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Governance of Decentralised Pay Setting in Selected OECD Countries

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Working Paper 3

GOVERNANCE OF DECENTRALISED PAY SETTING IN SELECTED OECD COUNTRIES*

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ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT

* . This paper has benefited from the comments and guidance provided by the project advisory group (see Annex I) and the respondents in the countries studies (Annex II). Useful comments were also provided by the OECD Public Employment and Management Working Party at its meeting on 7-8 December 2006.

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GLOSSARY

Award	Pay settlement decided by a public authority.
Bottom-up budgeting	A budget process which starts by all budgeted entities submitting resource requests which are then adjusted and aggregated into the total budget.
Collective agreement	Agreement on employment conditions made with a trade union, or with another form of employee representation. The agreement can regulate individual wages.
Decentralisation	A transfer of one or more tasks from a central to a sub-central level, either through delegation or through devolution.
Delegation	A decentralisation where the centre retains the responsibility for the outcome of decisions taken at sub-central level.
Devolution	A decentralisation where the full responsibility for outcome has been transferred to the sub-central level.
Individual agreement	Agreement on employment conditions made with a single individual.
Individualisation of pay	Differentiated pay arrangements where compensation and terms and conditions vary significantly between people undertaking similar tasks on the basis of an assessment of the merits and performance of the individual.
Pay	Pay is here used as a general concept including both base rewards and allowances, and in-kind benefits including health insurance, etc.
Pay bargaining	Pay setting through a negotiating process, followed by a formal individual or collective agreement.
Pay setting	The process of setting pay. It includes the application of statutory rules or clauses in collective agreements to individual employees.
Reference model	Standard formula or algorithm for taking account of pay developments in other sectors.
Remit system	A system where a pay setter has to submit its pay bid or bargaining parameters to a superior level for review and acceptance or approval. (Remit: to refer a matter for decision to an authority. Oxford English Dictionary.)
Single level system for collective agreements	All relevant elements are contained in the agreement(s) made at one level (national or sub-central). This can be a single agreement signed at central level for the entire public administration, but are more often multiple agreements signed at sub-central level.
Top-down budgeting	A budget system which starts by setting an overall ceiling for budget expenditures, which is then broken down into sub ceilings for sectors and budgets for budgeted entities.
Two level system for collective agreements	A central collective agreement signed by national social partners which sets the framework for secondary negotiations at sub-central level on <i>inter alia</i> wages. Employment conditions can be standardised by inclusion in the central agreements.
Unilateral pay setting	Pay setting without any formal individual or collective agreement. It may, however, have been preceded by an informal dialogue.

EXECUTIVE SUMMARY

This report reviews the governance of decentralised pay setting in the central government administrations in Australia, Denmark, Finland, the Netherlands, New Zealand and the United Kingdom. The review focuses on the decentralisation from the centre to a lower level; possible secondary delegations are not covered. Pay bargaining and industrial relations are not covered by the review, and the report only discusses these issues when it is necessary as a background to the main theme.

The review is based on interviews (see Annex II) made during visits to the European countries and by telephone with the other two countries. It also draws on information in documents, internet pages and other sources (see Annex III), and on a constructive consultation with the Trade Union Advisory Committee to the OECD. The report was reviewed at the December 2006 meeting of the Public Employment and Management Working Party of the OECD Public Governance Committee.

The six countries reviewed are not a random sample. They have been chosen because they have experience and interest in decentralised pay setting. They have provided a broad range of arrangements, practices and experiences and are thus also a good basis for comparisons and tentative conclusions. The tentativeness of the conclusions should be underlined; this is not a comprehensive study and the observations made are based on a limited material and can be open to interpretations.

The need for more differentiated pay setting in the public sector is probably the most important driver behind decentralisation. Both the labour market and the public activities have become less homogeneous, and public administrations need – just like any other employer – to develop pay-setting arrangements that are sufficiently flexible to enable an adaptation of pay systems and pay structures to:

- the specific situation and requirements of each organisational unit;
- the specific skills, merits and performances of each employee; and/or
- the competition for skills on the specific labour market.

As pay systems become more flexible, centralised pay setting becomes less rational and less efficient, since a differentiation reflecting individual competences, performances and business needs has to be based on information provided by and held at the local level. At the same time, decentralisation increases the transaction costs, since a single bargaining process is replaced by multiple bargaining processes. Decentralisation can therefore only be justified if it is used so as to generate a sufficiently large added value through an adaptation of the pay systems and pay structures to the business needs of each operational entity.

Australia's and New Zealand's constitutional and administrative setup reflects their British origins. They have single level collective bargaining, but also individual employment contracts in workplaces covered by collective agreements. Pay setting is extensively decentralised, but at the same time governed through bargaining parameters that the pay setters in the core government

administration are expected to adhere to. The budget and the bargaining processes are effectively separated, and the Ministries of Finance are not directly involved in the monitoring of the compliance with the bargaining parameters. They also have separate professional organisations promoting good human resource management (the Australian Public Service Commission and the New Zealand State Services Commission).

The arrangements in the United Kingdom are similar to those in Australia and New Zealand, but not as systematically evolved. Here, the Treasury handles the monitoring of compliance with the bargaining parameters, and the budget and the bargaining processes are not fully separated. The Cabinet Office is responsible for promoting good human resource management, and the Public Service Commissioner plays a more secondary role.

Denmark's and Finland's constitutional and administrative setups reflect the Nordic social and administrative culture with, *inter alia*, strong and reformist trade union movements. They have two level collective bargaining, with some employment conditions being regulated in central collective agreements, and others in local agreements. Pay setting is decentralised, but within an explicit framework defined in central collective agreements. The budget processes have to incorporate the outcome of the central negotiations, but are effectively separated from the local bargaining processes. The employer is represented in the central bargaining by separately managed parts of the Ministries of Finance (Denmark's State Employer's Authority and Finland's Office of the Government as Employer). The same departments within the Ministries of Finance are also professional organisations promoting good human resource management and assisting their government in drafting policies and statutes.

Pay bargaining in the Netherlands is less decentralised, and the arrangements are in flux. The Netherlands has single level bargaining in 13 sectors. Five of these are called *cabinet sectors* (line ministries) where the employer is represented by a minister, five are subsectors within the education sector, and three are sub-central government levels (provinces, municipalities and water boards). The budget and the bargaining processes interact within the cabinet sectors, but are separated for the subsectors and sub-central government sectors. Pay bargaining and other human resource management issues in the central government sector are coordinated by the Ministry of the Interior and Kingdom Relations, and there is no separate professional organisation at central level for promoting good human resource management, comparable to those in the other reviewed countries.

One of the conclusions of the comparative review is that there are two main alternatives for pay setting arrangements (see Table 5 in Section 6 for further details). These have in common the existence of a separate and professionally competent central agency able to govern and monitor the behaviour of the pay setting entities, and the provision of a standard and predictable envelope for the pay bill to the decentralised pay-setters. Each of the models works well in the context of the countries that operate it:

- *Remit-based approach*: A model with a central organisation that operates a remit system that enables a monitoring of the adherence to or observance of the government's bargaining parameters, and that also may promote common human resource management values and practices. This model is used in Australia and New Zealand.
- *Consensus-based approach*: A model with a central employer's office and a two level system for collective agreements. In these systems, it is the central collective agreements which provide the frameworks for decentralised pay setting. This model is used in Denmark and Finland.

The essential differences are:

- Denmark and Finland have two level collective bargaining; Australia and New Zealand have single level collective bargaining.
- Denmark and Finland separate responsibility for pay bargaining from responsibility for budget formulation by “firewalls” within the Ministry of Finance, with separate units responsible for each of these; Australia and New Zealand have distinct separate organisations for these functions.
- Denmark and Finland combine central responsibility for pay bargaining with responsibility for overall staff regulations within the government sector; Australia and New Zealand have distinct separate bodies for these functions.

Both models seem to work well for the countries that have them. The reason for that is probably that they are adapted to the specific political and administrative culture of the respective country. The models represent two different development paths: the Anglo-Saxon with, *inter alia*, a stronger focus on individual contract-based relations, and the Nordic with, *inter alia*, a stronger focus on cohesion and collective action. It is therefore not possible to make any general recommendations; each country has to find its own path starting from where they are.

It is however possible to draw some general conclusions from the review. They can be summarised as follows:

1. Introducing or extending decentralised pay setting involves a learning process. Formal rules are not enough – all parties must be comfortable with, and competent in, the process. The chances for a successful introduction and extension of decentralised pay setting can be substantially improved by adequate preparations before the introduction or extension of the decentralised pay setting. Conversely, inadequate competencies, inadequate support and monitoring, and distrust of the seriousness of the decentralisation will counteract any positive outcomes.
2. Governments should have a clear position on whether a specific human resource management element should be uniform throughout the entire central government administration, could vary between different parts of the administration but only within stated limits, or could vary freely between different parts of the administration; and adapt the scope of its decentralisation accordingly.
3. Appropriate financial management arrangements are essential for a well-functioning decentralisation of pay setting. The key aspect of these arrangements is that budget appropriations and pay bargaining should be effectively separated, so that the decentralised pay setting can take place within the confines of a stable and credible affordability¹ restriction.
4. Effective monitoring and assessment of the adequacy and appropriateness of decisions taken by the operational managers in pay setting entities is also essential for a well functioning decentralisation, especially over time. Countries with decentralised pay setting also need to invest in a corps of professional public managers with skills that are adapted to the specific context of the public administration.

5. Decentralised pay setting has positive effects on the performances of the public administrations, but this is contingent on the country having instituted adequate financial management and governance arrangements listed above. One should not, however, expect any immediate outcomes of the introduction of decentralised pay setting.

There appear to be distinctive advantages in applying a standardised initial adjustment of the budgets of pay setting organisations, since this reduces the transaction costs, improves the entities' ability for multi-year planning and allows the governments to concentrate their political deliberations on the organisations where there is a political case or business case for further adjustments.

One issue that is often raised in connection with decentralised pay bargaining is whether it is compatible with maintaining a sufficient coherence in pay and other employment conditions across the public administration. Several of the countries note that mergers between different pay setting entities have been complicated by differences in pay structures and pay levels, but these problems seem to have been manageable in most countries. The only country where there are indications of more troubling divergences of pay for persons with similar skills and jobs is the United Kingdom.

Differentiation is not necessarily the same thing as individualisation (where compensation and terms and conditions vary significantly between people undertaking similar tasks on the basis of an assessment of the merits and performance of the individual). Arguably, the potential for individualisation often has been overstated. It entails higher transaction costs than uniform and collective standards and agreements, and one should assume that a rationally acting operational manager will use standard contracts, standard conditions and collective pay structures unless there is a clear added value to be gained from individualisation.

It should be noted that the main subject of this report is the governance of pay setting and other aspects of human resource management in central government. Sub-central government and various types of semi-autonomous bodies create other challenges besides pay determination. These are not referred to here. These other bodies include private law entities that fulfil public functions and are fully or largely funded by the central government, either through economic transfers or through contract-like budget allocations. There are also private law entities owned by the state.

There are two main policy reasons why central governments seek to influence or control the human resource management practices in the sub-government sector. The first is that pay developments at sub-government level can drive pay demands at the central government level, especially when the labour market is tightly integrated. The second is that this would enable the central government to pursue other equity goals such as gender and minority group recruitment that are not easily achieved through such means as legislation or incentives in the intergovernmental fiscal transfers.

Without comment on the practical or political feasibility, the options available for a central government that wants to coordinate remuneration issues in the wider state sector vary according to the relationship with central government:

- Entities that are under direct government control (that is the government can issue binding directives) can be governed and co-ordinated through the type of systems described in this report. This can involve a professional oversight authority, appropriate bargaining parameters, and a monitoring system based on a remit process.

- Private law entities that are owned by the government can be governed through owner directives. These could, when appropriate, be subjected to the same type of governance as a public law entity under direct government control.
- Private law entities that operate under a government contract can be governed through contract clauses. These could also, when appropriate, be subjected to the same type of governance as a public law entity under direct government control.
- Any entity that receives a state subsidy or grant can be governed by making these subsidies or grants, wholly or in part, conditional on adherence to an appropriate set of bargaining parameters. These could therefore also be subjected to the same type of governance as a public law entity under direct government control.
- The government could, when appropriate, propose laws and other generally applicable statutes that would establish coherent remuneration conditions in all public and private law entities.

The relations between the central government and directly elected bodies at sub-government level may be especially sensitive, and not amenable to direct government instructions. In such cases, the government might have to rely – at least in the first instance – to consultations aimed at achieving a convergence of remuneration policies and bargaining positions.

1. Basic characteristics of the public administrations

1.1. Australia

1.1.1. General information

Australia² has a population of 20 264 082 (July 2006 est.) and a land area of 7.6 million square kilometres. It is a federation with six states and two territories, and a member of the Commonwealth. The data used for this study refers to the federal government, unless otherwise stated.

In the Australian Constitution, specific areas of legislative power are given to the federal government, including taxation, defence, foreign affairs, postal and telecommunications services. The federal level provides services including those related to industry (including agriculture and tourism), trade, environment, employment, families, and indigenous affairs. The federal level also co-ordinates and supports some activities at the state level. The Australian Public Service is organised in departments of state and a number of independently managed agencies.³

The states have legislative power over all other matters that occur within their borders, including police,⁴ hospitals, education and public transport.

Although local government has been in existence for more than 160 years, it is not recognised in the Australian Constitution. Responsibility for local government lies with the State and Territory governments. Consequently, the roles and responsibilities of local government differ from state to state.

1.1.2. The institutional arrangements

The **Department of Finance and Administration** supports the federal government in the preparation and ongoing management of the federal budget. It also develops and maintains the financial regulatory framework for the government sector, focusing on effective financial governance, financial management and accountability. It facilitates efficient government operations, in particular in relation to acquisition, management and divestment of government assets, supports ministers, senators and members of the Parliament and their staff, and promotes the effective and efficient use of information and communication technology by government entities.

The **Department of Employment and Workplace Relations (DEWR)** provides the Australian government with high quality advice, programmes and services to achieve efficient and effective labour market assistance, higher productivity and higher pay workplaces, and increased workforce participation. This department provides policy advice and guidance on workplace relations matters in the Australian government sector.

The **Australian Public Service Commission (APSC)** is a central agency within the Australian Public Service (APS) and provides leadership in improving the future capability and sustainability of the service. It promotes good practice in managing people, supporting leadership, learning and development in the APS, as well as fostering ethical behaviour and workplaces that value diversity. It also has an important evaluation role in working with agencies to ensure that the APS is performing effectively and consistently with the APS values.

The **Australian Fair Pay Commission (AFPC)** is a national body responsible for the setting and adjustment of wages and conditions contained in awards. In doing so, the AFPC protects workers in the bargaining process by protecting minimum wages and award classification wages in accordance

with the **Australian Fair Pay and Conditions Standard**, and thus protects workers in the bargaining process. The Australian Fair Pay and Conditions Standard sets out the minimum wages and conditions of employment that apply to employees under the *Federal Workplace Relations Act 1996*. In addition to the work of the AFPC, the **Australian Industrial Relations Commission (AIRC)** is a national tribunal dealing with employment issues including dispute settlement and unfair dismissal claims.

The **Office of the Employment Advocate (OEA)** provides support and information to both employers and employees on agreement making. Both individual and collective workplace agreements are lodged with the OEA who checks that they are made in accordance with workplace relations legislation, including the Fair Pay and Conditions Standard.

1.1.3. The human resource management arrangements

The last major reform of federal public sector human resource management took place in 1999 with the introduction of the Public Service Act 1999. The new Public Service Act retained the essentials of a professional, career public service and the focus on merit selection. It also introduced a concept called *values-based management*.

Responsibility for all human resource management has been delegated to the agency level. An agency head has all the rights, responsibilities and powers of an employer in respect of APS employees in the agency, including hiring and dismissal of employees. The Public Service Commissioner may issue general directions in writing to agency heads relating to the management and leadership of APS employees. Special federal laws deal with matters such as superannuation, worker's compensation, long-service leave and maternity leave.

Australia has a single level system for collective agreements. Under the Federal Workplace Relations Act 1996, there are six types of workplace agreements. Among these are *Australian workplace agreements (AWA)*, which are individual agreements, *Union collective agreements* and *Employee collective agreement*. An agency can use all three types of workplace agreements at the same time for different groups of employees. An estimated 70% of the agencies have union collective agreements, an additional 25% have employee collective agreements, and the remaining 5% of the agencies use only individual agreements. The share of government employees whose pay is set by collective agreements has increased from 86.6% in 2002 to 89.3% in 2004. The share whose pay is set through an individual arrangement has at the same time increased, from 7.4% in 2002 to 9.9% in 2004.⁵ The share whose pay is set through so called awards has decreased correspondingly.

The Australian government issued the present Workplace Relations Policy Parameters for Agreement Making in April 2006 to provide a framework for APS agencies in the agreement making process. Before a collective agreement can be approved and lodged with the OEA, DEWR assesses the collective agreement for consistency with the policy parameters. However, DEWR does not approve workplace agreements. It is up to the agency head and the relevant minister to decide whether or not to offer an agreement to employees. Under the policy parameters, agency workplace agreements are to be "simple and principles-based" instruments, and pay increases are to be linked to improvements in organisational productivity.

The APS has an employee classification system for employment which includes six non-executive levels and two executive levels. Beyond this, there are three senior executive service classifications. The pay scale for these classifications, however, is a matter for each agency to determine according to its own needs. Agencies are encouraged to incorporate performance-related pay elements in their pay systems. The annual remuneration survey undertaken by DEWR provides a report on salary variations and medians across the APS. There are also informal networks that assist

agencies in benchmarking with other agencies. Agencies can also procure additional support from private consultants.

1.1.4. The financial management arrangements

Australia practices bottom-up budgeting. Preparation of the budget begins in November each year with initial budget proposals identified by sector ministers. Following a review of these by a small group of senior ministers (including the Prime Minister), detailed proposals are brought forward in March to a committee of the Cabinet, for possible inclusion in the budget. Agreement by the government to the final details of the budget follows, with the budget papers tabled in the Parliament in May.

Australian government agencies are given a single budgetary allocation for administrative expenditure including pay. The standard model for calculating these is to adjust the budget by an index that measures the general price increases and pay increases in the wider labour market. Currently a standardised efficiency dividend of 1.25% is deducted each year for most agencies.

The only economic restriction on an agency's pay setting is that it has to be able to finance pay increases within its own budget. Agency pay increases should be linked to improvements in the productivity of the agency and financed from within the agency's own budget, and agencies have to take account of market pay for different skills. An agency that has difficulties in meeting its expenses within its total budget may seek a review of its financial health to be undertaken in conjunction with the Department of Finance. This may result in efficiencies being identified or in an adjustment to the agency's funding in the next year's budget.

