

Local Government Wages and Services: How Much Should Citizens Pay?

By Anthony M. Rufolo*

Public services are an important feature of American life. The policeman on the corner, the schoolteacher in the classroom, and the fireman climbing a ladder to save a life are familiar symbols of civic devotion, of service for service's sake. But these symbols date from an era when public employees were believed to have accepted lower paying jobs than they could have found in private industry. And some people are arguing that today's municipal employees are paid better and receive better fringe benefits for carrying lighter workloads than their private-sector counterparts.

Public-sector strikes and financial difficulties in several major cities have dispelled some of the aura that used to surround public employment. Faced with rapidly ris-

ing taxes, many citizens are beginning to ask whether the benefits of public services are being provided at a reasonable cost and, if not, what should be done. At the same time, public employees are insisting that they shouldn't have to bear the burden of public-sector fiscal problems. They point to the traditionally low pay in the public sector as evidence that they have to fight constantly to maintain their standard of living.

While local government employers are similar to private employers in some respects, they differ sharply in others. Both these facts must be borne in mind when analyzing municipal wages and determining just how well local governments trade off the demands of their employees against those of their constituents.

MUNICIPAL WORKERS SCORE GAINS

It used to be conventional wisdom that jobs in the public sector paid less than similar jobs in the private sector. This disadvantage was thought to be offset by more

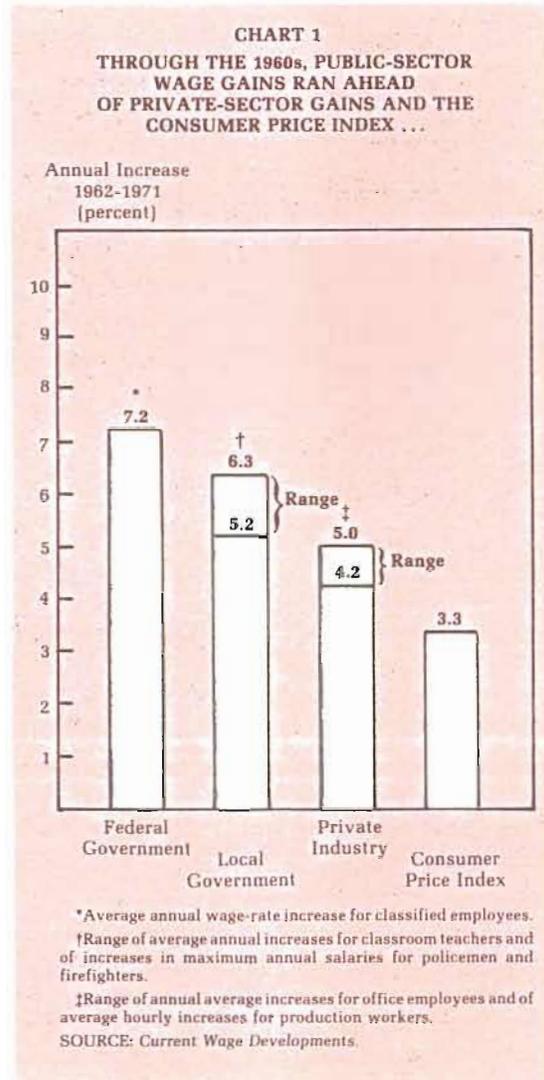
The author, who joined the Philadelphia Fed's Department of Research in 1974, holds a Ph.D. from the University of California at Los Angeles. He specializes in urban economics, microeconomics, and public finance.

job security, better fringe benefits, and less competitive pressure. But there is a good deal of evidence to suggest that, while fringe benefits, job security, and work pressures still favor the public sector, the municipal worker now holds an edge in wages too.

