal constraints

With regard to public sector wage-setting in Germany, it needs to be distinguished between public employees and civil servants (*Beamten*). Collective bargaining regulates wage-setting for the former. Unilateral legislation by the Government sets employment and pay conditions for the latter. Given the structure of the German public administration, three levels of employment exist: the Federation (*Bund*), the states (*Länder*), and the municipalities (*Gemeinden*). Public employers at each level are responsible for their employees and can choose whether to employ personnel as civil servants or as public employees. At the federal level, the sovereign employers are represented in negotiations by the ministry of the interior, flanked by the finance minister. At the *Länder* level, the regional finance ministers are grouped together in the so-called *Tarifgemeinschaft deutscher Länder* (TdL). At the municipal level, municipalities are grouped into a state level association *Kommunaler Arbeitgeberverband* (KAV). The 16 associations from each *Land* are then represented together by the *Vereinigung der kommunalen Arbeitgeberverbände* (VKA). Overall, until 2002, the three employers corresponding to the three public administration levels negotiated jointly with the trade unions under the leadership of the federal minister of the interior (a practice termed *Tarifgemeinschaft*).

Given that the German Constitution (*Grundgesetz*) attributes most of the competencies to the sub-national governments, the *Länder* and the municipalities are the entities which bear the costs for administrative personnel disproportionately. While for the *Länder* expenditure for personnel amount to around 40-45 per cent of their total expenditure, the municipalities spend 25 per cent of the budget on personnel, while the federal level spends only around 9-10 per cent (Destatis data).

Given this cost structure, personnel costs (a *stock*) (and hence wage increases (a *flow*)) constitute a major concern for the finance ministers of the *Länder* and municipalities. Most importantly, the states and municipalities act as tax collectors for the federation, with whom they share tax revenues according to vertical and horizontal fiscal equalisation grants which are enacted via pre-determined formulae. Given the taxation structure, the *Länder* and municipalities simply *cannot* readily manipulate their *marginal tax revenues*. The only way that the *Länder* have to increase their tax revenues is through changes in legislation via the *Bundesrat*, which would require the consensus of all the *Länder*. The result of this joint-decision trap (Scharpf 2005) is that the fiscal structure in which lower levels of government are embedded puts enormous pressure on the expenditure side – of which the personnel costs are among the most significant items – leaving not much choice other than to keep the personnel expenditure in check - disproportionately so for the *Länder*. This tense situation worsened after the absorption of the poor new *Länder* into the fiscal equalisation system in 1995.

In fact, wage restraint in the German public sector started both before (and in relation to) the EMU, and as a consequence of the fiscal costs of reunification. The *blühende Landschaften* promised by Helmut Kohl to his fellow Germans, inevitably came to clash with the fiscal constraints set in the Maastricht Treaty and the following Stability Growth Pact (forcefully insisted upon by the German finance minister Theo Weigel). Public sector wage restraint first emerged in 1994 via a wage freeze for civil servants unilaterally imposed by the government, together with a moderate wage settlement collectively negotiated for public employees. It was then pushed through decisively via a *Spaarpaket* before the fiscal year of 1997 - in order to comply with the Maastricht *vincolo esterno*. In the 1990s, public sector wage restraint occurred out of concerns for fiscal deficits by the federal finance minister Theo Waigel. The consolidation measures implemented in 1996 are effectively summarised by the IMF fiscal consolidation dataset:

> "Fiscal consolidation in 1997 was primarily motivated by deficit reduction and meeting the Maastricht deficit criteria … To shore up the public finances, the authorities adopted in late 1996 substantial discretionary fiscal measures as part of the budget for 1997, which were heavily weighted on spending cuts … With these measures, the authorities expected that the general government deficit would decline to 2% of GDP in 1997, safely under the Maastricht reference value. Spending cuts in the 1997 budget amounted to 1% of GDP and were based on wage restraint and retrenchments, spending limits imposed at the federal and state level, reducing sick pay coverage and restricting spa visits, and tightening eligibility for unemployment benefits."

