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Public sector investment: the government's central role in fighting the effect of inflation

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Interest rate hikes—A poorly targeted approach

01 This year's inflation rate is higher than it has been in almost 40 years. In response, the Bank of Canada has increased its policy rate multiple times since the start of the year in order to raise overall interest rates. By increasing the rates offered on mortgages and other kinds of credit, the Bank hopes to "cool" the economy, spurring people to cut down on borrowing, investments and consumption (and thus demand for goods and services), ultimately lowering prices.

02 However, this strategy to curb the inflationary spiral carries major risks. For one, it could slow economic activity so much that it causes a recession, leading to a significant increase in unemployment. Furthermore, the rising cost of borrowing will increase household debt. In other words, the strategy will penalize workers first and foremost.

03 This policy also fails to attack the true causes of inflation. Our current inflation is not the result of increased consumption and a subsequent uptick in the prices of goods and services, but is instead caused by factors related to a tightening of supply.[1] Global supply chain disruptions caused by the pandemic and the war in Ukraine, together with extreme climate events, have produced shortages and led to a surge in the prices of food and oil.

Key points

- Increased income from public sector job creation and wage indexing makes this anti-inflation strategy better for households than hiking the central bank's policy rate. 04
- Creating government jobs in renewable energy would help address the increase in oil prices by reducing dependence on fossil fuels. 21
- Investing in the public sector is beneficial, as it has a greater economic impact on GDP and jobs than investments in other industries. 26

1 Pierre-Antoine HARVEY and Guillaume HÉBERT, "With inflation on the rise, the Bank of Canada has two choices," Note, Institut de recherche et d'informations socioéconomiques (IRIS), August 11, 2022.

Public sector jobs as anti-inflation strategy

04 A better strategy than implementing policy rate hikes would be a two-pronged one that sought to both protect people's income and address the problem of prices. In particular, one attractive method would be to increase income by creating new public sector jobs, preserving existing jobs and indexing their wages. New public sector jobs created to advance the energy transition would tackle the price issue by helping to reduce the population's dependence on fossil fuels and buffer against surges in the price of oil.

05 Overall, the public sector is an excellent tool for fighting inflation, as investments in the sector have a greater impact on economic development than in other industries.

Increasing public sector income

06 Public sector jobs can be a safety net during times of inflationary crisis. The public sector provides jobs that maintain a strong middle class, making it a key player in keeping the economy healthy. It is important that we index wages for existing public sector jobs to preserve these gains and prevent real income from being eroded. In times of high inflation, cost of living increases rapidly and workers' purchasing power can be easily undermined.

07 Whenever governments adopt an austerity agenda, the importance of public sector jobs is always called into question. However, it is vital that we see public sector expenditures as potent investments in our economy and society, rather than as a money pit or net loss for taxpayers.

Public sector compensation as income, not expense

08 Stereotypes about "bureaucrats" promote the idea that public sector compensation is a burden on the community. In fact, however, resources spent on public sector employees not only help provide the public with essential services, but become income for workers whose spending contributes to the economic development of numerous regions and communities. This is because the wages that public sector employees spend make their way throughout the productive economy instead of being squirrelled away as private company profits.

09 The public sector also disproportionately employs women, meaning that investments in this sector can help narrow the gender income gap. Finally, as the public sector tends to offer better working conditions than many parts of the private sector where precarity is the norm, it helps a large segment of the population gain access to the middle class.

10 Overall, the public service is not a burden, but a major driver of economic and social development. Resources spent in the public sector should be seen as "income" and not as an "expense."

Indexing wages

11 Wage indexing—increasing wages to keep pace with inflation—is the simplest and most effective way to tackle problems caused by inflation. Most households will not substantially feel the impacts of rising prices if their pay stays on par or ahead of the Market Basket Measure.

12 Despite its effectiveness, this solution has been criticized by many who worry that increasing wages will trigger a spiral in which inflation drives up wages, in turn begetting higher inflation and leading to much higher prices in the long term.[2]

13 In reality, average wages have increased by 3.6% per year on average since the first quarter of 2020,[3] a slower pace than the 4.3% growth seen in overall inflation over the same two-year period. The fact that wages have not grown in step with inflation shows that there is no cause-and-effect relationship between the two.

14 Furthermore, this relatively fast growth in average wages is indicative of the "composition effect" rather than any actual increase in workers' wealth. It thus serves more as a reflection of distortions caused by the pandemic than an indication of wage growth.

15 During the post-pandemic recovery, we have seen a shift in the workforce from low- to higher-paid jobs. For example, in May 2022, there were 230,000 fewer jobs in low-wage industries such as accommodation and food services, transportation and warehousing, and other services (with average hourly wages of $17.75, $29.16 and $26.93, respectively) compared to May 2019, while over 540,000 new jobs were created in professional, scientific and technical services, educational services, and public administration (with average hourly wages of $39.16, $35.87 and $40.31, respectively) over the same period of time.[4]

16 As the Bank of Canada has noted, these changes in the composition of the workforce have caused average wages to rise.[5] Looking at average wage growth from May 2019 to May 2022, with workforce composition held constant, wages have grown at a rate of 3.1%[6] —lower than the average inflation rate of 3.7% for that three-year period.

