



research

# An examination of the Public Sector Wage Premium in Canada

**A critique of the 2008 study by the  
Canadian Federation of Independent  
Business (CFIB) called *Wage Watch: A  
comparison of public and private  
sector wages***

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### ***About This Report***

This report was commissioned by the National Union of Public and General Employees (NUPGE). The report was commissioned to examine the history of the public sector wage premium in Canada and examine the CFIB 2008 study's conclusions with respect to previous academic studies on the topic.

### ***About the Author***

David Macdonald is a Research Associate with the Canadian Centre for Policy Alternatives and the coordinator of the Alternative Federal Budget project for the CCPA. He is an independent economist with a Master of Arts (MA) degree from the University of Guelph. He is a frequent media commentator on national public policy issues. He has worked with the Rideau Institute, the Polaris Institute, the Green Party of Canada, Ottawa Community Groups, the Canadian and Ontario Associations of Community Health Centres and small businesses.

## ***Methodologies for Evaluating Wage Differentials***

There is a long history of studying the differences in pay between the private sector and the public sector both in Canada and internationally. The original theory was that the private sector, because it was constrained by its profits and therefore by market discipline, would be better able to control wages. The public sector, for its part, does not have a profit constraint and so economists theorized that workers in the public sector would have higher wages as a result. Six academic studies of this thesis have been conducted to date in Canada (this excludes non-academic work like that of the CFIB).

There are two basic techniques that are utilized by all the studies: the “Decomposition Technique” and the “Fixed-Effects” technique. The Decomposition Technique utilizes a large database of public sector workers and private sector workers. For each one of those workers, a substantial list of variables is compiled including: occupation, education, experience, gender, etc. as well as wage. These variables represent personal “endowments” that would be expected to legitimately affect wages.

For instance, it would not be fair to compare the check-out person’s wage at a private supermarket to the wage of an experienced government engineer with 20 years experience. The engineer should legitimately be paid more. If one were to cut the engineer’s wage to match that of the check-out boy, the engineer would quit and the government would suffer. In the same way, adjustments need to be made for differences for various education levels and years worked even when comparing one engineer to another.

The Decomposition Technique attempts to make a list of all the relevant variables, adjusts for them using statistical techniques and then whatever difference is left over is the “pure” wage premium.<sup>1</sup> The total wage premium would be like comparing our check-out person to the 20 year government engineer. The endowment wage premium would remove the vast majority of the total wage premium as it represents legitimate differences between the public and private sector based on education, experience, occupation, etc. The “pure” wage premium is whatever is left unexplained and is presumably due to a public sector wage premium.

The 2008 CFIB study uses a simplistic decomposition technique that misses key variables like education and experience.

One of the challenges of the decomposition technique is that the economist needs to know what the relevant variables are and needs to have them in a dataset. For instance, union membership was tagged as an important variable, but was not included in studies until after 2000 because it simply was not available. Perhaps there is a relevant variable like university grades that would move much of the wage premium from the “pure” side to the endowment side.

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<sup>1</sup> This is also called “Economic Rent”

The second technique, called “Fixed-Effects”, sidesteps this missing variable problem. Unfortunately it is only utilized in one study.<sup>2</sup> However, it offers an interesting second take on the wage premium. Instead of using statistical techniques to adjust for the fact that the public sector and the private sector have different amounts of education, occupation, experience, etc., the “Fixed-Effects” technique follows individual people as they move between the public and the private sector.

During any given year, some people will switch jobs from the public sector to the private sector and vice-versa. Because they are the same person both before and after the job switch with the same endowments of education, occupation and the like, no statistical adjustments are necessary. The only item we need to watch out for is voluntary switches which are often due to higher pay. Once these are excluded we can take a look at wage premiums without needing to worry that we are missing key individual characteristics.

### ***History of Canadian Study Results***

There is plenty of history in Canada of wage premium studies going back to 1979.<sup>3</sup> In total six academic studies have been published which have produced nine estimates using various datasets and techniques. These have all been detailed in Table 1 below. (None of the CFIB studies or estimates are included in Table 1 or elsewhere, unless otherwise noted, due to their lack of rigour as will be examined below.)

If we look at the decomposition wage premiums only, they vary from -1.7% to 12.8% for men (excluding studies before 2000 that do not adjust for union membership). That is to say, the decomposition studies have found that public sector male workers are paid 1.5% less to 12.8% more compared to their private sector counterparts after adjusting for occupation, education, experience, etc.