2.2 The Early 2000s: The *Länder* Offensive

In the early 2000s, the drivers for restraint were different. Wage restraint was the result of a process of institutional change which overhauled the old *Tarifgemeinschaft*. The process was driven and wanted by the finance ministers of the *Länder*. At the core of *Länder* finance ministers' preoccupations was the concern about keeping the personnel cost of their state administrations under control. They also started a controversy with the unions, in 2003, on extending working hours (Dribbusch 2006). For them, keeping costs down is of disproportionate importance given their cost structures and, especially, given the impossibility of freely manipulating their marginal tax revenues. To achieve this end, they opted to free themselves from the (expensive) leadership of the federal level in public sector wage negotiations. Also, they wanted to separate themselves from the (troublesome) municipal level in which public employees potentially have the highest disruptive power to affect negotiating dynamics thanks to their strength in basic community services (e.g., in local transport and waste disposal).

Negotiations to reform the system started after the signature of the 2002 collective/national contract and were concluded in 2005 with the creation of the *Tarifvertrag für den Öffentlichen Dienst (TVöD)* contract which regulates public employees at federal and municipal level. Wage restraint emerged as a combination of extended working hours, a rationalisation of special bonuses and a moderate lump-sum compensation of €300 per year in the years 2005, 2006 and 2007. The unions exchanged restraint for participation in reforming the old bargaining structure.

TdL did not want to be part of *TVöD*, and, after very tense negotiations and strike actions, throughout 2006, they reached an agreement with the unions on the creation of the new *Tarifvertrag für den Öffentlichen Dienst der Länder* (TV-L). The agreement envisaged lump sums of various amounts depending on the pay grades, to be paid out to employees in July 2006, January 2007 and September 2007, a rationalisation of special bonuses and the extension of working hours.

As a parallel development, the reform of the fiscal federalism system in 2006 has restored to the *Länder* the competence to legislate on the employment and wage conditions of their own civil servants. This has introduced an element of competitive federalism and created an horizontal diversification of wage conditions across the states, with Berlin and Bavaria located at the opposite extremes of the continuum (DGB 2016).

2.3 Public Sector Wage-setting in the Age of Prosperity

Germany is living through times of budget surpluses and almost full employment. Also, there is increasing difficulty in recruiting public employees (especially teachers and nurses). Public opinion also appears to be in favour of expanding public employment. Yet, one can barely notice an upward trajectory of wage increases. Why?

To be sure, increases in public employment in the categories mentioned are indeed visible. Yet, I argue that public wages are structurally prevented from increasing in Germany because of the unique public sector wage-setting regime.

With regards to the *TV-L* contract, *TdL* negotiators are forced to take into consideration the ability of the finance ministers from the poor *Länder* to pay. The poor states greatly value the benefits of collective bargaining coordinated through the *TdL*, especially in order to avoid direct wage competition with the richer *Länder* and to avoid setting up costly bargaining units to handle negotiations and internecine conflict. Moreover, they still have to make sure that the rich *Länder*, with a higher ability to pay, do not push up wage settlements driving them into bankruptcy. In the internal politics of *TdL*, it does not take much to convince the finance ministers of the rich states to hide behind the poor ones: they have, so to speak, an interest in being outvoted. Personnel costs are, on average, higher in the books of the old *Länder*, when compared to the new ones, which underwent a massive re-structuring after re-unification. Setting wages calibrated as a lowest common denominator decreases their *fiscal opportunity costs - i.e.*, frees fiscal resources can be spent on other items (or hoarded as budget surpluses, which the finance ministers of accountable states seem to value considerably). At the same time, richer *Länder* can blame the restraint on the poor finances of the others. *TdL* itself has an organisational interest in keeping the 15 state finance ministers together (Hesse is not in the *TdL*). The rich states would most probably have to pay higher wages than they currently pay (without upward competition) and would see their transaction costs in negotiations increase. The poor *Länder* would find themselves in a fully competitive federal system, in which they would be net losers. The system is granted some flexibility for diversification and competition via the possibility for the states of hiring civil servants and thus can unilaterally decree wage settlements.