Wages Move Up . . . The shift occurred as public-sector wage gains began to outdistance those of the private sector during the 1960s. According to the Bureau of Labor Statistics, certain sizable groups of urban government employees averaged larger annual wage gains than the corresponding groups in private industry and only slightly smaller ones than those of Federal employees (see Chart 1). Both groups gained with respect to inflation, which advanced at an annual rate of 3.3 percent, but public workers' wages clearly were growing faster. At first public employees were trying to catch up, but by 1971 the percentage gains were so great that nine of eleven cities studied by labor economist Stephen H. Perloff had public-sector clerical employees averaging higher dollar wages than their private-sector counterparts. Two other groups studied by Perloff—data processing and maintenance/custodial personnel—also showed higher wages in a majority of the eleven cities.¹

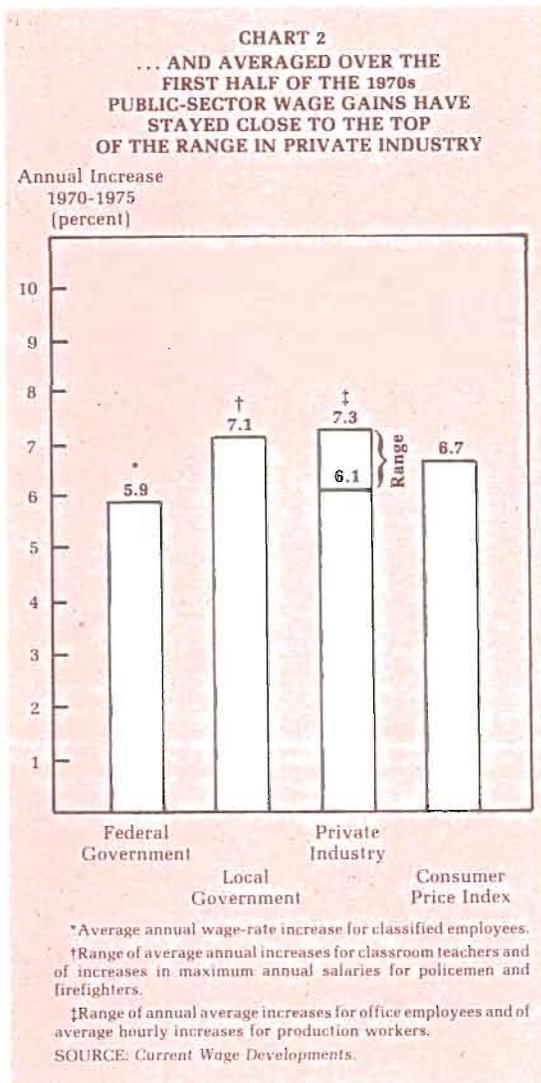
The figures for the 1970s don't show public-sector workers continuing their clearly higher rates of wage growth, but neither do they indicate any significant lag behind the private sector in wage increases. Indeed, during the first half of the 1970s, while Federal employees have had their salaries growing less rapidly than those in the private sector, local public employee groups have attained a rate of wage growth which is near the top of the range for private-sector groups (see Chart 2).

¹Stephen H. Perloff, "Comparing Municipal Salaries with Industry and Federal Pay," *Monthly Labor Review* 94, 10 (1971), pp. 46-50.



Even if local public employees obtain only the same wage-rate growth as private-sector workers, they will maintain their relative wage advantage as long as they're starting from a higher base, as many are. A recent Pennsylvania Economy League study² found that four groups of Philadel-

²*Citizens' Business*, February 5, 1976.



ity. Workers generally are willing to trade some money income for things like job security and fringe benefits. While it is difficult to compare the nonwage features of a job, the evidence indicates that urban public employees tend to hold advantages in these too. One study found, for example, that the unadjusted ratio of fringe benefits to payment for hours spent working was about the same for municipal workers as for workers in the private sector.³ But it also pointed out that the unadjusted measure tends to understate the cost of fringe benefits to cities, since many cities have not financed their pension plans adequately and are less likely than private firms to count paid time for rest periods as a fringe benefit. Adjusting the ratio to reflect rest time and pension costs shows that, on average, public-sector employees have larger fringe benefits than employees of private firms. Even if we make no such adjustments, public-sector employees with a given benefit-to-wage ratio receive a larger package of fringe benefits than do their private-sector counterparts because they have higher wages per hours worked; more money must be spent on fringe benefits to achieve the ratio found in the private sector.

In addition to higher wages and fringe benefits, public employees also appear to have greater job security. The job security offered by public-sector employment certainly is not absolute. But its extent can be seen in the fact that, with the aid of Federal emergency job programs for state and local government, public employment continued to grow right through the recent recession.⁴

phia city workers made 11 to 38 percent more than their private-sector counterparts while only one group made less (by 2.6 percent). This means that the city paid \$1,070 to \$2,884 more per year for the average worker in all but one group while paying \$370 less per year for the average worker in the remaining group.