Women, in decomposition studies, have a much higher wage premium that ranges from 10.0% to 17.1% (again excluding studies before 2000 that do not adjust for union membership). That is to say, women in the public sector make between 10.0% and 17.1% more than their counterparts in the private sector after adjusting for education, occupation, experience, etc. As we will see below, this higher premium for women is critical to explaining why the wage premium exists and why the CFIB 2008 study has completely excluded it.

When it comes to the “Fixed-Effects” technique (where individual people are tracked as they change jobs between public and private sectors), there is no statistically valid wage premium for men. That is to say, men make no more or no less as they switch between the public and the private sectors. For women, a wage premium persists, at between

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<sup>2</sup> Mueller, Richard, “Public- and Private-Sector Wage Differentials in Canada Revisited,” *Industrial Relations*, Vol 39 (2), July 2000, pg 375-400.

<sup>3</sup> Gunderson, Morley, “Earnings Differentials between the Public and Private Sectors” *The Canadian Journal of Economics*, Vol 12(2), May 1979, pg. 228-242.

6.3% and 9.3%.<sup>4</sup> As individual women involuntarily switch from the public sector to the private sector (due to a layoff for instance) they lose 9.3% of their income. As women involuntarily switch from the private sector to the public sector they see an income gain of 6.3%.

While there is only one “Fixed-Effects” study, Mueller, the study’s author concludes “...I am not as certain of my [decomposition] results [after seeing the “fixed-effects” results]”. The fixed-effects technique circumvents the missing variable problem with decomposition studies and so provides a tantalizing new approach.

**Table 1: Wage Premium Studies in Canada**

Study	Data	Pure Wage Premium Men (Women)	Coverage
Gunderson 1979 <sup>5</sup>	1971 Census	6.2% (8.6%)	All Public Sector
Shapiro & Stelcner 1989 <sup>6</sup>	1981 Census	4.2% (12.2%)	All Public Sector
Prescott & Wandshneider 1999 <sup>7</sup>	1991 & 1982 Survey of Consumer Finances	1981 14.1% (14.6%)	All Public Sector
		1991 13.4% (22.3%)	
Mueller 2000 <sup>8</sup> (Decomposition)	1988-1990 Labour Market Activity Survey	-1.7% (17.1%) <sup>9</sup>	Provincial Public Sector
Mueller 2000 <sup>10</sup> (Fixed Effect)	1988-1990 Labour Market Activity Survey	0% <sup>11</sup> (6.3%-9.3%) <sup>12</sup>	All Public Sector

<sup>4</sup> Mueller, Richard, “Public- and Private-Sector Wage Differentials in Canada Revisited,” *Industrial Relations*, Vol 39 (2), July 2000, pg 395.

<sup>5</sup> Gunderson, Morley, “Earnings Differentials between the Public and Private Sectors” *The Canadian Journal of Economics*, Vol 12(2), May 1979, pg 228-242.

<sup>6</sup> Shapiro, Daniel & Stelcner, Morton, “Canadian Public-Private Sector Earnings Differentials, 1970-1980” *Industrial Relations*, Vol 28 (1), Winter 1989, pg 72-81.

<sup>7</sup> Prescott, David & Wandshneider, Bo, “Public/Private sector wage differentials in Canada – evidence from the 1991 and 1982 surveys of consumer finance”, *Applied Economics*, 31, 1999, pg 723-731.

<sup>8</sup> Mueller, Richard, “Public- and Private-Sector Wage Differentials in Canada Revisited,” *Industrial Relations*, Vol 39 (2), July 2000, pg 375-400.

<sup>9</sup> Adjusted for the first time for union membership

<sup>10</sup> Mueller, Richard, “Public- and Private-Sector Wage Differentials in Canada Revisited,” *Industrial Relations*, Vol 39 (2), July 2000, pg 375-400.

<sup>11</sup> No statistically significant figures

<sup>12</sup> Involuntary “Leavers” and “Joiners”

Gunderson 2000 <sup>13</sup>	1997 Nov Labour Force Survey	12.8% (11.2%)	Provincial Public Sector
	1996 Census	8.7% combined	Provincial Public Sector
McLean & Vincent 2003 <sup>14</sup>	2000 Survey of Labour Income and Dynamics (SLID)	5% (10%) <sup>15</sup>	All Public Sector

From the history of nine estimates contained in six studies, it is important to note several things. For women, there is always a positive, statistically significant public sector wage premium. The wage premium for women is almost always bigger than that for men. For men, there is only one instance of a negative wage premium where the private sector is paid more than the public sector.

