

## 8. Public sector pay and pensions

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### Summary

- The public sector pay bill has been increasing since the beginning of this decade, reflecting both higher public sector employment and rising levels of public sector pay. As it squeezes spending, the government is attempting to slow pay growth in the public sector. It claims that to do so is important in controlling inflation.
- The case for using a public sector pay policy to help target inflation is weaker than some recent government statements have suggested. It is certainly not the case that public sector pay increases have to be held to 2% just because the UK has a 2% inflation target. Over time, public sector pay will need to reflect productivity improvements across the whole economy.
- The Bank of England believes that pay increases of around 4½% a year across the whole economy would be consistent with the inflation target. Headline public sector pay increases consistent with the inflation target will generally be lower because of relatively high 'pay drift' for some groups of public sector workers.
- Relatively generous public sector pensions mean that a public sector worker is on average around 12% better off than a private sector worker on the same basic salary. This gap has grown over the past decade as a result of private sector retrenchment. The government has made modest progress on reform, but unfunded public pension liabilities continue to grow. The gap between public and private sectors does not look sustainable. The case for further reform is strong.
- The 'staging' of a number of pay review body recommendations last year has delivered modest, but strictly one-off, savings. There would be significant risk to the credibility of the pay review body process if the government were to make a habit of not implementing recommendations. This would have long-term costs.
- Public sector pay is much lower relative to private sector pay in London and the South East than in other parts of the country. If the government wishes to broadly equalise the quality of public services across the country, it should increase public sector pay more quickly in areas where it is relatively low.

### 8.1 Introduction

Public sector pay and pensions have been looming increasingly large in recent years among public policy challenges. Given the numbers involved, this is not altogether surprising. The public sector pay bill amounted to £161 billion in 2006, representing 32% of all government

expenditure, 12.4% of national income.<sup>1</sup> Payments of public sector pensions amount to 1.5% of national income,<sup>2</sup> while the total stock of public sector pension liabilities has been estimated by the Government Actuary's Department at £530 billion as at March 2005.<sup>3</sup> When total figures for March 2006 are eventually released, they will show liabilities of at least £725 billion.

Although pay and pensions tend to be tackled separately in the public debate, we deal with them together here because they are clearly both aspects of the remuneration package enjoyed by public sector employees. And, although accounted for differently, they each form part of the cost to government of employing staff.

Both pay bill and estimated pension liabilities have been rising swiftly in recent years. The early part of this decade saw significant increases in public sector employment and, in many parts of the public sector, major reforms to pay systems. On average, public sector pay rose faster than pay in the private sector. This was partly a catching-up period for the public sector and partly a deliberate strategy to improve pay systems, to ensure vacancies were filled and to attract new workers in to fill the new posts. More staff and higher pay led, of course, to swiftly increasing costs. In a tighter fiscal environment, the government is now trying to rein in the pay bill, using a claimed link between public sector pay settlements and inflation as a justification for restraint. For parts of the public sector, and in particular the Civil Service, workforce reductions are also occurring.

Pension liabilities have also been increasing quite dramatically in recent years. A large part of the increase is due to changes in the way pension liabilities are measured, but real liabilities have also been growing as a result of increases in the number of public sector employees, increases in pay and larger-than-expected increases in longevity. At the same time, the coverage of generous final salary pension schemes has diminished quite swiftly in the private sector, with the result that the relative generosity of public sector pension provision has risen. The government has responded with a reform programme aimed at increasing the normal pension age across the main final salary public sector schemes, but only for new employees.

In the face of smaller pay increases, job cuts in some areas and pension reforms, public sector unions have been growing increasingly restive. They successfully delayed and caused to be amended the original proposed pension reforms which were due to be implemented in 2005. They have also led a smattering of strikes over pay and job losses in the Civil Service. The unions have been particularly upset by the government's decision last year to 'stage' pay review body recommendations, in particular the decision not to pay in full the 2.5% increase proposed for nurses and other health service workers, and more recently the police.

In these circumstances, the government is going to face a number of tricky decisions over the coming months:

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<sup>1</sup> Total current expenditure is estimated at £501 billion for 2006. Both numbers are from the ONS.

<sup>2</sup> HM Treasury, *Long-Term Public Finance Report: An Analysis of Fiscal Sustainability*, December 2006 ([http://www.hm-treasury.gov.uk/media/6/0/pbr06\\_longtermpublicfinancereport\\_476.pdf](http://www.hm-treasury.gov.uk/media/6/0/pbr06_longtermpublicfinancereport_476.pdf)).

<sup>3</sup> Note that this is a stock, not an annual flow like the pay bill, and so cannot be compared with the pay cost numbers. We go into more details on these estimates in Section 8.4.

- how to respond to pay review body recommendations when they come between now and the Budget;
- how to trade off the risk that pay costs will grow against the risks of industrial unrest and/or a possible return to recruitment and retention problems;
- whether to try to make progress towards greater local pay variation;
- how to respond to threats of expensive equal pay claims;
- how to finalise reforms to public sector pensions and whether to push towards further changes, particularly in light of recently legislated future increases to state pension age;
- whether to change pay-setting mechanisms, either by lengthening the pay deal terms or by abandoning the arbitrage of pay review bodies;
- to what extent to follow a public sector pay policy aimed in part at damping down inflation.

In this chapter, we start in Section 8.2 by setting out some of the facts on the size of the public sector pay bill and workforce and how this has changed in recent years. Section 8.3 compares changes in pay rates between public and private sector pay and assesses what room for manoeuvre the government has and what options it faces in particular sectors, with some focus on specific issues of local pay and equal pay. We then consider, in Section 8.4, where the pension reform programme has reached and what further options remain. Section 8.5 looks in more detail at the pay review body process. In Section 8.6, we come to a discussion of pay-setting mechanisms and the relation between public pay growth and inflation, as these have been at the core of recent policy debates. Section 8.7 concludes.

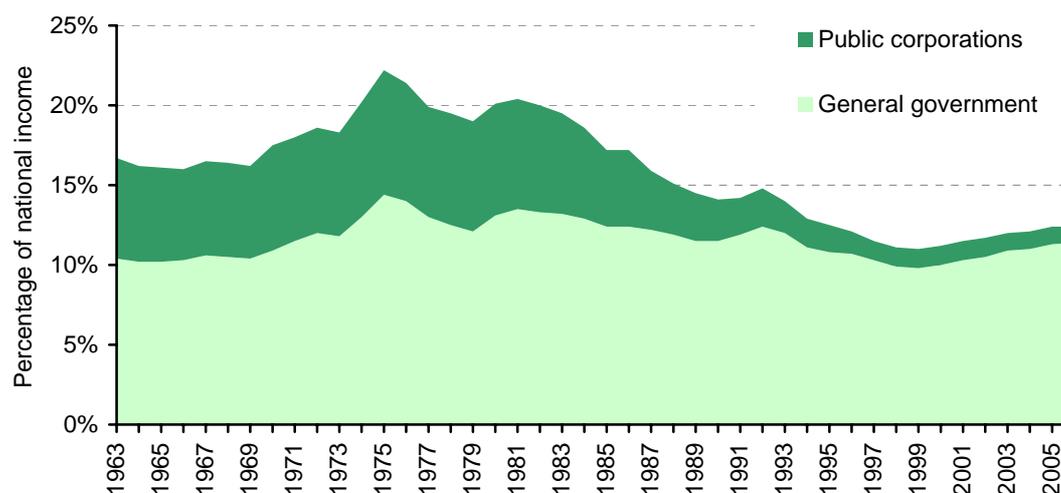
## **8.2 The public sector pay bill and workforce**

Following a long period of decline, in large part reflecting the privatisation of public corporations, the public sector pay bill in the UK has been increasing steadily since 1999. Figure 8.1 shows the long-term evolution of public sector compensation as a share of national income since the early 1960s. From a peak of 22.0% of national income in 1975, public sector compensation declined to a low point in 1999 of 11.0% and has since increased to 12.4% in 2006, a rise of 1.4% of national income.

From a low of £103 billion (in 2006 prices) in 1998, the pay bill excluding public corporations has increased by 43% in real terms to reach £148 billion in 2006. This is to be compared with the 32% real increase in total public expenditure over the same period and the small increase (in real terms) of the pay bill over the period from 1990 to 1998.

Changes in the public sector pay bill can be decomposed into changes in the size of the workforce and changes in the average wage cost to the government of employing staff. Table 8.1 shows changes in workforce numbers for some of the key groups of the public sector between 1997 and 2006. Compared with the rest of the public sector, the numbers of teaching assistants, police, doctors and NHS staff have risen relatively quickly, the number of public administrators has risen relatively slowly, and the number of people in the armed services has fallen in absolute terms as well as relative to the rest of the public sector workforce.

Figure 8.1. Public sector compensation



Sources: ONS, *United Kingdom National Accounts: Blue Book*, 2007 (<http://www.statistics.gov.uk/StatBase/Product.asp?vlnk=1143&Pos=1&ColRank=1&Rank=272>); ONS, *National Accounts Concepts, Sources and Methods*, 1998 ([http://www.statistics.gov.uk/downloads/theme\\_economy/Concepts\\_Sources\\_&Methods.pdf](http://www.statistics.gov.uk/downloads/theme_economy/Concepts_Sources_&Methods.pdf)).