... and Benefits Follow. Of course, wages are not the only measure of a job's desirabil-

³Labor-Management Relations Service of the National League of Cities, United States Conference of Mayors, and National Association of Counties. "Second National Survey of Employee Benefits for Full-Time Personnel of U.S. Municipalities." Washington, 1974.

⁴Robert W. Bednarzik, "The Plunge of Employment During the Recent Recession," *Monthly Labor Review* 98, 12 (1975), pp. 3-10, reports that all but one manufacturing group and one nonmanufacturing group in

Do public-sector workers have lighter workloads than those in the private sector? There doesn't seem to be any easy way to answer this question. It appears, however, that municipal employees in many instances are required to work fewer hours. Six of the eleven cities studied by Perloff, for example, require 35 or fewer hours per week from employees in most job classifications listed. In comparison, the average basic workweek in the private sector was 39 hours or above in most classifications.⁵

In short, urban public employees appear to have reversed the past trend of trading off higher compensation for more job security. They now seem to have higher wages, more fringe benefits, and greater job secu-

private industry showed declines in employment from September 1974 to April 1975. Over the same period, state and local government employment swelled 3.5 percent.

⁵"National Survey of Professional, Administrative, Technical, and Clerical Pay, June 1971," U.S. Department of Labor, Bureau of Labor Statistics, Table 9.

rity than most of their private-sector counterparts.

WHY LOCAL GOVERNMENT PAYS BETTER

The public sector is subject to unusual forces that can lead to relatively high wages, while it lacks, or has only in an attenuated form, some of the checks and balances that the market imposes on wage settlements in the private sector.

High Public Wage Rates Have Economic Causes. The municipal labor market appears to have economic characteristics that permit or even favor relatively high wage levels (see Box). The kinds of goods and services that come from the public sector—police and fire protection, for example—probably would put labor in a strong bargaining position even if they were produced by private industry, but the lack of competitive market pressure in the public sector adds strength to labor's bargaining position. Under market conditions, a higher

BOX

HOW WAGES ARE SET

The wage rate is the price of labor, and basic economic theory says that it's determined more or less by supply and demand. Of course, not all labor is the same, just as not all cars are the same, so that in practice different workers obtain different wages depending upon their training, experience, work habits, and so on. A wage may be considered high when it is above the wage that would be set in a competitive market.

But markets never are perfectly competitive, so there are many opportunities for wages to be set too high or too low. Unions may be pushing wages up. Or management may not know the going wage and guess wrongly about it. Or large firms may be exercising their market power to keep wages down.

Economists argue that wherever the wage rate is set, market forces will tend to push it back toward the market level—if the market is competitive. Suppose, for example, that wages are higher than they would be if they were set in a competitive market. Their being high will tend to induce more workers to apply for jobs and fewer to quit. This is a sign to the employer to lower his wage offer. Similarly, if his wage offer is below the market wage, he will find fewer workers asking for jobs and more workers quitting; and he'll have to raise his wage offer to attract employees. In order to maintain high wages, workers must prevent other workers from offering to do the same job for a lower wage and prevent employers from eliminating the job.

Market forces can act as a constraint on wages even when the labor market is not competitive. These forces tend to create a trade-off of wages against employment. As a firm's wage costs are

pushed up, it will try to replace some of its labor with machines. And as the added costs show up in higher prices for the firm's product, the firm may find itself losing sales. If wages are pushed too high, the firm may cease to be competitive in selling its output and go out of business.

A number of factors determine how great the reduction in the number of workers will be for a given wage increase. The employees will be more likely to attain relatively high wages if it is difficult or expensive to substitute capital for labor, if the amount of final product the firm can sell is not very sensitive to its price, or if wages are a very small part of total production costs.*

The municipal labor market appears to be influenced heavily by forces that make wages higher than they would be if they were set in a competitive market. There is no competition to sell output. There really aren't any profits to maximize. And usually it's difficult to substitute capital for labor in production.