Over time, wage premiums have risen, hitting a peak with the 1990-91 data used in Prescott & Wandschneider 1999 and Mueller 2000. However, the two most recent studies appear to show that that wage premium is going back down. This is likely not a result of real-world effects and is more probably related to the inclusion of new variables like union membership. As the datasets contain more variables that readily explain difference in pay, the wage premium drops. Nonetheless, to date it is still positive and larger for women.

One final point is that the missing variable problem for decomposition studies can itself be measured. Economists may not know what important characteristic of a worker is missing but they can measure how much they are missing. Statistical techniques can be used to estimate the proportion of the wage gap that is being explained by the included endowment variables – it is called the  $R^2$  value. In all of the studies, the  $R^2$  values are always below 60%. What this means is that even in the best study, which is Gunderson 2000 at 57%, there is still more than 40% of the wage gap that is not being explained by the existing variables. Perhaps if we knew what those additional variables were, much of the wage premium could be explained as just legitimate differences between workers. For instance, university grades are not yet available, but it may be that the public sector hires those with better averages and so this might explain a part of the remaining wage premium.

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<sup>13</sup> Gunderson, Morley, Hyatt, Douglas & Riddell, Craig, “Pay Differences between the Government and Private Sectors: Labour Force Survey and Census Estimates” *CPRN Discussion Paper No. W/10*, February 2000

<sup>14</sup> MacLean, Brian & Vincent, Claude “Are estimates of a public-sector wage premium reliable”, *Presented 32<sup>nd</sup> Annual Conference of ACEA Charlottetown PEI Oct. 17-19 2003*

<sup>15</sup> Based on Model 3 with employer based definition of Public Sector Tables 8 & 9, MacLean, Brian & Vincent, Claude “Are estimates of a public-sector wage premium reliable”, *Presented 32<sup>nd</sup> Annual Conference of ACEA Charlottetown PEI Oct. 17-19 2003* pg 30

The first three studies are also the least predictive, with their variables explaining only 20%-30% of the wage gap. Although the CFIB study did no statistical analysis, it is likely that with its limited variable set, it may explain even less of the wage gap, meaning it is missing 80% or more of the endowment variables. This, of course, also means that its estimates are poor compared to other studies done on the matter.

## **Source of the Wage Premium**

### **Gender**

The source of the persistent wage premium, particularly for women, is fascinating. As noted above, one can be fairly confident that women employed in the public sector are being paid more than women in the private sector, other things being equal. This interesting conclusion has been reached in every single academic study to date but has been completely excluded from the CFIB 2008 study.

Since Gunderson in 1979, this result has been explained consistently in the same way: governments wishing to be model employers have paid more to low skilled women. In essence, equal pay policies within the public sector have pushed up the wages of low-skilled women.

Equal pay for equal work has meant that women working in the public sector are not discriminated against as much as women in the private sector. Instead, as equal pay policies have levelled the playing field by paying women the same as men if they do similar work, public sector wages for women, particularly low skilled women, have risen.

It was not until Gunderson's 2000 study that this effect was better understood in terms of occupation. Gunderson separated workers into three equivalently sized categories: Service, Clerical and Managerial Professionals. He then looked at the wage premiums for both men and women in each of these categories.

He found that the wage premium is not shared equally across the board; instead it is quite focused in particular areas. The wage premium for women working in the service sector at the provincial level was a whopping 30% and only 3% for men in the same sector.<sup>16</sup> Service sector women who work for a provincial government make 30% more than their private sector counterparts. However, men in the service sector do not enjoy the same premium. As one would expect, women seem to be disproportionately benefiting from equal pay for equal work policies in traditionally low paid sectors like service.

Interestingly, there is a much smaller wage premium of 9% for women at the provincial level doing clerical work. Gunderson speculates that female clerical workers have not

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<sup>16</sup> Gunderson, Morley, Hyatt, Douglas & Riddell, Craig, "Pay Differences between the Government and Private Sectors: Labour Force Survey and Census Estimates" *CPRN Discussion Paper No. W/10*, February 2000, pg 50.

benefited nearly as much from equal pay policies as comparisons to higher paid male dominated professions are more difficult.<sup>17</sup>

Another fascinating result of the job type breakdown is that “Managers/ Administration/ Professionals” make 41% more in the private sector compared to the public sector.<sup>18</sup> Higher level government managers are actually underpaid compared to their private sector counterparts. It would appear that while governments do not have a profit constraint like the private sector, they do have political constraints.