Table 8.1. Public sector workforce in the UK

	1997	2006	% change, 1997–2006
National Health Service	1,190,000	1,522,000	+28%
<i>Of which:</i>			
Doctors (England)	89,619	126,251	+41%
Nurses (England)	318,856	398,335	+25%
Education	1,131,000	1,397,000	+24%
<i>Of which:</i>			
Teachers (England & Wales)	437,980	476,940	+9%
Teaching assistants (England)	68,074	199,331	+193%
Police	230,000	275,000	+20%
Public administration	1,139,000	1,245,000	+9%
<i>Of which:</i>			
Civil Service	516,000	558,000	+8%
Other public sector	708,000	733,000	+4%
HM Forces	220,000	204,000	-7%
Other health and social work	436,000	385,000	-12%
Construction	124,000	65,000	-48%
<b>All public sector</b>	<b>5,178,000</b>	<b>5,826,000</b>	<b>+13%</b>

Notes: Headcounts. These annual figures relate to the June quarter. The 1997 figures are not seasonally adjusted whereas the 2006 figures are.

Sources: ONS, *Public Sector Employment*, June 2007; DCSF, *Statistical Evidence to School Teachers' Review Body (STRB) 2007* (available at <http://www.teachernet.gov.uk/management/payandperformance/pay/reviseversion/>); NHS data from the Information Centre (available at <http://www.ic.nhs.uk/statistics-and-data-collections/workforce>).

Given the large increases in spending in labour-intensive services, such as health and education, this increase in staff numbers is not surprising. It was intended as a way to help increase the output of public services. But such increases are unlikely to continue with overall spending planned to grow by only 2.1% per annum in real terms over the next spending review period. Given these spending plans, for the workforce to continue to grow to any significant degree would require either an increase in the proportion of total spending going on the workforce or what would probably be unsustainably slow growth in pay levels (to which we come in Section 8.3).

The government has already started to reduce numbers employed in the Civil Service (see Box 8.1) but this is unlikely to be sufficient to provide room for increases in other groups of the public sector workforce.

### **Box 8.1. Civil Service reductions**

The government has trumpeted recent reductions in the number of civil servants. This follows its decision in Spending Review 2004 to implement some of the recommendations made by Sir Peter Gershon, who reviewed efficiency across Civil Service departments.<sup>a</sup> That spending review announced that there would be gross reductions in the full-time equivalent (FTE) Civil Service workforce of 84,150 between April 2004 and April 2008, implying gross reductions of 70,600 after 'reallocation' to the front line. The time of reckoning is very close. In October 2007, the Treasury published a progress report suggesting that by June of that year 66,275 of the 70,600 required net reductions had been achieved.<sup>b</sup> This looks like a triumph.

Concern has been expressed, however, about the discrepancies between these figures and ONS figures showing rather smaller reductions in Civil Service numbers. Latest ONS data show Civil Service numbers falling from 538,000 in 2004Q2 to 499,000 in 2007Q3, a fall of just 39,000.<sup>c</sup>

What explains these differences? It is difficult to be precise because the government has chosen not to publish a reconciliation between the ONS figures and the ones it uses to measure progress against its target.

Some of the differences are clear enough and clearly justifiable. For example, in April 2005 the Magistrates Court Service was brought together with the Court Service to form Her Majesty's Courts Service and as a result ONS reclassified the 11,000 former magistrates' staff into the Civil Service. Clearly, this should not count against the target. Other differences include:

- geographical coverage: ONS figures include devolved administrations, the government target does not;
- scope: government target includes reductions in military support staff not included in ONS figures;
- adjustments reflecting controlled expansions or new burdens: a Treasury technical note suggests that 'if the work of the Civil Service has expanded, due to factors that were unforeseen at the start of the efficiency programme ... then Departments can make a case to have these additional posts excluded from progress against their efficiency programme'.<sup>d</sup>

This leaves us with two problems. First, it is not at all clear that, across government as a whole, this last exclusion is legitimate. If a target to reduce Civil Service posts makes sense, then it is hard to see why one would accept increases as a result of 'new burdens'. The Treasury would certainly not argue that 'new burdens' justify increasing the spending allocations departments are given under its 'firm and fixed' spending reviews – it would require offsetting savings to be made elsewhere.

Second, and perhaps more fundamentally, if the government wants its policy to be fully credible, it should publish a clear reconciliation between its own figures and ONS figures. Given that the end date for this target is April of this year, we would expect the government to publish such a reconciliation alongside its assessment of whether or not it has succeeded in meeting its target. It is a shame that it failed to do so in its update of October 2007, where no attempt at explanation or reconciliation of the figures was made.

Going forward, no further specific targets for Civil Service headcount reductions were announced in the 2007 Comprehensive Spending Review, but 5% annual real reductions in administration budgets across departments were announced.<sup>e</sup> With real pay per head unlikely to fall by much (if at all), and with staff costs forming a majority of administration budgets, this implies further reductions in Civil Service numbers.

How much further this will be possible without losses in capability it is hard to know. Given recent problems at HMRC, which has delivered the great bulk of the 13,000 or so net reductions in staff recorded for the 'Chancellor's departments', the government might wish to consider whether further across-the-board cuts of this magnitude are likely to be too risky.

<sup>a</sup> P. Gershon, *Releasing Resources to the Front Line: Independent Review of Public Sector Efficiency*, July 2004 ([http://www.hm-treasury.gov.uk/media/C/A/efficiency\\_review120704.pdf](http://www.hm-treasury.gov.uk/media/C/A/efficiency_review120704.pdf)).

<sup>b</sup> HM Treasury, *2004 Spending Review: Efficiency Progress to June 2007*, October 2007 ([http://www.hm-treasury.gov.uk/media/2/E/pbr\\_csr07\\_efficiency265.pdf](http://www.hm-treasury.gov.uk/media/2/E/pbr_csr07_efficiency265.pdf)).

<sup>c</sup> Note that these are FTE figures and thus not directly comparable with the headcount figures in Table 8.1.

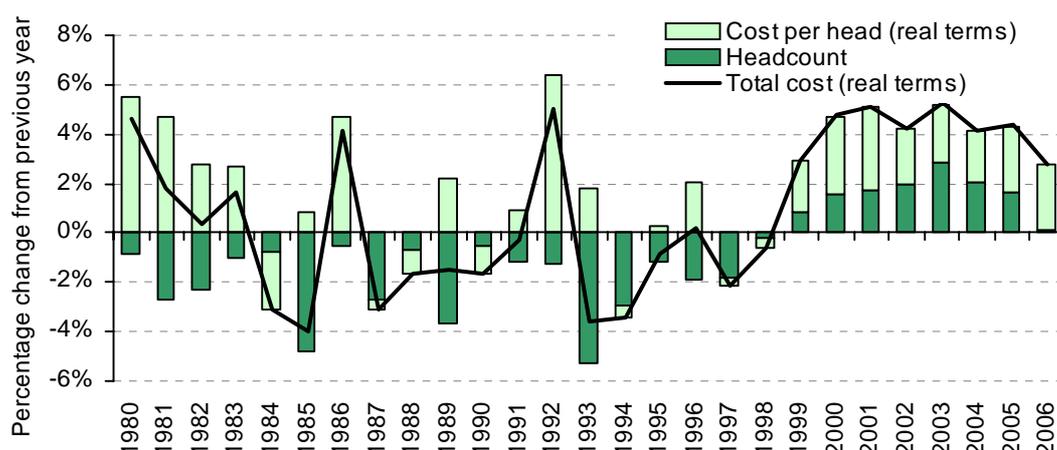
<sup>d</sup> HM Treasury, *Comparing Quarterly Civil Service Employment Estimates with Progress against Departmental Efficiency Programmes*, April 2006 ([http://www.civilservice.gov.uk/documents/doc/statistics/workforce\\_reductions\\_tech\\_note.doc](http://www.civilservice.gov.uk/documents/doc/statistics/workforce_reductions_tech_note.doc)).

<sup>e</sup> Page 43 of HM Treasury, *2007 Pre-Budget Report and Comprehensive Spending Review*, October 2007 ([http://www.hm-treasury.gov.uk/pbr\\_csr/report/pbr\\_csr07\\_repindex.cfm](http://www.hm-treasury.gov.uk/pbr_csr/report/pbr_csr07_repindex.cfm)).

## 8.3 Public sector pay trends and levels

Not all the recent increase in the public sector pay bill is due to an increase in numbers employed. A significant part is due to an increase in the real pay of public sector workers. Figure 8.2 shows the percentage increase in the public sector pay bill (in real terms) split between the increase in headcount and the increase in cost per head since 1980. Conservative governments from 1980 to 1997 reduced headcounts on average by 2% each year (in large part through privatisations) while increasing real cost per head by 1.6%. The Labour government, on the other hand, has increased headcounts yearly by 1.1% as well as increasing cost per head by 2% over the period from 1997 to 2006.

Figure 8.2. Changes in the public sector bill, 1980–2006



Note: The cost of public sector employees includes contributions to National Insurance and payment of current pensions.

Sources: ONS, *United Kingdom National Accounts: Blue Book*, 2007

(<http://www.statistics.gov.uk/StatBase/Product.asp?vlnk=1143&Pos=1&ColRank=1&Rank=272>); authors' calculations.

Figure 8.3 shows how public sector pay levels have changed relative to the private sector since 1997. In the first part of the period, private sector pay rose faster than public sector pay – between May 1997 and April 2001, private sector average earnings increased by 21% against 14% for the public sector. From 2001 to 2006, pay in the public sector, and particularly in the health sector, rose significantly more quickly than in the private sector. The overall gap that had opened up since 1997 had essentially disappeared by January 2006 (42.6% increase since May 1997 for the public sector, 44.0% for the private sector). That pattern has been slightly reversed since then, as the increase for the entire period until September 2007 stands at 51% for the public sector against 54% for the private sector.