1.2. Denmark

1.2.1. General information

Denmark has a population of 5 450 661 (July 2006 est.) and a land area of 42 300 square kilometres (excluding the Faroe Islands and Greenland). It is a unitary state and a member of the European Union. The data used for this study refers to the national government administration, unless otherwise stated.

The central administration is divided into a number of ministries that consist of a department and one or more separately managed agencies⁶ (*styrelser*). Each department is headed by a minister and a permanent secretary (civil service), and the agencies by director-generals (civil service).

The local state administration consists of local offices for state-wide agencies that provide services, such as the police, the prison service and the working environment authorities, and of other types of institutions or bodies such as universities, regional archives, and the lifeboat service.

The Danish state is characterised by a high degree of decentralisation. The municipalities (*kommune*) and counties (*amt*) are the primary implementing agencies of the state, and are responsible for the vast majority of social services, primary and secondary education and health services. They are partly financed by local taxes and partly by a national block grant. As a result of an extensive local government reform enacted in 2005, 275 municipalities were to be merged to 99 by 1 January 2007, and the 14 counties reorganised into five regions.

There are a large number of semi public/semi-private institutions that carry out the same or similar functions as the state and municipal administrations; such as self-governing institutions within the social and education sectors, private nurseries and schools, vocational colleges, incinerator plants used by more than one local authority, and state-owned companies.

1.2.2. *The institutional arrangements*

The **Ministry of Finance** is responsible for public governance, regulatory management, organisation and leadership of the public administration. The ministry is also responsible for the preparations for the annual negotiations between the government and the local governments, and for monitoring the outcome of the agreements.

The ministry's **Administrative Policy Centre** (*Administrationspolitisk center*) coordinates the administrative and governance policy tasks of the ministry. Its key goals are good governance and an efficient public administration. It also supports the **Forum for Public Management** (*Forum for Offentlig Topledelse*), bringing together both state, regional and local government managers in support of the government's modernisation programme.

The **State Employer's Authority** (*Personalestyrelsen*) is a separately managed agency within the Ministry of Finance. It administers the state's general responsibilities as an employer in the area of wages, pensions, personnel and management policy. It enters into central collective agreements and other agreements with trade unions representing the employees in the state sector, and provides guidance and assistance to ministries and agencies. The authority has separate divisions for collective agreements and wage policy, for legal issues and retirement systems, and for personnel and management policy.

The **Agency for Governmental Management** (*Økonomistyrelsen*) is a separately managed agency within the Ministry of Finance. It promotes sound financial control and efficiency in the public sector.

1.2.3. *The human resource management arrangements*

Denmark has a traditional Nordic industrial relations model with a two level system for collective agreements. Labour legislation and other statutory regulations only play a secondary role on the labour market. Employment conditions are primarily regulated by national collective agreements and normally complemented and/or amended by local collective agreements. The central agreements provide a framework for pay setting, and individual wages are set through local agreements.

Thirty-five percent of state employees are civil servants or are employed on civil service-like conditions. They are not allowed to take industrial action, but have better retirement and redundancy conditions than those employed on normal labour market contracts. Their pay is determined by a formal grading and salary system, and by a central collective agreement setting the pay at each grade and salary step. Their share of total central government employment is gradually being reduced, and the government's goal is that only uniformed personnel and civil servants at the highest levels should have civil service status.

The Danish system for pay setting in the state administration is more centralised than in the other Nordic countries. In the 1970s the right of each ministry to negotiate pay and working conditions within its sector was transferred to the Ministry of Finance, which has subsequently acted as the employers' organisation for the separate ministries and institutions. In the 1980s and 1990s, changes in

the structure and content of the collective agreements re-introduced local negotiations on pay and working conditions. These have however to be exercised within a centrally adopted framework.⁷

The bargaining parameters used by the State Employer's Authority in negotiating the central collective agreement are determined in a process which involves both the political level and the budget office in the Ministry of Finance. The minister is the formal head of the central negotiations about wage increases and other major issues. Negotiations about agreements on other specific issues are delegated by the Minister to the State Employer's Authority. In practice, the State Employer's Authority negotiates all central agreements, but both the Minister and the Permanent Secretary are continuously informed of the process.

The main collective agreement contains a link to the wage developments in the private sector. Eighty percent of the previous year's difference between the pay increases in the private and in the state sector is added to or subtracted from the already agreed pay increases. During the last year, pay developments in the private sector were very restrained, and the agreed pay increases in the government sector were therefore reduced.

More than 60% of state employees are now in a new pay system that entails a transition from a seniority-based pay system to locally designed business-oriented pay systems. In the new systems, aggregate pay for an individual can consist of:

- a basic wage;
- a functions allowance (*e.g.* special areas of work, or responsibility);
- a qualifications allowance (*e.g.* education, further training or experience); and
- a component based on results or performance (*i.e.* efficiency), paid either on an individual or a group basis.

The central collective agreements contain general pay increases for all government employees. Departments and agencies are able to agree to additional pay increases for their employees, if they can afford them within their own budget. Seven percent of the total payroll for employees on new pay systems is local allowances. Local pay increases for other employees than senior managers have to be agreed with a local trade union representative.

The wages for senior managers are set at the central level. In addition, the State Employer's Authority gives each ministry authority to use a certain amount for personal allowances for senior managers. It is also possible to give a one-off-payment or a performance-related component which is not restricted by that allocated total.

The State Employer's Authority is expected to monitor the use and outcome of the delegated pay setting, and have issued reports on indicators that might be used to spot any unintended use of the new pay system.

The State Employer's Authority provides advice on pay setting to departments and agencies. It also places a number of statistical tools at the disposal of departments and agencies, such as a database on collective agreements, and an internet-based database on pay and employment conditions (*ISOLA*) that can be used to analyse pay developments in an organisation, a ministerial sector or the entire government administration.

1.2.4. The financial management arrangements

Denmark practices top-down budgeting. Multi-year budget estimates are presented in each budget. The Ministry of Finance proposes overall budget targets, and these are broken down into ceilings for consumption and income transfers for each ministry. Sector ministries submit draft budget proposals for their sector for negotiations in the government.

After the fiscal year has begun, changes to the appropriations in the budget can only be implemented through decisions in the Parliament Finance Committee. All applications must be approved by the Ministry of Finance before they can be sent to the Committee.

Departments and agencies normally receive last year's allocation minus a productivity deduction of 2% and an increase based on an estimate of outcome of the central level wage negotiations. Allocations are increased through a supplementary budget if the central agreement becomes more expensive than expected. Pay developments in the private sector only affect the allocations through the central collective agreement. There is thus no reference model.

About half of the departments and agencies have a special expenditure limit for wages. Among those are the ministerial departments and the more traditional administrative agencies, while more business-like agencies are given more freedom. The latter group of agencies can thus use additional income or savings on other expenditure to increase staffing and/or wages. They can also carry forward surpluses and deficits to the next budget year.

1.3. Finland

1.3.1. General information

Finland has a population of 5 231 372 (July 2006 est.) and a land area of 304 000 square kilometres. It is a unitary state and a member of the European Union. One province (the Åland Islands) has a constitutionally guaranteed self-government. Finland is bilingual (Finnish and Swedish), with Finnish as the dominating language.⁸ The data used for this study refers to the national government administration, unless otherwise stated.

The central administration is composed of 13 ministries, which may include departments with executive functions, and independently managed agencies (*ämbetsverk*). The division of responsibilities between the ministers is agreed each time a new government is formed.

Employment and Economic Development Centres promote business, industry and regional development. Regional Environment Centres deal with issues related to environmental protection and land use planning. State Provincial Offices act as general administration, supervisory and security authorities at regional level. In addition, a large number of district authorities operate in different administrative branches.

Finland has a long tradition of municipal self-government, and the municipalities play a central role in society through organising most of the welfare services. At present there are 432 municipalities in Finland. Joint municipal authorities organise high-cost services, in particular, and regional councils are responsible for regional development and land use planning. The government has recently initiated a structural reform programme after an agreement with the Association of Finnish Local and Regional Authorities. The aim is to merge municipalities to create larger and more capable municipalities, and to create Service Districts for care for sick, elderly and children.

1.3.2. *The institutional arrangements*

The **Ministry of Finance** prepares economic and fiscal policy. It is also responsible for the state employer's and human resources policy, and for the overall development of the public administration. Its main goal is to care for the national finances in a manner conducive to the best possible development of the Finnish economy. In the present government, a second minister in the ministry is responsible for the public administration and the personnel policy. The highest civil servant in the ministry is the Permanent Secretary of State, assisted by two Permanent Under-Secretaries of State with responsibility for economic affairs and for public administration and state employer policy.

The ministry's **Public Management Department** (*Avdelningen för utvecklandet av förvaltningen*) is responsible for management policy in central government and serves as the government's expert on administrative development. It supports inter-agency administrative reform work and promotes measures to improve service provision and quality throughout central government.

The ministry's **Personnel Department** (*Personalavdelningen*) is responsible for employer and personnel policy in central government and is at the same time an agency; the **Office for the Government as Employer** (*Statens arbetsmarknadsverk*), which conducts the collective bargaining at central level, promotes the competitiveness of the central government as an employer and supports government agencies in their role as employers.

The office's **Unit for Collective Agreements** (*Förhandlingsenheten*) acts as the employer representative on behalf of central government in collective bargaining at national level and protects the interests of the state employer in incomes policy and labour policy, and in policy decisions relating to working life. It also supports government agencies in their role as employers. The **Unit for Personnel Policy** (*Enheten för personalpolitik*) drafts legislation on civil servants, pensions and other terms of employment in central government. The **Unit for Research** (*Utredningsenheten*) is responsible for the state employers' pay statistics, human resource information and data systems at the central level. It also supports government agencies by producing comparative information for them.

The **State Treasury** (*Statskontoret*) is an agency responsible for advice on good management, production of corporate economic information, asset and debt management, and insurances.

The **Ministry of the Interior** is responsible for the regional administration, state local administration, population registers, police services and border guards. A second minister in the ministry is responsible for regional and local development, including the basic legal and financial preconditions for the self-governing municipalities.

1.3.3. *The human resource management arrangements*

Finland has a traditional Nordic industrial relations model with a two level system for collective agreements. Employment conditions are regulated by national collective agreements and complemented and/or amended by local agreements. The central agreements provide a framework for wage setting, and individual wages are set through agreements with trade union locals.

A comprehensive tripartite⁹ income policy agreement was signed in December 2005, covering the period until the end of September 2007. The agreement covers about 90% of Finnish employees and has a strong influence on the developments in the remaining areas. The agreement includes wage increases and tax reductions, and ensures that employees will get an annual increase of purchasing power of 1.5-2%. The agreement also includes other improvements for the employees.

The legal status of state civil servants (83% of the central government employees) is laid down in the State Civil Servants Act, while the legal status of personnel in a contractual employment relationship is covered by the general Employment Contracts Act. The Act on Collective Agreements for State Civil Servants covers collective agreements on terms and conditions of service for civil servants, while the general Collective Agreements Act does the same for personnel on an ordinary employment contract.

The present collective agreement covers both state civil servants and employees under contract at national level, and is based on the Comprehensive Income Policy Agreement. At local level there is also a possibility to negotiate separate collective agreements for state civil servants and employees under contract. However, the agency specific collective agreements on agencies' salary systems are typically single agreements.

A major reform of the pay system was implemented through the previously mentioned local agreements and is now almost complete. The coverage of the new pay systems will be 100% at the end of 2006. These agency specific systems are drawn up according to general principles contained in the central agreement. The salary is made up of a basic salary based on the demands of the job, plus a personal component based on personal performance and competence. The demands of the job and performance will be reviewed annually in individual discussions on performance and professional development. In some cases, the new systems also take account of experience through a component based on years of service or specific working conditions. The present central agreement contains a general pay increase for all employees and a pool for additional increases allocated through local agreements.¹⁰ The agreement also contains a special pool for allocation to female employees with low incomes.¹¹

The central collective agreement has to be approved by the responsible minister. Normally, there is no political involvement in the actual pay bargaining, although it has happened once (during 25 years) that an activist minister has interfered in the bargaining process. A recent conflict involving the border guards also came close to becoming a political issue.

The Office for the Government as Employer compiles and publishes statistics on central government personnel and its structure and conditions of employment. Regular surveys are conducted on labour costs, staff conditions and turnover, changes in salaries and progress in reforms of salary systems, and also on the competitiveness of central government as an employer. This statistical information is used to support collective bargaining and personnel policy decision-making at both central and local level.

1.3.4. The financial management arrangements

Finland practices top-down budgeting. At the beginning of the electoral period, the government takes a decision on the ceiling for expenditures over the entire electoral period. The allocation of expenditures by administrative branches is revised each year. The overall spending limits set by the government provide a framework for the ministries in preparing their proposals for the next budget.

Based on these spending limits and on directives issued by the Ministry of Finance, the ministries issue their own directions to agencies and departments in their sector. The ministries can propose changes to their spending limits. The proposed changes are then considered by the government when it decides on its final budget proposal for approval by the President and submission to the Parliament.

Supplementary budget proposals can be presented to Parliament during the fiscal year. In general, the same procedures are applied in formulating supplementary budget proposals as in formulating the budget.

Local authorities are guaranteed extensive autonomy under the Constitutional Act, the main provisions of which include the power to levy taxes and the right to decide on how to manage their own funds. Local authorities decide on the local income tax rate independently and on the property tax rate within a margin set by the government. In addition, they receive a share of corporate tax revenue, the amount of which is decided by the government. Economic differences between municipalities are levelled out by means of a system of central government transfers.

The income policy agreement is an important factor in calculating the economic envelope available to agencies and other local pay setters during the period covered by the agreement. There is no known reference model for taking account of pay developments in other sectors during periods with no valid income policy agreement. The Budget Department is not actively involved in pay determination, since that might undermine their key task of containing costs. An economic accommodation of a need for higher than average pay increases would thus have to be initiated by the ministry concerned.

1.4. The Netherlands

1.4.1. General information

The Netherlands has a population of 16 491 461 (July 2006 est.) and a land area of 41 500 square kilometres. It is a unitary state and a member of the European Union. The data used for this study refers to the national government administration, unless otherwise stated.

The central administration is organised into 14 ministries, and all but one¹² are headed by a minister. Until recently, departments were the sole element of central government and they consequently were in charge of policy development as well as implementation. Since 1994, an increasing number of agencies (*agentschappen*) have been carved out of core ministries, increasingly dividing the policy formulating function and the policy execution function. The total number of agencies is now 27, but it is expected that about 25 more agencies will be established in the near future.

An agency is a separately managed part of a ministry, with its own budget and financial administration. However, ultimately the minister is in charge, having ministerial responsibility for the agency. In addition there are a number of independent administrative bodies (*zelfstandige bestuursorganen*), which are organisations executing government tasks, but not covered by ministerial responsibility.

There are 12 provinces (*Provincie*), 458 municipalities (*Gemeente*) and 27 district Water Boards (*Waterschap*). The latter are public bodies charged with water management in a region. Their area of its responsibility does not coincide with provincial or municipal borders, but with the basins of the rivers in an area.

There are a large number of service-providers with a semi public/semi-private character that are financed by the state or from social security premiums. These service providers work for the public interest, but are not considered to be public activities. This cluster of organisations is known as the “contributed and subsidised” sector (*Gepremieerde en Gesubsidieerde, G&G*) and includes a large scale of bodies, ranging from public health entities to orchestras.

1.4.2. *The institutional arrangements*

The **Ministry of Finance**'s three main policy areas are budgetary policy, financial and economic policy and taxation policy. In general terms, budgetary policy concerns government income and expenditure; financial and economic policy involves the financial markets and the financial position of the government, the corporate sector and the population, and taxation policy is about everything involving taxes. When the Council of Ministers has agreed on the expected level of incomes and expenditures, the Minister of Finance draws up the national budget in consultations with colleagues.

The **Ministry of the Interior and Kingdom Relations** (*Ministerie van Binnenlandse Zaken en Koninkrijksrelaties, MBZK*) (hereafter referred to as the Ministry of the Interior) has the core responsibility for the public administration and a coordinating role in establishing the terms of labour and conditions in the public sector. The ministry is responsible for the government's policy concerning civil servants, and for the job classification system, the systems for pensions and social security, and the general conditions of employment. Furthermore, the ministry is responsible for promoting a representative public service in regard to gender, ethnic minorities and disabled citizens.

1.4.3. *The human resource management arrangements*

The Netherlands does not use formal collective agreements in the state sector. Instead, negotiations result in joint conclusions¹³ which are implemented through government decisions. The importance of these conclusions is strengthened by a government ordinance requiring trade union agreement to any changes in pay and employment conditions.

The negotiations take place on a single level, with some issues being negotiated by the Ministry of the Interior for the whole of the government, while others including pay are negotiated at sector level. There are currently thirteen pay bargaining sectors.¹⁴

This model (*Sectorenmodel*) was introduced in 1993. Central negotiations take place in the Council for Public Sector Labour Relations (*Raad voor het Overheids Peroneelsbeleid*); a body with both a consultative and advisory function to Cabinet, Parliament and the individual sectors. At sub-central government level¹⁵, the social partners meet in sector committees. The responsible minister represents the employer in the so called cabinet sectors, while the Provincial Employers League (*Interprovinciale Werkgeversoverleg*), the Union of Municipalities (*Vereniging van Nederlandse Gemeenten*) and the Union of District Water Boards (*Unie van Waterschappen*) act as collective employers at the sub-central government level.

The education sector is subdivided into several branches, where subsector employer bodies negotiate with the trade unions. Primary and secondary education will likely also gain status as independent sectors, thus bringing the number of pay bargaining sectors to 15. Until then, the Minister of Education acts as the employer for these domains.

Initially, nearly all terms and conditions of employment were negotiated at the central level with the Minister of the Interior in a coordinating role, only leaving minor issues to be decided at sector level. However, the centre of gravity has shifted to the sector level, leaving the pension issues to be the last issue to be dealt with at central level. There are, however, discussions about also shifting pension issues to the sector level.

The Minister of the Interior issues bargaining parameters (*Speerpuntenbrief*) after agreement in the Cabinet. It contains norms to be observed in the negotiations with unions, covering a range of issues where the government wants agreements, from pay and pensions to disability benefits and

childcare facilities. It also contains ceilings for the budget allocations to each sector. Its contents are binding for the employers in the cabinet sector, but only indicative for the employers in other sectors and at the subsector level. The negotiations normally take place during the following spring.

1.4.4. *The financial management arrangements*

The Netherlands practices top-down budgeting. When a government is formed,¹⁶ a total financial framework for expenditures is issued in the form of a Governmental Agreement (*Regeerakkoord*). This is intended to govern the government's financial policy till the next election.