*For a detailed analysis see Milton Friedman, *Price Theory* (Chicago: Aldine Publishing Company, 1962), Chapter 7, or Paul Samuelson, *Economics*, 8th ed. (New York: McGraw-Hill Book Company, 1970), p. 563.

cost for an input tends to decrease the amount of that input used in production. This means, other things being equal, that if wage rates go up, fewer laborers will be hired. Thus, in the market, the tradeoff of employment against wages usually places a constraint on wage demands.

At some point, machines become cheaper than human beings in some production processes. But many people argue that it's relatively hard to substitute machines for people in the public sector because most public output takes the form of services. Again, in the market, higher production costs typically lead to higher prices, lower sales, and fewer jobs. But even if people bought government services from the private sector, they probably wouldn't cut their consumption very much as prices rose, because these services tend to be so important. And so cutbacks in employment are not likely to follow a rise in wages.

Further, even when labor has a strong bargaining position, competitive pressures give firms in the private sector a strong incentive to keep costs down. But these pressures are not as strong in the public sector, since government usually has a monopoly on the services it provides and doesn't have to compete for sales. Where

private institutions do compete with government, as in education, the citizen must continue to pay taxes and support the government-run establishment even if he doesn't use its services, so government provision isn't put to a complete market test even here. And government budgets are so complex that most citizens don't know how much they're being charged in taxes for any of the myriad services they have to buy. Thus they are not in a position to find out whether any of these services could be provided at a lower cost.

Available empirical evidence supports the argument that, for all these reasons, the demand for labor in the public sector will not be very sensitive to increases in wages paid.⁶ Therefore, when public-sector workers decide, as they appear to have done, that they want higher wages even at the cost of some job security, the economic forces that put bounds on wages in the private sector are found to be weaker in local government.

Politics Can Push Public Wages Either Way. Certain features of political life also

⁶Ronald C. Ehrenberg, "The Demand for State and Local Government Employees," *American Economic Review* 63 (1973), pp. 366-379.

may affect wages for public employees, as when long-range planning is complicated by the desire to show short-run results. Faced with heavy voter resistance to tax hikes, for example, the public executive may find it attractive to curb wages severely, forgetting that, in the longer haul, doing so may cost him trained workers and make it harder to hire qualified replacements. Or he may be swayed by pressure from public employees themselves. A raise now might be covered by a tax increase later or treated as a pension fund increment that won't come due for many years.

It's important to consider also that voting is not a one-issue process. In choosing a candidate, voters must vote for policies, levels of service, and so on, even though they don't know what the cost of specific government services is or should be. Even local tax bills may not tell the total cost of running the local government because of grants from state or Federal sources. Thus a public official who isn't successful at holding wages in line (or who actually raises costs by pushing wages down too far) may be reelected because people count his performance in other areas more heavily than in controlling the cost of public services.

Unions Sometimes Reinforce Upward Pressure. A number of people have suggested that unions have a greater effect in the public than in the private sector.

Unionization has become very significant in the public sector, and the rise in unionism has coincided with the surge in wages. Until the late 1950s, public employee unions were almost unheard of; however, a 1970-71 survey reported that more than 60 percent of all employees in cities with a population over 10,000 belonged to unions or employee associations.⁷ The number almost certainly has

increased since then, and as the number increases, so does bargaining strength. Edward M. Gramlich illustrates the clout that public employees might be able to exercise in the city of New York:

If each [city government employee] was married, lived in the City, and had one close friend or relative who would vote alike on city issues, conceivably 1,350,000 votes, 30 percent of the entire voting age population and roughly half the probable number of voters, could be marshalled in favor of making some strategic concession to, or dealing leniently with, unions.⁸

What evidence we have indicates that unionized public employees generally are paid best and that both unionized and non-unionized municipal workers are paid better than their private-sector counterparts. Thus there appear to be two independent effects that lead to higher municipal wages—one that comes from unionization and one that comes from being in the public sector.

WAGES AND PERFORMANCE

Wages are only one part of the municipal employment issue. The other part is what the wages buy. Few would object to paying larger salaries to employees who are commensurately more productive. Although it's difficult to get any direct measure of productivity in the public sector, it seems clear that the public institutional setting does not create strong productivity incentives.

