

Assumptions underlying the 2004 private sector wage settlements have not held

When nationwide private sector wage settlements were made in 2004, two underlying assumptions were that inflation would develop in line with the Central Bank's target and that the cost increases entailed by the agreements would be broadly indicative for other labour market settlements. Under a review clause, a joint committee appointed by the negotiating parties, the Federation of Labour (ASÍ) and Confederation of Employers (SA), would convene in November 2005 and November 2006 to assess whether these assumptions had held. If it found that they had not, the contracting parties could either review the wage package within the settlement or revoke the settlement en bloc.

In November 2005, the review committee found that the assumptions had not held and the wage section of the agreements was renegotiated.¹

Since then, both prices and wages in other sections of the labour force have exceeded the underlying assumptions. SA presented a formal proposal for a wage review on June 2 with the aim of preventing a period of uncertainty until the scheduled revision in November 2006, and the prospect that wage settlements would be revoked in the run-up to next year's general election. A new agreement was reached on June 22.

Twin aims ...

The main objective of the new agreement is to "change inflation expectations in 2007 by bringing inflation into line, in the second half of that year, with the 2.5% target laid down in the wage agreement and in the Central Bank of Iceland's inflation target".² Targets are set by ASÍ and SA for maximum three-month rises in the CPI (see Table). On these assumptions, the twelve-month rise in the CPI in Q4/2007 will be close to 3.5%, and thus somewhat above the 2.5% inflation target.³ However according to the ASÍ and SA assumptions, the annualised quarterly rise in the CPI would be under 2.5% in the second half of the year.

The second objective of the agreement is to "reduce the misalignment that has developed between contractual wage rates in the parties' settlements and those of the public sector" and a two-point agreement was made to that effect.

Social partners' targets for inflation developments (%)

	Quarterly change in CPI will be below:	Annualised quarterly change	Quarterly year- on-year change
Q3/2006	3.7	15.6	10.0
Q4/2006	2.9	12.1	11.7
Q1/2007	1.2	4.9	11.8
Q2/2007	1.0	4.1	9.1
Q3/2007	0.7	2.8	5.9
Q4/2007	0.6	2.4	3.5

1. See Economic and Monetary Chronicle, *Monetary Bulletin* 2005/4, 106-7.

2. ASÍ and SA objectives for reducing inflation, and cooperation between the social partners and the Government in connection with the agreement of June 22, 2006. Posted (in Icelandic) on the websites of ASÍ (www.asi.is) and SA (www.sa.is), June 22, 2006.

3. The inflation target is defined in the Declaration by the Government of Iceland and the Central Bank of Iceland on an inflation target and a change in the exchange rate policy from March 27, 2001, which states: "The Central Bank aims at an average rate of inflation, measured as the annual 12-month increase in the CPI, of as close to 2½% as possible."

Box VI-1

Review of private sector wage agreements

... and two-point agreement

The agreement between ASÍ and SA is in two parts. First, the joint ASÍ and SA review committee agreed to establish a "safety net" ensuring wage-earners a minimum rise of 5.5% over the preceding year. Wage-earners whose wages have risen by less shall be awarded a rise equivalent to the shortfall from that figure.

Most private sector employees have probably received contractual wage increases of at least 4-5% over the past year. The broad private sector wage settlement included an across-the-board rise of at least 2.5% on January 1, 2006. A review of pay scales added a further increase estimated as costing employers 1%. Furthermore, a one-off payment of 26,000 kr. was made in December 2005 as part of the November review, which is equivalent to an additional 0.65% increase in monthly wages. In its own right, the safety net for wage developments will therefore probably not cost employers much, although companies might be affected to varying extents. The committee's new agreement also ensures that settlements remain in effect for their original duration, i.e. until the end of 2007.

Second, ASÍ and SA, with the latter's national member associations, upped all monthly wage rates by a flat 15,000 kr. as of July 1. The social partners estimate that the increment represents an 8% increase on average wages of the entire group to whom the settlement applies. Wage costs are not expected to rise by this much, because employees who are already paid more than the basic rate will only receive the difference between their current extra wages and the increment. It was also agreed to raise the minimum wage for full-time employment from 108,000 kr. to 125,000 kr., or almost 16%, over the term of the settlement.

Public sector wages automatically incorporate the minimum rise

Most public sector wage agreements allow for them to be revised in line with the findings of the joint ASÍ and SA review committee. This means that their agreements will automatically be adjusted to incorporate the private sector's 5.5% safety net for wage developments. However, since the flat-rate increment and minimum wage hike were not part of the review committee's findings but a separate annexe to the ASÍ and SA national member associations' settlements, public sector agreements will not be automatically adjusted to incorporate this part of the package.

Government involvement in the agreement

The Government of Iceland announced the following measures to facilitate the agreement between ASÍ and SA:⁴

1. The personal income tax rate will be reduced by 1% in 2007 instead of the announced 2% cut, while the personal income tax credit (personal allowance) will be increased by 8.3% over and above the previously decided 2.25% increase as of the beginning of next year. The tax-free income threshold will therefore be increased by 14% at the beginning of 2007, instead of 8%. Also, the personal tax credit will be indexed to the CPI. These changes will entail only a negligible increase in cost to the Treasury in 2007, because 1% of its announced 2% income tax cut has been withdrawn, but indexation of the personal allowance could cut Treasury revenues by 2 b.kr. in 2008.

4. The Government likewise announced its support for the goal of ASÍ and SA to reduce inflation in 2007 and "will cooperate closely with the parties to ensure the implementation of the economic premises underlying their agreement, especially as regards the development of prices." Posted on the website of the Prime Minister's Office (www.forsaetisraduneyti.is) on June 22, 2006 (in English on June 23).

2. Legislation on mortgage interest allowance will be reviewed if rising housing prices erode these tax credits substantially. It is uncertain whether this will entail cost increases beyond the budget assumptions, because the sharpest rises in housing prices took place after the budget assumptions were decided.
3. Child allowances will apply to children up to the age of 18 instead of the present 16, at an estimated additional annual cost of 600-700 m.kr.
4. Contributions to adult education and job training will be increased by 120 m.kr. on an annual basis.
5. The Government will initiate cooperation with the social partners on foreign labour issues and the underground economy.
6. Basic monthly unemployment benefit will be increased by 15,000 kr. to almost 114,000 kr. as of July 1, a rise of more than 18%. The ceiling for income-related unemployment benefit will also increase from 180,000 kr to 185,000 kr. Based on the current level of unemployment this will cost an estimated 350 m.kr. per year, but could prove considerably higher if unemployment increases in line with forecasts by the Central Bank and others.