In January each year, the Ministry of Finance updates multi-year expenditure projections, and in March the spending ministries submit Policy Letters outlining, *inter alia*, new expenditure proposals. On basis of this, and taking into account the recent economic outlook and other macro-economic parameters, in April, the Minister of Finance sends Letters of Totals (*Kaderbrief*) to spending ministries stating their maximum level of spending for the coming year. The budget is presented to Parliament in September, after internal negotiations between the Minister of Finance and colleagues.

Simultaneously, the Minister of the Interior calculates and decides on a pay index that determines the economic envelope for pay setting. The pay index is based on a reference model (*Referentiemodel*) that takes account of pay developments in the private sector as well as of developments of the social contributions paid by employers. However, the government can decide to amend the index through a unilateral policy decision. During the spring, the Minister of Interior issues the pay envelop letter (*Ruimtebrief*) to cabinet sectors and their subsectors about the calculated levels of pay related expenses concerning the current year. If the pay increases agreed to by an employer is higher than the pay index, then that employer has to finance this by reductions in other parts of its budget.

1.5. *New Zealand*

1.5.1. *General information*

New Zealand has a population of 4 076 140 (July 2006 est.) and a land area of 270 000 square kilometres. It is a unitary state and a member of the Commonwealth, with a constitution similar to that of the United Kingdom. New Zealand is bilingual (English and Maori). The data used for this study refers to the national government administration, unless otherwise stated.

The *public sector* is composed of the *state sector* and the local governments. The state sector (also referred to as the wider state sector) is the common term for the organisations whose financial situation and performance is reported in the annual financial statements of the government. The state sector includes the *State Services*, some departments that are not part of the State Services, tertiary education institutions, Offices of Parliament, and state-owned enterprises. The State Services consists of *Public Service Departments* and *Non-Public Service Departments*, all *Crown Entities* (except tertiary education institutions), and a variety of organisations and the Reserve Bank of New Zealand. Most State Service employees are employed in crown entities, predominantly in the health and education sector.

The local governments are autonomous. They comprise 12 regional councils, 15 city councils and 57 district councils. The regional councils are responsible for the management of water, air and land use, river management and flood control, harbour navigation and safety, biosecurity control, marine pollution and oil spills, regional land transport planning and contracting of passenger services. The district and city councils are responsible for community well-being and development including land

use planning and development control, environmental health and safety including building control, civil defence, infrastructure (roads and transport, sewerage, water/storm water), recreation and culture.

1.5.2. The institutional arrangements

The **Treasury** supports and advises the government on economic and financial policy, including fiscal policy and budget management and financial statements. It is one of three central agencies responsible for providing leadership, coordination and monitoring across the entire public sector. The second is the **Department of the Prime Minister and Cabinet** which advises and supports the Executive (the Governor-General, the Prime Minister and the Cabinet). In addition, the department assists in co-ordinating the work of the core public service departments and ministries.

The third is **State Services Commission** (SSC). The Office of State Services Commissioner is central to New Zealand's politically neutral, professional and permanent public service. The Commissioner is both Chief Executive of the State Services Commission and the holder of a statutory office. In the latter capacity, the Commissioner acts independently in a range of matters to do with the operation of the public service, the State Services and the wider state sector.

Among the Commissioner's responsibilities are: to promote and develop policies and standards for personnel administration and equal employment opportunities for the public service; to promote and develop senior leadership and management capability for the public service; to provide advice on management systems, structures and organisations in the public service and Crown entities; to set minimum standards of integrity and conduct that are to apply in the public service, most Crown entities and some other agencies; and to advise the government on the structure of the state sector, including the allocation of functions between agencies.

One significant aspect of the institutional arrangements in New Zealand is their flexibility. There is a great variation in arrangements across the state sector, and there are a number of design and operational choices within the New Zealand public management model that governments can and do vary over time. For example, the State Services Commission has significant discretion as to how to exercise its authority in practice, and the Commission plays a less active role in state sector pay-fixing now than it did 20 years ago.

This overall shift is consistent with the public management principle of accountability being aligned to the locus of responsibility. In the public service, for example, this principle is manifested through a statutory instrument of delegation and bargaining parameters.¹⁷ The use of such delegations and bargaining parameters is a policy choice that can be changed if necessary. Furthermore, the conditions applying to the delegations, and the application and content of the bargaining parameters themselves involve design choices. These matters are currently under review by government. The likely outcome is that ministers will expect the State Services Commission to take a more proactive role, both within the public service, and the broader state sector in future, consistent with chief executive accountability for substantive bargaining.

1.5.3. The human resource management arrangements

Responsibility for human resource management is exercised at the agency level. Generally speaking, the chief executives of state entities have all the rights, responsibilities, and powers of an employer, including hiring and dismissal of employees.¹⁸

New Zealand has a single level system for collective agreements. The pay of state employees is regulated in *individual contracts* or *collective agreements*. Collective bargaining is considered as an important part of building productive employment relationships, but the proportion of New Zealand labour covered by collective agreements in the public sector has fallen to 49%.

New Zealand has, as noted above, a more detailed classification of public entities than most countries, and the degrees of freedom in operational matters and pay arrangements varies substantially. Another factor worth noting is that the collective agreements do not have to cover the actual pay setting; that is sometimes done through a less formal consultative process for workers covered by the collective agreements.

In 2000, the government signed a “Partnership for Quality” agreement with the largest public service union (the Public Service Association, PSA). This agreement focuses on establishing co-operative and open relationships, and was updated in 2003. The focus of the new agreement is to broaden the implementation of the principles of the agreement across a greater number of departments and agencies, and to deepen the impact of the agreement.

As noted above, the State Service Commission issues bargaining parameters that reflect the government’s policies and expectations for collective bargaining and employment relations. They also aim at encouraging co-ordination and fostering a whole-of-government approach to employment relations and conditions. Formally, the bargaining parameters only apply to collective bargaining in the public service. However, to the degree that the parameters set out general government policies and expectations on employment issues, public service departments are also expected to apply them in all other setting of terms and employment conditions. Crown entities are also expected to have regard to the parameters.

The State Services Commissioner has the statutory authority to negotiate and enter into collective agreements in the public service (even though the respective Chief Executive remains the employer). The Commissioner can, and has, delegated the power to negotiate collective agreements to each Chief Executive, on the condition that they consult the State Services Commission about their bargaining and comply with the government’s bargaining parameters.

Agencies in the wider state sector do not have to consult the State Services Commission on collective bargaining, unless they are specifically instructed to do so. The Commission, however, is able to provide advice and support to those agencies, based on these parameters.

1.5.4. The financial management arrangements

The New Zealand budget process is still evolving, and significant elements of top-down processes have been introduced through the use of early Budget Policy Statements and teams of ministers allocating resources within broad cross-sector allocations. Governments are required by statute to publish their long-term fiscal objectives each year. The annual budget process operates within overall limits on expenditure, to ensure that those fiscal objectives are achieved. The strategy phase of the budget sets the overall funding level, the broad spending priorities, and funding allocations for priority areas. The overall limits and broad priorities are signalled to the public through the legislatively required Budget Policy Statement.

The initiatives phase of the budget sees ministers submitting bottom-up proposals for new spending, which are then prioritised within the funding set aside for priority areas before being approved by Cabinet. Senior ministers also meet to consider priorities, before the government decides on its budget package.

Those New Zealand state sector agencies that are subject to government budget controls are given budget allocations for various categories of services that they provide, and are expected to manage all input costs, including remuneration, within those allocations. There are no automatic adjustments of budgets for most pay-setting entities. The normal baseline is last year's budget plus adjustments for structural changes. Pay setting entities are expected to search for ways of reducing costs and improving productivity in order to be able to finance pay increases. If they consider that they need a higher budget allocation, they have to submit their business cases and argue for them.

There is no set model for taking developments in the private sector into account, though nothing prevents chief executives from doing so. The ability of pay setting entities to argue that their labour market situation and recruitment and retention or capability challenges are distinctive can play a role in the budget process.

All state sector entities can run operating deficits, but departments require explicit government authorisation to do so and many crown entities require approval to borrow, which imposes a degree of discipline on spending decisions that create deficits. At the moment there are a small number of agencies that have overspent, and a number that have problems avoiding it.

1.6. The United Kingdom

1.6.1. General information

The United Kingdom has a population of 60 609 153 (July 2006 est.) and a land area of 245 000 square kilometres. It is a political union made up of four constituent countries (England, Scotland, Wales and Northern Ireland), and a member of the Commonwealth and of the European Union. The data used for this study refers to the national government administration, unless otherwise stated.

The public sector is comprised of the *central government*, *local governments* and *public corporations*. The central government includes government departments and their agencies; the devolved administrations in Scotland, Wales and (when reinstated) Northern Ireland; non-departmental public bodies; and any other non-market bodies controlled and mainly financed by the central government. Local government include all types of public administration which only cover a specific locality, and any non-market bodies controlled and mainly financed by them. Public corporations are market bodies controlled by either the central government or a local government and include government-owned companies and trading funds.

Whether or not a body is in the public sector is determined by the degree of control. A body will be in the public sector, if the central government or a local government exercises wide-ranging control over its general corporate policy and day-to-day operations.

During the last decades the United Kingdom has undergone a series of public management reforms aimed at improving the performance of central government. Among these are the creation of agencies, headed by a Chief Executive, with clear responsibilities and lines of reporting. A distinction was made between core activities, undertaken by the policy making departments, and the execution of these policies by agencies.

1.6.2. The institutional arrangements

The **Cabinet Office** is the centre of government and the "head office" of government (together with the Treasury). Its overarching purpose is making government work better. The department has three core functions which enable it to achieve this overarching purpose:

- supporting the Prime Minister – to define and deliver the government’s objectives;
- supporting the Cabinet – to drive the coherence, quality and delivery of policy and operations across departments; and
- strengthening the civil service – to ensure the civil service is organised effectively and has the capability in terms of skills, values and leadership to deliver the government’s objectives.

The Cabinet Office is also responsible for the overall human resource management within the civil service. The Civil Service Commissioner ensures that the civil service remains effective and impartial by setting standards of recruitment and hearing appeals under the Civil Service Code.

The Treasury is the United Kingdom’s economics and finance ministry, and is led by **the Chancellor of the Exchequer**. It is responsible for formulating and implementing the government’s financial and economic policy. Its stated aim is to raise the rate of sustainable growth, and achieve rising prosperity and a better quality of life with economic and employment opportunities for all. The Treasury’s Spending Reviews set firm and fixed three-year departmental expenditure limits and their Public Service Agreements with the departments set the targets that each department intends to achieve. Through the Remit Process, the Treasury seeks to ensure that levels of, and pay increases across the whole of the public sector do not cause inflationary pressures and are consistent with the wider fiscal environment.

The main task of the recently established internal **Public Sector Pay Committee** is to oversee all significant public sector pay rises, to establish a set of common objectives for pay across government, and to ensure that both pay awards and pay systems across the public sector are evidence-based, represent value for money and are financially sustainable in the long run. It will also assess the departments’ pay and workforce strategies. The Committee is chaired by the Cabinet Office and with permanent Treasury membership.

Eight independent **Pay Review Bodies** advise the Prime Minister and a variety of Secretaries of State, on matters referred to them, primarily making annual recommendations about pay levels for the 1.8 million public employees within their respective area of responsibility.¹⁹ The **Office of Manpower Economics** provides support for the Pay Review Bodies.

1.6.3. The human resources management arrangements

The United Kingdom uses a single level system for collective agreements. Pay for certain groups of civil servants is however set by government decisions after proposals from independent pay review bodies.

Government employees in the United Kingdom can be either civil servants or other staff, and either employed on normal civil service terms or similar terms, or employed under contract law. About 550 000 of the 2.6 million central government employees are civil servants.

The public management reforms during the last decades have been paralleled by a reform of the pay bargaining process for civil service employees. The old structure of a small number of highly centralised agreements was dismantled. In its place a delegated system of department and agency wage setting was introduced, in which each pay setting entity was empowered to set its own rates of pay and establish its own grading structure. All departments with executive agencies (except the Department for Work and Pensions, DWP) have sub-delegated authority for terms and conditions to them. All

departments have designed pay systems to suit their business needs, although there are similarities in the grade and pay band structures used that stem from the old pay system.

In 2000, the Cabinet Office, the cross-sector civil service unions and the Council of Civil Service Unions (CCSU) signed a National Partnership Agreement aimed at promoting a positive and effective relationship between departments, agencies and their trade union representatives. Through this agreement, the Cabinet Office accepted the unions as the legitimate representatives of the employees, and recognised that effective representation must be achieved by genuine joint involvement and participation. The unions, in their turn, accepted that the Cabinet Office must work within the overall framework and policies set by the government.

The Cabinet Office has overall responsibility for managing the government's policies on pay and performance management for civil servants. The Treasury, working with the Cabinet Office, operates a pay remit system to ensure bargaining units operate within affordable and consistent parameters, and that pay systems are modernised (*e.g.* to support improved delivery and promote equality and fairness).

The pay remit process covers the pay setting arrangements for most of the civil service and for public sector workers in non-departmental public bodies. Each bargaining unit has to secure annual approval for their pay bids from the Treasury. As part of this process, the Treasury sets out a framework that serves as bargaining parameters, and includes affordability reference points, as well as approval criteria for pay remits. In general, departments will need to demonstrate that their pay remit is affordable and that it should not generate inflationary pressure. Departments are also requested to consider their pay, relative to others in the same relevant labour market segment.

The main agencies and non-departmental public bodies need to have the approval of their minister before submitting their pay remit to the Treasury. In addition, the new Public Service Pay Committee will have the power to scrutinise particularly contentious individual remits.

The Pay Review Bodies use available evidence and their own independent research to formulate recommendations on the remuneration of employees within their sector. Their recommendations are submitted to the Prime Minister and Secretaries of State early in each new year.

1.6.4. The financial management arrangements

The Budget Statement of the Chancellor (the Minister responsible for the Treasury) outlines the total amount of money that will be spent on all government activities (both mandatory and discretionary). The Chancellor also has the power of and responsibility for setting spending limits or fiscal restraints on the government. The budget is thus not the result of political negotiations between ministers.

The Treasury is legally bound to present two economic forecasts each year. The Chancellor presents a Pre-Budget Report in the autumn, with a progress report on what has been achieved so far and an update on the state of the economy and the government finances. The Budget Statement delivered in Parliament in spring contains all the revenue legislation for the year, along with a few spending plans that reflect government priorities. The Spending Reviews then allocate discretionary spending among government departments. Previously spending reviews were issued each year, but the present Chancellor introduced multi-year spending reviews when he took office.

The administrative budgets for most departments are set through the Spending Reviews. The pay remit process also enables the Treasury to ensure that pay awards are do not cause inflationary pressures, are affordable within the overall fiscal environment, and offer value for money.

2. Modernising public governance

There is a traditional way of organising and governing public administrations that first came into being in Western Europe in the 17th century during its transition from archaic governance systems to government systems better adapted to the growing importance of private commercial activities, and to the introduction of democratic parliamentary systems. Many political leaders in different countries contributed to the development of this system, but the name most often associated with it is the scientist Max Weber.²⁰ Its main components are that:

- the exercise of public authority should be based on law and exercised in a legally correct manner;
- citizens should be guaranteed equal treatment if the circumstances are equal, and without regard to social standing or political affiliation;
- a politically neutral and professional public administration should be able to serve any government equally well; and
- this is to be assured through statutory human resource management, presuming and supporting life-long careers in the public administration.

The term “New Public Management” was first coined as a label for a specific set of measures relating to the public administration introduced by the government of the United Kingdom. It quickly became a management paradigm for the modernisation of the public sector that has been used by many governments since the 1980s.

New Public Management is a broad and very complex term that *has been* used to describe a wave of public sector reforms throughout the world. It includes, *inter alia*, *public choice*, *principal-agent* and, drawing from business administration, *service management* theories. Its main hypothesis is that more market-like elements in public governance and more market orientation in the public administration will lead to greater cost-efficiency for governments, without having negative side effects on other objectives and considerations. Compared with the old Weberian form of public management, it represents a movement away from laws and statutes towards goals, and from due processes towards formal measures of results and efficiency improvements.

The new public management philosophy can be broken down into three separate policy sets. One of them is oriented at reducing the direct intervention of government in the economy through deregulation and downsizing. A second set is oriented at enhancing competition, through outsourcing and the introduction of consumer choice solutions. These are not relevant for this study.

The third set, however, entails a new form for governing and managing the public administrations. Its basic hypothesis is that an efficient production of public services had to be organised and managed in a different way than the traditional Weberian public administration. Its main tenets are that:

- the person that meets the customer should be enabled and empowered to respond to the customer’s needs and requests;

- the principle of identical service should be replaced by a principle of appropriate service, based on an assessment of the client's conditions;
- statutory regulations prescribing correct procedures should therefore be replaced by contract-based relations focussing on outcomes;
- input controls and other forms of ex-ante controls should as far as possible be replaced by accountability for results; and
- managers should be enabled to promote efficiency and effectiveness through an increased freedom to structure and manage their organisations.

Special case 1. New Zealand's diversified agencies

The Department of Child, Youth and Family Services was²¹ a government agency with legal powers to intervene to protect and help children who are being abused or neglected or who have problem behaviour. It provided residential and care services for children in need of care and protection and for young offenders, it assessed people who wish to adopt children and reported to the Family Court on adoption applications, and it funded community organisations working with children, young people and their families.

The department was the dominating employer of social workers in New Zealand. The combination of a strong professional corps and a high unionisation degree resulted in a traditional type of collective agreement with post-related pay with some performance-related pay elements, but basically standardised pay progression within each category.

The New Zealand Trade and Enterprise is a crown entity promoting national economic development and has a board predominantly appointed from the private sector. It offers a wide range of services and programmes applicable throughout the lifecycle of firms from start-ups to established groups of exporters. These include training programmes, market information, funding assistance, and facilitating networking and partnering opportunities for qualifying companies.

The agency has employees both in New Zealand and overseas. It primarily recruits from the private sector. The unionisation rate is low and it has no collective agreement. It uses remuneration bands for each post, and looks both at the market rates for similar skills and experiences and at the individual performance when it sets pay.

Over the last 100 years, public administrations have acquired a broader range of functions including various forms of physical and immaterial infrastructures, education and social services. A report to the Finnish government²² on the reorganisation of the central state administration pointed out this heterogeneity of the modern public administration, and argued that each of the different types of tasks had its own logic and rationality, and that the appropriate form of public governance and management depends on the tasks that are to be governed and managed.