Figure 8.3. Trends in public and private sector pay since 1997

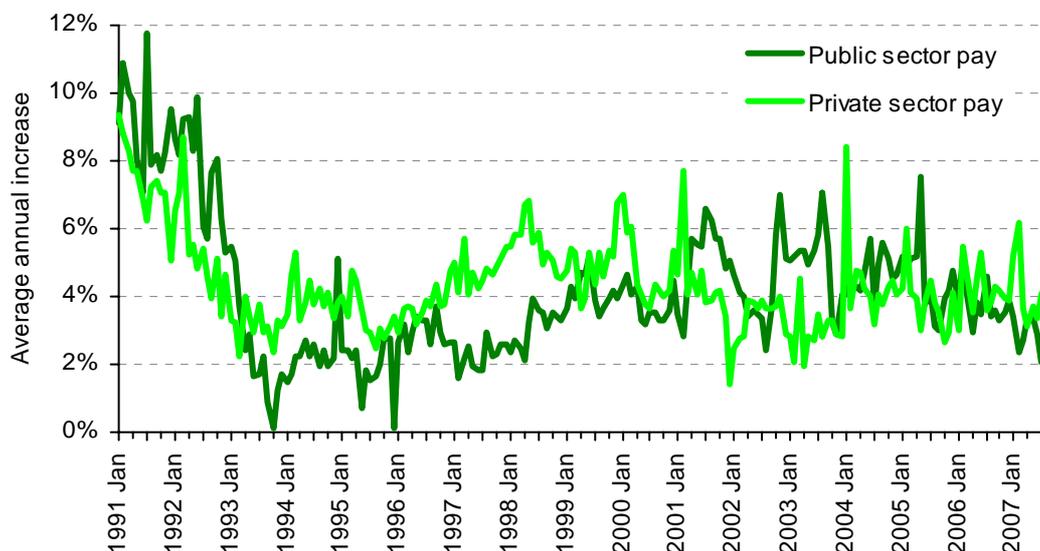


Note: The monthly indices have been smoothed by annual moving average in order to smooth the bonuses effect in the private sector at the end of the year.

Source: ONS, average earnings indices (AEI) not seasonally adjusted and including bonuses (series LNNI for the public sector and LNKX for the private sector).

Over longer periods, there is a well-known pattern of periods of gradual reduction relative to private sector comparators followed by periods of catch-up. Figure 8.4 shows the relative pay increases in the public and private sectors since 1991. To some extent, the period between 2000 and 2006 was just such a period of catch-up. Over the 1990s, public pay had been held in check, with average pay increases smaller than those in the private sector.

Figure 8.4. Trends in public and private sector pay since 1991

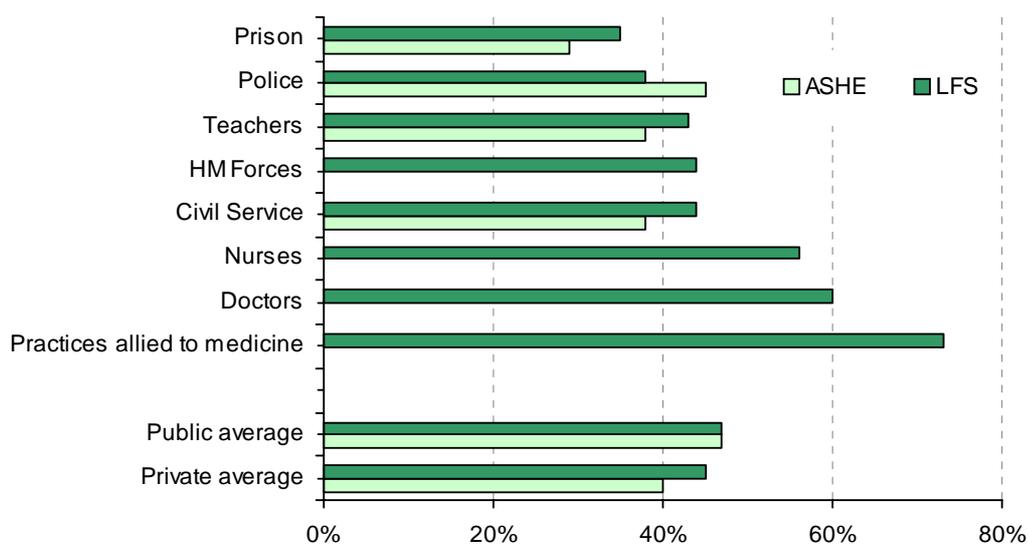


Source: ONS, average earnings indices (AEI) not seasonally adjusted and including bonuses (series LNNI for the public sector and LNKX for the private sector).

But it is a mistake to think of the experience of the different parts of the public sector over the past decade as having been uniform. Some groups – for example, those in the health service – have experienced rather substantial pay increases. Others – for example, civil servants and prison officers – have received pay increases below the public sector average. Figure 8.5 provides one particular illustration of this using the Labour Force Survey (LFS) – and where possible the Annual Survey of Hours and Earnings (ASHE) – to compare increases in the average salaries of different groups of public sector workers. While this conflates changes in composition with changes in pay levels, it is the most comprehensive method of comparison.<sup>4</sup> Between 1997 and 2006, doctors and nurses have seen their earnings increase by 60% and 56% respectively. Figures from ASHE differ marginally from figures from the LFS due to differences in sampling and measurement, but teachers, civil servants and prison officers seem to have always been below the public average of 47% earnings growth. The armed

<sup>4</sup> Measures of earnings growth can come from a variety of sources (LFS, ASHE, Monthly Wages and Salaries Survey), can measure different elements of remuneration (including or excluding bonuses or overtime) and can be measured in different ways (over different time periods, with different weights for composition changes). Each measure provides a slightly different number for public and private sector comparison even though the overall picture is not changed. For example, the public sector has had slightly bigger earnings increases than the private sector over the period 1997 to 2006 using ASHE or LFS (as in Figure 8.5) but similar earnings growth if one looks at ONS earnings estimates based on the Monthly Wages and Salaries Survey (as in Figures 8.3 and 8.4).

Figure 8.5. Average increase in nominal earnings, 1997–2006



Notes: 'Practices allied to medicine' are occupations such as medical radiographers and physiotherapists. In both data-sets, public sector groups are identified using SOC occupations. As doctors and nurses are both public and private sector workers, it is not possible to compare ASHE and LFS numbers for these groups. A similar problem arises for teachers, but as teachers' pay in the private sector is driven by the public sector, we have presented ASHE numbers for the teachers' group. Data from ASHE are not available for HM Forces.

Sources: Labour Force Survey (LFS) and Annual Survey of Hours and Earnings (ASHE) tabulations from ONS (<http://www.statistics.gov.uk/STATBASE/Product.asp?vlnk=13101>); authors' calculations. We thank the UK Data Archive for having provided the rights to use the Labour Force Survey (<http://www.data-archive.ac.uk/>).

forces and police are closer to the public average if ASHE numbers are to be preferred to LFS ones.<sup>5</sup>

## Regional issues

The pattern of regional pay appears to differ between the public and private sectors. Figure 8.6, for example, shows average pay levels for male graduates by sector and region. It is immediately clear that graduates in the public sector earn significantly less in London and the South East than their private sector counterparts. In Northern Ireland, the North East and Wales, the opposite is true. More specific examples of this phenomenon include the fact that the median male teacher in London is at the 40<sup>th</sup> percentile of the male graduate earnings distribution in London, whereas his counterpart in the North East is at the 50<sup>th</sup> percentile of the equivalent distribution and his counterpart in Northern Ireland is at the 60<sup>th</sup> percentile.<sup>6</sup>

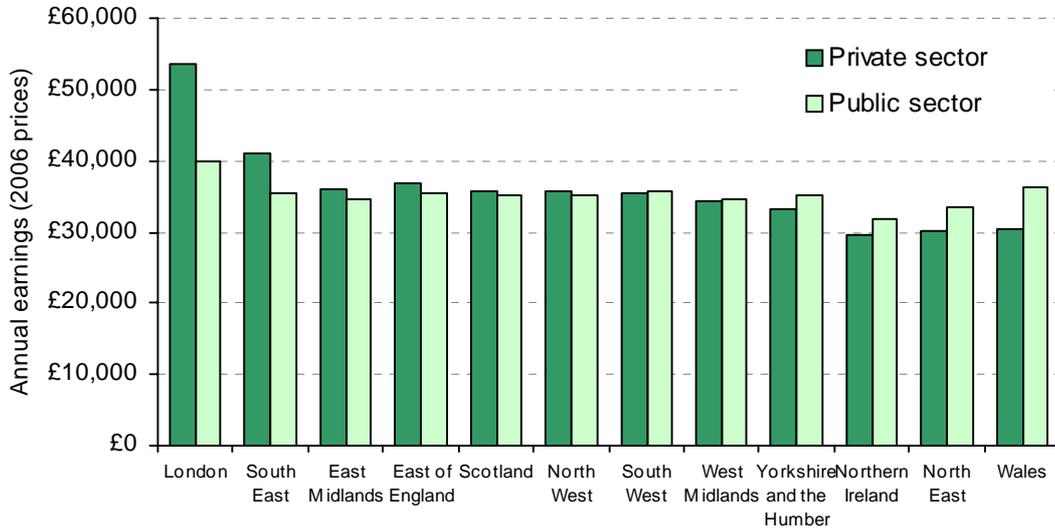
This pattern of relative pay is to some extent felt in recruitment problems and sometimes in retention issues. For example, measured vacancy rates of teachers in Figure 8.7 show that the recruitment problems experienced by schools at the turn of the millennium were very severe for London, somewhat important in the South East and East of England, but less so in the rest of the country.

<sup>5</sup> Sample sizes are much bigger in ASHE than in LFS.

<sup>6</sup> Authors' calculations using Labour Force Survey 2006.

A similar pattern can be uncovered for retention issues by looking at turnover rates. Figure 8.8 shows that staff turnover among teachers is highest in London, the South East and the

Figure 8.6. Public and private sector average earnings for male graduates by region



Note: We have computed average earnings for 2004, 2005 and 2006 in 2006 prices in order to increase the sample size.