With regard to the *TVöD* contract, a similar logic applies, although without the cleavage rich vs poor states. This is because poor municipalities are widespread also in West Germany. Substantial wage increases are prevented from the necessity to avoid bankruptcy of poor municipalities and/or a likely increase of transfers from the Federal level. Negotiators in the *VKA*, together with the federal finance and interior ministers, are aware of the necessity to avoid costly settlements which risk endangering the finances of lower levels.

Thus, in the German system, key explanatory factors for public sector wage restraint are the structure of the public sector wage-setting regime, the direct accountability of *Länder* finance ministers and their isolation from political influence.

3. The Political Economy of Public Sector Wage Inflation and Restraint in Italy: *We will Find the Money, if we Like*

3.1 The 1990s: Depoliticisation of Public Sector Collective Bargaining?

Until the end of the 1960s, pay and employment relations in Italy were unilaterally set by the sovereign employer through laws or administrative acts. In this system, public employees enjoyed the employment status of civil servants, which guaranteed employment security and seniority careers (Rusciano 1978). Over time, collective bargaining rights were granted and, during the 1970s, the practice spread throughout the branches of the public sector, until the 1983 *Legge Quadro* introduced collective bargaining as a primary mode of pay determination – although contracts still needed to be transformed into administrative acts to come into effect. The introduction of collective-bargaining rights in conjunction with civil servant status gave birth to a regime of "double guarantee", or, as scholars have put it, "pluralism without markets" (Lorenzo Bordogna 1994; Giugni 1992). During the 1980s, this public sector wage-setting regime led to uncontrolled wage inflation and politically-tolerated, leapfrogging dynamics in a context of union fragmentation and recurring disputes (Cella 1991).

The public sector wage-setting regime of the first republic consisted of a highly fragmented system in which smaller trade unions (*sindacati autonomi*), independent of the peak level confederations, the CGIL, CISL and UIL, had established a dense network of clientelistic relations with political referents in parliament (Ricciardi 2013, 120-27). This network led to what was termed "wage jungle" (*giungla retributiva*) (Gorrieri 1973) to indicate the practice of setting public sector wages regardless of any economic or administrative logic. Wage-setting in the public sector simply responded to the political logic of (re-) producing consent. Political actors in parliament were thus able to pass specific laws (*leggine settoriali*)[93] hiding them from the scrutiny of public opinion, delivering favourable provisions (income and non-income related) to their affiliated sub-groups of workers in the public sector (Talamo 2009b).

Major reforms of the system of public sector pay determination were passed in 1992-1993 with the ambition to make the process "apolitical" and to contain public expenditure. The public law status of public employees was abolished and the employment relationship was "privatised" (*privatizzazione del pubblico impiego*). Collective bargaining became the legal method[94] to regulate terms and conditions of employment. The reform of the summer of 1993 introduced a two-tier wage-bargaining system in which the main pillar

93 This practice was unveiled also by a Parliamentary Commission (Commissione Coppo) in 1977 and later denounced in the famous "Report on the fundamental problems of the State" by Professor Massimo Severo Giannini in 1979.

94 Approximately 80% of public employees were subjected to the reform. Core functions of the state were not privatized, such as judges, police, the army, *etc.*

consisted of nationally agreed and uniform wage increases negotiated between the newly-created independent agency (*Agenzia per la Rappresentanza Negoziale delle pubbliche amminstrazioni* - ARAN) and the trade unions. The second pillar regarded wage increases at the decentralised level to be negotiated by individual administrations and the workplace personnel representation bodies in a context of "organised decentralisation" (Lorenzo Bordogna 2012; L Bordogna, Dell'Aringa, and Della Rocca 1999).