The Finnish analysis is convincing. The old Weberian public management paradigm may still – as specialists in administrative law argue – be the most appropriate way of governing and managing the exercise of public authority, while the new public management is probably a better way of governing service production. This is a strong argument in favour of asymmetric models for pay setting, where the actual format is adapted to the character and business needs of each pay setting organisation.

3. Systemic issues

3.1. Pay

Labour costs are a dominating element in the cost structure of the public administrations, and pay levels are the dominant factor behind labour costs. Public administrations have to continuously search for more cost-efficient ways of organising and undertaking their activities and this must include measures that enable them to provide a higher output with the same number of employees, or an equal output with fewer employees. For the same reasons, public administrations should avoid paying more than the relevant market wage.²³

Pay is basically compensation for services provided, and thus an integral part of the contract between an employer and an employee. Seen in this perspective, the appropriate pay level corresponds to what is necessary in order to recruit and retain a sufficient number of employees with adequate skills and competencies. Employment in the civil service was however traditionally seen as a fiduciary relation, and not as a contract-based relation. Pay was therefore set as to provide an appropriate standard of living.²⁴ A recurring problem in public administration is, however, that pay for managerial staff has not kept up with the market wage.

The labour market consists of a number of submarkets for different skills and competencies in different locations. Both the level of the market pay and its evolution over time varies between these submarkets. Individual skill profiles have also become more important in submarkets characterised by competition for the available quality labour.

Relatively high pay increases in a specific submarket due to competition for scarce labour is normally a positive feature. As actual pay is adjusted to reflect the market conditions, the scarce labour resources will gradually be re-allocated to the jobs where they create the highest added value. Relatively high pay increases should also over time lead to an increased supply of labour in that submarket.

The public administration has traditionally been regarded as a separate submarket, and parts of it may still be. Sub-standard pay levels in these parts would not cause any immediate labour retention problems in these parts, but could lead to employee dissatisfaction and to difficulties in attracting new recruits to apply for positions in those submarkets.

Today, however, most parts of the public administration compete with private enterprises for skilled labour. The range of activities has become broader, a larger share of the workforce has contract-based employment, and affluence-driven value shifts makes labour more mobile. Sub-standard pay levels in these parts of the public administration would affect the recruitment and retention of labour. At the same time, however, skilled and attractive job seekers will not only look at pay but also at the attractiveness of the work itself and of the workplace. Internal competition for labour in these parts of the public administration would not add significantly to the already existing competition pressure.

These parts of the public administrations are also facing other challenges. One of the recurrent phenomena in the public administrations in OECD member countries is relatively high pay for new entrants on the labour market, but slower pay developments and therefore sub-standard pay levels for more experienced and skilled labour. The increased differentiation of pay increases necessary to rectify such imbalances strains labour relations.

Another challenge is that the average pay levels in the public administrations in some OECD member countries are increasing at a slower rate than the average pay level in their private sectors. One reason can be a need to reduce a budget deficit. Pay for public employees is a substantial part of the public expenses, and restrained pay increases may seem more effective and less harmful than more fundamental reductions of the public commitments. Another reason can be that rising non-discretionary expenditure may limit the scope for discretionary expenditure, including pay increases for public employees. Yet another contributing factor may be that the different rates of average productivity increases in the private and the public sector implies a larger potential for pay increases in the private sector than in the public sector.

There are also two recurring concerns that may call for a geographical differentiation of pay. Most of the workplaces in the central government administration are located in the capital or in the larger cities where the cost of living – especially for housing – is higher than in other parts of the country. At the same time, however, government agencies that provide services in remote areas may have to resort to special allowances or higher pay in order to attract and retain skilled workers.

Pay is an important management tool, and the strongest motive for decentralised pay setting is that public managers need to have access to and a willingness to use this tool, if they are to be able to pursue performance and result-based goals. Relative differences in pay and pay adjustments can be used to signal expectations and to reward good behaviour and good performances – or to punish bad behaviour. Pay increases that are consistently higher than inflation strengthen the ties between the employer and the employees and promote retention, while pay increases that are consistently lower than inflation increase employees' incentives to find another employment.

A key element in understanding how an employer – private or public – handles pay setting is *transaction costs*. Individual decisions for many employees would be very resource demanding, and rational employers will seek to standardise pay setting, unless there are specific and visible gains from differentiation.²⁵

The normal form of standardised pay setting in a public administration is a common grading system for all posts, where each grade is associated with a pay level or a pay scale with discrete steps. The progression within a pay scale is based on seniority, and individual merits and skills only taken into account in selections for promotion to a post in a higher grade.²⁶

The move towards differentiation based on *business needs* could start by a centrally determined introduction of sector- or agency-specific fixed pay increments for employees with special skills or service conditions. The move towards differentiation based on *individual qualifications* could start by introducing a temporary performance bonus, or by making the progression within the pay scale dependent on discretionary assessments of the employee's skills and performance.

The final stage in this evolution is devolution of individual pay decisions to the operational units. They would, however, also find that individual decisions for many employees, while seeking an appropriate balance between standardised and individualised components in their pay systems and employment conditions, would be very resource demanding.

What the centre of a public administration can not devolve is however the financing of the pay bill. All forms of decentralised pay setting have to take place within an economic framework that ensures central control of aggregate costs.

Finally, the negative effects of arbitrary or subjective pay setting deserve attention. Employment is not only an economic relation but in most cases (and certainly in the civil service) a fiduciary relation. Unless the motives for differences in pay levels and increases are understood and accepted by the employees, differentiated pay setting may lead to increased discontent and alienation at the workplace. This would weaken the ties between the employer and the employee and the retention rates, and affect workplace morale and work efficiency negatively.

In this context, one should note that most personal attributes vary among individuals according to the so-called normal distribution (bell curve). An individual differentiation of pay would be easier and more meaningful close to either end of the distribution, but more difficult and less meaningful among the employees clustered around the centre of the distribution.

3.2. Decentralisation of pay setting

The term *decentralisation* is used as a general concept, involving a transfer of competence from a single competent authority to several other bodies. Decentralisation can take the form of devolution or delegation. The term *devolution* is used for a parallel transfer of competence and responsibility, and *delegation* when the central authority has retained the responsibility and therefore also the final say. Decentralisation is sometimes also used for a geographical dispersion of activities, but the report would generally refer to *deconcentration* in such circumstances.

One can confidently assume that half a century ago, pay setting in all the central government administrations in the OECD member countries was centralised. Since then all OECD member countries have introduced at least some elements of decentralisation in pay setting in their central government administrations. There has been virtually no discussion of the determinants of decentralisation in the non-market, public sector of the OECD member countries, but it is obvious that trends in private sector pay setting and the decentralisation of pay bargaining in the private sector has had a significant impact on the arrangements in the public sector.²⁷

One important factor has been the increased heterogeneity of the workforce during the last half century. Private companies have, as a result, constructed pay and grading structures, which are appropriate to their specific skill mix and which encourage the appropriate employment and redeployment of labour.²⁸ During the same period, the public administrations in OECD member countries have diversified their activities, and have consequently also experienced an increased heterogeneity in their labour needs.

Decentralisation co-varies with the spectrum from career-based employment systems to position-based employment systems. A traditional civil service system (entry at young age, tenure for life, mobility between different parts of the public administration, and a formalised promotion system) would require a centralised management that included pay. Both the potential and the incentives for decentralisation grow as the focus moves from career-based to position-based systems, and from a procedural orientation to one focused on performance.

The need for more differentiated pay setting in the public sector is also obviously one of the key drivers behind decentralisation of pay-setting. It is possible to differentiate even in a centralised system, but it makes sense to decentralise differentiation that has to be based on information provided by and held at the local level. A decentralised differentiation could involve a differentiation of pay according to:

- the specific situation and requirements of each organisational unit;
- the specific skills, merits and performances of each employee; and/or
- the competition for skills on the specific labour market.

Decentralisation of pay setting interacts with changes in the way wages are set. Pay statutes give way to collective and individual pay contracts, and unilateral pay setting gives way to pay bargaining. The political level that was responsible for the pay statutes often chooses to focus on frameworks, principles and accountability mechanism, and to hand over responsibility for pay bargaining and the actual pay setting to civil servants at central and sub-central level. Trade unions have therefore often – sometimes unknowingly – taken the first step towards decentralisation and differentiation by demanding the right to negotiate about pay setting, and to regulate pay in collective agreements.

The perceived advantages of decentralised pay setting arrangements are:²⁹

- *Recognising the heterogeneity of public services.* Decentralisation permits more diverse pay and grading structures which are attuned to organisational goals and to the diverse services that the organisations deliver. Under decentralised arrangements, departments and agencies can introduce the pay and grading structures that are most appropriate for their organisation.
- *Clarifying organisational goals.* Responsibility for pay and grading encourages managers in public sector organisations to think more fundamentally about the objectives of the organisations they run, and how the pay and reward structure helps the organisation in meeting its strategic objectives.
- *Encouraging innovation.* Decentralisation encourages departments and agencies to experiment both with the organisation of work and with different payment systems, such as team and individual rewards tying pay to performance.
- *Increased investment in training.* Decentralisation enables organisations to design structures and reward systems that induce their employees to stay with the organisation for a period of time that is sufficient to allow both the organisation and the individual to earn a return on their share of the investment in training.
- *Realigning pay.* Decentralisation allows organisations to adjust the pay of their employees to the specific market situation. They also enable the organisations to adjust the pay of their managers to levels appropriate to the risks and responsibilities associated with senior jobs.

Pay setting has to be decentralised to the managers of relatively homogeneous operational organisations if these advantages are to materialise. This will not be possible as long as the real influence over pay setting still resides at political level within sector ministries. Nor does decentralisation in itself guarantee any of these advantages. The outcome of decentralisation will depend on if and how the managers of the operational organisations that assume responsibility for pay and grading arrangements make use of the new opportunities. There is also a set of possible disadvantages of decentralised pay setting:³⁰

- *Higher transaction costs.* There are transaction costs associated with setting pay and posting pay schedules. A decentralised system replaces the single pay bargaining of the centralised system with many separate negotiations, leading to higher administrative and bargaining costs.

- *Opaque wage signals.* Individuals seeking work, changing jobs or merely monitoring developments in the market will have to acquire and process a greater amount of information than under a centralised system. Decentralised systems will also be associated with greater uncertainty over the true structure of relative rewards at times when large numbers of pay structures are subject to frequent changes.
- *Opportunities for monopolistic or monopsonistic behaviour.* Decentralisation could expose the employer to the exploitation of monopolistic behaviour when a union is the sole “seller” of labour in the local market. Under these circumstances, the union could seek to set the rate of pay above the labour market clearing rate. On the other hand, when an organisation is the sole buyer of particular skill in a local market, opportunities for monopsonistic behaviour exist and pay may be driven down.

The spectrum of different pay decentralisation arrangements in the public sector ranges from very restrictive to almost total. The normal arrangement is vertical, from a single central pay setting authority to a relative large number of pay setters at lower organisational levels. There are, however, also cases of horizontal arrangements, from a single central pay setter to separate central pay setters in each ministerial sector. Mixed systems are possible, and there are therefore four possible modes – centralised, horizontally, vertically, and finally both horizontally and vertically decentralised. Table 1 below contains the basic characteristics of the systems in the six reviewed countries.

The arrangements in Denmark and Finland can be classified as delegation. The existence of a central collective agreement means that the competence would revert to the central parties if the local parties fail to reach an agreement. Central approval is only shown as a restraint in the United Kingdom because its remit system also concerns the level of the pay bid, while the corresponding elements in other countries only concern other aspects of the local agreements.

Table 1. Pay decentralisation arrangements

Country	Type of decentralisation	Restraints
Australia	Extensive vertical devolution	Bargaining parameters Affordability
Denmark	Limited vertical delegation	Central collective agreement Affordability
Finland	Extensive vertical delegation	Income policy agreement Central collective agreement Affordability
Netherlands	Horizontal devolution and elements of vertical delegation	Bargaining parameters Affordability
New Zealand	Extensive vertical devolution	Bargaining parameters Affordability
United Kingdom	Varied vertical delegation	Bargaining parameters Central approval Affordability

The arrangements in the Netherlands differ from these in the other five countries in that their “sector model” is not a form of decentralisation, but a fragmentation of the central political authority through a horizontal devolution to a small number of sector ministries. Pay setting thus remains centralised and under political control within each ministerial sector. There are, however, elements of vertical delegation in the education sector.

The arrangements in Australia are formally not a complete devolution, since collective agreements have to be approved by the responsible minister. It can, however, for all practical cases be classified as a devolution. The same can be said about the arrangements in New Zealand, where pay setting has been devolved from the government to the State Services Commissioner, but then formally only delegated to departments and agencies.

A recurring concern in countries that have not yet decentralised pay setting is the risk of harmful pay dispersion. A government has, as noted initially in this section, to desire some kind of pay differentiation in order to embark on decentralisation. This at the same time entails a risk for unwarranted pay dispersion between employees with similar tasks and qualifications, but it is also obviously possible to mitigate this risk (*cf.* Australia, Denmark, Finland, and New Zealand) and thus prevent any major negative effects. These issues are discussed in depth in Section 3.3.

Public administrators are often especially concerned that decentralised and differentiated pay setting might impede the internal mobility in the public sector. It seems likely that there can be transitory problem linked to the first softening of the uniform statutory systems, especially if this only concerns parts of the public administration. It is at the same time unlikely that pay structures would impede mobility after the administration has made a full transition to post based employment and differentiated pay, and when the operational managers can negotiate the entrance pay with the job seekers. Pension systems³¹ with non-transferable rights could however continue to impede mobility.

Public administrators are also often concerned that delegated pay setting would entail a weaker central control over the development of pay costs, and a risk for cost increases due to internal competition for skills that are in short supply. This is primarily a question of the adequacy of the financial management arrangements. These are discussed in depth in Section 4.2.

Most of the countries studied also have constitutional arrangements that entail devolution of pay setting to sub-national entities (states in Australia, municipalities in other countries). Subcontracting of publicly financed work to external service providers is also a form of devolution of pay setting. These dimensions are however outside the scope of this study.

3.3. *Coherence and pay decentralisation*

*Coherent*³² and *coherence* are general although normally unspecified properties of good remuneration policies in public administrations. These expressions should not, however, be seen as synonyms of *uniformity*, or as incompatible with a differentiation of pay and other employment conditions. They do imply, however, that any differentiation should result in a logical and consistent remuneration structure.

There is a broad consensus within OECD member countries that since public administrations have become more heterogeneous, service quality and efficiency will require a larger degree of adaptation of pay setting and other human resource practices to individual competences and performances, and to business needs.

Centralised pay setting can be based on a pay framework that includes pay differentiation after objectively determinable factors such as held post, education, seniority and locality. Any adaptation to individual competences and performances or to business needs would however require assessments, and therefore also a more intimate knowledge of the individual and the business, and a more direct involvement in the development and efficiency of the organisation concerned. These types of differentiation would therefore require a decentralisation – through delegation or through devolution –

of remuneration policies. Decentralisation of remuneration policies is thus inherently linked to a desire for an adaptation to individual competences and performances, and/or to business needs.

Coherence can be described as a *ceteribus paribus* condition; pay and other employment conditions should be equal if all other relevant factors are equal. A corollary to this is that a non-uniform differentiation is compatible with coherence, if it is the result of an appropriate adaptation to individual competences and performances, and to business needs.

Non-uniformity is inevitably associated with a degree of uncertainty, and an unwarranted differentiation of pay and other employment conditions would entail costs for the public administration concerned that could be substantial.³³ A decentralisation of remuneration policies should therefore be accompanied by the introduction or strengthening of managerial elements aimed at ensuring a sufficient coherence in the decentralised assessments of individual competences and performances. The chief executives of sub-government organisations would also have to be more proficient in operational management than senior civil servants in centralised systems.

Among the measures that could be undertaken by the centre to promote an increased coherence in decentralised remuneration policies are:

- developing and disseminating *reference standards* or *standard assessment* methods;
- establishing a *classification standard* for posts would as a base for comprehensive pay statistics that would enable assessments of the ensuing pay structure;
- developing and operating mechanisms that ensure accountability for both the use of the decentralised mandate and for the achieved results, with the *development of relevant metrics and indicators*; and
- training in and other forms of *capacity-building* support to those who work with decentralised remuneration policies.

The decentralisation of remuneration policies can be partial or total. Governments may, depending on their context, goals and core values, want to retain uniformity or other forms of central control over some aspects of pay setting or over some employment conditions. A review of actual practices in the OECD member countries will reveal a broad variation in the practical applications of these concepts, from a seemingly total acceptance of all forms of locally determined differentiation to a very strict adherence to a centrally determined framework with only minor scope for decentralised decisions.

An adaptation to *market pay* levels will in itself provide a form of appropriate adaptation to individual competences and performances. A public administration that pursues such a policy benefits from the invisible hand of the market in creating an appropriate pay structure. Such policies also entail an acceptance of the existing competition for scarce skills, whether between public employers or with private employers.³⁴

It is often stated that a uniform pay structure and uniform employment conditions are necessary in order to enable *internal mobility* within the public administration. A general decentralisation of remuneration policies would, however, enable all sub-government organisations to design remuneration policies adapted to their own recruitment needs. There is thus no reason to assume that sufficiently coherent decentralised remuneration policies would impede internal mobility.

A government might want to retain central control over the retirement age and over benefits after retirement³⁵. This is especially true for defined-benefits schemes, where the full costs only appear after a large number of years, and for pay-as-you-go schemes, where today's costs have little to do with today's activities. However, the government might also want to retain central control over fully funded contribution-defined schemes, for equity reasons.

One should note that a total individualisation of all remuneration details entails substantial transaction costs. An employer can thus achieve substantial cost efficiencies by establishing standardised work and employment conditions that are used unless there are sufficient compelling reasons to deviate from them. It can also be expected to retain centralised control over the remuneration of the chief executives (senior civil service).

3.4. *The principal-agent relation*³⁶

In economics, the problem of motivating one party to act on behalf of another is known as “the principal-agent problem”. This problem arises when a principal compensates an agent for performing certain acts which are useful to the principal and costly to the agent, and where there are elements of the performance which are costly to observe.

The contract between a principal and an agent is normally an incomplete contract, written in a world of information asymmetry, uncertainty and risk. The principal's ability to achieve an optimal outcome depends on an ability to make the agent handle the delegated authority in an appropriate way. However, the agent has a distinctive set of values and interests, and what is optimal from the point of view of the agent can be different from what is optimal from the point of view of the principal. In addition, principals normally do not know enough about whether (or to what extent) a contract is or has been satisfied.

Delegation of pay setting from a single central authority to a number of other organisations creates a principal-agent relation. The centre retains the ultimate responsibility for pay systems and pay structures, but the outcome will depend on the behaviour of the pay setters. The centre therefore has to design and implement strategies and methods by which it can ensure that the operational goals of the pay setters (the agents) are aligned with the strategic goals of the centre (the principal).