Sources: Labour Force Survey, 2004, 2005 and 2006.

Figure 8.7. Vacancy rate for all teachers by region since 1997



Sources: DfES, *Statistical Evidence to School Teachers' Review Body (STRB) – September 2006* (available at <http://www.teachernet.gov.uk/management/payandperformance/pay/SatsEvidenceSept2006/>); DCSF, *Statistical Evidence to School Teachers' Review Body (STRB) 2007* (available at <http://www.teachernet.gov.uk/management/payandperformance/pay/revisedversion/>).

Figure 8.8. Turnover rate of teachers in 2006



Source: DCSF, *Statistical Evidence to School Teachers' Review Body (STRB) 2007* (available at <http://www.teachernet.gov.uk/management/payandperformance/pay/revisedversion/>).

East of England. These correlations between the pay differential and staff turnover are not necessarily causal – factors other than pay might play a part in high turnover in big cities – but they underline specificities of the London labour market that are hard to ignore.

Interestingly, there appear to be other ways in which public sector labour markets respond to pay differentials. In particular, the demographic characteristics of workers in the same sector differ by region. For example, teachers in London are, on average, younger than those in the rest of the country, with 46.5% of teachers in London being aged under 40 compared with just 38.5% outside London.<sup>7</sup> Experienced teachers are also more prevalent outside London than in the capital. Similar differences can be found for nurses and other public sector groups.

The result is that, by an accident of the characteristics of regional labour markets, the characteristics of those delivering key public services differ quite dramatically across the country. Other aspects of the 'quality' of public sector workers may also vary as a result and there is some evidence that this makes a difference to outcomes in health. For example Hall, Propper and Van Reenen (2006)<sup>8</sup> found impacts of higher outside wages for nurses on particular health outcomes.<sup>9</sup>

With a constrained budget and limited scope to increase wages across the board, there is a clear prima-facie case for raising wages differentially across the country.<sup>10</sup> Table 8.2 presents

<sup>7</sup> Average over the period 1997–2006. Source: Authors' calculations using the Labour Force Survey.

<sup>8</sup> E. Hall, C. Propper and J. Van Reenen, 'Can pay regulation kill? Panel data evidence on the effect of labor markets and skills on hospital quality and productivity', NBER, 2006 (<http://www.nber.org/~confer/2006/si2006/hc/vanreenen.pdf>).

<sup>9</sup> For example, they found that a 10% increase in outside wages available to nurses can result in a 3% to 8% increase in death rates among emergency admissions for acute myocardial infarction.

<sup>10</sup> The regional variations that occurred in 2007 cannot be seen as a step in the right direction. The fact that the Scottish and Welsh administrations accepted pay review body recommendations in full for nurses and police rather than 'staging' them meant that the effective increases were higher in Scotland and Wales than in the rather more constrained labour markets of London and the South East.

some estimates of what might be possible within an overall headline increase of 3% for teachers. An increase of 2.8% in parts of the country where teachers' pay is highest relative to the private sector would allow an increase of 3% in a middle group of regions (East Midlands and East of England) and increases of 3.2% in the South East and 3.9% in London. An alternative with greater regional variation could involve 2.5% for areas where teachers' pay is highest relative to the private sector, 3% for the middle group of regions, 3.5% in the South East and 5.4% in London.

**Table 8.2. Regional changes in teachers' pay: possible options with a budget equivalent to a 3% headline increase**

<b>Government Office Region</b>	<b>Share of the workforce</b>	<b>Headline increase possible (1)</b>	<b>Headline increase possible (2)</b>
North East	4.9%	2.8%	2.5%
North West	7.7%	2.8%	2.5%
Yorkshire and the Humber	8.1%	2.8%	2.5%
West Midlands	9.1%	2.8%	2.5%
East Midlands	6.5%	3.0%	3.0%
East of England	3.8%	3.0%	3.0%
London	6.2%	3.9%	5.4%
South East	27.2%	3.2%	3.5%
South West	8.1%	2.8%	2.5%
Scotland	9.2%	2.8%	2.5%
Wales	4.7%	2.8%	2.5%
Northern Ireland	4.6%	2.8%	2.5%
UK average	100%	3.0%	3.0%

Sources: Authors computations, using LFS for regional weights.

## Equal pay issues

One further specific issue facing government is that of 'equal pay'. The money potentially at stake is highly uncertain but could be very considerable – one off costs of more than £3 billion in local government alone.<sup>11</sup> The main issue is that, particularly in local government and the NHS, reviews of pay systems aimed at ensuring compliance with equal pay legislation have uncovered significant anomalies. Many of these were put right in the NHS through the Agenda for Change programme, which led to a dramatic shake-up in pay levels and structures, and ongoing increases in pay costs. Anomalies are also gradually being dealt with in local government, though much more slowly than initially intended. Some of the ongoing cost to local government (estimated by local government employers as a permanent increase in pay bill in the order of 4%<sup>12</sup>) has been absorbed and some remains to come.

<sup>11</sup> <http://www.communities.gov.uk/news/corporate/490459>.

<sup>12</sup> Local Government Employers, *Unblocking the Route to Equal Pay in Local Government*, November 2006 (<http://www.lge.gov.uk/lge/core/page.do?pageld=54477&path=52690.20&activeId=61539>).

The biggest immediate financial worry to government, though, comes from potential immediate liabilities for back pay. Claims for equality of treatment apply not just to current and subsequent pay but can involve payment of six years' back pay. Because reviews of pay structures – such as those undertaken through Agenda for Change – unearth unequal treatment issues and deal with them going forward, they provide a clear basis for making claims for back pay. Estimates of potential liabilities are hard to verify but it appears that in local government, at least £3 billion (an employers' estimate) will be needed to clear these liabilities. NHS employers are less willing to provide estimates of costs, but more than 13,000 claims have been lodged and some settlements have been significant, suggesting a potential liability running into billions of pounds. It does not seem possible to be more specific.

On the local government front, significant extra support has already been announced in the form of 'capitalisation directions', which effectively permit capital receipts or borrowing to be used to make the one-off back payments. A sum of £500 million was allocated in this way in September 2007.<sup>13</sup> It is likely that significant further directions will be required.

## Summary

The key policy problem for the government is to judge whether public sector pay is now at the 'right' level, and for how long lower increases than in the private sector are sustainable. There are relatively few signs of real strain at the national level. Vacancy levels among teachers and nurses, for example, are well down on the problematic levels of 2001. Three issues are clear, however:

- Returning relative pay levels to where they were in 2001 does not look like a wise move, given the problems that arose at that time. Overall, that would require only three or four years of increases 1 percentage point below the increases in the private sector. It would not be an efficient policy if we were to enter another cycle of overly-depressed public sector pay increases and another period of catch-up a few years down the line.
- Different parts of the public sector have experienced very different trends over the last few years. For example, whilst health service workers have enjoyed above-trend increases, civil servants have had smaller increases than the private sector. The case for treating them like this going forward looks weak.
- Whilst there do not appear to be major problems at a national level, there are important regional variations, and issues for some specialisms, that government might need to address.
- The potential cost of equal pay claims over the next few years is uncertain and could be very large. A key question for government is going to be the extent to which these claims are funded from the main pay bill, thereby holding other pay down, or from other money, thereby either reducing services or increasing borrowing.

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<sup>13</sup> Local Government Employers, op. cit.

## 8.4 Public sector pensions

As we mentioned in the introduction to this chapter, pay is only one part of public sector compensation. The other major part, often ignored when public and private remuneration are compared, is pension provision. Table 8.3 shows proportions of public and private sector workers in different sorts of pension scheme.

**Table 8.3. Proportions of public and private sector employees who are active members of different types of employer-sponsored pension scheme**

Type of employer provision	Proportion of public sector employees	Proportion of private sector employees
Occupational defined benefit	76.5%	17.0%
Occupational defined contribution	3.4%	8.3%
Group personal pension	0.8%	8.1%
Stakeholder	0.3%	4.6%
Unknown	4.1%	4.0%
No employer-sponsored pension	15.0%	58.0%

Sources: There are numerous different estimates of pension coverage. We use data direct from ONS available at [http://www.statistics.gov.uk/downloads/theme\\_labour/ashe\\_2006/tabP2.1a.xls](http://www.statistics.gov.uk/downloads/theme_labour/ashe_2006/tabP2.1a.xls). Other estimates produce results that are qualitatively similar.

There are striking differences between the sectors. More than three-quarters of public sector employees are members of a defined benefit occupational pension scheme as against just 17% of private sector employees. (A defined benefit (DB) scheme is one in which the pension income it provides depends on years of membership of the scheme and a measure of salary, typically taken close to when the individual leaves the pension scheme.) Private sector employees are more likely to be active members of other forms of employer-sponsored scheme. Nevertheless, 58% are members of no employer-sponsored provision, as against just 15% of public sector employees.

Coverage is not the only difference. There are also differences between sectors in the value of pension accruals. A recent estimate by Disney, Emmerson and Tetlow (2007)<sup>14</sup> suggests that the average value of the accrual of pension rights for public sector employees is around 25% of salary. In other words, the additional pension accrued for one more year in employment is on average worth a quarter of gross salary. So an average public sector employee who is a member of the pension scheme with a headline salary of £20,000 would have a remuneration package including pension worth not £20,000 but £25,000. Private sector scheme members have a slightly lower accrual of about 20%, so that the scheme member on £20,000 would have a pay and pensions' remuneration package valued at £24,000. The authors conclude that the main reason for this difference is the lower normal pension age in most public sector schemes (generally 60, as against 65 in most private schemes).<sup>15</sup> We return to this below.