In many ways, wages are not closely related to a public employee's performance. Civil service, while it removes much of the employment decision from the political arena, also seems to remove some of the productivity requirements placed on employees in the private sector. First, civil service makes it very difficult to fire employees for any reason, including poor performance. Second, in the absence of the

⁷Richard R. Nelson and James L. Doster, "City Employee Representation and Bargaining Policies," *Monthly Labor Review* 95, 11 (1972), pp. 43-50. Reprinted with corrections as Reprint No. 2845, U.S. Department of Labor, Bureau of Labor Statistics.

⁸"New York: Ripple or Tidal Wave?" *American Economic Review* 66, 2 (1976), pp. 415-429.

profit motive, the periodic fat-trimming that occurs in the private sector because of sluggish business is much less likely to occur in local government.

In addition, overall public pay levels in many areas are set according to the prevailing wage in local private industry, so the public pay scale does not reflect worker productivity the way private pay scales are supposed to reflect it. Further, many public employee groups take prevailing private wage increases as a floor from which to start bargaining for their own raises, biasing wages upward.

The net effect of civil service and of tying municipal wages to private-sector wage rates probably is to make the benefit that the public-sector employee receives from any increase in his productivity relatively low. Civil servants, therefore, are likely to have less of an economic incentive than their private-sector counterparts to increase productivity.

GETTING THINGS DONE

When confronted with evidence of high wages and low efficiency incentives in government, many people argue that public-sector wages should be frozen or lowered and unions abolished or restricted. Such proposals, however, are aimed more at symptoms than at causes. A simple solution, such as freezing or reducing wages in the public sector, may or may not be beneficial to the community. If workers respond by reducing their output or their actual hours worked, then no one is better off.

A Dose of Competition. The important thing is to get the job done at the lowest possible cost. And some people think the best way to achieve this aim is to buy municipal services from private contractors or other units of government. Some towns, for example, collect taxes and pay a private firm to provide fire protection or to collect the garbage. If it seems that one firm is

charging too much, the contract goes to someone else next year. Both managers and employees have an incentive to be efficient and protect their jobs.

Contracting out tends to work best when the contracted service or output is easy to measure. Otherwise it doesn't work so well. Contracting for judicial services, most would agree, wouldn't be an acceptable way of getting those services because it's hard to define appropriate criteria for judicial contract performance. And most people would not want profit incentives to become involved in the administration of justice. But it's relatively easy to set up performance criteria for garbage collection services, such as twice-weekly pickup and no spillage. And competition for contracts by providers of these services would help to hold costs down.

Contracting out presents opportunities for abuse, even as an in-house operation would. And it doesn't introduce complete competition, because cost constraints require that a single decision about who gets the contract be made for everyone. But these same cost constraints are there no matter who provides the service. Contracting out may not solve all the problems, but it appears to hold much promise as a means of injecting incentives for efficiency into municipal government.

Politics Versus Efficiency. Another advantage of contracting out is that it helps depoliticize the production of public services. Civil service systems were intended to insulate employees from political pressure, and many seem to do this very well; but politics works both ways, and civil service systems don't keep employees from exerting political pressure on their bosses. Thus we still don't have the separation of economics from politics that was one goal of civil service. Political interaction is important for working out the programs that municipalities will pursue, but injecting political pressures into the production side

of these programs makes productivity gains harder to achieve.⁹

Tying Wages to Productivity. The crucial point is that some of the difficulties of the local public sector can be alleviated by harnessing economic incentives. If a worker's salary is tied to his productivity, then both the worker and the taxpayer are being treated fairly. It is primarily when this balance does not occur that we find wasted resources. Wages can be tied to productivity both by negotiating directly with workers and by creating appropriate incentives within government.

Other proposals for improving productivity center on improving the incentives for department heads in the public sector through periodic evaluations of efficiency in achieving stated objectives. Some favor having the department head justify his entire budget periodically (zero-base budgeting). Here the aim is to give the department head the incentives he needs to initiate appropriate incentives for his employees. Another tack is to give some form of direct productivity incentives to employees who generate cost savings, through bonuses for beneficial suggestions and the like. These proposals aim at changing the efficiency incentives in government by reaching down to the key figure—the individual worker.