One should note that the extent and severity of this problem will depend on the ambitions of the centre in relation to such things as pay systems and coherent pay structures. The problem will be much simplified if the centre is prepared to accept variations in pay systems and structures, and only wants to retain a degree of control over pay levels and pay increases, and will disappear if it is prepared to devolve the full responsibility within a fixed framework.³⁷

The solution to the principal-agent problem is to provide appropriate incentives so that the self-interested rational choices that the agents make will coincide with the choices that the principal desires. The principal should therefore look at:

- the appropriateness and efficiency of the environment in which the contract is established;
- the appropriateness and efficiency of the design of the contract;
- the efficiency of the incentives provided to the agent;
- the efficiency of the mechanisms for monitoring the agent's activities and the outcome; and

- the ability of the principal to hold the agent accountable for sub-standard outcomes or inappropriate actions.

It is also possible to identify four basic principles of contract design: ³⁸

1. The *Informativeness Principle* essentially states that any measure of performance that (on the margin) reveals information about the effort level chosen by the agent should be included in the compensation contract.
2. Setting incentives as intense as possible is not necessarily optimal from the point of view of the principal. The *Incentive-Intensity Principle* states that the optimal intensity of incentives depends on four factors: the incremental profits created by additional effort, the precision with which the desired activities are assessed, the agent's risk tolerance, and the agent's responsiveness to incentives.
3. The *Monitoring Intensity Principle* is complementary to the previous principle, in that situations in which the optimal intensity of incentives is high correspond to situations in which the optimal level of monitoring is also high. This is because monitoring is a costly means of reducing the variance of agent performance, which makes more difference to profits in the kinds of situations where it is also optimal to make incentives intense.
4. The *Equal Compensation Principle* essentially states that activities equally valued by the principal should be equally valuable to the agent. Agents may be engaged in several activities, and if some of these are not monitored or are monitored less heavily, these will be neglected, as activities with higher marginal returns to the agent are favoured. Targeting certain measurable variables may cause others to suffer.

3.5. *Pay bargaining*

The original relation between the state and its servants was based on mutual rights and responsibilities. The servants were expected to be faithful and loyal, and in exchange they enjoyed the status of civil servants and were provided for throughout their lives, although seldom at a conspicuous standard of living. Bargaining for higher pay was not part of the deal; neither at individual nor at collective level.

The attitude of the state as employer toward its employees has undergone remarkable changes since then in the OECD member countries. Fiduciary relations are increasingly replaced by contractual relations that deprive the state employees of their special statutory rights. The state has abandoned unilateral authoritarianism and recognized that its employees have a legitimate right to voice their interests and concerns.

The widespread transition to dialogue and consultation can take various forms. Information, consultation and bargaining are distinctive modes on the scale of exchange. Consultation and negotiation may manifest themselves as exclusive or as complementary mechanisms. Their nature can differ, from merely a distinctive expression of an opinion to negotiations aiming at formal contracts. Though all countries in this survey now have pay bargaining in the public administration, they differ in how they have institutionalised the social dialogue and the setting of pay and other employment conditions.

Collective pay bargaining requires the existence of clearly identifiable and mandated partners. This typically means that the government has to designate one or more competent organisations and empower them or them to negotiate and sign collective agreements. Furthermore, one or more sufficiently representative organisations representing the government employees has to exist. Both the criteria for representativeness and the bargaining procedures can be statutory or agreed between the parties.

It is equally possible to have pay bargaining in a centralised as well as in a decentralised pay setting environment. Decentralised pay bargaining does however add a new dimension to delegated pay setting since it sets up a principal-agent relation. The pay setter as agent is engaged in two different contract relations – with the principal and with the trade unions representing the agent’s employees. The principal often wants to hold the agent to its intentions and its contract, but at the same time – since the principal in this case is an elected government – does not wish to be seen as responsible for unnecessary conflicts between the agent and the trade unions. This may provide the agent with an opportunity to renegotiate its contract with the principal to make it conform to its contract with the trade unions.

A central framework agreement between an office representing the government as an employer and national trade union associations will – as seen in Denmark and Finland – provide the government with an increased control over this dual contract situation. The same framework effect can, however, also be achieved – as seen in Australia and New Zealand – through centrally designed bargaining parameters and a remit process that enables the centre to supervise the application of these parameters.

Collective agreements are normally made with a trade union, but as seen in the Australian case can also be made with another form of employee representation. The content of collective agreements varies. Their main purpose is to regulate the content of the standard contract used by the employer, including grading systems and pay scales, when such systems are used. They can also cover other human resource management issues, such as guarantees for a minimum level of employee training. It is possible that they are also in some countries used to regulate work processes and other managerial and operational issues.

The details of pay setting also vary between countries. Individual wages that follow from generally applied pay schedules are determined through either statutes or collective agreements. Individualised and differentiated wages are determined either through unilateral employer decisions, individual agreements with a single employee, or through collective agreements. Mixed forms are also possible. A collective agreement could for example contain minimum clauses and regulate procedures for pay setting and grievances, but leave the actual pay setting to the employer or to an individual agreement.

The degree of involvement of trade unions in pay setting thus varies between countries. This reflects differences in legal rules, trade union strength and characteristics, history and culture of industrial relations and government policy. This study will treat these aspects as factual circumstances and will not discuss the causes for or the effects of these differences.

Special case 2. Different forms of Australian labour contracts

The Australian Workplace Relations Act identifies six different modes of workplace agreements. The choice relates to a number of features, which concern the individual or the collective, both employers and employees, the shape of employee representation, and the novelty of a project, business or undertaking. All workplace agreements have to be lodged with the Office of the Employment Advocate.

An Australian Workplace Agreement is an individual written agreement between an employer and an employee. Employees can negotiate their own contract, or opt for a bargaining agent to act on their behalf.

An Employee Collective Agreement is a written agreement between an employer and a group of employees who will be covered by the agreement. The employees can use a bargaining agent. Employee collective agreements are approved through a vote of the relevant employees.

A Union Collective Agreement is a written agreement an employer and one or more trade unions. The union negotiates on behalf of the employees. Union collective agreements are approved through a vote of relevant employees.

An Employer Greenfields Agreement and a Union Greenfields Agreement are signed before any persons are employed. They are used for new projects or businesses.

A Multiple Business Agreement is a collective agreement that enables multiple employers to make a single agreement that applies to all of their businesses. A multiple business agreement would typically be used in a franchise operation where there are a number of businesses carrying on the same type of business that wishes to offer you the same working conditions.

When there is no agreement, the terms and conditions of employment can be decided through an award.

The different Australian workplace agreements set out the terms and conditions of employment. They replace the terms and conditions detailed in an award that would otherwise apply, with the exception of certain protected conditions. Collective agreements do not replace a current Australian Workplace Agreement or another collective agreement that has not reached its nominal expiry date. An Australian Workplace Agreement replaces any collective agreement or previous workplace agreement that would otherwise apply to the employee. They may override employment conditions in state or territory laws, if the agreement mentions those conditions. However, they cannot override state or territory laws which cover occupational health and safety, workers' compensation or training arrangements.

Article 2 of ILO Convention No. 87 on Freedom of Association and Protection of the Right to Organise (1948) proclaims that “workers and employers, without distinction whatsoever, shall have the right to establish and, subject only to the rules of the organisation concerned, to join organisations of their own choosing without previous authorisation”. The standards set forth in ILO Convention No. 87 are applicable to all workers without distinction whatsoever, and hence cover government employees. Public servants should therefore enjoy the right to create and join organisations of their own choosing, without prior authorisation, so as to promote and safeguard their interests.

The union density in the public sector of the countries under review is higher than in their respective private sectors. The job security of civil servants and the tolerant or favourable attitude of the authorities toward civil servants' organisations are deemed to be key factors behind the higher union density in public administrations.

Trade union attitudes to decentralisation of pay setting vary. The literature indicates that traditionally organised trade unions may have difficulties in handling delegated pay setting, and that the introduction of delegated pay setting may pressure them to modify their organisations, their operational processes, and to replace or retrain trade union officials. On the other hand, there are also cases where trade unions have modernised their organisations and working methods, and become able to use the decentralisation to the advantage of their members. There are also indications that

decentralised bargaining leads to a stronger membership involvement in pay bargaining and other aspects of trade union work. However, trade unions generally seem to be wary – if not outright hostile – to individually differentiated pay, although it is possible to find exceptions.³⁹

4. A comparative analysis

4.1. *Institutional arrangements for pay setting*

This section deals with how the centre is organised to handle decentralised pay setting. The institutional arrangements are, as shown below, specific to each country. Underlying the different arrangements are also different systems for allocating authority and for administrative law.

Two of the countries have unconventional arrangements and no clear separation between the political and the administrative level. The individual ministers are still responsible for the pay setting in the central government administration in the Netherlands (except in the education sector). Furthermore, the Netherlands does not have the same type of collective agreements for central government employees as the other countries, and their agreements can be described as joint conclusions that are afterwards confirmed by government decisions. Their pay negotiations in the “cabinet sectors” do not seem to be effectively separated from the budget process. The United Kingdom has a single level system with a formal delegation to sector departments or sub-departmental bodies, but the real control over pay setting seems to be shared between the Treasury and the independent pay review boards.

The central collective agreement in Denmark and in Finland plays the same role as the bargaining parameters in Australia and New Zealand, but has the advantage that they have been agreed with the national trade union confederation and are binding for the local trade unions. Another advantage is that they are used for agreements on standardised conditions for the whole of the central government administration.

Three of the countries – Denmark, Finland and New Zealand – have separate professional central organisations that set the parameters of the bargaining process, and which are either formally independent of the political level, or separately managed although an organisational part of a ministry. The review did not find any indications of direct political involvement or interference in pay setting in these countries, with the exception of the Comprehensive Income Policy Agreement in Finland. It seems that these professional organisations have been essential for the achievement of relatively well-functioning pay reforms in these countries. Australia seems to have achieved a similar outcome by a more comprehensive devolution with pay issues in the central government sector handled by a ministry with a general labour market responsibility.

A comparison between Denmark and the Netherlands is intriguing. Denmark transferred all authority on collective pay setting from the sector ministries to a single central authority in the 1970s. Since then, Denmark has gone on to extend decentralisation and is at present introducing a new pay system designed to facilitate a local adaptation to business needs. The Netherlands went the other way in 1993, transferring the authority from a single authority to the sector ministries.⁴⁰ Since then further developments have however been limited to the education sector, where subsectors have taken over the pay bargaining.

The Danish centralisation seems to have been both driven by and a pre-requisite for the ensuing decentralisation. The central governance was regarded as necessary for an adequate governing of a network with a large number of pay setting organisations. If this is true, then one can surmise that

developments in the Netherlands have been held back by the absence of a single central authority similar to those existing in Australia, Denmark, Finland and New Zealand.

In both Denmark and Finland, the same department in the Ministry of Finance is responsible for both central negotiations and workplace relations, and for state personnel policy and statutory regulations. This solution seems, however, to have worked well for these countries, and probably reflects an established consensus between the social partners not to intermix these two dimensions. The countries that have delegated pay setting and other human resource management functions to a separate organisation have however found it necessary to retain the responsibility for policy and statutes at the ministerial level.

Australia provides a good example of an effective separation of the government's internal budget processes from the collective bargaining processes. In this way, Australia is able to avoid situations where the budget allocations become an element in pay bargaining. It has also been able to handle the implicit conflict between market-oriented pay setting arrangements and traditional statutory civil service arrangements. The separation seems to have been driven by a desire to allow agencies to operate under the same conditions as other employers on the Australian labour market. At the same time, Australia has not managed to implement a complete devolution, since collective agreements are still expected to observe bargaining parameters issued by a central authority.

New Zealand stands out because of the State Services Commission with its statutory powers and a broad field of responsibility. There were, however, indications that this mixture of statutory powers – which includes appointments of Chief Executives for limited terms and assessments of their performances – may have had detrimental effects for its advisory and consultative role in relation to the organisations headed by these agencies.

Special case 3. New Zealand's State Services Commission

The Office of State Services Commissioner is central to New Zealand's politically neutral, professional and permanent Public Service. The Commissioner is both chief executive of the State Services Commission and the holder of a statutory office. In the latter capacity, the Commissioner acts independently in a range of matters to do with the operation of the public service, the State Services and the wider state sector.

The Commissioner appoints and employs public service chief executives on behalf of the Crown; reviews the performance of public service chief executives on behalf of their responsible Ministers; and investigates and reports on matters relating to departmental performance.

Under the State Sector Act, the power to negotiate and enter into collective agreements in the public sector rests with the State Services Commissioner (even though the respective chief executive remains the employer). The Commissioner can, and has, delegated that power to negotiate collective agreements to each chief executive, on the condition that they consult the State Services Commission about their bargaining and comply with the governments bargaining parameters.

Among the Commissioner's responsibilities are also: to promote and develop policies and standards for personnel administration and equal employment opportunities for the public service; to promote and develop senior leadership and management capability for the public service; to provide advice on management systems, structures and organisations in the public service and Crown entities; to set minimum standards of integrity and conduct that are to apply in the public service, most Crown entities and some other agencies; and to advise the government on the structure of the state sector, including the allocation of functions between agencies.

The institutional arrangements in the United Kingdom seem to be very flexible, and this has seemingly not only been a positive factor. The recent introduction of a new additional supervisory function – the Public Sector Pay Committee – seems to indicate dissatisfaction with the functioning of the existing arrangements. The interviews also gave clear indications that pay systems had not been adapted to specific business needs to the extent that the government had hoped for, and that the administration had experienced coherence problems.

In sum, a robust office of the government as employer, able to set the parameters for pay bargaining, seems an important foundation for decentralised pay setting.

4.2. *The financial management arrangements*

This section deals with the general budget arrangements, and how these set frameworks and interact with the delegated pay setting process. The financial management arrangements are a key determining factor for an adequately functioning system for decentralised pay setting. In centralised pay setting systems, the centre exerts simultaneous control over both economic frameworks and pay setting, and it has no imperative need to separate or formalise either of these processes. This changes when pay setting is decentralised.

Decentralised pay setting involves a significant principal-agent problem, and in fact played a key role in the development of that theory. The principal's primary goal can be described as pay increases that are as high as necessary, but not a penny higher, with a secondary goal of sufficient flexibility to take the differences in desired pay increases between sector, professions, localities and individuals into account. The agent on the other hand – the local pay setter – wants to maximise the economic base of its own organisation, improve the attractiveness of its employment, and avoid conflicts with employees and their trade unions. These issues are discussed in depth in Section 3.4.

Without a clear separation of the budget process from the pay setting process, one would run a substantial risk of these two being intermixed. The agent would be more interested in negotiating a larger budget allocation than in being confrontational in the local pay setting process. The agent would – to cite an experienced pay negotiator – side with its employees and/or trade unions against the budget authority rather than represent the government's interest in the negotiations with them.

All countries reviewed have also separated these processes from each other. There is, however, a difference between Denmark, Finland and the Netherlands which use multi-year top-down budgeting, and Australia which uses more traditional bottom-up budgeting. The United Kingdom is somewhere in between, due to the unusually strong mandate for the minister responsible for the Treasury (the Chancellor). New Zealand has previously had traditional bottom-up budgeting, but has recently introduced significant top-down elements into its budget process.

As long as the centre controls the entire process, it can deal with the economic envelope for each sub-entity in its turn and on its own merits, since no decisions are then taken until the entire process is finished. Decentralised pay setting increases the transaction costs and risks inherent in this method, and most budget authorities have found it more rational to deal with all pay setting entities at the same time and in a uniform way. This makes it possible to concentrate the government's political deliberations on a limited number of sub-entities. The exceptions are the United Kingdom, where a drawn-out remit process affects the economic envelope available for pay increases, and the Netherlands, where there is some interaction between the budget and the pay setting processes within the so called cabinet sectors.

Australia, Denmark, Finland and the Netherlands are explicit in taking wage developments in the private sector into account when determining the economic envelope for pay increases in the public sector. This is not surprising. The attractiveness of the total package of conditions and compensations associated with public employment must be sufficient for a public administration to be able to recruit the employees that it needs. The pay can be lower than in the private sector, since this is compensated by other advantages, but pay increases cannot be consistently lower than in the private sector without eroding both the social compact between the state and its servants, and the attractiveness of public employment.

Each of the countries studied has its own way of doing this. The review probed for the existence of formal reference models that link pay developments in the private sector to either the computation of the budgets of pay setting organisations, or to expenditure limits for pay costs. The only formally declared reference model that was identified is Sweden's, although the Australian model is fairly similar. This does not, however, exclude the possibility that there are informal models or rules of thumb elsewhere, that are part of the trade secrets of budget departments, and thus not in the public domain.

Special case 4. The Swedish reference model

Swedish government agencies have a single administrative budget and no special expenditure limits for pay costs. The starting point for all political deliberations about agency budgets is a standardised adjustment of the previous year's budget based on separate indices for pay, lease costs and other administrative costs.

The two government agencies Statistics Sweden and Swedish Agency for Government Employers annually compute an index of wages increases in the private manufacturing industry. The average of the last 10 year's productivity development in the private service sector is then deducted from the index. The result is applied to all agency budgets, unless the central collective agreement contains extra increases for certain activities or professions. In that case the index is adjusted for the agencies concerned.

Political deliberations can however lead to both increases and reductions of agency budgets in relation to the standardised adjustment.

New Zealand relies instead on the ability of pay setting organisations to increase productivity sufficiently to finance pay increases. Organisations that are unable to do this have to submit and argue for their business cases for more funds during the next budget round, showing, *inter alia*, their relative wages and the potential consequences for recruitment and retention.

Table 2. Setting the economic envelope for pay increases

Country	Key actor/actors	Interaction between pay bargaining and the budget	Main driver of the economic envelope
Australia	Budget office	Based on standardised adjustment, no direct interaction	Outcome of budget process
Denmark	Budget office and state employer's office	Based on standardised adjustment, no direct interaction	Outcome of central collective agreement plus ex-post correction for differences to private sector
Finland	Budget office and state employer's office	Based on standardised adjustment, no direct interaction	National comprehensive income policy agreement
Netherlands	Budget office and Ministry of the Interior	Based on standardised adjustment, but also direct interaction	Outcome of budget process
New Zealand	Budget office	Based on standardised adjustment, no direct interaction	Outcome of budget process
United Kingdom	Budget office	Discretionary adjustment and direct interaction	Outcome of remit process

The way the economic envelope is set varies between the countries. The budget authority⁴¹ is always a key actor, but in countries with a central collective agreement, the state employer's office also plays a key role. Sector ministries are of course always involved in the setting of the economic envelope. A significant factor for the stability of the system is probably if there is any *direct* interaction between the local pay setter and the process for setting the economic envelope for pay increases. This seems to be linked to whether the adjustment in relation to last year's budget is determined local pay setter by local pay setter, or if it is based on a standard adjustment.