The wage contracts were to last for a two-year duration (*biennio contrattuale*) and the wage increases were to be decided according to three criteria. First, wage increases at national level were to be calculated according to the rate of "expected inflation" (*Tasso di Inflazione Programmata, TIP*) for the subsequent two-year contract. This rate would have to be negotiated in a concerted manner between the government, employers and the unions during two sessions (one in the spring and one in the autumn) throughout the preceding year. Second, in the event of a discrepancy between the expected and the actual inflation, the subsequent two-year contract would have to incorporate resources *ex post* on order to compensate for lost purchasing power. This provision would be calculated upon the basis of the difference between the expected rate of inflation and the actual rate. To these criteria for centrally determined wage increases, local administrations could add resources to the central contracts according to productivity increases. These additional resources would have to be paid in part by resources granted from the central level and in part by the finances of the local administrations.

The creation of the independent agency, ARAN, as the monopolistic representative of all public administrations in national level negotiations had the purpose of insulating wage bargaining from the incursions of party politics. The technical body, in a principal-agent relationship with the government, was meant to prevent the distortions of the previous model. After the *Mani pulite* scandal(s) in the 1990s, the political establishment came to be held inadequate to continue handling wage negotiations for political purposes. However, the creation of ARAN could not circumvent the political nature of public sector wage-setting in which the fiscal costs for the determination of wage increases had to be earmarked in budget laws. The way in which Italy reformed its system did not shelter the finance ministers from party politics. ARAN would negotiate with the trade unions on how to distribute resources, while the *quantum* of the fiscal resources to be earmarked before the government's mandate remained fully in the hands of the government.

During the 1990s, the trade unions acted responsibly in the determination of the public sector pay. In a context of weak political parties, the unions played a major role in tripartite consultation for the reform of collective bargaining and, above all, the production of public sector wage restraint. The unions exchanged wage restraint with political influence on the determination of legislation related to the re-structuring of public sector employment relations (Talamo 2009a, 4-5). Unions also shared in the objective of complying with the external constraints imposed on public finances by the accession phase to the EMU in 1999[95] (Hancké and Rhodes 2005).

3.2 The Early 2000s: The Return of (Political) Incomes Policies

The scenario for public sector wage-setting changed substantially with the advent of the centre-right coalition (2001-2006) led by Silvio Berlusconi. Although, formally speaking, the institutions for public sector collective bargaining were not changed during the years of inflation (mostly 2002-2006), the function of pay determination was re-oriented towards a logic of political consent. This was made possible by the inconsistencies of the structure created in 1993, which made room for the return of the politicisation of public sector wage determination.

95 Confirmed in interviews with heads of public sector branches of CGIL, CISL, but also confirmed in interviews with decision makers in the top echelon of ARAN. Interviews carried out in winter 2017/2018.

According to the legal structure, the government would decide the fiscal resources to be earmarked in the budget law which preceded the beginning of the two-year contract. These resources, inserted in the budget law, were decided *ex ante* by the sovereign employer and would be publicly known to all actors. Since resources are already earmarked before the beginning of negotiations between ARAN and the unions - and unions know the exact amount already granted - this becomes the "point of non-return" in the bargaining cycle. Instead of serving as a ceiling for wage setting, the determination of the *quantum* by the government makes room for political contestation. The unions, in fact, contest the amount of available resources, oppose the beginning of negotiations with ARAN, and exploit the already-agreed upon number in order to increase the resources required by lobbying the government.

The capability of the unions to obtain greater resources depends on the willingness of the government to reach a compromise with them. The centre-right government was not united behind a policy of public sector wage inflation. In fact, the House of Freedoms (*La Casa delle Libertà*), as the coalition was named, was not united at all. It consisted of four very heterogeneous parties geographically and sociologically rooted in different parts of the country (Diamanti 2003). After the end of the first republic, the centre-right had been formed in 1994 (and reformed in 2001) by Berlusconi's capacity to bring together, into a unique political space, parties with strongholds in different parts of the country.

