

9. Public sector pay and pensions

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Summary

- Public sector pay cost £174 billion of public spending in 2008. The pay bill rose steadily as a share of national income from 2000 to 2005, partly because of increased employment and partly because of pay increases that were, on average, faster than those seen in the private sector. The pay bill has been cut modestly since then as a share of national income (although not yet in real terms). The fiscal retrenchment planned by the Treasury will soon require a tighter squeeze.
- Overall, pay levels in the public sector are probably not significantly out of line with those of similar workers in the private sector, once you take into account factors such as their age, education and qualifications. However, there are areas of divergence. In particular, there are gaps in favour of public sector workers in regions outside London and the South-East, which remains an area for reform in the long run.
- There is evidence that public sector workers have fared better than their private sector counterparts in the recession. A couple of years of pay freezes or other restraint could save significant money in the short run and, in current labour market conditions, would be unlikely to create recruitment problems. But, given the tendency for public sector workers to ‘catch up’ following periods of pay restraint, further cuts in the public sector workforce are more likely to deliver the lasting reductions in public spending as a share of national income sought by the Treasury.
- In the long run, a big anomaly remains the pension provision enjoyed by public sector workers. With salaries broadly in line with their private counterparts, the large pension advantage they enjoy translates into a total package that is substantially more generous. The only way to access this money in the short run would be to levy additional pension contributions on public sector workers.

9.1 Introduction

The public sector pay bill amounted to £174 billion in 2008, representing 30% of all government expenditure or 12% of national income.¹ Cuts to spending on public services will inevitably require cuts in the public pay bill in real terms. In part, this ought to come naturally if the size of the workforce falls in response to reductions in the scale of public services, although getting this to happen will not be straightforward. But the main question we focus on here is the extent to which there may, or may not, be scope to cut remuneration levels for public workers.

So far, public sector workers appear to have emerged relatively unscathed from the recession. They have suffered neither substantial job losses nor the cuts in earnings that many employees in the private sector have faced. As a result of the latter, average

¹ ONS, *United Kingdom National Accounts: Blue Book*, 2009, <http://www.statistics.gov.uk/statbase/tsdtables1.asp?vlnk=bb>.

earnings have grown faster during the recession in the public sector than in the private sector.

Government and Opposition alike have recognised that savings could be made from freezing or cutting public sector pay. If it appears uncontroversial to suggest reducing the pay growth of public sector workers in the aftermath of the recession, important issues remain as to how and by how much to cut or freeze pay. The issues we consider are the following:

- Are public sector workers paid ‘too much’ relative to private sector comparators? By how much could public spending be reduced either by freezing or cutting public sector pay?
- With large regional variations in the public–private pay gap, would it make sense to apply any pay cuts selectively across the country?
- Are there reasons to target cuts towards higher earners?
- Given that pensions are a large part of the public sector remuneration package, should policymakers focus on total remuneration, not just on pay?

In this chapter, we start in Section 9.2 by setting out the size of the public sector pay bill and workforce and how this has changed in recent years. Section 9.3 compares public and private sector pay levels, accounting for differences in the composition of the two sectors. Section 9.4 shows how big a spending cut can be achieved through either cuts in pay or cuts in the number of jobs in the public sector. We then consider, in Section 9.5, public sector pensions and how they change the overall judgement on the public–private remuneration gap. Section 9.6 concludes.