⁹A recent example of an attempt to depoliticize wage negotiations occurred in San Francisco. Voters approved a referendum in 1973 that shifted the right to negotiate with city unions from the mayor to a professional negotiator.

SUMMING UP

Have public employees moved to a position where their power over the public is being used to fatten their paychecks and reduce their workloads, or would public workers be exploited in the absence of strong safeguards? As in most cases of this sort, there's truth on both sides. Every employer would like to produce his output for as low a cost as possible, and a mayor faced with reelection is concerned with every item, including wages, that might force a tax increase. It's also the case, though, that employees prefer higher wages to lower ones and often are inclined to overvalue their services. Further, public employees usually wield political as well as economic power which, when coupled with other characteristics of the public sector, seems to give them further advantages over their private-sector counterparts. The current system of wage determination is not likely to lead to efficient production, equitable wages, or happy citizens.

The best method for dealing with this situation probably will vary from community to community, but a few principles are clear. Wage settlements should be removed as much as possible from political influence. If employees demand private-sector kinds of bargaining rights, they should be held accountable for the equivalent of private-sector productivity improvements. And market-type competition should be introduced wherever practical. The public sector surely is different from the private, but, just as surely, some of the features of private production could be adapted to stimulate public output.

SUGGESTIONS FOR FURTHER READING

The author has collaborated with W. Hirsch in developing, "A Model of Municipal Labor Markets," *Journal of Urban Economics* 2 (1975), pp. 333-348. H. Wellington and R. Winter discuss the ways private-sector workers differ from municipal workers in *The Unions and the Cities* (Washington: The Brookings Institution, 1971). Also recommended is a collection edited by D. Hamermesh—*Labor in the Public and Nonprofit Sectors* (Princeton: Princeton University Press, 1975)—which presents related papers and some empirical work.

Annual Operations & Executive Changes

DIRECTORS AND OFFICERS

The Board of Governors of the Federal Reserve System has designated John W. Eckman, Chairman and President of Rorer-Amchem, Inc., Fort Washington, Pennsylvania as Chairman of the Board of this Bank for 1977 and Werner C. Brown, President of Hercules Incorporated, Wilmington, Delaware as Deputy Chairman, also for 1977.

W. J. Smouse, President of The First National Bank in Bedford, Bedford, Pennsylvania has been elected to be the Class A-3 Director of this Bank for a three-year term, replacing Thomas L. Miller, President of the Upper Dauphin National Bank, Millersburg, Pennsylvania.

William S. Masland, President of C. H. Masland & Sons, Carlisle, Pennsylvania has been reelected as the Class B-1 Director of this Bank for a three-year term.

In May 1976, Jack K. Busby, President and Chief Executive Officer of the Pennsylvania Power & Light Company, Allentown, Pennsylvania was elected to the Class B-2 Directorship to succeed C. Graham Berwind, Jr., President and Chief Executive Officer of the Berwind Corporation, Philadelphia, Pennsylvania, who had resigned from the Board.

The Board of Governors of the Federal Reserve System has named Jean Crockett, Professor of Finance at the Wharton School of the University of Pennsylvania, Philadel-

phia, Pennsylvania to a three-year term as a Class C Director.

In another action, the Bank's Directors have appointed Roger S. Hillas, Chairman of the Provident National Bank, Philadelphia, Pennsylvania to be the Member of the Federal Advisory Council from the Third Federal Reserve District. He succeeds James F. Bodine, President and Chief Operating Officer of the First Pennsylvania Corporation and the First Pennsylvania Banking and Trust Company, Bala-Cynwyd, Pennsylvania.

In March 1976, Peter M. DiPlacido was promoted to Vice President and Ronald G. Foley, formerly Director of Cash Operations, was made Cash Operations Officer. In July, G. William Metz, Vice President, became the Bank's Custody Control Officer. In December, Warren R. Moll, Assistant Vice President, retired after 43 years of service to the Bank, and Stanley J. Forst, Director of Computer Applications, resigned.

Judith H. Helmuth, Operations Improvement Officer, and Ronald D. Watson, Research Officer and Economist, both have assumed additional duties as Assistant Secretaries effective January 1977. Also effective January 1977, Guy H. Edwards, Director of Data Processing and Technical Services, has been promoted to Systems Planning and Development Officer.