17 The most recent data on wage settlements in Canada confirm that wage growth has been relatively subdued. Wage increases in settlements negotiated in 2021 and 2022 have averaged 1.9%, only slightly higher than the average of 1.5% seen in the five years preceding the pandemic.[7] The actual data show

2 Frederic BOISSAY et al., "Are major advanced economies on the verge of a wage-price spiral?" *BIS Bulletin*, no. 53, May 4, 2022.
3 STATISTICS CANADA, Table 14-10-0306-01, Employee wages by occupation, monthly, unadjusted for seasonality, July 8, 2022.
4 STATISTICS CANADA, Table 14-10-0063-01, Employee wages by industry, monthly, unadjusted for seasonality, July 8, 2022. Authors' calculations.
5 BANK OF CANADA, *Monetary Policy Report*, April 2022, p. 14.
6 Compared to 4.3% with the composition effect included.
7 GOVERNMENT OF CANADA, *Major wage settlements by sector and year*, July 1, 2022, https://www.canada.ca/en/employment-social-development/services/collective-bargaining-data/wages/wages-year-sector.html.

that inflation is not caused by wage increases. However, we expect negotiated wages to increase in the next few months in response to inflation.

18 Cost-of-living adjustments to wages have no amplifying effect on inflation, as wages are only one factor in product pricing, alongside raw materials and components, capital financing, profit margins and productivity. Wages represent on average 18.0% of business operating expenses, compared to 74.7% for purchases of goods, equipment and services.[8]

19 Taking into account the increase in average productivity in the decade before the pandemic (1.1% per year), and assuming that businesses will decrease their profits and lower their profit margins, wages can very well be indexed without those wage increases spiralling into further inflation.

20 If a wage-price spiral were to materialize, the government could alleviate its impact by manipulating the price side of the equation, where it is able to exert greater control (in areas such as electricity, housing and public transit). This would make it possible to index wages without fear of triggering widespread inflation, especially since some prices do not change in response to demand and, as mentioned, wage increases are not the sole cause of the increase in the cost of living. Natural disasters, for example, can also cause food prices to shoot up.

A government-led energy transition to avoid high gas prices

21 Controlling prices dovetails well with increasing wages as an approach to fighting the impacts of inflation. Combining them into a two-pronged anti-inflation strategy could be better for households than policies that revolve around interest rates.

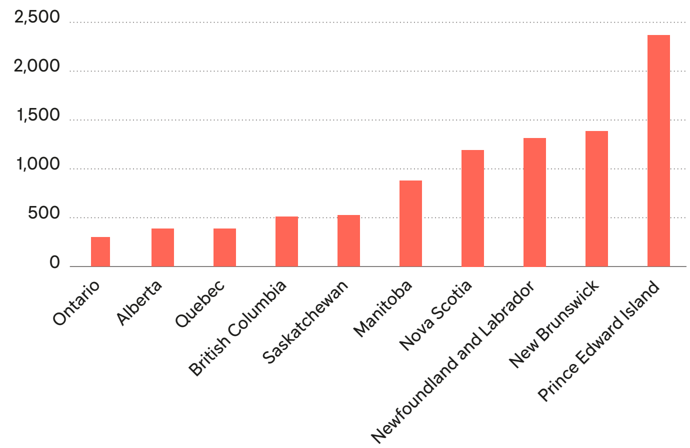
22 With the climate crisis raging and oil prices soaring, a government-led energy transition would allow us to move away from relying on fossil fuels and reduce our vulnerability to higher fossil fuel prices.

23 The public sector could be leveraged as a job creator in areas of the country that are dependent on natural resource extraction. A strong public sector could also help foster the economic diversity and resilience of communities where economic activity is concentrated in a small number of industries.[9]

24 In Alberta, for example, the oil and gas extraction industry accounted for 27.5% of the province's GDP in 2021,[10] whereas public sector industries only made up 16% of its total GDP.[11] And as Graph 1 shows, Alberta is the province in Canada with the second-lowest number of jobs in the federal public service per 100,000 people, clocking in with 394 jobs. With its reliance on fossil fuels high and its public sector employment numbers low, Alberta has a potentially significant opportunity to diversify its economy through the public sector.

Graph 1

Number of federal public service employees per 100,000 people, 2021



SOURCES: Treasury Board of Canada Secretariat, *Population of the Federal Public Service by Province and Tenure*, 2021; Statistics Canada, Table 17-10-0005-01, Population estimates on July 1st, by age and sex, 2021. Authors' calculations. Note that the data exclude jobs in the National Capital Region.

25 For this strategy to be effective, jobs must specifically be created in alternative energy sectors. It would be a good idea to add staff to the divisions of Natural Resources Canada and Transport Canada that support industries producing renewable energy sources with a low socio-environmental impact, such as the wind, solar and geothermal energy sectors, as well as energy-efficient solutions.