In the North, Berlusconi had secured a pact with the *Lega Nord* (Northern League) centred on the middle classes' quest for a neo-liberal agenda comprising tax cuts, fiscal federalism, a clampdown on immigration, and reduced state intervention. After the disastrous experience of the mid-1990s, the House of Freedoms campaigned together again and won the elections in 2001, opening a new era for the centre-right. Although *Alleanza Nazionale* (AN) was the second political force in the coalition (12%), and Gianfranco Fini, its leader, had been appointed deputy prime minister, Berlusconi saw, as the driving force of the coalition, a special alliance with Umberto Bossi, Northern League's leader, and Giulio Tremonti, the appointed finance minister acting as the guarantor between the two leaders. This special relationship came to be known as the "Northern axis" (Diamanti and Lello 2005, 22-23). Proof of the close ties between Berlusconi and Bossi was the recurring practice of dining together at Berlusconi's villa in Arcore every Monday evening to discuss the interests of the Northern middle classes, small- and medium-sized enterprises, and freelance professionals.

As representatives of the South - and the centre - the coalition included the post-fascist *Alleanza Nazionale* (AN) and the post-Christian-Democratic *Unione di Centro* (UDC). These parties were rooted in the Southern areas of the country which were characterised by high levels of unemployment and in which public sector employment (and wage inflation therein) has historically played a key role as a socio-economic stabiliser in the local economies (Cassese 1977; Santoro 2014). The remaining forces of the coalition, AN and UDC, thus came to constitute the "Southern bloc" - inspired by the values of the Social Right (*destra sociale*), representing the lower classes of the South and employees in the public administration. As the leader of UDC put it to me, the Southern bloc "represented all those people which were not taken care of by the Arcore tablemates" (interview with the then leader of the UCD. Rome, 9 February 2018). AN and UDC strongly, and vocally, supported public works and infrastructure building in the South, as well as resources for public employment, with a special eye on the Lazio region where most of the central administrations are based and where AN has historically been strongly rooted.

The bargaining cycles which led to public sector wage inflation in Italy are the two-year contracts of 2002-2004 and 2004-2006. On both occasions, the direct mobilisation of political capital by Gianfranco Fini, the deputy prime minister and leader of AN and the Southern bloc, was of fundamental importance for increasing fiscal resources previously granted through budget laws. With regard to public sector wage policy, Fini has been repeatedly capable of imposing the interests of the Southern bloc on the whole coalition, especially against the will of the finance minister Tremonti. AN and UDC, in coalition with the trade union confederation CISL (the most representative union in the public sector), have always been open with respect to their interest in representing the vast constituency of public employees for whom they forcefully obtained the increase in the resources available for public sector contracts.

Politically, allowing for public sector wage inflation served two inter-twined purposes. For Berlusconi's *Forza Italia*, conceding inflationary wage increases in the public sector had the purpose of dividing the unions (the CISL from the irksome CGIL) during their open contestation regarding the government's reformist agenda. Berlusconi acted behind the scenes to support the political mediation of the deputy prime minister with the trade unions. For the Southern bloc of the coalition, Fini's political mediation came to serve their electoral interests perfectly. In courting their core constituency, the public employees, AN's leader Fini repeatedly proved himself capable of overcoming the opposition of the other coalition partner, the Northern League, which was opposed to generous public sector increases. Notwithstanding this opposition, Fini managed to exploit public sector wage increases in favour of political consent by successfully mobilising political capital to increase resources for public wages in subsequent budget laws. There has been, in this sense, a clear political willingness on the part of the Italian sovereign employers to grant inflationary wages for reasons other than the mere adjustment of the personnel expenditure to macroeconomic developments.

3.3 Public Sector Wage-setting in the Age of Sovereign Debt Crises: The Show must not Go on

The pattern of public sector wage inflation in Italy started to be reversed in the 2006-2008 wage bargaining cycle. This occurred under the pressure exercised by the finance minister Tommaso Padoa-Schioppa in the centre-left coalition in government. The finance minister strongly wished to enforce a wage freeze during the negotiations for the renewal of the 2006-2008 public sector contracts. This was meant to compensate for the wage excesses of the previous two bargaining cycles (2002-2004 and 2004-2006) which had occurred under the centre-right coalition in government. Wage freezes were only avoided at the very last minute thanks to the political mediation of the Prime Minister Romano Prodi during private negotiations with the heads of the public sector branches of the trade unions confederations (Interviews conducted with the then leaders of the public sector branch of CGIL (in Bologna, 20 November 2017) and of CISL (in Rome, 5 February 2018)). However, much less money was earmarked for public contracts and the result was a harsh conflict between the finance minister and the prime minister.