9.2 The public sector pay bill

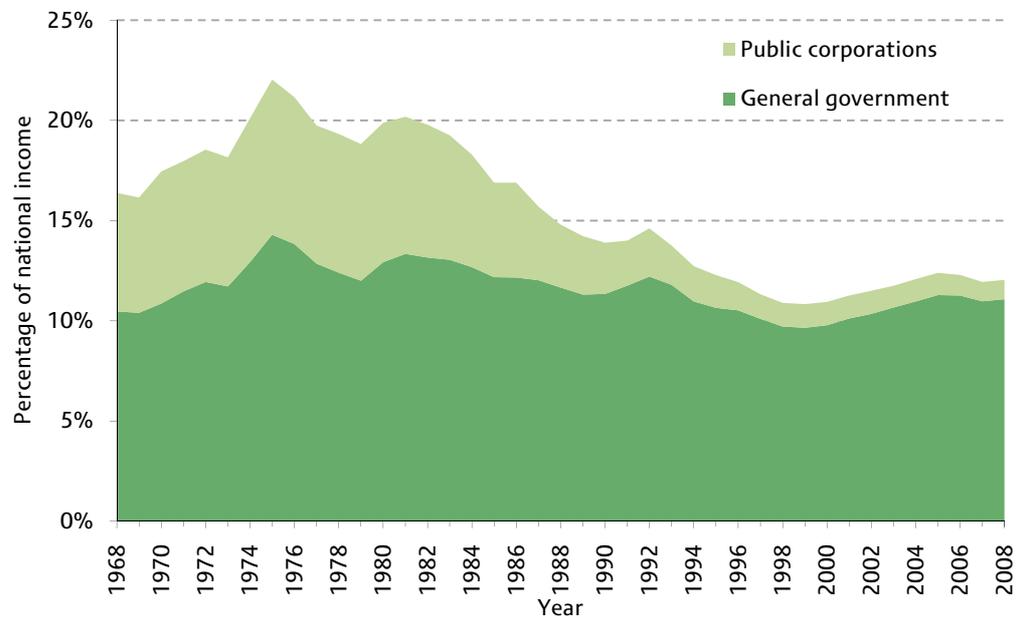
Figure 9.1 shows the long-term evolution of public sector compensation as a share of national income over the last 40 years. From a peak of 22% of national income in 1975, total public sector compensation (the two shaded areas combined) declined to a low in 1999 of 11%, in large part reflecting the privatisation of public corporations. Between 1999 and 2005, the pay bill grew steadily, but since then it has fallen back slightly (by 0.4 percentage points) such that the total in 2008 stood at 12% of national income. Turning to the general government pay bill (i.e. excluding public corporations), from a low of £109 billion (in 2008 prices) in 1998, it grew by 4–6% per annum in real terms up to 2006 to reach £157 billion. In the years 2007 and 2008, it grew at a much slower rate – below 1% per annum – reaching £160 billion in 2008.

These numbers do not fully incorporate the banks that have been nationalised during the height of the financial crisis. The Office for National Statistics (ONS) reclassified these corporations at the end of 2008 and they will appear in the public sector statistics for the year 2009 (see Box 9.1).

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 per employee. Figure 9.2 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 1979 to 1997 reduced headcounts on average by 2.0% each year (in large part through privatisations) while increasing real cost per head by 1.4% a year. The Labour

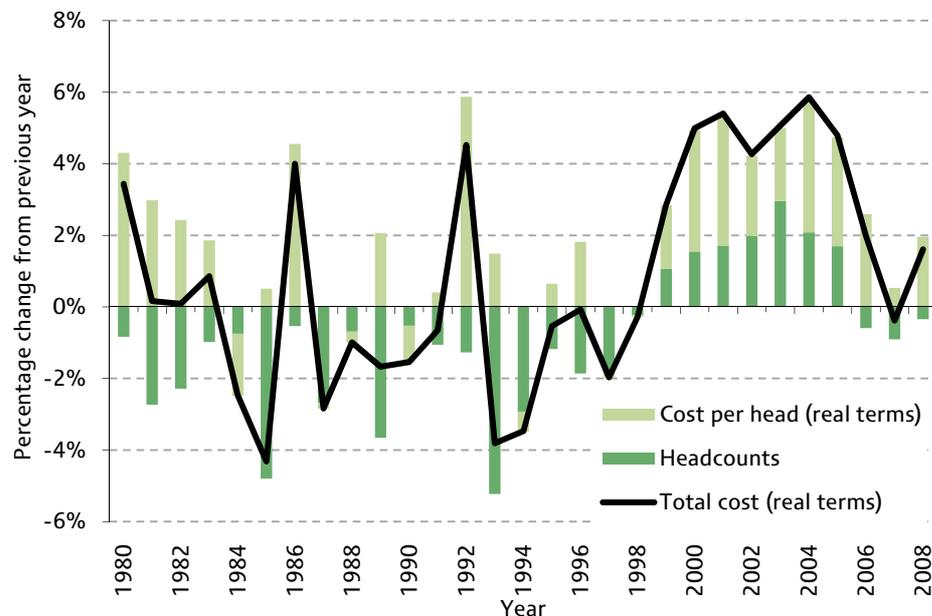
government, on the other hand, has increased headcounts yearly by 1.0% as well as increasing cost per head by 2.3% a year over the period from 1997 to 2008. However, most of the increase in the public sector pay bill was concentrated during the period 2000–05, with costs per head rising by 3% per year in real terms over this period. Note that reductions in the public workforce started in 2006, before the financial crisis.

Figure 9.1. Public sector compensation



Source: ONS, *United Kingdom National Accounts: Blue Book*, 2009, <http://www.statistics.gov.uk/statbase/tsdtables1.asp?vlnk=bb>.