High return on investment in the public sector

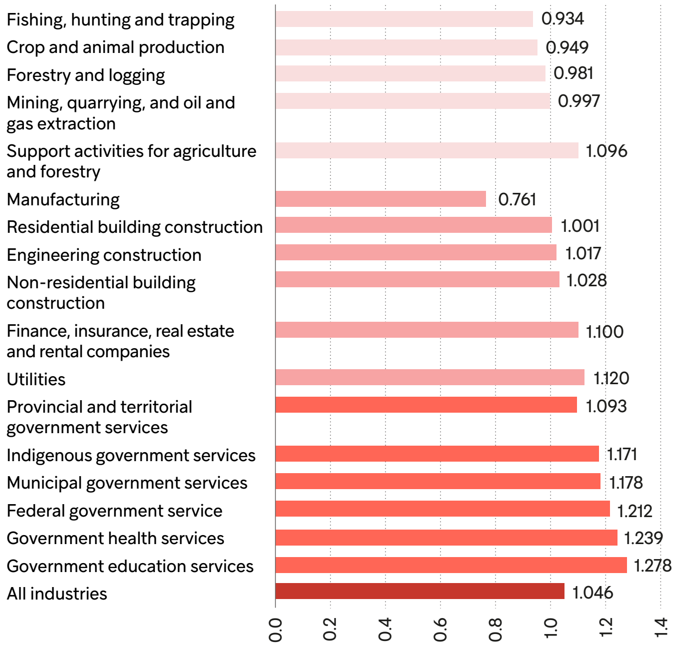
26 Finally, investing in the public sector pays dividends. The economic effects of spending in the public sector on both GDP and employment are greater than those of spending in other industries in the country.

27 As Graph 2 shows, for every dollar spent in the public sector, between $1.09 and $1.28 is added to the Canadian economy (in terms of GDP), compared to returns of $0.93 to $1.10 from the primary sectors. And as Graph 3 shows, every million dollars invested in the public sector creates between 9.27 and 16.69 jobs, whereas the same amount of money creates between 4.26 and 11.98 jobs in natural resource sectors. Both graphs illustrate how spending in the public sector generally yields a greater economic payoff than investing in the primary and secondary sectors in terms of value added and jobs created.

8 STATISTICS CANADA, Table 33-10-0006-01, Financial and taxation statistics for enterprises, by industry type, July 8, 2022. Authors' calculations.
9 François DESROCHERS and Bertrand SCHEPPER, *The Public Services: an important driver of Canada's Economy*, Note, IRIS, September 25, 2019, p. 5.
10 STATISTICS CANADA, Table 36-10-0402-01, Gross domestic product (GDP) at basic prices, by industry, provinces and territories, May 2, 2022.
11 Ibid., industry sectors 22, 61, 62 and 91.

Graph 2

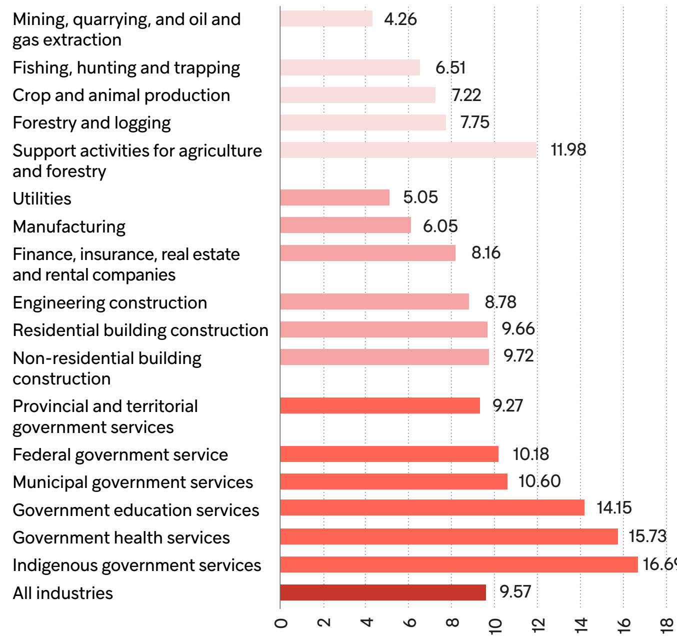
Direct, indirect and induced effects of $1 of output on GDP at basic prices, by industry, Canada, 2018



SOURCE: Statistics Canada, Table 36-10-0013-01, Input-output multipliers, summary level, total multiplier, November 18, 2021.

Graph 3

Number of direct, indirect and induced jobs created per $M of output, by industry, Canada, 2018



SOURCE: Statistics Canada, Table 36-10-0013-01, Input-output multipliers, summary level, total multiplier, November 18, 2021.

In this brief, we explained how public sector jobs could be used as a tool to fight the impacts of inflation and laid out the economic benefits of investing in the public sector over other industries. Protecting workers' purchasing power by creating good jobs and indexing wages, plus diversifying the economies of resource-based communities as part of a government-led energy transition, would both help increase household income and provide a solution to counter rising gas prices. Investing in the public sector also has a greater economic impact on GDP and jobs than investments in other industries. All in all, we are proposing a way to fight inflation that takes into account the ongoing climate crisis and is financially fairer to workers than the traditional approach of hiking the central bank's policy rate.

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