<sup>14</sup> R. Disney, C. Emmerson and G. Tetlow, 'What is a public sector pension worth?', IFS Working Paper W17/07, October 2007 ([http://www.ifs.org.uk/publications.php?publication\\_id=4051](http://www.ifs.org.uk/publications.php?publication_id=4051)).

<sup>15</sup> We should not neglect their additional important conclusion that part of the difference also reflects different age and earnings profiles between sectors.

Across the population of public and private sector workers, the difference is much more dramatic than this suggests, because scheme membership is so much lower in the private sector. Very importantly, employer contributions to defined contribution (DC) schemes are much lower. Employers with DC schemes make contributions of 6% of salary on average on behalf of their employees.<sup>16</sup>

If we make the (generous) assumption that employers make contributions to group personal pensions and stakeholder pensions similar to those that they make to occupational DC schemes, we are in a position to compare the average value of employer-provided pensions in the public and private sectors.

Public sector DB pensions are, on average, worth 19.125% of total salary (i.e. 76.5% of 25%). If we take account of the fact that public sector employees on average contribute 3.9% of salary to their occupational scheme, this value falls to 16.1%. Assuming that the other 8.5% of public employees with some form of employer pension provision get a 6% contribution from their employer adds another 0.5% to this giving a total average value of public sector pensions of about 16.6% of salary.

Private sector DB schemes are worth 3.4% of total salary (i.e. 17% of 20%). This is reduced by employee contributions of 4.6% on average, to just 2.6% of salary. If the other 25% of private employees with some form of employer provision get a 6% contribution from their employer, this adds a total 1.5% to the value of private sector pension provision by employers, bringing the total to 4.1% of salary.

These are all very rough calculations, but they suggest that on average, to compare private and public sector remuneration including pensions, one needs to add about 12% more on to public sector wages than on to private sector wages – a dramatically large amount in this context.

In addition, there are important distributional differences between the two sectors – for example, there is a stronger relationship between probability of scheme membership and earnings in the private sector than in the public sector.

## **Changes over time**

These differences between public and private sector are not static. The generosity and coverage of schemes in the private sector have been falling. The most important change in the private sector has simply been the reduction in coverage of occupational schemes. According to the Government Actuary, the number of active members of private sector occupational schemes fell from 6.5 million in 1991 to 4.7 million in 2005.<sup>17</sup> The other important shift has been the increasing importance of (generally significantly less generous) DC schemes in this total, such that only an estimated 3.7 million private sector employees were active members of a DB scheme in 2005. And fewer than 2 million of them are in ‘open’ DB schemes – in

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<sup>16</sup> Table 8.3 of Government Actuary's Department, *Occupational Pension Schemes 2005*, June 2006 ([http://www.gad.gov.uk/Documents/13th\\_Occupational\\_Pension\\_Schemes\\_Survey\\_05.pdf](http://www.gad.gov.uk/Documents/13th_Occupational_Pension_Schemes_Survey_05.pdf)).

<sup>17</sup> Government Actuary's Department, *Occupational Pension Schemes 2005*, June 2006 ([http://www.gad.gov.uk/Documents/13th\\_Occupational\\_Pension\\_Schemes\\_Survey\\_05.pdf](http://www.gad.gov.uk/Documents/13th_Occupational_Pension_Schemes_Survey_05.pdf)).

other words, schemes that new employees are able to join. This matters because it might begin to give us a handle on the future 'steady state'. Even if no more schemes close or change their rules, we could end up in a situation in which fewer than 2 million private sector employees are accruing a DB pension. The Pensions Commission took a much gloomier view, concluding that the number will stabilise below 1.6 million and that 'it is difficult to see private sector DB provision, certainly final salary in form, playing more than a minimal role in the future UK pension system'.<sup>18</sup>

The reason this matters for the public sector is that the difference between public and private sector remuneration packages has been changing quite rapidly over time as a result of this private sector retrenchment, and this looks set to continue to change.

## Public pension reform

Given these differences between sectors, it is not surprising that the government has been trying to reform some of the public sector schemes. One reason this is particularly important is that (with the exception of the local government scheme) most public sector schemes are unfunded – that is, liabilities being built up today are not matched by the accumulation of funds to pay for them, but will need to be met from future tax receipts.

The scale of these unfunded liabilities is very substantial – estimated at £530 billion in present-value terms by the Government Actuary's Department as at March 2005. This liability is growing rather fast as a consequence of earnings growth and rapid improvements in mortality, as well as accounting changes which are reducing the discount rates used (see Box 8.2 for details). New figures will show a further significant rise in liabilities. Indeed, it is straightforward to calculate from a recent note by the parliamentary Scrutiny Unit, and the published accounts of the NHS scheme,<sup>19</sup> that the liabilities of the main schemes had risen to £725 billion by March 2006. The Treasury estimates that the cost of payments from unfunded public service pensions will rise from about 1.5% of GDP now to 2.0% of GDP by 2030.<sup>20</sup>

Changes to the main unfunded schemes have finally been agreed, following the government's U-turn in the run-up to the 2005 general election. Reforms were due to be introduced at that point to increase the normal pension age to 65 for the main schemes (NHS, teachers and Civil Service) for all new members and to phase in the increase for current members. In the event, union pressure forced a renegotiation, culminating in an agreement in November 2005 that effectively saw current members exempted from any increase in pension age. The government's condition was that the savings of £13 billion (in present-value terms) that would have been generated from the originally proposed reforms should be maintained.

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<sup>18</sup> Page 48 of Pensions Commission, *A New Pension Settlement for the Twenty-First Century: The Second Report of the Pensions Commission*, November 2005 (<http://www.webarchive.org.uk/pan/16806/20070802/www.pensionscommission.org.uk/publications/2005/annrep/annrep-index.html>).

<sup>19</sup> Sources: Parliamentary Scrutiny Unit, *Public Sector Pensions*, Briefing Note, May 2007 (<http://www.parliament.uk/documents/upload/publicsectorpensions.pdf>); page 26 of *NHS Pension Scheme and NHS Compensation for Premature Retirement Scheme: Resource Accounts 2006–07*, November 2007 (<http://www.official-documents.gov.uk/document/hc0607/hc10/1007/1007.pdf>).

### Box 8.2. Public sector pension liabilities

A large number of central government pension schemes are unfunded schemes. The government pays pensions when its employees retire, but does not make contributions to a fund to pay for them while they are working. As a result, the government has an implicit debt toward its employees (and former employees) which amounts to the future pensions it has promised to pay.

The Government Actuary's Department (GAD) computes these pension liabilities using estimates of life expectancy and assumptions on salary growth and discount rates. The current official number is £530 billion for March 2005; Figure 8.9 reproduces the recent evolution of these estimates.<sup>a</sup>

**Figure 8.9. Official estimates of pension liabilities**



Sources: Table 8, page 60 of N. Record, *Sir Humphrey's Legacy: Facing Up to the Cost of Public Sector Pensions*, Institute of Economic Affairs, 2006 (<http://www.iea.org.uk/files/upld-book390pdf?.pdf>) using various parliamentary answers quoting official estimates from GAD.

Pension liabilities have increased for various reasons: increases in life expectancy have been repeatedly underestimated; increases in public pay in recent years have outpaced the GAD assumption of 1.5% real increases (as public pensions depend on final salaries, public pay increases have an immediate impact on pension liabilities); and the number of public sector workers has increased over the period.

Estimates of pension liabilities are considerably higher if the discount rate used to compute them is reduced. The discount rate measures the real interest rate that could be earned if the assets corresponding to the liabilities were to be placed at no risk for the duration of the liabilities. Until 2005, the GAD used a discount rate of 3.5%. This rate was high compared with the rate used to estimate private sector liabilities (i.e. the AA corporate bond rate – 2.8% in 2004 – following Financial

<sup>20</sup> HM Treasury, *Long-Term Public Finance Report: An Analysis of Fiscal Sustainability*, December 2006 ([http://www.hm-treasury.gov.uk/media/6/0/pbr06\\_longtermpublicfinancereport\\_476.pdf](http://www.hm-treasury.gov.uk/media/6/0/pbr06_longtermpublicfinancereport_476.pdf)).

Reporting Standards FRS17) and therefore it was reduced to 2.8% for 2006 and further to 1.8% for 2007. This will increase estimated liabilities by a large amount, putting the March 2006 number closer to three-quarters of a trillion pounds.

Which discount rate to use is an important question. Some have argued that the most appropriate rate is to be found in the index-linked gilt market where the government can borrow money. Using the rate of return at long duration on this market gives much lower discount rates (1.12% for 18 years' duration and above), suggesting much higher pension liabilities estimates. Record (2006)<sup>b</sup> thus estimates pension liabilities for March 2006 at £1,025 billion. On the other hand, the index-linked gilt rate might be artificially low as a result of government regulations pertaining to funded pension schemes (they have to buy index-linked gilts). Hawksworth (2006)<sup>c</sup> has suggested using expected GDP growth, as it is the theoretical rate of return of an unfunded system in equilibrium and as the government's income follows GDP growth. Pension liabilities valued in such a way would be higher than current estimates but are likely to be lower than the values mentioned by Record (2006) as GDP growth is expected to be between the index-linked gilt rate of 1.12% and the 2.8% corporate bond rate.

To facilitate the public debate on these estimates, GAD should publish sensitivity analysis to its central estimate of pension liabilities based on changes in pay, employment, longevity and discount rate.

<sup>a</sup> The £530 billion March 2005 figure is the latest official estimate mentioned in HM Treasury, *Long-Term Public Finance Report: An Analysis of Fiscal Sustainability*, December 2006 ([http://www.hm-treasury.gov.uk/media/6/0/pbr06\\_longtermpublicfinancereport\\_476.pdf](http://www.hm-treasury.gov.uk/media/6/0/pbr06_longtermpublicfinancereport_476.pdf)). The figure for 2006 was not published in the 2007 Pre-Budget Report. New estimates for March 2006 show that liabilities for the main schemes were £725 billion.