Figure 9.2. Changes in the public sector pay bill



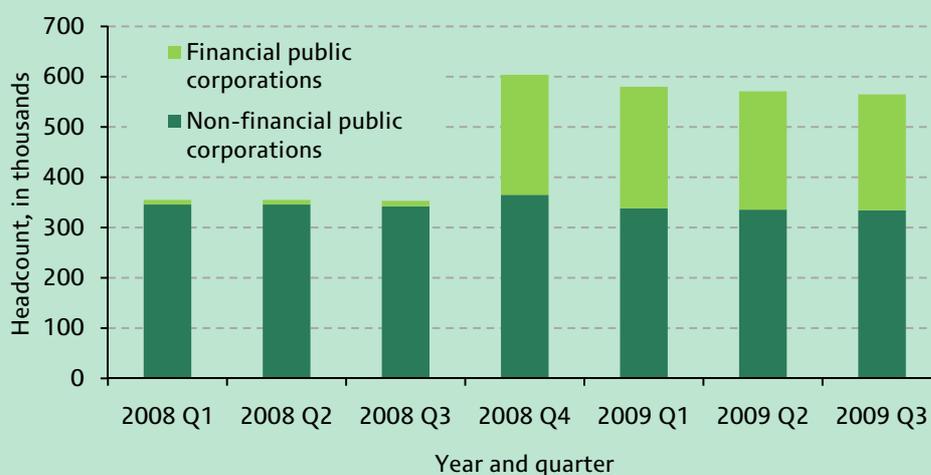
Sources: ONS, *United Kingdom National Accounts: Blue Book*, 2009, <http://www.statistics.gov.uk/statbase/tsdtables1.asp?vlnk=bb>; authors' calculations.

Box 9.1. Some new public sector workers

The ONS announced in February 2009 that Bradford and Bingley, the Royal Bank of Scotland and the Lloyds Banking Group were being reclassified as public corporations with effect from the last quarter of 2008. Northern Rock had already been reclassified as part of the public sector from October 2007.

These nationalisations have consequences for the picture official statistics paint of the public sector: they represent new public sector workers and also change the average earnings in the public sector by simple composition change. Figure 9.3 shows the increase in the number of employees of public sector corporations. In the last quarter of 2008, more than 228,000 workers joined the public sector as a result of bank nationalisations, representing a 71% increase in employment in public corporations and a 4% increase in the public sector workforce as a whole.

Figure 9.3. Employees in public corporations



Source: ONS, 'Public sector employment', Statistical Bulletin, 16 December 2009, <http://www.statistics.gov.uk/pdfdir/pse1209.pdf>.

This increase in the size of the public sector is likely to be a temporary effect, as the government intends to return these organisations to private ownership.

The average earnings index (AEI) from ONS (used in Figures 9.4, 9.5 and 9.6) is so far only marginally affected by the reclassification of banks in the public sector from August 2009 onwards. The AEI series is an index number, so reflects growth in earnings (not its level). In calculating the index, employment weights are held fixed across consecutive periods so that compositional changes, such as the inclusion of large numbers of (presumably higher-paid) financial sector employees does not affect the index. Reclassification will only matter to the extent that future earnings *growth* among reclassified employees is different from that elsewhere in the public sector.

The new average weekly earnings (AWE) series is different, as the employment weights are updated monthly and will therefore reflect changes in the composition of both sectors. For instance, the latest publication from ONS^a shows that the three-month-average AWE annual growth in November 2009 amounts to 3.8% in the public sector including financial services but only to 2.8% excluding them.

a. Table 15 of ONS, *Labour Market Statistics*, 20 January 2010, <http://www.statistics.gov.uk/pdfdir/lmsuk0110.pdf>.

Table 9.1. Public sector workforce in the UK

	1997	2008	% change, 1997–2008
National Health Service	1,190,000	1,510,000	+27%
<i>Of which:</i>			
<i>Doctors (England)</i>	89,619	133,662	+49%
<i>Nurses (England)</i>	318,856	408,160	+28%
Police	230,000	285,000	+24%
<i>Of which:</i>			
<i>Police community support officers</i>	–	15,683	–
Education	1,131,000	1,393,000	+23%
<i>Of which:</i>			
<i>Teachers (England & Wales)</i>	437,980	476,410	+9%
<i>Teaching assistants (England)</i>	34,800	125,200	+260%
Public administration	1,139,000	1,224,000	+7%
<i>Of which:</i>			
<i>Civil service</i>	516,000	522,000	+1%
Other public sector	708,000	738,000	+4%
HM Forces	220,000	193,000	–12%
Other health and social work	436,000	380,000	–13%
Construction	124,000	55,000	–56%
All public sector	5,178,000	5,778,000	+12%

Notes: Headcounts. These annual figures relate to the June quarter. The 1997 figures are not seasonally adjusted whereas the 2008 figures are.

