

## **Non-technical summary**

The aim of this study is to empirically investigate the public-private wage differentials in Kosovo and Albania and to what differences could be attributed to. The public sector wage setting can have an important effect on labour market efficiency and macroeconomic outcomes. If the government offers higher wages it may absorb the highly skilled workers hence crowding out the private sector employment. If, alternatively, the public sector offers less competitive wages it might find it difficult to attract and retain well-qualified employees thus seriously impacting the quality of services provided by the public sector.

Figures indicate that the wages are currently in favour of public sector in both countries. In addition to theoretical expectations several other factors have influenced the wage difference between public and private sector in Kosovo and Albania. Post-independence in 2008, very large increases in public sector wages were evident in Kosovo. Nepotism and mobbing are major challenges of employment in public sector in both countries. The prevalence of political influence in recruitment of public servants disrupts independence and accountability of recruitment process by prioritizing political allegiance over quality of service provision. Hence, educated individuals may end up in private sector despite the wage gap in favour of public sector or perform low skilled jobs due to very high unemployment rates.

Analysing the public-private wage gap is certainly an interesting issue to study given that both countries have undergone in-depth restructuring of the economy as well as have continuously recorded underperforming labour market indicators. Moreover, the labour market institution set-up is similar as both countries have a minimum wage setting system; however they use different currencies. The official reporting on the private wage sector in both countries might be underestimated due to large scale of informality. The extended presence of international institutions in Kosovo may also constitute an important source of differences in the wage pay gap between public and private sector.

To this purpose, nationally representative data from Kosovo Household Budget Survey 2011 and Albanian Living Standard Measurement Survey 2012 are used. In order to address the double sample selection problem arising from non-random selection of labour market participants as well as assignment to public or private

sector employment, the approach in Heitmueller (2006) is followed. More precisely, a two-step Heckman approach is employed, based on which selection terms are calculated. In a second stage, separate wage regressions are estimated for each country, and selection terms are included in wage regressions in order to correct for self-selectivity due to unobservables.

Due to expectations that labour market may differently compensate equivalent characteristics between genders, wage equations of the public and private sector for men and women are estimated separately. The Oaxaca-Blinder Decomposition technique is employed to determine whether the wage gap is attributable to the differences in the individuals' characteristics or to the differences in the remuneration endowments (wage discrimination). In addition, following Chernozhukov et al., (2013) the decomposition technique of quantile and distribution regression-based estimators are also utilized in order to complement the findings along the entire distribution of wages.

The estimations are performed only for men in Kosovo sample given the model estimated for women using two-stage Heckman technique could not be identified. The results of men's regressions suggest that individuals do not select randomly into employment and sector hence wage regressions cannot be estimated separately. For Albania, there is evidence of sample selection bias in the employment and sector selection for women, but not for men. The results on the wage gap for men support the expectations that wages are higher for men employed in the public sector in Kosovo and for both men and women in Albania. The decomposition results suggest that higher wages in the public sector are explained by better characteristics in both countries. Had men in the public sector had the same characteristics of men employed in private sector they would have been paid less in both countries.

Our results also suggest that men employed in the public sector would have been worse off if they would have the characteristics of their counterparts in private sector across the entire wage distribution; although the differences are more pronounced at lower part of the wage distribution for both countries. In Kosovo for low wages the gap can be attributed to different returns to characteristics whereas for higher wages differences are attributed to better characteristics of employees. In Albania, wage differences are attributed to better characteristics of the employees in the public sector

along the entire wage distribution for both men and women, while there is evidence of significant differences in returns only for the lower wage deciles.

An implication deriving from the results is that for both countries private sector productivity and services could have been better if the public sector would not be employing the most qualified individuals. Moreover, the differences in returns to characteristics for low wages may indicate that the private sector is not strictly implementing the minimal wage requirement.