<sup>b</sup> N. Record, *Sir Humphrey's Legacy: Facing Up to the Cost of Public Sector Pensions*, Institute of Economic Affairs, 2006 (<http://www.iea.org.uk/files/upld-book390pdf?.pdf>).

<sup>c</sup> J. Hawksworth, *Public Service Pension Liabilities and the Fiscal Rules*, PriceWaterhouseCoopers, 2006.

In most contexts, one would consider £13 billion to be a very significant sum. But two things are worth noting. First, this is a one-off saving on the net present value of liabilities, not an annual saving. Second, it represents only a small fraction of the measured increase in liabilities over the past decade.

Negotiations since then have been protracted, but new terms have now been agreed between government and the main Civil Service, NHS and teacher unions. Importantly, these are expected to keep within the budgetary savings prescribed and have indeed resulted in new normal pension ages of 65 for new members, whilst maintaining age 60 for current members. This concession for current members will have long-lasting consequences. It means that significant numbers of teachers, nurses and civil servants will still be able to retire on full pensions at age 60, 30 years hence and even after the state pension age has risen to 67.

Importantly, however, government and unions have also agreed cost sharing between employees and employers for any future increase in costs, with caps on employer costs. In the teachers' scheme, for example, employer contributions rose from 13.5% to 14.1% in January 2007, whilst employee contributions rose from 6.0% to 6.4%. Going forward, there is a commitment to share equally any increase or decrease in costs resulting from actuarial revaluations – for example, in the light of greater-than-expected increases in life expectancies

– with a 14% ceiling on employer contributions from the 2008 revaluation. Given that the ceiling has already been reached, this commitment means that all future increases will be felt by employees.

The main NHS scheme will change from April 2008, again with normal pension age rising for new entrants but remaining unchanged for current members. Contribution rates will rise for higher earners, from 5% or 6% currently to 6.5% for those earning between £19,166 and £63,416, from 6% to 7.5% for those earning up to £100,000 and to 8.5% for those earning more than £100,000. Employer contributions are capped at 14% and would have had to rise to 15.3% in the absence of these reforms, at a cost of £430 million per year.

These cost-sharing agreements with increased member contributions to reflect increasing costs are significant and can help protect government finances into the future. For pension members, higher employee contributions will be very similar to a pay cut, with the one notable difference that a pay cut would reduce their expected pension whereas higher employee contributions do not. But, overall, the reforms are modest, given both the rate at which liabilities have been increasing and the big – and growing – difference between the public and private sectors. Whilst the difficulty of agreeing even the current set of reforms will discourage government from pursuing these issues further in the short run, in the longer run this cannot be the end of the story. At the very least, there must be a strong case for aligning public service pension ages with the state pension scheme.

More fundamentally, it is unclear why the government should choose to remunerate its employees so much through deferred pay (pensions). It is not clear that its employees value that method of remuneration as much as the large increase in immediate pay that would have the same monetary value – and hence whether the public sector as an employer is getting good value for this spending. And, of course, providing a full pension to high-quality teachers and nurses at age 60 provides them with a strong signal to retire at that age when we are likely to want to continue employing them.

## **8.5 Pay review bodies**

Pay-setting mechanisms in the public sector are inherently different from wage bargaining in the private sector for a variety of reasons. For example, some public sector workers cannot strike; public sector pay setting can be highly political (particularly for groups such as nurses and teachers); public sector workers are also voters; and, in some cases, the government can have unusual market power, being the only, or very dominant, employer of some types of worker – soldiers, police, brain surgeons etc.

One helpful way of splitting up public sector workers is according to how their pay is set. From government's point of view, there are three groups:

- The Civil Service makes up about 10% of the public sector, and central government has direct control over its pay awards.
- Another 40% or so are covered by pay review bodies (PRBs). The PRBs cover nurses, doctors and other health service staff, teachers, the armed forces, prison officers and certain senior public servants such as judges and senior civil servants. The PRBs

recommend increases and government can decide whether or not to accept the recommendations.

- The rest of the public sector, of which local government is the most important part, negotiates pay with their employers. Here, central government control is more limited, though of course pay increases are always constrained by the overall spending envelope.

In this section, we look particularly at the pay-setting mechanism for groups covered by pay review bodies and discuss possible reforms for the pay-setting mechanism.

## The pay review body process

Pay review bodies, which are independent of government, take evidence from government, staff and other interested parties and then, having regard to such issues as recruitment and retention, affordability and comparability, make recommendations to government.

### Box 8.3. What 'staging' pay awards means

When an award is 'staged', the government formally accepts the headline pay award recommendation from a pay review body, but only part of the increase is paid immediately and the rest is not paid until later in the year.

In the case of nurses, the 'staging' of the 2.5% increase (1.5% in April and the rest in November) corresponds to an increase in annual pay of 1.92%. In the case of the police in England and Wales, the 2.5% increase paid from December rather than backdated to September corresponds to an increase in annual pay of 1.88%. In the last year, 'staging' pay awards has been a way for the government to limit real headline increases to below 2% while still formally following PRB recommendations.

But 'staging' is not equivalent to a lower pay increase. Had the government increased nurses' pay by 1.92% since April, nurses would have received the same amount of pay in 2007–08 but their annual pay would be lower at the end of the year. Hence, next year's award would have been on top of a lower base. A lower pay award has long-term effects on pay while 'staging' does not. 'Staging' pay awards saves money for the government only in the short term. Therefore the political cost to the government from 'staging' pay awards does not deliver a lower pay bill in the long run.

The Royal College of Nursing has estimated the savings for nurses at £60 million.<sup>a</sup> Our own computations lead to an estimate of £80 million for nurses and around £40 million for the police. None of these figures is large compared with the overall pay bill.

<sup>a</sup> BBC, 'Nurses to be balloted over action', 16 May 2007 (<http://news.bbc.co.uk/1/hi/health/6654547.stm>).

The government does not have to accept the recommendations, but in the past it usually has done – since 1999, it has 'staged' the recommendations from the PRBs on only seven out of 49 occasions. However, four of these occasions – affecting judges, prison officers, nurses and the police – were in 2007. Given the purpose and nature of the process – to provide independent advice in respect of groups of workers who have either forfeited the right to strike or with whom government finds it politically difficult to negotiate directly – if

government were to get into the habit of rejecting recommendations then it is likely that the process would collapse. Last year saw recommendations from some of the review bodies which, whilst not rejected outright, were ‘staged’ (which makes them less generous in the short term). Most controversial was the ‘staging’ of the 2.5% increase for nurses, with 1.5% awarded as from April but the rest only becoming payable in November, and more recently the 2.5% increase for police in England and Wales, which was backdated to December instead of the recommended date of September. Box 8.3 explains ‘staging’.

The government chose to ‘stage’ the awards in order to limit overall headline awards for PRB groups in 2007–08 to below 2% (1.9%<sup>21</sup>). We come to the rationale for this in the next section, but it is worth considering in what sense it has in fact been achieved. Table 8.4 shows

Table 8.4. Headline versus full year actual increase

PRB remit group	Number in group	Headline increase (value in 2008–09)	Increase received 2007–08
Armed forces	187,000	+3.3%	+3.3%
Prison officers (England & Wales)	33,607	+2.5%	+1.9%
Police (England & Wales)	144,000	+2.5%	+1.9%
Police (Scotland)	16,000	+2.5%	+2.5%
Nurses (England & N. Ireland)	406,000	+2.5%	+1.9%
Nurses (Wales & Scotland)	84,000	+2.5%	+2.5%
Doctors and dentists (GB)	174,710		
<i>Of which:</i>			
<i>Hospital staff</i>	107,240	+2%	+1.8% <sup>a</sup>
<i>General medical practitioners</i>	42,590	0%	0%
<i>General dental practitioners</i>	24,370	+2%	+2%
Teachers (England & Wales)	476,000	+2.5%	+2.5%
Judiciary	2,100	+2.4%	+2.4%
All (weighted)		2.48%	2.24%
All (weighted, excluding teachers)		2.48%	2.12%
All (weighted, excluding teachers, Scottish police and Scottish and Welsh nurses)		2.48%	2.08%

<sup>a</sup> This number is an approximation by the authors, given that the effect of ‘staging’ the pay award depends on the distribution of salaries within hospital doctors and dentists. Headline increase for doctors and dentists corresponds to the increase in average gross earnings computed by the pay review body as a result of its recommendation. In practice, the PRB recommended £1,000 flat increase for all hospital consultants and £650 flat increase for doctors in training (see NHS Employers’ website, <http://www.nhsemployers.org/pay-conditions/pay-conditions-2350.cfm>). This corresponds to higher percentage increases for lower-paid doctors (for instance, an increase of 3.3% for clinical medical officers with annual salary of £30,179) and conversely lower increases for better-paid doctors (for instance, an increase of 1% for a consultant with annual salary of £95,831). The ‘staging’ of the award affected only the lowest-paid doctors as the increase in April was up to the lesser between 1.5% and the flat rate (either £650 or £1,000). For instance, the ‘staging’ reduces the annual increase from 3.3% to 2.26% for a doctor with £30,179 salary but leaves unchanged the 1% increase for the better paid consultant. For general dental practitioners, the PRB recommended a gross earnings base increase of 3%, leading to an average 2% increase in earnings after expenses. Sources: Pay review bodies; departmental announcements.

<sup>21</sup> See quotation in Section 8.6.

the headline recommendation, the value of the actual pay increase in 2007–08 (different when the increase is ‘staged’) and the numbers in each group for various PRB groups.