The government does not want to be seen to be lavishly rewarding civil servants. Policies like that of Ontario of publishing all civil servant salaries above \$100,000 can be a very effective way of constraining public sector wages at the high end in the absence of a profit constraint. The data bears out the effectiveness of political constraints on high end public sector wages.

In essence what has happened in the civil service is that the pay difference between the entry level, female service positions and the management positions has narrowed. Low skilled women are not as discriminated against in the public sector as they are in the private sector for doing similar work to a man. Conversely, management positions are not as lavishly rewarded as they are in the private sector.

## **Immigrants**

Only one study examined the wage premium as it relates to immigrants. Prescott & Wandshneider 1999 included whether a worker was “foreign born” or not into their calculations. They found that the “foreign born” designation had no statistical effect on those working in the public sector.

However, the private sector was a different story. Men, who were “foreign born” saw their incomes decline 14% in the private sector. Women saw a slightly smaller, yet still substantial income decline of 11%. It appears that immigrants get a much fairer shake in the public sector than they do in the private sector. For both male and female immigrants, the wage disparity declines over time.

Immigrants may be experiencing a similar effect that we saw previously with women. The public service, in an attempt to overcome discrimination prevalent in the private sector, pays those routinely discriminated against a wage comparable to others doing a similar job. In the case of women, they are paid as much as men doing the same job. In the case of immigrants, they are immediately paid the same as the general population whereas, in the private sector, they need to wait years before this happens.

While in both cases, women and immigrants are clearly being paid more than in the private sector, the reason isn't greedy public sector unions sticking it to the taxpayers. Instead, governments have actively decided to discriminate less.

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<sup>17</sup> Ibid. 18.

<sup>18</sup> Ibid. 48.

## Unionization

Only the papers including and following Mueller 2000 included union membership as an endowment variable in their decomposition analyses. That is, only three of the six papers adjusted for whether workers were members of a union or not. The studies that did not adjust for union membership failed to do so due to a lack of appropriate data and each highlighted the need for future studies to include union membership when it became available.

There is a wide disparity between the public sector and the private sector in terms of union membership. For instance, 80% of the public sector is unionized while only 18% of the private sector belongs to a union.<sup>19</sup> The argument for union membership as an endowment variable is that union bargaining tends to increase wages. Perhaps the wage premium seen in the first three non-adjusted papers reflected the fact that more of the public sector is unionized. As this argument goes, higher pay in the public sector has nothing to do with no profit constraint on governments and everything to do with more union penetration.

The data for union membership is somewhat mixed. Mueller 2000 was the first to include union membership as a variable. He got the rather odd result that by including union membership, the pure wage premium increased instead of decreasing. One would expect that by including such a critical variable as union membership, some of the wage premium would be shifted from the “pure” side to the legitimate “endowment” side. Oddly, Mueller found the opposite.

However, both Gunderson 2000 and McLean & Vincent 2003 have findings in line with what one would expect. Both find that by including union membership as a variable, the wage premium drops, and in both cases quite substantially. What that suggests is that a large part of the wage difference between the public and private sectors has nothing to do with the sectors per se and has more to do with the fact that unions are better at raising workers’ wages and have managed higher density in the public sector.

Gunderson 2000 finds that the non-union-membership-adjusted wage premium drops from 10% to 6% when union membership is controlled for. As noted previously, Gunderson’s 2000 study had the best fit to the data of any study to date explaining 57% of the wage premium.

McLean & Vincent 2003 also saw a drop in the wage premium once they adjusted for union membership. For men, the wage premium dropped from 8.4% to 5.4%. For women, it went from 18% to 14%.

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<sup>19</sup> Ibid. 6.

In both studies, adjusting for union membership leaves much less unexplained wage premium. Somewhere between 30-40% of the wage premium is explained away by the fact that there are simply more union members in the public sector.