The process in Australia is, as noted above, similar to the Swedish process described in the special case above. The main difference is that Australia seems to make a discretionary assessment of the need for an adjustment for "normal" pay increases on the labour market. Some Australian employees have had their wages set through awards, and this might have influenced the assessments earlier.

In Denmark, the budgets for pay setting entities are adjusted, if necessary, to accommodate an unexpectedly expensive central collective agreement. Another specific element in the Danish model is that the central collective agreement provides for an *ex post* correction for 80% of the differences in pay developments between the private and the public sector.

Two of the reviewed countries have no clear separation of the budget process and the pay setting process. The sector ministries in the Netherlands are both involved in the budget process and responsible for pay setting. It seems that they do not always seek vigorously for solutions within their own budget but tend to request additional funding, which sometimes has been provided. In the United Kingdom, pay setting entities seem to negotiate with the Treasury as part of their remit process.

The scene in Finland is dominated by the Comprehensive Income Policy Agreement that covers a large majority of Finnish enterprises and employees and that sets the agenda for both the political actors and the social partners for several years. The specific factors behind this probably go back to Finland's vulnerable situation after the Second World War, which created a strong culture of national cohesion and collaboration. Agency budgets are normally set to accommodate expected price increases and the pay increases indicated in the income policy agreement. The central collective agreement for the state sector then becomes only an expeditionary function supplementing the income policy agreement.

Special case 5. Finland's social compact

The first Finnish Comprehensive Income Policy Agreement (*Inkomstpolitisk uppgörelse*) was negotiated in 1968. They are tri-lateral⁴² policy agreements that can cover a wide range of economic and political issues, such as salaries, taxation, pensions, unemployment benefits and housing costs. With the Comprehensive Income Policy Agreements, the government, the trade unions and the employers try to reach a common understanding of the best choices for the national economy in terms of economic growth and real wages. This is then implemented through central collective agreements and secondary sector agreements.

The income policy agreements are not prescribed by law. If the employers' and employees' national organisations can not reach an agreement, no comprehensive treaty is signed. In that case, unconditional pay negotiations are carried out by the individual trade union federations with no government participation.

The Finnish government considers that the 2005-2007 agreement has stabilised the labour market and strengthened domestic consumption and employment.

A survey in May 2004 showed that a qualified majority of Finnish employees preferred an income policy agreement to each trade union federation negotiating individually. In June 2006, the Congress of the Central Organisation of Finnish Trade Unions strongly endorsed the incomes policy co-operation between the government and the social partners.

The principal-agent problem involved in delegated pay setting has meant that budget authorities⁴³ that were used to exerting control over the entire pay setting process have reservations about whether pay setting entities will respect the government's interests or even instructions. Among the fears are that pay setting entities will be too generous with pay increases, and that agencies will start to compete with and outbid each other for attractive employees. They therefore tend to be unwilling to delegate authority without either retaining some controls, or introducing new countervailing factors.

It is therefore not unusual for the centre to retain central approval of local pay agreements and decisions, at least initially. They may also retain or introduce expenditure limits for pay costs as part of the budget of each sub-entity. Denmark still uses this element, but only for what they refer to as "bureaucratic agencies". Danish agencies that are more business-like and that may have external revenues are excluded.

It appears that the best countervailing mechanism is a budget process that is clearly separated from the pay setting process, and that results in a standardised adjustment of the budgets of all pay setters. A strict budget regime and the conviction that pay and related expenses have to be accommodated within the budget minimise the risk that a pay setter might become too complaisant. These mechanisms do not prevent a local pay setter from buying over an employee from another agency, but it can not do that consistently since it has to finance its pay bid within a uniformly adjusted budget. Australia has therefore consequently abolished all other restrictions than the affordability principle.

One should also note that employers compete with each other for labour that is sometimes abundant, sometimes scarce. This is basically a positive phenomenon, even if it involves two public employers, since it leads to improved allocative labour market efficiency. It also means that the public administrations must set pay so that public employment is sufficiently attractive compared with the alternatives available for public employees and job seekers.

The standardised adjustment of the budgets of pay setting entities is, however, not without problems. The relative market wage for different skills is not static, and a standardised compensation for pay increases will over-compensate some pay setters and under-compensate others. What is more serious, however, is that the potential for productivity improvements varies between different activities. Organisations that can mechanise, digitalise or simplify their processes have a larger

potential for productivity increases than organisations that deal with people. The use of a uniform productivity deduction thus means that some pay setters are in fact subjected to real budget cuts every year, while others may be able to use surplus productivity achievements for pay increases or other cost increases.⁴⁴

Over time, and as the effects accumulate, these mechanisms will lead to some pay setting entities finding themselves in an untenable situation, unable to pay adequate wages to their employees or unable to provide the outcomes and/or outputs that the government expects. Other pay setting entities may have unnecessary large economic resources at their disposal, and this may lead to their employees being paid higher wages than other government employees with the same skills and type of post.

Countries that base their budget process on standardised adjustments to the budgets of pay setting entities therefore also have regularly to evaluate the effect on the economic resource base of and the relative wages in each pay setting agency. One alternative might be to group pay setting entities after their potential for productivity increases and to use separate standardised adjustments for each group. The review did not find such explicit elements in any of the six reviewed countries, but it is evidently an implicit part of the budget process.

4.3. The governance of pay and other forms of compensation

This subsection deals with governance of pay and other forms of compensation for government employees, except for the financial management arrangements.⁴⁵ It includes:

- the implementation of whole-of-government policies for pay and other forms of compensation;
- the extent and design of the decentralisation of pay setting authority; and
- the support provided to managers responsible for local pay setting.

Table 3. Central co-ordination of pay setting

Country	Central actor	Principal means
Australia	Department of Employment and Workplace Relations	Bargaining parameters Central monitoring of local collective agreement
Denmark	State Employer's Authority	Central collective agreement
Finland	Office for the Government as Employer	Central collective agreement
Netherlands	Ministry of the Interior	Bargaining parameters
New Zealand	State Services Commission	Bargaining parameters Central approval of local collective agreement
United Kingdom	The Treasury The Cabinet Office	Bargaining parameters Central approval of local pay bids

The decentralisation of pay and other forms of compensation for government employees is almost never a complete devolution. Some aspects may have been devolved, but others have only been delegated and yet others remain centralised.⁴⁶ Even governments that have devolved the pay setting (subject to affordability) have other policies and priorities that they expect the government administration to implement and/or adhere to.

A key concept in this regard is *coherence* (see Section 3.3). Governments do not want the employment conditions to differ too much within their administrations; partly for equity reasons, but partly also because differences are thought to impede mobility within the public administrations. Yet another reason may be that a national co-ordination of trade union activities in different workplaces necessitates a parallel co-ordination on the employer's side. The countries that have been reviewed have different ways of handling this need for coherence and employer co-ordination.

Denmark and Finland have two-level systems for collective agreements. This makes it possible for the central negotiating organisation – which in both countries is a part of the Ministry of Finance – to choose to what extent it includes coherent whole-of-government conditions in the central agreement, and to what extent it delegates the authority to decide on a condition to the pay setting entities. It can also set standard conditions in the central agreement that can be amended or replaced by a local agreement. The local pay setting entities are bound by the central collective agreement, and cannot appeal to the political level. The central negotiating organisation has however to acquire trade union acceptance for its choices.

Special case 6. The Danish Central Collective Agreements on Pay

The central pay negotiations in Denmark do not take place within a fixed economic envelope, but are instead tightly controlled by the Ministry of Finance. They thus become an element in a wider social dialogue between the government and national trade union confederations. Separate agreements are signed with the major trade union organisation for state employees; that is the Association of Danish State Employees' Organisations (*Statsansettes Kartel*), unions within the State and Municipal Employees' Negotiation Community (*Stats- og Kommunalt Ansattes Forhandlingsfællesskab*) and the organisation for university graduates, the Danish Confederation of Professional Associations (*Akademikernas Centralorganisation*).

A new pay system was introduced in 1997, and now covers about two-thirds of the central government employees. A large part of the individual wage increases are allocated already in the central agreement, and local agreements so far only deal with a minor part including performance-related pay elements.

Eighty percent of the difference between previous year's pay increases in private and in the public sector is added to or subtracted from the increases agreed on in the central agreement. This link between wage developments in the private and the public sector has facilitated the central wage negotiations by reducing an element of uncertainty for the trade unions.

The central pay statistics in the ISOLA database enables comparisons between pay levels for similar tasks in different departments/agencies, and can be used by both the trade unions and the local pay setters.

Australia and New Zealand have single level systems for collective bargaining. In these countries, the central supervisory body issues bargaining parameters that the pay setting entities are expected to apply and implement, and monitors adherence to these parameters. This supervision is oriented towards structural issues and other forms of compensation than pay.

The United Kingdom has a similar system, but a more complex arrangement for supervising the decentralised bargaining. The majority of UK departments and agencies have expressed concern about the operation of the remit system used by the United Kingdom, or at least of some aspects of the current arrangements. These are considered as too bureaucratic. For agencies, pay bids may have to pass several layers of scrutiny, including their parent department and the Treasury, before final approval. At the same time, departments and agencies questions the contribution of the remit system to the efficiency of the pay setting process, especially when it amounts to internal bargaining over less than a half percent of the total pay bill.

Remit systems provide the central employer authority with a flexible tool for monitoring decentralised pay setting and for promoting a desired level of coherence in pay systems, pay setting and other employment conditions, especially when combined with annually updated bargaining parameters. They make it possible to apply a subsidiarity criterion in determining the proper balance between coherence and local adaptation. The scope of the remit process can be managed through the bargaining parameters. They also make it possible to extend the scope of decentralisation gradually, through step-by-step reductions of the issues covered by the bargaining parameters.

Special case 7. Remit systems

A remit system is a process whereby a central authority monitors or approves local pay bids or policies before they are implemented.

A remit system can be designed in many different ways. At one end of the spectrum are centralised systems involving central approval of all components in a local pay bid. At the other end of the spectrum are purely advisory systems where the pay setter can choose which aspects to remit.

A typical remit system in a country with decentralised pay setting would be selective and less than commanding, but more demanding than just advising. The centre would only monitor elements which are perceived to be of a special importance for the implementation of the government's policies, or for the coherence of the totality of the remuneration system. The pay setter could have an option of disregarding the centre's advice, but would then be expected to provide an objective and professional motive for doing so.

Central collective agreements in countries with two-level collective bargaining fulfil many of the functions of remit systems. These countries may however also have remit elements built into their central collective agreements.

The central collective agreements and government bargaining parameters in the reviewed countries have not been analysed in detail, but three elements stand out.

Pensions and other forms of retirement benefits are normally still handled at central level. One reason can be that many pensions systems are still based on defined benefits and/or pay-as-you-go schemes, and that they therefore represent long-term commitments. Another reason may be that a uniform pensions system strengthens coherence and facilitates internal mobility. A transition to a contribution-defined system⁴⁷ would however achieve the same results, and would enable a convergence of private and public systems. The choice between consumption ability now and after retirement would be clearer, and it would be possible to decentralise contribution decisions.

Several countries have retained *uniform grading systems* for posts even after they have decentralised pay setting. These then serve as classification systems, and enable them to monitor pay developments and to produce statistics on the average pay for each type of post, and on the relative pay level in different pay setting entities.

All countries have called for pay setting entities to introduce *performance-related* pay elements in their pay system. These however still only seem to account for a small part of the total pay envelope. Performance is generally assessed by the nearest superior, and employees generally seem to have the possibility to ask the next higher superior to review the decision if they are not satisfied with it. A recurrent observation was that supervisors have difficulties in making negative assessments, and there is evidently a risk for an assessment drift in these systems that deserves attention.⁴⁸

Non-transparency of performance assessments can also cause problems. In the United Kingdom, for example, performance-related pay seems to be generally accepted and supported by most departments and agencies, but their implementation seems less successful. Most public employees are felt to lack a clear understanding of how performance-related pay works, and the underlying objectives

were often perceived only to be to reduce the pay bill. Many comments also stressed the non-transparency of the arrangements for performance related pay.

All countries still manage pay and other employment conditions for the *senior managers* at the central level. This is very understandable, since the heads of the pay setting entities would belong to this group.

Pay setting is a demanding activity, and one which most operational managers have no experience of before the decentralisation of pay setting. The picture obtained in several countries was that the transition period from introduction to full use of the potential of decentralised pay setting often becomes extended due to inadequate training and support before the start of the new systems. In several countries, the centre seems to have been more interested in maintaining the controls than in promoting of pay systems and structures adapted to the business needs of each pay setting entity.

Countries with a central collective agreement tend to produce detailed pay statistics for the government administration, based on a common grading or classification system. Such statistics enable both the central and the local negotiators to compare the pay of an employee with the pay for other government employees holding similar positions. Countries with collective bargaining at a single level tend to use more superficial pay analyses, often undertaken by external consultants.

The systems for monitoring the use and outcome of decentralised pay setting generally seem to be underdeveloped. The Danish Parliamentary Auditors have, for example, reviewed the implementation of the new Danish pay system. In their report, they point to the lack of sufficient tools and systematic procedures for monitoring and documenting the outcome of local pay negotiations, and for feed-back from local to central level. At the same time, they note that such tools must be simple, lucid and operational and allow for comparability of data from different organisations.

Furthermore, the handling of the delegated responsibility may not always be adequately taken into account when assessing the performance of operational managers. This might be an indication of an asymmetrical reward situation; that the merit of having undertaken appropriate pay reforms is not large enough to outweigh the demerits of internal conflicts due to opposition to pay reforms. If so, it would contribute to the seemingly limited adaptation to specific business cases achieved so far in the countries reviewed.

4.4. *The governance of other human resource issues*⁴⁹

This section deals with the centre's governance of the operational human resource management in sub-entities, except for pay and other forms of compensation. The focus is on the interaction between the central entity responsible for human resource issues in the central government administration and other parts of the administration. Table 4 shows the organisations looked at, and if that organisation also is responsible for pay issues.

Table 4. Governance of non-pay human resource issues

Country	Actor	Relation to pay issues
Australia	Australian Public Service Commission	Separated
Denmark	State Employer's Authority	Integrated
Finland	Office for the Government as Employer	Integrated
Netherlands	Ministry of the Interior	Integrated
New Zealand	State Services Commission	Integrated
United Kingdom	Cabinet Office and Public Service Commissioner	Separated

The discussion on *coherence* in the previous section is relevant also for the issues discussed in this chapter. There are a number of areas where the centre typically wants to influence the behaviour of the operational managers in the human resource management field, either in order to achieve a better coherence or to further central policy goals. Among these are reducing sickness absence, promoting ethnic diversity and promoting gender equality. This review has not explored these issues further, but it seems clear that aspects of gender equality in relation to pay have to be handled on a whole-of-government basis. The only example found comes from Finland, where the present central collective agreement for the state sector contains a special pay pool for extra increases for female employees with low salaries.

Special case 8. Handling the gender equality issue

The labour markets in OECD member countries contain two qualitatively different types of gender inequality. Most of the countermeasures are aimed at outright discrimination in hiring, pay setting and promotion.

However, the labour markets also contain male-dominated and female-dominated professions and segments, and market pay tends to be significantly lower in the latter. It is not possible to explain this by reference to objective and rational factors. It is instead the result of historical and cultural reasons, and a form of structural discrimination.

It is difficult to counter this structural discrimination in the context of decentralised pay setting with standardised adjustments of the budgets of pay setting entities. An operational manager who tried would find that he had to finance the extra increases by reducing the pay increases of other employees, and this would make him vulnerable; both for paying some employees above market rates, and for paying other employees below market rates.

This type of structural discrimination can therefore only be countered by the centre. The centre can target professions and/or sectors, allocate extra money to these groups, and ensure through clauses in central collective agreements or government bargaining parameters that the extra money is used in a correct way.

In most cases, the primary goal of *senior management* and/or *management development* is reported to be to improve management capacity and skills, especially in performance-oriented management. The general impression, based on the interviews, is however that there is seldom any systematic monitoring or assessment of management skills and performance. The exception is New Zealand's State Service Commission, since the State Services Commissioner actually selects and appoints the chief executives of other central government bodies.

Material relating to *civil service values* is seemingly not as widespread outside of the English-speaking countries, but this may only reflect a difference in administrative culture rather than a higher perceived importance of the subject. These three countries have adopted formal codes of conduct. The Australian Public Service Commission stands out with value-based management as a key tenet, and with substantial supporting activities. Among these are a statement of Australian Public Service Values, a Code of Conduct and a special Merit Protection Commissioner.

Issues related to industrial relations and collective agreements dominate the internet sites of the central authorities in Denmark and Finland. This reflects the two-level bargaining system existing in these countries, which increases the need for information and guidance from the centre to the pay setting entities at the secondary level. It does seem, however, as if this is done at the expense of other non-pay related human resource management issues. One can compare with New Zealand's State Services Commission. The SSC does not sign any agreements itself, but only monitors and advises on local pay bargaining. At the same time, it provides a relatively broad range of guidance, advice and services in other human resource management areas.

4.5. *The pay setting process*

The focus in this section is on how operational managers handle decentralised pay setting. Interviews were conducted with two representatives for pay setting entities in each of the countries.⁵⁰ These were not selected randomly, but suggested by contacts in the countries as being interesting examples. They may therefore not be representative for the average pay setters.

In the interviews a number of common themes emerged that seem important for a fuller understanding of the challenges and problems of decentralised pay setting. Amongst these are:

- the increased transaction costs inherent in decentralised pay setting, and the need to create a corresponding added value;
- the scope of the replacement of centrally determined grading systems, pay bands, pay scales, and automatic or semiautomatic progression system with adapted arrangements;
- the design and use of performance related pay elements in the remuneration systems;
- the occurrence of peer consultations and pay benchmarking with other sectors and employers;
- trade union involvement in decentralised pay setting;
- the role of the individual employee in decentralised pay setting.

In Australia, the government's policy is that agency heads should make individual contracts (AWAs) available to all employees. Individualisation is, however, associated with higher transaction costs and it has been inferred that agencies therefore tend to use individual agreements only when there is a clear business need for an individualisation of the contracts, such as for managers and specialists. However, individual agreements also introduce an element of flexibility, since agencies do not have to consult the Department of Employment and Workplace Relations before signing an individual agreement. It is therefore easier for an agency to handle a specific need through individual agreements than through a revision of the collective agreement. The responsibility for ensuring that an AWA is consistent with the Government's Workplace Relations Policy Parameters remains, however, with the Agency Head.