As is plain from Table 8.4, it is hard to see in what sense PRB increases have been below 2% on average. On the most generous interpretation, which excludes teachers (who have been in a two-year pay deal), police in Scotland and nurses in Wales and Scotland, the average increase for 2007–08 is slightly above 2%. The long-run effective increase including all PRB groups is virtually 2.5%. For all groups for 2007–08, the impact of government decisions on ‘staging’ was to reduce the average PRB pay awards from the 2.48% recommended to 2.24%. This achieved a one-off saving of around £120 million (calculated as 0.6% of the pay bill of nurses and the police).

There is a cost to the government of amending pay review body recommendations in terms of immediate political or industrial relations difficulties. A perhaps more important cost may be damage to the credibility of the pay review body process itself. There are good reasons for having independent recommending bodies. It is not clear that there is an alternative that would satisfy both sides. Direct negotiations with teachers and nurses have proved politically very hard in the past, which is why they were brought under the PRB system in the first place. Direct negotiations with groups such as the armed forces are very difficult, especially when they have no right to strike. Tying pay increases to some kind of formula, as happened for police pay until recently, is very inflexible. Pay review bodies avoid these problems, but they are only credible when both sides accept the outcome in all other than exceptional circumstances.

### **Multi-year awards**

Chancellor Alistair Darling has recently mooted the possibility of longer-term pay deals. In the early part of this decade, a number of such multi-year awards were put in place, often as part of a strategy to reform pay systems. Reforming pay systems – to overcome inequities, to allow assimilation between two organisations joining together or just to simplify by reducing numbers of bands and allowances – can be an expensive and complex business. Multi-year awards can provide flexibility to accommodate change, can provide time and space to negotiate and implement change rather than spending that time on annual pay negotiations, and can provide a degree of certainty to employees. It is not clear from recent government statements, though, that this is what it has in mind for future multi-year deals.

Rather, the purpose seems to be to provide certainty and to minimise inflationary pressures. In the words of the Prime Minister,<sup>22</sup>

It means as people face mortgage bills and utility prices they know exactly what their income is likely to be ... The whole purpose of this is keeping inflation under control ... There is no point in a big salary rise that’s wiped out by a big inflation rise.

Such deals will indeed provide certainty over nominal earnings, but not over the – presumably more important – level of real (inflation-adjusted) earnings. We come to the issue of inflation in the next section, although it would be helpful if the Prime Minister were to spell out

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<sup>22</sup> Quoted by the BBC at [http://news.bbc.co.uk/1/hi/uk\\_politics/7176170.stm](http://news.bbc.co.uk/1/hi/uk_politics/7176170.stm).

through exactly what mechanism three-year pay deals in the public sector will keep inflation under control.

One recent experience is worth reflecting on in this context. Teachers are currently about 16 months through a two-year deal, running from September 2006, which offered 2.5% increases in each of the two years covered, but with a possibility of a review if inflation exceeded 3.25%. Inflation duly did rise above this level. The government, however, chose not to reopen the deal, rather promising to consider the effects of inflation in the forthcoming pay award. This serves to illustrate the risk-sharing issues implicit in longer-term pay settlements.

The new pay deal for teachers, announced on 15 January, covers the three years from September 2008. It involves headline increases of 2.45% in the first year and 2.3% in each of the subsequent years.

## **8.6 Public sector pay policy and inflation**

Beyond the question of the pay-setting mechanism lies the more profound question of what might be the 'right' level of public sector pay. Why have the independent pay review bodies diverged from the government in their assessment of a fair and affordable pay award? What principles should guide public sector pay policy?

Assessing whether public sector pay is at the 'right' level is a very difficult task. Public sector labour markets are far from the perfectly competitive paradigm. On the one hand, employees often have a market power when they are the sole providers of indispensable services. On the other hand, employers have a monopsony power as they are often the sole employers of specific skills that may have been accumulated by their employees. In addition, the government might have good reasons to use public sector employment and earnings to help steer macroeconomic conditions.

Indeed, the current public sector pay policy seems to place considerable emphasis on concerns over inflationary pressures. The 2007 Comprehensive Spending Review explicitly linked concerns over inflation with public sector pay increases:<sup>23</sup>

In contrast to periods of higher inflation in previous decades, the credibility of the UK's monetary policy framework has kept inflation expectations anchored and earnings growth has remained subdued. The Government has demonstrated its commitment to this by delivering overall headline awards for Pay Review Body groups in 2007–08 that average 1.9 per cent.

... It is therefore important that public sector pay settlements continue to be consistent with the achievement of the Government's inflation target of 2 per cent.

It is important to understand what this policy guidance might mean as there seems to be some confusion – in two senses. The first is the complex issue of what the relationship between

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<sup>23</sup> Page 22 of HM Treasury, *2007 Pre-Budget Report and Comprehensive Spending Review*, October 2007 ([http://www.hm-treasury.gov.uk/pbr\\_csr/report/pbr\\_csr07\\_repindex.cfm](http://www.hm-treasury.gov.uk/pbr_csr/report/pbr_csr07_repindex.cfm)).

public sector pay and inflation actually is. The second is what a reasonable interpretation of a pay settlement ‘consistent with’ achieving the 2% target might be.

On the first of these, the Prime Minister clearly sees a very direct relationship. He recently claimed that ‘staging’ last year’s pay awards had ‘helped break the back of inflation in Britain in 2007’.<sup>24</sup> On the other hand, Professor Stephen Nickell, a former member of the Bank of England’s Monetary Policy Committee, said recently: ‘They [public sector pay rises] have nothing to do with inflation’.<sup>25</sup>

For macroeconomists, what matters is the difference between overall government spending and taxation. If the government is running a deficit, it might add to inflationary pressures, whereas if it is running a surplus, the government is likely to cool down demands and therefore slow inflationary pressures. There are, however, two cases in which public pay settlements have a direct influence on inflation. First, if public pay is a residual from government spending, public pay settlements determine the deficit the government is likely to run. Second, if public sector pay settlements signal inflation expectations, then public sector pay increases might lead to further private sector pay increases, which in turn might fuel inflation and lead the central bank to raise its interest rate.

Using public sector pay as a tool to promote lower inflation comes at a price, however. The increased public–private pay differential will have to be ‘caught up’ later on if one does not want the quality of public sector workers to decrease. And, more importantly, it might not be efficient in the long run if expectations in the private sector are left unchecked by the central bank.

Even if one accepts the government’s pledge to limit inflationary pressures using public sector pay as a countercyclical tool, the question remains of what level of public sector pay growth is compatible with the government’s inflation target. Here there seems to be further confusion.

Keeping public sector pay settlements consistent with the 2% inflation target is not the same as saying that headline increases should be kept to 2%. The Bank of England has made it clear that it considers economy-wide earnings growth of around 4½% to be consistent with its inflation target<sup>26</sup> – if productivity is growing by 2½% per annum, then 2½% pay growth would simply reflect the greater productivity of workers in the economy and be consistent with zero inflation. By the same token, pay growth across the public sector of around 4½% should be entirely consistent with the inflation target of 2%.

As the Department for Children, Schools and Families (DCSF) has said regarding the most recent pay deal for teachers, of headline increases of 2.45% in the first year and 2.3% in the two subsequent years,<sup>27</sup>

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<sup>24</sup> Quoted by the BBC at [http://news.bbc.co.uk/1/hi/uk\\_politics/7176170.stm](http://news.bbc.co.uk/1/hi/uk_politics/7176170.stm).

<sup>25</sup> Norma Cohen, ‘Inflation driven by potatoes’, *Financial Times*, 10 January 2008.

<sup>26</sup> Mervyn King, ‘Monetary policy and the labour market’, speech at the Employment Policy Institute’s Fourth Annual Lecture on 1 December 1998 (<http://www.bankofengland.co.uk/publications/speeches/1998/speech29.htm>).

<sup>27</sup> Quoted by the BBC at <http://news.bbc.co.uk/1/hi/education/7188649.stm>.

What the Prime Minister said was that going forward public sector pay increases must be consistent with keeping inflation at 2%. This is the first of the settlements he was referring to. He didn't say public sector pay would have to be 2%.

Indeed. In fact, given very limited pay drift among teachers (see Table 8.5 later), it is at least arguable that a rather higher settlement would have been 'consistent with keeping inflation at 2%', though it might not have been consistent with delivering education policy within the current fiscal envelope.

This simple arithmetic often bumps into questions related to the 'right' measures of inflation and productivity. It has been argued – wrongly – that public sector pay increases should follow public sector productivity.<sup>28</sup> As public sector productivity has not been increasing very much in recent years, so the argument goes, this might lend credence to the view that the 'right' level of public pay increase should be similar to the inflation target, i.e. 2% per annum. After all, one of the first principles of economics is that people should be paid at their marginal productivity.

But this cannot follow in the long run for the provision of public services. The reason is that there is labour mobility between sectors (at least in the long run). Even if productivity in teaching English has not increased since the nineteenth century, it would be very difficult to attract young graduates into becoming teachers while paying them the same wage (in real terms) as their counterparts 150 years ago. As a result, wages in different sectors (conditioning on qualifications and the relative enjoyment derived from the occupation, plus any other part of the remuneration package – such as pensions) should be equalised and follow average productivity growth in the economy. Imperfect labour mobility might give the government some ability (market power) to award lower pay increases to some groups of public sector workers, specifically those who have the fewest private market alternatives. But that strategy is bound to come to an end in the long run if recruitment of similarly qualified workers is the objective of the government.