The original thesis that governments cannot contain wages because they do not have a profit constraint appears incorrect. In fact, governments actively constrain the pay of their managerial staff due to political constraints. They do pay women and immigrants more to remove discrimination that exists in the private sector, but this can hardly be seen as government spending not constrained by profit margins. As well, higher unionization rates go a long way to explaining higher pay in the public sector.

### ***Critique of the CFIB 2008<sup>20</sup> Study***

Given the breadth of the academic studies so far on precisely this topic, it is surprising that the CFIB uses a sub-standard methodology in analysing their data. Clearly the CFIB study had access to a fairly extensive census dataset and so data availability could not have been the problem. The most recent academic studies on the matter were concluded almost 10 years ago and sufficient variables were available then.

Unfortunately, the CFIB 2008 study has an inadequate methodology that might have been appropriate for the 1960s but not for 2009. The CFIB 2008 study is using a poor imitation of the decomposition approach that avoids statistical analysis that would provide economic rigour.

The decomposition technique that is used in every academic study to date was developed independently in 1973 by Blinder<sup>21</sup> and Oaxada.<sup>22</sup> Its foundations are now so routine that they are taught in undergraduate econometrics classes.<sup>23</sup> Nonetheless, the CFIB 2008 study has failed to use even these basic techniques. The authors of the CFIB study remark that the “academic” approach is “complex.”<sup>24</sup> It may well appear complex to uninitiated readers, but avoiding obvious advancements in economic theory for the sake of readability seems inappropriate.

The CFIB study only adjusts for three main variables: occupation, geography, and age. Even the first 1979 study of wage premiums adjusts for over 10 variables. For instance, we could have two men, both 35 years old. One has barely graduated engineering and, having spent most of his time travelling India and Europe, has one week of job experience as an engineer in Toronto. The other has a PhD and post-doctoral work in advanced bridge construction with 10 years experience and was hired as an engineer in

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<sup>20</sup> Mallett, Ted & Wong, Queenie, “Wage Watch: A Comparison of Public-sector and Private-sector Wages”, *Canadian Federation of Independent Business*, December 2008.

<sup>21</sup> Blinder, A. “Wage Discrimination: Reduced Form and Structural Estimates.” *Journal of Human Resources*, 1973, 8(Fall):436–55.

<sup>22</sup> Oaxaca, Ronald. “Male-Female Wage Differentials in Urban Labor Markets.” *International Economic Review*, 1973, 14(October):693–709.

<sup>23</sup> Least Squares regression analysis is a common feature in 2<sup>nd</sup> and 3<sup>rd</sup> year introduction to econometrics courses.

<sup>24</sup> Mallett, Ted & Wong, Queenie, “Wage Watch: A Comparison of Public-sector and Private-sector Wages”, *Canadian Federation of Independent Business*, December 2008. pg 6.

Toronto. The CFIB study, because it makes no adjustments for education or experience, cannot tell these two men apart because they are the same age and they are both working as “engineers” in the same place: Toronto.

In fact, if the more educated man was paid more than the less educated one, the CFIB study would consider that a wage premium. Most reasonable people would expect that the more educated man should be paid more because he has significantly more to offer. The CFIB study sees no difference and recommends that the wages of the more educated man be cut to match those of the less educated one. The obvious result would be that the more educated man would quit and get another job and the public sector would lose a valuable employee.

For a decomposition study, two of the most important variables for explaining the wage premium are education and experience. These two variables are included as a necessary first step in every academic study to date including the first one published 30 years ago. To exclude these in an academic study would mean that study would likely never make it through the approval process of an academic journal.

It is standard in opinion polls to report for instance that support for a political party was 34% +/- 2%, 19 times out of 20. If a poll reported that support was 34% with a margin of error of +/-30% you would not pay much attention to the poll because it is clearly flawed. A somewhat similar calculation called  $R^2$  is possible with the decomposition analysis. As noted above, the best study managed to explain 57% of the wage difference which means that more than 40% has not been explained by the variables. Such a high unexplained percentage suggests that the studies are missing key variables. Once these variables are included, the wage premium may well decline or be explained away.

The early 1980 studies were explaining only 20% to 30% of the wage premium again suggesting that they were missing significant variables. The 1980 studies are adjusting for significantly more variables than the 2008 CFIB study. The latter does no statistical analysis whatsoever and so has no idea how valid its methodology is.