Australian employee collective agreements seem to be used primarily in workplaces with a low unionisation and no representative trade union counterpart.

The main motive for decentralising the pay process is, in all the countries reviewed, the need to enable operational managers to adapt their pay systems to their own business needs, which would include some sort of increased differentiation. This outcome has not always been fully achieved, since most pay setters choose the easy way and kept the old pay structure. This does not exclude the possibility that adaptation and differentiation will increase as the operational managers become more experienced and skilled.

New Zealand provides a good example of a consistent and complete decentralisation. There is no common or centrally imposed remuneration system or practice, and Public Service Departments are expected to plan remuneration as part of their overall departmental business planning. The result is a broad range of varied pay arrangements.⁵¹ Some departments may have a single system that applies for all of its employees. Other departments may operate different arrangements (in terms of progression

criteria, pay ranges and use of market surveys and other data) for different occupations or job families. A common factor is, however, probably that an agency's pay system will apply to all relevant employees, irrespective of whether or not there is a collective agreement. The reason for this is that operating different remuneration systems for employees who perform similar work would be more difficult and costly to manage and administer, and could result in harmful inequities between employees.

The only example found of a formal evaluation of a new decentralised pay arrangement comes from Denmark. The Danish Parliamentary Auditors have reviewed the new Danish pay system. Their general assessment is positive, and they note that all reviewed organisations have adopted local pay policies. At the same time, however, they found it less satisfactory that the criteria for awarding local pay increases have not yet been sufficiently linked to the goals of the pay setting organisation. Instead, they are still predominantly based on professional and personal qualifications, and on functions. They also found it less satisfactory that none of the reviewed organisations could yet show that the new pay system had had any effects on the productivity or the quality of the organisation's activities.

This is, however, not surprising, since it will take time for operational managers to build up the competence necessary to take full advantage of the new pay system. The very consensus-oriented Danish industrial relations system also means that local trade unions have to be given time to adapt to the new system.

Interviews in Finland, where the gradual introduction of a new pay system for state employees in Finland has dragged on for 15 years, gave a similar impression. Several reasons were given for the slow uptake. One was the economic depression in the beginning of the 1990s. Another was that it had to be introduced within the existing economic envelope. Departments and agencies were thought not to have been sufficiently prepared; central training in pay setting was only organised three years ago. Trade unions also seem to have been insufficiently prepared.

The developments in the Finnish university sector are very illustrative of the problems encountered when introducing decentralised pay setting. A group of universities (covering 25% of state personnel) were among the first and most ambitious, and started to work on a new pay system in 1995. The first attempt was, however, not successful. The ambitions were set too high, and the system became too complex to handle. In addition, there was no consensus on how to handle trade union resistance. A common simplified system was then developed in co-operation with the Ministry of Education and the Office for the Government as Employer, and finally accepted by the trade unions in the beginning of 2006. It is based on separate assessment and grading systems for academic staff and other employees. Competency and performance assessments are agreed between the employee and his/her supervisor, or referred to the next higher level. The aggregated assessments for different universities are compared and adjusted in order to prevent an assessment drift.

The developments in the Netherlands are also illustrative. The 13 so called sector employers have been granted more liberty to allocate resources within their budget, and to differentiate the terms and conditions of work. Initially there was one pay grading system for all cabinet sectors. This is still largely the case, as the cabinet sector employers initially merely copied the original system. A number of modest amendments have however been introduced since then.

The decentralisation of pay setting in the Netherlands does not go beyond sector level.⁵² Managers on lower levels in the central government sector have no ability to differentiate pay, other than for minor remuneration elements. The sector employers have on more than one occasion proposed the introduction of performance related pay, but never managed to reach an agreement with the trade unions on the design. The statutory requirement for agreement prevents the employers from

taking a unilateral decision, and the sector employers have so far refrained from linking pay increases to an agreement on performance-related pay elements. There are however some agreements on performance-related pay, for instance in the provincial sector.

The experience in the United Kingdom provides an example of coherence problems. The old structure of a small number of highly centralised agreements has been replaced by a system of department and agency pay setting. The varying financial ability of individual organisations to meet their specific pay needs directly implies some divergence and reduced pay coherence across departments and agencies. A UK government survey from 1996-98 shows evidence of a weak trend towards a greater spread around the average pay development in departments, suggesting a small but not significant divergence. There are more recent indications that the divergences in pay levels can now be substantially larger for specific departments, agencies or occupations.

Most labour markets in developed countries have for historical reasons uncalled-for pay differences between female-dominated professions and male-dominated professions. Both the budget allocations and the central collective agreements are normally calculated in a standardised way, and reducing pay increases for other groups in order to increase wages for women in low-paid professions would only create new imbalances and resentment with the other employees. The only observed example of a central measure to rectify these imbalances is Finland's special pay pools for extra increases for female employees with low incomes.

Trade union relations and involvement are most intensive in Denmark and Finland due to the high organisation rate and the two-level system for collective agreements in these countries.

Among the other countries, New Zealand provides an example of a deliberate development of a constructive trade union involvement. The basis for this is the *Partnership for Quality* agreement that the government signed a with the largest public service union (the Public Service Association, PSA) in 2000 and later renewed. One way of involving the unions is to set up a joint working group to consider remuneration or performance management during the term of a collective labour agreement. Many departments with collective agreements are sometimes required (by explicit provisions in the collective agreement itself) to engage or consult the relevant unions over the annual market review and salary adjustment process. Any resulting remuneration change would then apply across the department, not just to union members covered by the collective agreement.

Special case 9. Safeguards against misuse of decentralised pay setting

A pay system is not just about purpose, but equally about values and about inducing a culture. On an abstract level it defines the relation between the employer and employee. A local pay grading system will only be sustainable if it is based on generally accepted principles and if the employer is credible in the intention to act according to these principles.

Among the dangers of decentralised pay setting is the appearance of favouritism, of arbitrariness, and of outright discrimination of any kind. These elements are detrimental to the credibility of the civil service values, to the workplace as such and ultimately to the pay system as such. The consequences may be alienation, dissatisfaction, lack of motivation and increased recruitment and retention problems.

Pay systems therefore need to be designed to provide safeguards against these types of misuse. They should include credible systems for treating complaints, such as procedures for internal reviews of pay decisions, or submission of contested pay decisions to independent appeals boards. Trade unions are also often able to bring complaints and evidence to misuse to the attention of supervisory levels. Finally, operational managers can be trained and supporting in order to enable them to take fairer and appropriate pay decisions. This could include special courses in gender and ethnicity issues.

The involvement of unions in New Zealand is facilitated by the fact that the government employers and the largest public sector union (PSA) have agreed that remuneration systems need to be fair, transparent, consistently applied, affordable, easily understood and administered, sufficient to attract and retain good staff, and compliant with the government's bargaining parameters. Nevertheless, there are some differences in opinion. The government employers do not, for example, want to have a universally applied remuneration system, although they accept some generally applied principles, while unions seek a higher degree of standardisation across public service departments.

In the United Kingdom, relations with the trade unions have been less harmonious. The major unions for civil servants (organised in CSSU) disagreed with the decision in 1994 to delegate pay setting, and have never accepted the massive disassembling of the central bargaining machinery or the direction which pay bargaining has been taken since then. However, they now seem to recognise that there is no overwhelming desire in departments and agencies to return to centralised pay negotiations, and that the operational managers have seen some perceived advantages in the delegation. Present union policy is thus oriented towards a national framework approach on pay and related conditions.

4.6. *The outcome*

There are relatively few hard facts available about the outcome of decentralised pay setting. Much of the basis for the assessments has been provided by comments from persons interviewed. When these were corroborated by similar comments from other persons, in literature and by analysis of the conditions and consequences of decentralised pay setting, they have been considered to be reasonably credible. The outcome in terms of pay levels or details of pay systems have not been reviewed since the analysis has focused on governance and process perspectives.

The main motive for decentralisation is the need to allow operational managers to adapt human resource management arrangements to the business needs of their organisation. One key issue is thus to what extent pay setting entities have taken advantage of the decentralised mandate to adapt pay structures to the business needs of their organisation. There is clear evidence of such developments in all countries reviewed.

However, it is undoubtedly a slow process, and it will evidently take longer time for the full outcomes to materialise than the most ardent proponents of decentralisation assume. Finland introduced their new pay system about 15 years ago, and Denmark almost 10 years ago, but neither of these two systems have yet matured. There is clear evidence that the reason for the slow process is that it is a learning process. Both operational managers and employee representatives have to acquire competence and experience in pay setting and in analysing the business needs of their organisation before they are able to take full advantage of the new systems. Inadequate capacity building before introduction, or distrust of the seriousness of the centre's intentions, will also lead to local pay setters being too cautious, and retaining structures similar to the old centralised systems.

A logical corollary to this is that adequate central support for the pay setting entities is essential for the achievement of the desired outcome. This can take the form of management selection and training, handbooks and other forms of guidance, and statistical tools assisting operational managers in evaluating their own pay structure and in benchmarking with other pay setting entities. There are indications that the lack of such support will delay the materialisation of the desired outcome, and that it may also contribute to a backlash and to the rationality of the entire reform being questioned.

One interesting issue is to what extent the decentralisation has led to an individualisation of pay. These are not identical concepts, although decentralisation is probably a prerequisite for individualisation. There is also an element of individualisation in the universal interest in performance-related pay elements, and Australia and New Zealand have introduced individual pay agreements as part of their reforms.

Arguably, the potential for individualisation is often overstated. It entails higher transaction costs than uniform and collective standards and agreements, and one should assume that a rationally acting operational manager will use standard contracts, standard conditions and collective pay structures unless there is a clear added value to be gained from individualisation. It is a reasonable assumption that both skills and performances would tend to adhere to a normal distribution, that the transaction costs of differentiation around the centre is high, and that a realistic ambition might be a differentiation that affects the top and the bottom 10-15%.

Another key issue is if the economic frameworks have been sufficient to ensure that overall pay developments are compatible with maintaining both stable public finances and attractive public employment. Nothing was found that indicated that this is not the case in any of the countries. At the same time, there seem to be distinctive advantages in applying a standardised initial adjustment of the budgets of pay setting entities, since it reduces the transaction costs, improves the entities' ability for multi-year planning and allows the governments to concentrate their political deliberations on entities where there is a political or business case for further adjustments.

A final key issue is whether the decentralised pay setting arrangement has been able to maintain a sufficient coherence in pay and other employment conditions. Several countries seem to have experienced that mergers between different pay setting entities have been complicated by differences in pay structures and pay levels, but these problems seem to have been manageable in most countries, probably due to standardised adjustments of the budgets of pay setting entities. The exception is the United Kingdom, where applying both bottom-up budgeting and the remit process entity by entity seems to have created unforeseen differences in financial capacity, and cases of substantial and unwarranted divergences of pay for persons with similar skills and jobs.

5. Two governance models

The two governance models that we have identified – the remit model and the consensus model – are essentially very broad and flexible frameworks. They are based on a limited number of structural elements, but within these there are a range of different design options available for governments. Both models therefore allow a flexible application, both over time and across the spectrum of different central government bodies.

A common element in both these two models is that normally, the political level is only involved in setting policy and adopting frameworks, but not in the pay bargaining or in the actual pay setting. These functions are instead handled by the civil service level, whether at central or sub-central level. New Zealand is however the only country where there is a fire-wall between the political level and the pay bargaining. There are, however, clear expectations in the other three countries of a political “hands-off”.

5.1. *The remit model*

This model is based on single level bargaining. Coherence across the central government administration is ensured by a set of common *bargaining parameters* and a *remit process*. The actual pay bargaining and pay setting have been devolved or delegated to sub-central units, but these have to submit their draft pay agreements to another organisation for assessment or approval before signing them.

The bargaining parameters serve as the carrier of common elements and principles, and for political initiatives. In Australia, they are issued by the government and in New Zealand by a central government personnel agency, the State Services Commission (SSC).

In Australia, pay agreements have to be approved by the relevant minister. The chief executives of the sub-central bodies have to submit their draft agreements to the Department of Employment and Workplace Relations (DEWR) for assessment of their compatibility with the bargaining parameters. The opinion of DEWR is also merely advice, but the chief executive has to inform the minister about the advice when seeking approval of the pay agreement.

In New Zealand, pay bargaining and pay setting has been devolved to the SSC and then delegated to the chief executives of sub-central bodies. They have to submit their draft agreements to the SSC for assessment of their compatibility with the bargaining parameters. The opinion of the SSC is merely advice, but it is given against the background of SSC control over the term appointments of the chief executives.

The present bargaining parameters in Australia and New Zealand are relatively limited in scope and this provide for a substantive sphere of managerial discretion. Bargaining parameters can, however, in theory also be very detailed, leaving little to be settled in the actual bargaining process. This versatility could be used for a staged introduction of decentralised pay bargaining and pay setting, through a gradual increase over time of the spheres of managerial influence.

The point in the Australian bargaining parameters that has caused most discussions between chief executives and the DEWR seems to be the call for “simple, principles-based agreements”. The pay bargaining bodies are said to have had difficulties in making the transition from the existing more complex arrangements to the desired types of arrangements in a single bargaining round.

The relatively short Australian bargaining parameters is supplemented by a longer guideline document⁵³. These guidelines are integrated into the New Zealand bargaining parameters, which therefore is a more extensive document. The New Zealand bargaining parameters include a reference to the *Partnership for Quality* agreement that the government has signed with the largest public service union (the New Zealand Public Service Association). This agreement focuses on establishing co-operative and open relationships and reflects government policy on the sort of relationships it wishes to the public administration to have with the trade unions.

Australian bargaining parameters⁵⁴

1. Agreements are to be consistent with the government's workplace relations policies. These include: *i)* compliance with the Workplace Relations Act; *ii)* direct relations between employers and employees; *iii)* protecting freedom of association; *iv)* simple, principles-based agreements; *v)* making AWAs available to all staff; and *vi)* employer and employees having primary responsibility for resolving workplace disputes (including industrial action).
2. Improvements in pay and conditions are to be linked to improvements in organisational productivity and performance. Other than in exceptional circumstances, pay increases are to apply prospectively.
3. Improvements in pay and conditions are to be funded from within agency budgets.
4. Agreements are to include compulsory redeployment, reduction and retrenchment provisions, with any changes not to enhance existing redundancy arrangements. An agency minister may, in consultation with the minister assisting the Prime Minister for the public service, approve separate financial incentives to resolve major organisational change. Such incentives are to be cost neutral to the agency in the context of the major organisational change.
5. Agreements are to facilitate mobility across the APS by: *i)* maintaining structures that are consistent with the Classification Rules, with salary advancement to be guided by performance; and *ii)* retaining portability of accrued paid leave entitlements.
6. Agreements are to include leave policies and employment practices that support the release of Defence Reservists for peacetime training and deployment.

The remit process in Australia and New Zealand is, as shown by their bargaining parameters, not a simple application of formal criteria or a pass-or-fail test. It provides instead for a dialogue between the pay setter and the remit body, where the pay setter is expected to demonstrate that the draft collective agreement is appropriate, given the pay setter's business case. This also links the remit process to the general accountability mechanisms and to the performance assessments of the chief executive of the pay setting organisation.

The bargaining parameters in Australia and New Zealand do *not* cover the actual cost of the agreements or the ensuing pay levels. Instead, both make explicit references to the *affordability* principle. The Australian bargaining parameters thus state that *Improvements in pay and conditions are to be funded from within agency budgets* and the New Zealand bargaining parameters that *Departments should set remuneration levels taking into account ... ability to pay within approved baselines*. The sub-central pay bargaining thus take place within the confines of the total economic envelope of the pay setting organisations, which has been provided in advance through a separate process.

Neither of these two countries have a special expenditure limit for pay. Pay setting organisations are able to use extra-budgetary revenues and savings on other types of expenditure for increased staff costs, whether in the form of more employees or of higher average pay.

The arrangements in the United Kingdom are similar to those in Australia and New Zealand, although more complex and less transparent. Their main weakness is that the budget process is not sufficiently separated from the bargaining process, and that the United Kingdom has not implemented a full devolution under an affordability principle. Instead, the remit process includes the actual cost of an agreement and affects the budget envelope of the pay setting organisation. At the same time, a large number of public employees still have their wages set by awards and not by agreements. This lack of a systematic approach to pay bargaining and pay setting may be the main reason why the United Kingdom is experiencing serious coherence problems.

New Zealand bargaining parameters⁵⁵

General government policy on remuneration is:

- Departments' remuneration systems should be focused on contributing to achieving outcomes and maintaining/improving output performance by: *i)* developing and maintaining the organisational capability to achieve the outcomes set out in their statements of intent; *ii)* providing incentives and opportunities for employees to develop required skills/expertise, and/or to improve performance.
- The government should pay levels of remuneration that are fair (to employees) but not extravagant (in fairness to the taxpayer).
- Remuneration systems must be fair and transparent and linked to a transparent and fair system for adjusting salaries to reflect increases in skills/competence (whether generated through experience or training), and/or improved performance.
- Remuneration principles should be agreed with employees and unions.
- In general, the government expects that minimum pay rates will be a matter for negotiation and that, unless there is a good reason not to, these will be included in the collective agreement.
- The government does not generally favour remuneration systems which allow salary progression solely for time spent in the job – in general, it is expected that progression beyond the minimum rate be based on merit.

Departments should set remuneration levels taking into account:

- market demand for the relevant skills/capabilities, experience, and responsibilities;
- recruitment and retention factors;
- ability to pay within approved baselines;
- comparisons with other groups within the department;
- any government policies, from time to time, aimed at achieving wider outcomes for employees generally or for particular groups of employees, for example policies and processes relating to pay and employment equity.
- other factors relevant to the particular department.

Employment agreements should contain provisions setting out what happens in restructuring and redundancy situations. This should include a "technical redundancy" clause so that staff who are offered positions in a new agency (and their terms and conditions of employment remain largely unchanged) will not be entitled to redundancy payments;

Departments must get State Services Commission approval before developing proposals to relax current sick leave provisions through the introduction of open-ended sick leave;

Departments must consult with the State Services Commission prior to developing any significant proposals:

- to significantly improve annual, parental or other leave entitlements;
- to significantly improve benefits or employee entitlements under the State Sector Retirement Savings Scheme or to otherwise provide for (or alter arrangements for) other superannuation or retirement-related payments;
- regarding allowances or pay differentials for employees in particular localities/regions;
- regarding pay and employment equity initiatives.

5.2. *The consensus model*

This model is based on pay bargaining at two levels. First, a central collective agreement covering all central government employees is negotiated with the relevant trade unions. This central agreement is then implemented through secondary negotiations at sub-central level. Coherence across the central government administration is ensured by the clauses in the central agreement.