Economics suggests that individuals should be paid at the value of their marginal productivity. Relative prices of goods in each sector will therefore adjust to the rising cost of producing these goods and services. If productivity gains are harder to achieve in publicly-provided services (such as health and education), then the cost of these services is likely to follow average productivity growth and therefore grow at a higher rate than average prices. Economists have long reflected on this issue and called it 'Baumol's cost disease' after the seminal paper by William Baumol on the implications of growth differences across sectors.<sup>29</sup> One implication of this literature is that the relative size of the public sector is likely to grow if services provided by the public sector are 'superior' goods (in other words, if individuals want to consume more of them as they grow richer) and if the government maintains the same

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<sup>28</sup> The Treasury has been reported in the press to be making this point: 'So long as productivity in the public sector was rising sufficiently, higher pay rises would be in order, the Treasury said, since compensation to reward higher productivity would not contribute excessively to demand and hence inflationary pressure' ('Strike action "inevitable" on teachers' pay', *Financial Times*, 16 January 2008).

<sup>29</sup> W. Baumol, 'Macroeconomics of unbalanced growth: the anatomy of urban crisis', *American Economic Review*, 1967, 57(3): 415–26. For a more recent discussion, see N. Oulton, 'Must the growth rate decline? Baumol's unbalanced growth revisited', *Oxford Economic Papers*, 2001, 53(4): 605–27, available as a discussion paper at <http://www.bankofengland.co.uk/publications/workingpapers/wp107.pdf>.

public coverage of these services. To take an example, if individuals want to spend more on health as they grow richer and if health services are to be publicly provided, the share of national income spent on health has to increase. Wages in the health sector will follow average productivity growth (even if this sector experiences no productivity growth by itself) and the cost of producing health will increase for the government.

The second issue with the policy guidance on public sector pay settlements concerns the 'right' measure of inflation. There have been rows over the relative merits of using consumer price index (CPI) measures versus retail price index (RPI) measures. The RPI has been in use in the UK since the beginning of the twentieth century, while the CPI is the result of recent international homogenisation. In the UK, the RPI measure has led to consistently higher estimates of inflation than the CPI. Which is appropriate to use depends on the circumstances and what one is trying to achieve. The CPI is a 'better' measure of the genuine increase in the cost of living because it allows for the possibility of changing expenditure patterns in the face of price rises. On the other hand, it is not a good measure of the cost of living of many employees because it excludes part of housing costs. From the point of view of measuring what is consistent with the inflation target, however, the CPI is the correct benchmark because that is how the inflation target is denominated and the CPI is the measure used by ONS in measuring productivity growth.

#### Box 8.4. The economics of public sector pay setting

Setting public sector pay is neither easy nor straightforward. Other things being equal, holding public sector pay below the levels available in the private sector is likely to lead to recruitment and retention difficulties and/or reductions in the quality of staff willing to work in the public sector. Conversely, more generous reward packages in the public sector might lead to the crowding out of private sector activity and excessive levels of public spending. Over the long run, and abstracting from planned changes in the composition or quality of the public sector workforce, one would expect remuneration in public and private sectors to move together, in line with the overall rate of productivity growth in the economy.

Both individual performance and productivity are very difficult to observe in the public sector.

A simple rule of thumb to devise pay settlements would be to compute the rate of gross earnings growth compatible with the **inflation target** of 2%, which depends on the estimates of the **productivity growth** in the economy (currently between 2% and 2½% a year). If one takes a cautious view on this estimate, it leads to overall earnings growth of 4%. Increases in the relative generosity of public sector pensions should reduce this number: growth in gross earnings can be allocated between pay and deferred pay. One then needs estimates of **pay drift**, using data for recent years and different groups. These estimates of pay drift and increasing pension costs would then be subtracted from the 4% figure to give the **headline increase** consistent with the 2% inflation target. It need not equal 2%.

Once these clarifications have been made, is it fair to say that 4½% pay increases for the public sector are non-inflationary? Not necessarily. Remuneration growth is not the same as headline pay increases, for two main reasons – relative pay drift and pension costs (see Box 8.4).

Average levels of pay per person can grow in part because of pay drift, when the average pay grade increases as well as the average rate of pay for that grade. Pay drift may occur when the bottom points on pay scales are removed, or when people are promoted to higher paying jobs more quickly than previously, or when a pay system is not in equilibrium – people are moving up newly-created or extended scales.

So what level of headline increase would be consistent with achievement of the inflation target? Table 8.5 shows estimates made by government departments of the amount of pay drift for particular groups. It is low for teachers as their pay system is in equilibrium. It is much higher for NHS staff, particularly over recent years following reforms to pay systems. This pay drift is projected to decline in the coming years as the system approaches equilibrium.

Table 8.5. Pay drift estimations

Workforce group	Pay drift estimation, 2006–07	Pay drift estimation, 2007–08	2007–08 headline increase consistent with 2% inflation and 2.5% productivity growth	2007–08 headline increase consistent with 2% inflation and 1.5% productivity growth
Teachers	0.23–0.28%	0.15–0.20%	4.3%	3.3%
Doctors	3.6%	0.7%	3.8%	2.8%
Nurses 1 <sup>a</sup>	2.7%	2.5%	2.0%	1.0%
Nurses 2 <sup>a</sup>		1.6%	2.9%	1.9%
Armed forces		0.6%	3.9%	2.9%

<sup>a</sup> The second set of figures provided for nurses (2) correspond to the average actual pay drift estimated by the Department of Health for the period 2000–05, whereas the first set (Nurses 1) correspond to the projected pay drift for the year 2007–08.

Notes: The Department of Health does not provide any indication of why pay drift is predicted to drop massively for doctors. Headline increases mentioned in this table do not take account of the increasing cost of public sector workers compared with the private sector. Estimates of this increasing cost are not available and, as pay drift estimates are themselves of poor quality, one should not take the figures mentioned in this table at face value.

Sources: Pay review body reports for pay drift estimations, especially page 85, table 7.4 of the Review Body for Nursing and Other Health Professions, *Twenty-Second Report 2007*

([http://www.ome.uk.com/downloads/361072\\_Cm7029\\_WEB.pdf](http://www.ome.uk.com/downloads/361072_Cm7029_WEB.pdf)); authors' calculations.

One should note that these estimates of pay drift, however important for government spending plans, do not seem to be produced in a very transparent way. It is not clear how accurate they are. For example, the Review Body on Doctors' and Dentists' Remuneration underlines in its latest report that 'no explanation was given for the substantial reduction in the forecast level of drift this year [from 3.6% in 2006–07 to 0.7% in 2007–08]',<sup>30</sup> whilst the Review Body for

<sup>30</sup> Page 14 of Review Body on Doctors' and Dentists' Remuneration, *Thirty-Sixth Report 2007*, March 2007 (<http://www.ome.uk.com/downloads/Cm%207025.pdf>).

Nursing and Other Health Professions has expressed considerable exasperation at the apparent inability of the Department of Health to provide credible and consistent figures for pay drift.<sup>31</sup>

Given the emphasis that the Health Departments place on pay drift in their evidence this year, it is clearly important that they provide accurate figures based on transparent and comprehensible analysis which unpacks its various components. This they have not been able to do.

In addition, the projection of pay drift for nurses for 2005–06 by the Department of Health (2.7%) was significantly higher than actual pay drift turned out to be (1.7%). Given the variability of the estimates, it is not clear that these new projections can be considered reliable. The other departments' predictions, where they are not missing altogether, do not seem to be much more explicit.

Table 8.5 shows our estimates of the headline pay increases consistent with the 2% target for inflation and two estimates of productivity growth (see Box 8.4). The estimates can vary considerably following the estimates of pay drift and productivity growth. More information should be given by the government on these estimates in order to improve confidence in them.

## 8.7 Conclusion

Public sector pay has risen more quickly than private sector pay since 2000, although the picture is much less clear if one goes back just a few more years. At the same time, the relative value of public sector pensions has risen quite swiftly, and public sector workers now on average have pension benefits from their employers that are worth in the order of 12% more of their gross pay than do private sector workers. These changes in pay and pension arrangements should be seen together.

On the basis of our analysis, we would draw the following tentative conclusions for policy:

- There are currently relatively few recruitment and retention problems in the public sector, so there is no need on these grounds for pay increases above those enjoyed in the private sector.
  - However, there are significant regional variations and a strong case for skewing the allocations of any fixed pot of money to areas such as London and the South East, where public sector workers are less well paid relative to private sector workers, at the expense of areas where they are relatively better paid.
- There is only a limited economic case for an across-the-board public sector pay policy.
  - While the public sector as a whole has done relatively well in recent years, different groups have experienced quite different increases.

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<sup>31</sup> Page 87, paragraph 7.68 of Review Body for Nursing and Other Health Professions, *Twenty-Second Report 2007*, March 2007 ([http://www.ome.uk.com/downloads/361072\\_Cm7029\\_WEB.pdf](http://www.ome.uk.com/downloads/361072_Cm7029_WEB.pdf)).

- The argument that 2% headline increases are required to control inflation is not a strong one. In some sectors at least, higher increases look perfectly compatible with the inflation target.
- The pay review body process has served the government well for a significant period. Other pay-setting and negotiating mechanisms do not look attractive. There are risks to the government in persistently rejecting PRB recommendations because doing so will put the mechanism at risk.
- The pension reforms negotiated by government have made some progress and have involved some important changes resulting in reductions in long-term costs. However, upward cost pressures appear inexorable, the gap with the private sector is large and growing, and maintaining a pension age of 60 for current employees in the face of a state pension age rising to 68 looks even more unsustainable now than it did in 2005 when the original proposals to increase the pension age for public sector employees were dropped. This is surely unfinished business.
- In some key policy areas regarding the workforce, pay and pensions in the public sector, the evidence made available by the government is lacking. Government should make it a priority to rectify this.
  - In some cases, the government itself seems to be operating with inadequate information – estimates of pay drift for key workforce groups, for example. This needs to be rectified urgently if the government is going to spend public money effectively.
  - In other cases, government is backward in making available its own data or calculations – reconciling estimates of changes in Civil Service numbers and providing up-to-date estimates of public sector pension liabilities, for example.