While the CFIB study appears to have a more specific breakdown of occupation, its lack of key variables like education and experience will surely handicap its final results. To properly evaluate the validity of the CFIB study’s findings,  $R^2$  needs to be calculated and published just like the margin of error for an opinion poll. Without key variables like education, experience and gender, it would not be surprising if the  $R^2$  for the CFIB study was lower than that of any of the academic studies.

Besides education and experience, the CFIB study has also excluded gender which again is a key variable in every academic study to date. Women’s wage premium being larger than men’s is seen universally as an indicator of why the wage premium exists for public sector employees.

Amazingly the CFIB study does not include the words “women” or “female” at all which is impossible to avoid in all the other academic studies. Displaying the higher wage premium for women would likely tip off readers to one of the reasons for the wage premium: equal pay for equal work. Instead of being honest about prevailing theories for the wage premium, the CFIB appears instead to have decided to exclude it and hope that no one notices.

The CFIB study publishes two figures for provincial wage premiums of 7.9% without benefits and 24.9% with benefits. What is fascinating is that there is essentially even less basis for saying that with benefits the wage gap is 24.9% than for saying that without them it is 7.9%. The CFIB study admits their census dataset does not even contain benefits data, making it hard to see how they could have calculated an adjusted wages+benefits premium.<sup>25</sup>

What the study appears to have done is taken some generalized averages and just multiplied them by the wage gap. There is not even an adjustment for age much less for education, experience or gender. So the 24.9% wage gap is comparing a 22 year old engineer with one week of work experience to a 55 year old engineer with 30 years experience and who has done post-doctoral work in bridge design. The CFIB wage gap of 24.9% is arguing that the 55 year old should get the same pay and benefits as the 22 year old, which most reasonable people would not agree with.

Playing “fast and loose” with the figures strains the credibility of the study as it is clearly attempting to hide major parts of the wage premium story. The original policy thought behind the wage premium was that if such a premium existed, the wages of public sector workers could be cut by the wage premium and service levels would not decrease. Since public sector workers could do no better in the private sector, they would take the wage cut and not quit. A wage premium could then be used as a justification for an across the board wage cut with the promise that service levels would not suffer.

The CFIB 2008 study, of course, makes this argument and states: “The findings of this latest study not only confirm those of the previous four, but they suggest that governments as a group are losing control of the employment costs – benefit costs in particular.”<sup>26</sup> The conclusion is that salary costs and benefit costs are out of control in the public sector. Given the rudimentary nature of the CFIB study, whatever figures they eventually calculate should be read with extreme caution. The benefit wage premium figures in particular are so badly calculated that they are essentially meaningless.

From the studies that do have academic rigour and use up-to-date methodologies, it is quite clear that public sector salary costs are not at all “out of control.” Particularly at the high end, if anything, they are far too low. The managerial staff within the public sector takes a massive 41% pay cut to stay in the government’s employ. With such

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<sup>25</sup> Ibid. 2.

<sup>26</sup> Ibid. 3.

drastic pay restrictions it is a wonder that any competent managers can be found to work in the government.

At the low end, women and immigrants have gained from the government push not to discriminate and instead provide equal pay for equal work. This has driven up the wages for low skilled women in the service sector of the government such that they are paid the same as men who do similar work. Again, it is hard to see how eliminating gender-based discrimination in the workplace means that salaries are “out of control.”

Every single academic study has commented on the above two issues, lowering the wages at the top end and pushing up women’s wages at the bottom. For the CFIB study to completely exclude this discussion means that the authors have either not read the academic studies on the matter, which seems unlikely since they reference them or, worse still, that they know about these issues and deliberately decided to hide them in the hopes that no one catches on. Either result casts serious doubt on the impartiality of the study.

As a final note, the CFIB 2008 calls for governments to not agree to any additional pay increases above inflation until the wage gap has been eliminated.<sup>27</sup> The result presumably would be to make the public sector a better reflection of trends in the private sector. While they do not state this, the likely affect of this policy would be to re-institute discriminatory practices that pay service sector women and immigrants less. It would also call for managers to get the same kind of lavish perks they receive in the private sector.

Clearly neither of these two results would be desirable from a public policy perspective. While there should be little argument that there is likely a small wage premium of 5% to 10%, particularly for women, the wage premium is due largely to the elimination of gender based discrimination that exists in the private sector. It seems unlikely that policy makers would wish to erase those gains for the sake of eliminating the public sector wage premium.

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<sup>27</sup> Ibid. 16.