Measures for wage restraint were introduced unilaterally in 2008 (2009 budget law) written by Giulio Tremonti, before Italy came under pressure from the financial markets in summer 2011. Restraint was then strengthened by various governments (political and technocratic) in 2010 and 2011 and eventually extended in 2013 until, in spring 2015, a verdict of the Constitutional Court has declared the multi-year wage freeze pursued unilaterally by various governments since 2010 to be unconstitutional. The judgment forced the government to restart collective bargaining with the trade unions for the years ahead without, however, imposing compensation for lost purchasing power, which would have severely endangered the weak state of public finances. Legislation passed in 2008 had imposed a wage ceiling on the wage increases, declaring unlawful every wage agreement that went beyond the established ceiling. A decree law of May 2010 unilaterally cancelled wage rounds for 2010-2012. This freeze was then extended via administrative decision for the years 2013 and 2014 (Lorenzo Bordogna and Pedersini 2013).

Conclusions

Public sector wage-setting is an extremely interesting field in which to observe the discrepancies in policy-making between Germany and Italy. The relevance of public sector wage-setting in the political economy of European integration stems from two factors. Public sector wage policy coincides necessarily with fiscal policy. Given the enormous size of the public sector in advanced economies, divergent public sector wage trajectories can underpin discrepancies in the fiscal co-ordination of the EMU participants. Secondly, public sector wage-setting can produce negative spillovers for REER competitiveness, and underpin trade imbalances.

In Germany, the observable pattern of marked wage restraint started in the mid-1990s out of fiscal concerns by the federal finance minister. It was then driven by fiscal concerns of the *Länder* finance ministers, in the 2000s. As we observe the German public sector wage-setting regime today, after the reforms of the early 2000s, it emerges that *Länder* finance ministers are institutionally sheltered from political incursions and are locally accountable. Given the structure of its fiscal federalism and of the employers' interest representation, Germany is institutionally entrapped into a low-wage-increase equilibrium, which impedes a more inflationary stance in public sector wage-setting.

In Italy, the observable pattern of public sector wage inflation of the early 2000s can, first and foremost, be attributed to the political willingness of sovereign employers to tolerate inflation for strategic political advantages. Patterns of wage inflation in good times, followed by austerity and cuts in hard ones, resemble *hubris* and *nemesis* tragedies. For Italy to survive in a hard currency regime with Germany at its core, a re-structuring of its public sector wage-setting regime should be a priority so as to avoid de-stabilising wage/fiscal expansion and subsequent austerity measures. Cyclical developments in wage-setting are also likely to have a strong impact on the morale of public employees and the quality and efficiency of the public administration.

I wish to conclude with an important clarification. There is no pretension here to praise Germany and belittle Italy; nor should the reader see this paper as support for the austerity measures pursued as *nemesis* in the public sectors of the GIIPS. Rather, it is the opposite reasoning that motivates my inquiry: from the perspective of the EMU macroeconomic governance, both trajectories of marked restraint and inflation are equally deplorable.

Indeed, the core countries of the EMU have been able to produce stable public sector wage trajectories both before and after the crisis (Figure 1). This has contributed to stabilise their REERs (Figure 2). Hence, a more balanced approach to public sector wage policies exists, and not just in abstract terms. Future research could take off from this observation and ask what the institutional determinants of balanced wage growth in public sectors are. Looking at these countries' public sector wage-setting regimes should teach us something about how to design a set of institutional changes aimed at avoiding the problem of structural divergence when the good times return.

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