One advantage of this model is that the parameters governing and confining the sub-central bargaining (corresponding to the bargaining parameters in the remit model) has been agreed to by the central trade union organisations. They should therefore also govern the behaviour of the local trade union representatives. At the same time it means, however, that the government cannot set any parameters unilaterally.

Denmark and Finland have set up government employers offices which can best be described as internal agencies within their Ministries of Finance. These offices are separately managed although still under ministerial tutelage, and act as the government's representative in the central bargaining process. One can assume that there is a set of internal bargaining parameters governing this bargaining, but these are normally not in the public domain. The final agreements have to be approved by the government, but this is generally seen as a technicality.

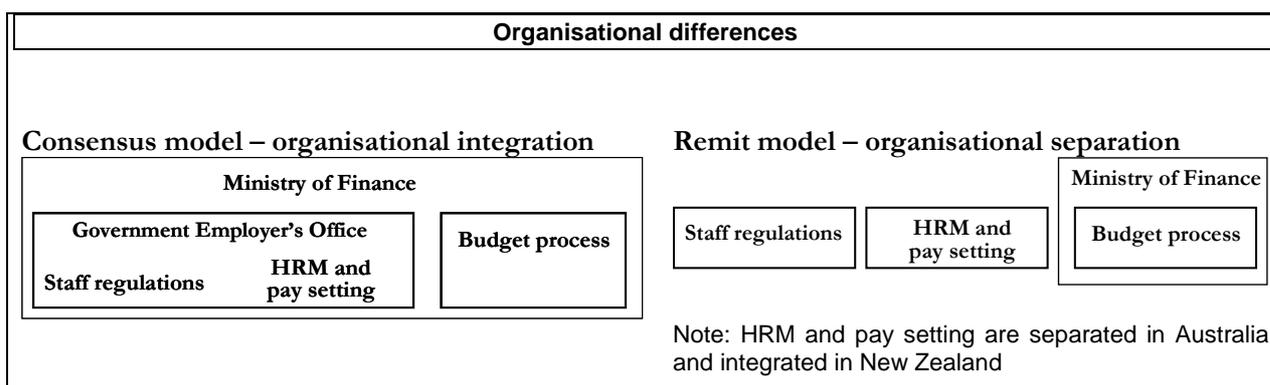
In Denmark, the central collective agreement interacts with the budget process. The budget for the sub-central organisations are normally set before the central pay bargaining begins, but the budgets can be revised upwards if the central agreement turns out to be more expensive than expected. In Finland, both the budget process and the central pay bargaining are preceded by a comprehensive national income agreement that determines the allowed level of pay increases.

Sweden has taken this model a step further, by setting up its government employer's office as an external agency. Pay bargaining and pay setting have been devolved to the individual government agencies, these elect the executive board of the office, and the board appoints the chief executive. The central collective agreement is not subject to government approval, with the exception of any clauses concerning retirement benefits. Sweden has instead implemented the same type of affordability principle as Australia and New Zealand.

The content of the central collective agreement can in theory vary from being very limited and providing a substantive sphere of managerial discretion, to being very detailed, leaving little to be settled in sub-central bargaining. This provides for the same versatility as the bargaining parameters used in the remit model. The model can thus also be used for a staged introduction of decentralised pay bargaining and pay setting through a gradual increase over time of the sub-central spheres of managerial influence.

Most of the annual pay increases in Denmark are general increases agreed in the central collective agreement, and only a minor part is the result of local agreements. The local share is larger in Finland, but most of the pay increases are still general increases agreed in the central collective agreement. Again, Sweden has taken this model a step further by having only minimum individual and collective guarantees in the central collective agreement, and leaving the actual pay setting to the sub-central negotiations.

The central collective agreement also governs situations where the sub-central parties fail to reach an agreement. In Denmark there can be no locally determined pay increases unless the sub-central parties reach an agreement. In Finland, the pay pool set aside for local distribution is shared equally among all employees, if there is no local agreement before a set deadline. A third alternative would be for the parties to the central collective agreement to mediate and if necessary settle the differences between the sub-central parties.



Explanatory box: Different functions at the centre

Budget function: The part of the centre that supports the government in formulation and implementation of the budget; that is of the economic envelopes for the different public activities.

Staff regulations function: The part of the centre that supports the government in drafting and implementing staff regulations and other statutes relating to central government employment.

Human resource management function: The part of the centre that advises the government in human resource issues, and that supports and evaluates sub-central human resource management.

Pay bargaining function: The part of the centre that either negotiates a central collective agreements for central government employees, or monitors and evaluates the implementation and outcome of sub-central pay bargaining for central government employees.

6. Conclusions

The six countries reviewed are not a random sample. They have been chosen because they have experience and interest in decentralised pay setting. They have provided a broad range of arrangements, practices and experiences and thus also a good basis for comparisons and tentative conclusions. The tentativeness of the conclusions should, however, be underlined; this is not a comprehensive study and the observations made are based on a limited material and can be open to interpretations.

There are two distinct alternatives represented among the six countries; the Australia/New Zealand model and the Denmark/Finland model (see Table 5). The arrangements in the Netherlands and in the United Kingdom seem less cohesive and still under evolution.

Table 5. Arrangements for decentralised pay setting

Country	Collective agreements	Economic envelope	Focus issues
Australia and New Zealand	Single level system combined with individual contracts	Standard underlying base for adjustments	Double focus on pay and general human resource management
Denmark and Finland	Two-level system	Standard underlying base for adjustments	Main focus on pay and other conditions
Netherlands	One-level system	Adjustments assessed on case by case basis	Main focus on pay and other conditions
United Kingdom	One-level system	Adjustments assessed on case by case basis	Double focus on pay and general human resource management

Both the two distinct models seem to work well for the countries that have them. The reason for that is probably that they are adapted to the specific political and administrative culture of the respective country. The models represent two different development paths; the Anglo-Saxon with, *inter alia*, a stronger focus on individual contract-based relations, and the Nordic with, *inter alia*, a stronger focus on cohesion and collective action.

It is therefore not possible to make any general recommendations; each country has to find its own path starting from where they are. It is, however, possible to draw some general conclusions from the review. These are grouped under five headings.

6.1. *Introducing or extending decentralised pay setting*

Introducing or extending decentralised pay setting involves a learning process. Both operational managers and employee representatives have to acquire competence and experience in pay setting and in analysing the business needs of their organisation before they are able to take full advantage of a decentralised pay setting authority.

The chances for a successful introduction and extension of decentralised pay setting can be substantially improved by adequate preparations before the introduction or extension. A logical corollary to this is that adequate central support for the pay setting entities is essential for the materialisation of the desired outcome. There are indications that the lack of preparations and support for decentralised pay setting will delay the materialisation of the desired outcome, and that it may even contribute to a backlash, and to the rationality of the entire reform being questioned.

6.2. *Safeguarding coherence*

The main motive for decentralisation is the need to allow operational managers to adapt human resource management arrangements to the business needs of their organisation. This will entail a differentiation of arrangements across the central government administration, and is therefore at variance with coherence. The main conclusion is therefore that governments should have a clear position on whether a specific human resource management element:

- should be uniform throughout the entire central government administration;
- could vary between different parts of the administration, but only within stated limits; or
- could vary freely between different parts of the administration.

The first group of elements should continue to be determined at central level, even if other decisions on other human resource management elements are decentralised. They could be determined either through statutes or regulations, or through central collective agreements.

The second group of elements can be *delegated* to operational managers, but should still be governed by the centre, either through bargaining parameters and central control of the conformity of local arrangements, or through a clear framework in statutes or central collective agreements.

The third group of elements can be *devolved* to operational managers, and the role of the centre limited to monitoring development and holding operational managers accountable *ex post* for outcomes and for the adequacy and appropriateness of the arrangements. The fact that the elements

have been devolved does not however prevent the centre from issuing policy documents on the desired quality and characteristics of these elements.

6.3. *Governing decentralised pay setting*

Appropriate financial management arrangements are essential for a well-functioning decentralisation of pay setting. The key aspect of these arrangements is that budget appropriations and pay bargaining should be effectively separated, so that the decentralised pay setting should take place within the confines of a stable and credible affordability restriction. It is also obvious that the countries that apply a standardised initial adjustment of the budgets of pay setting entities have been able to create a more stable and adequate environments for decentralised pay setting than countries that decide on budget adjustments on an entity by entity basis. The first mode would also reduce transaction costs and enable a clear focus on the cases where there is a significant case for an additional adjustment.

There are two main alternative structures for governing decentralised pay setting. Countries with single level systems for collective agreements have a central agency that issues bargaining parameters, and that monitors that collective agreements signed by sub-entities conform to these parameters. Countries with two level systems for collective agreements have a central agency that negotiates and signs central collective agreements that set an economic and legal framework for secondary negotiations at lower levels.

The limited evidence does not allow any conclusion that one of these two alternative structures is better than the other. The key important characteristic is probably instead the adaptation to the national context. One common denominator is, however, the existence of a separate and professionally competent central agency able to govern and monitor the behaviour of the pay setting entities.

6.4. *Implementing decentralised pay setting*

Effective monitoring and assessment of the adequacy and appropriateness of decisions taken by the operational managers in pay setting entities is essential for a well-functioning decentralisation, especially over time. It is essential that the operational managers are held accountable, both for their decisions and for the outcomes that they have achieved.

Countries with decentralised pay setting also need to invest in a corps of professional public managers with skills that are adapted to the specific context of the public administration. What this would entail is outside the scope of the study, but it seems clear that among the minimum requirements are term limits, and assigning higher importance to general management skills than to area-specific expertise.

The chances for a positive outcome of decentralised pay setting can be improved if the central agency provides adequate and appropriate support for the decentralised pay setting. This should include such elements as guidelines, handbooks, training, peer consultation networks and statistical tools that enable the pay setting entities to benchmark their pay system and pay structure to that of other pay setting entities within the central government administration, and to the evolution of market pay for comparable skills and tasks.

6.5. *Expected outcomes*

Decentralised pay setting can evidently have positive effects on the performances of the public administrations in questions. This is, however, contingent on the country having instituted adequate financial management and governance arrangements.

At the same time one should not expect any immediate outcomes of the introduction of decentralised pay setting. Both the operational managers and the employee representatives have to gain sufficient competence and skills in pay setting in order for the full benefits to materialise. The corollary to this is that a gradual introduction is probably preferable to a broad and radical change at one point in time. Consequently, the implementation time for this type of reforms should probably be counted in decades and not in years.

Finally, it would not be rational to make a complete change over to individually differentiated pay and other conditions. Standard contracts and conditions are a well-established way of reducing transaction costs, and a rational employer would only use individual contracts and conditions when there is a clear business case for it, and added value to be gained.

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ANNEX II: PERSONS INTERVIEWED FOR THE PROJECT

The persons interviewed are listed in the following order.

- a. The central HRM and/or employer function
- b. The central budget function
- c. Pay setters
- d. Trade unions representing government employees

AUSTRALIA

- a. Tulip CHAUBURY, Department for Employment and Workplace Relations
- b. John IGNATIUS, Department of Finance and Administration
- c. David DIMENT, Australian Tax Office
Keith FAIRBROTHER, Department of the Environment and Heritage
- d. Alastair WATERS, Community and Public Sector Union

DENMARK

- a. Søren Rotvig ERICHSEN, Anne Kirstine DAMSAGER and Marianne HANSEN, State Employer's Authority
- b. Mogens PEDERSEN, Ministry of Finance
- c. Erik CHRISTIANSEN and Susanne HANSEN, Danish Competition Authority
Doris DETHLEFSEN and Kristoffer ALMDAHL, Risø National Laboratory
- e. Helle JENSEN, Association of Danish State Employees' Organisations (STK)
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FINLAND

- a. Teuvo METSÄPELTO, Office for the Government as Employer
Veikko LIUKSIA, Office for the Government as Employer
Seija PETROW, Office for the Government as Employer
- b. Hannu MÄKINEN, Budget Department, Ministry of Finance
- c. Tiina ERÄNKÖ, Police Department, Ministry of Interior
Jouni KEKÄLE, University of Joensuu
- d. Harri SIRÉN, Federation of Salaried Employees

NETHERLANDS

- a. Kees MAAS, Ministry of Interior
- b. Meindert SMALLENBROEK, Ministry of Finance
- c. Ed PRIESTER, Ministry of Interior
Ina SJERPS, Association of Netherlands Municipalities (VNG)
Jan VERINGA, Ministry of Education
- d. Xander DEN UIJL, ABVAKABO FNV

NEW ZEALAND

- a. Rosemary HANNAH-PARR and Janine HARVEY, State Services Commission
- b. Gerald MINNEE, New Zealand Treasury
- c. Anne Marie TAGGERT, Department of Child, Youth and Family Services
Cheryl CROOKS and Fiona CAMERON, New Zealand Trade and Enterprise
- d. Richard WAGSTAFF, Public Service Association

UNITED KINGDOM

- a. Christopher S. JOHNSON, Employment Policy and Practice Division, Cabinet Office
John WHITTAKER, Employment Policy and Practice Division, Cabinet Office
Farha BHATT, Employment Policy and Practice Division, Cabinet Office
- b. Mike BATLEY and Adrian DOTTRIDGE, The Treasury
- c. Angus GRAY, Department for Work and Pensions
Neil MACINTOSH - Department for Environment, Food and Rural Affairs
- d. Geoff LEWTAS – Public and Commercial Services Union

ANNEX III: REFERENCE MATERIAL

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NOTES

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1. “Affordability” means that the pay setter should be able to finance the resulting costs with the present budget.
 2. Its formal name is the Commonwealth of Australia.
 3. The legal designation is “agency” but they can be called, *inter alia*, agency, authority, bureau, commission, corporation, institute, office or service depending on their character.
 4. There is also a federal police responsible to the Australian Commonwealth government.
 5. Australian Bureau of Statistics. Employee Earnings and Hours, May 2002 and May 2004.
 6. These are sometimes called “directorates” in English texts. This report uses the official Danish translation.
 7. Andersen, Due and Madsen p211-12.
 8. National designations are given in Swedish in this document.
 9. These agreements are negotiated by the social partners on the basis of conditional pledges from the government, and are thus dependent on Parliamentary approval.
 10. The general pay increase for 2005 was 30.06€ per month, but not less than 1.9% of the individual salary. The pool for local allocation during 2005 was 0.6% of the total pay sum.
 11. Tjänste- och arbetskollektivavtal om justering av anställningsvillkoren för statsanställda 14.12.2004.
 12. Currently the Ministry of Development Corporation is headed by a secretary of state (*staatssecretaris*).
 13. These are, however, called collective agreements.
 14. State, Police, Defence, Judiciary, Education, Universities, Higher Professional Education, Academic Hospitals, Research Institutes, Occupational and Adult Education, Provinces, Local Authorities and District Waterboards.
 15. That is provinces, municipalities and water boards.
 16. Normally in the beginning of each electoral period.
 17. The bargaining parameters are determined by Cabinet (reflecting the government’s broad policies and expectations for collective bargaining and employment relations) and issued by the State Services Commission.
 18. In some cases the employer role is vested in boards (such as school boards of trustees).
 19. The areas covered are the armed forces, the police, the prison service, health professions, school teachers, the judiciary and the Senior Civil Service.
 20. 1864-1920. Professor in Commercial Law in Berlin, Political Economy in Freiburg and Heidelberg and Sociology in Vienna.
 21. The Department of Child, Youth and Family was merged with the Ministry of Social Development on 1 July 2006.
 22. Kiviniemi, M. och Virtanen, T. (2000).

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23. It may sometimes be difficult to find comparable positions or occupations in the private sector, but there are a number of tools for pay assessment that can be used.
 24. One example is the so called *Alimentationsprinzip* that still plays an important role in the German debate.
 25. Another motive for standardization might be a desire to avoid the risk for misuse of authority that follow with discretionary decisions.
 26. This is a description of the Swedish system as it looked before 1976. The elements are, however, recurrent features in contemporary systems in other OECD member countries.
 27. See for example Bender and Elliott (2003).
 28. See for example Bender and Elliott (2003), Eichengreen and Iversen (1999).
 29. Based on Bender and R.F. Elliott (2003), p. 11-12.
 30. Based on Bender and Elliott (2003) p. 13-14.
 31. Retirement benefits. This problem can easily be avoided in countries with superannuation schemes and other forms of contribution-defined schemes.
 32. Coherent adj. (origin Latin *cohaerere*) 1 (of an argument or theory) logical and consistent. 2 able to speak clearly and logically. (Oxford English Dictionary).
cohérent adj. (1524; lat. *cohærens*, p. prés. de *cohære* « adhérer ensemble ») 1 Qui présente de la cohérence, de l'homogénéité. 2 Qui se compose de parties compatibles, liées et harmonisées entre elles (discours, pensée). 3 Dont le déphasage est constant au cours du temps. (Nouveau Petit Robert).
 33. Among the possible costs are overpaying, losing valuable staff by underpaying, demoralising staff by subjective pay setting, hampering internal mobility and making organisational restructuring more difficult
 34. Rising market pay levels for scarce skills are in this perspective seen as resulting in an improved allocation efficiency and over time to an increased supply of these skills.
 35. This would include all forms of early retirement schemes.
 36. This section relies extensively on information retrieved from www.wikipedia.com.
 37. See Section 3.2 for a definition of delegation and devolution.
 38. Milgrom and Roberts (1992).
 39. See for example Fairbrother and Yates (2004).
 40. Sub-central government levels are negotiating separately in both countries.
 41. Part of the Ministry of Finance in Denmark, Finland and the Netherlands, and of the Treasury in Australia, New Zealand and the United Kingdom.
 42. They are negotiated between the social partners on the basis of conditional pledges from the government.
 43. This section deals only with the direct budget aspects of this problem. The other aspects will be dealt with in Section 4.3 on the central governance of pay setting.
 44. The upside of this problem exists even at zero productivity dividend.
 45. These are dealt with in Section 4.2 on the financial management arrangements.
 46. See Section 3.2 for a definition of the concepts of delegation and devolution.
 47. Superannuation system.
 48. See also OECD (2003a).

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49. The analysis in this section is mainly based on information available on the internet.
 50. See Annex II for a list of the interviewed persons.
 51. The range of varying business needs is illustrated by special case in Section 2 of this report.
 52. Sub-sector in the education sector.
 53. Supporting Guidance: Workplace Relations Policy Parameters for Agreement Making in the Australian Public Service.
 54. The text has been slightly edited version of the original document *Workplace Relations Policy Parameters for Agreement Making in the Australian Public Service*.
 55. The text is an edited excerpt from the longer original document *The Government's Bargaining Parameters*.
 56. Gerard Minnee replaced Paul Carpinter from the New Zealand Treasury after the latter's retirement.
 57. This document is only available in Finnish and Swedish.