Sources: ONS, *Public Sector Employment, Q3 2009*, <http://www.statistics.gov.uk/pdffdir/pse1209.pdf>; DCSF, *Statistical Evidence to School Teachers' Review Body (STRB) 2008* (available at <http://www.teachernet.gov.uk/management/payandperformance/pay/2009/>); NHS data from the Information Centre (available at <http://www.ic.nhs.uk/statistics-and-data-collections/workforce>); police workforce data from the Home Office Statistical Bulletin, <http://police.homeoffice.gov.uk/publications/police-reform/Police-strength-Mar092835.pdf?view=Binary>.

Changes in the size of the public sector workforce over the last decade have been far from evenly spread across professions. Table 9.1 sets out these changes for some of the key groups between 1997 and 2008. Compared with the rest of the public sector, the numbers of teaching assistants, police, doctors, nurses and NHS staff have risen relatively quickly. The number of public administrators – the famous faceless bureaucrats – has risen relatively slowly. In the civil service, recent reductions in numbers have almost entirely reversed the growth in the early years of the decade. Numbers in the armed services have fallen.

9.3 Cutting pay, shedding jobs or both?

Faced with the need for a sharp fiscal tightening, highlighted by Chapter 2, policymakers have embraced calls for 'tough choices on public sector pay'.²

Vince Cable, the Liberal Democrats' deputy leader and Treasury spokesman, said in September 2009: 'We must stop civil service bonuses and the culture of massively

² Page 112 of HM Treasury, *Pre-Budget Report 2009*, December 2009, http://www.hm-treasury.gov.uk/prebud_pbr09_repindex.htm.

inflated salaries. A freeze in the total pay bill is better than cuts in services'.³ The policy announced by the Liberal Democrats involves limiting wage increases in the public sector to £400 per person, implying an annual increase of 1.8% for the median public wage earners (earning £22,400) and 0.9% increase – or less – for the 10% highest earners of the public sector (earning above £44,200). George Osborne, the Shadow Chancellor of the Exchequer, announced for the Conservative Party: 'You will see that whoever wins the election is going to have to ask from 2011 each part of the public sector to accept a one year pay freeze. We shouldn't include public servants earning less than £18,000. ... A pay freeze of the scale I'm talking about is the equivalent to saving 100,000 public sector jobs'.⁴ The government, in its 2009 Pre-Budget Report (PBR) follows a similar line, announcing a 1% cap on public sector pay for 2011–12 and 2012–13 and a freeze in pay for senior staff.⁵

Box 9.2. How do you say 'public sector pay cuts' in Irish?

The words 'laghdú pá san earnáil phoiblí' will still be resonating in the heads of many Irish public sector workers. In February 2009, the government introduced a pension levy for public sector workers, reducing take-home pay by between 3% and 9% depending on earnings level. Then, in his 2010 Budget, the Finance Minister Brian Lenihan announced further public sector pay cuts ranging from 5% at earnings of €30,000 to 15% for high earners on €200,000. This announcement caused uproar among the public workforce and has resulted in industrial action. Has this Irish policy development any meaningful implications for policymakers in the UK?

Arguably, the main difference in the pressures on public sector workers between Ireland and the UK arises not because the fiscal hit in Ireland has been the more severe, but because public sector workers were paid relatively more generously in Ireland prior to the crisis. Research by the Economic and Social Research Institute (ESRI), based in Dublin, suggests that in Ireland the public–private sector pay gap had increased substantially in the years between 2003 and 2006, from 14% to 26% in favour of the public sector.^a In contrast, work by researchers at IFS suggests that the overall public sector pay premium in the UK does not seem to depart strongly from zero.^b Estimates based on 2006–09 data in this chapter (see Table 9.3), using a similar methodology to the Irish study, suggest wage premiums of 2% for men and 7% for women, much lower than the Irish numbers. So perhaps the Irish had much more scope to reduce public sector pay without endangering recruitment and retention of quality staff. This comparison is valid only for pay, however, and we come back to the issue of public sector pensions in Section 9.5.

a. E. Kelly, S. McGuinness and P. O'Connell, 'The public-private sector pay gap in Ireland: what lies beneath?', ESRI Working Paper 321, 2009, <http://www.esri.ie/UserFiles/publications/20091102110232/WP321.pdf>.

b. R. Disney and A. Gosling, 'Changing public sector wage differentials in the UK', IFS Working Paper WP08/02, 2008, <http://www.ifs.org.uk/publications/4117>.

³ Vince Cable's speech to the Liberal Democrat Conference, 21 September 2009, available at <http://www.libdems.org.uk/speeches.aspx>.

⁴ Speech to the Conservative Party Conference, 6 October 2009, http://www.conservatives.com/News/Speeches/2009/10/George_Osborne_We_will_lead_the_economy_out_of_crisis.aspx.

⁵ Government policy was also announced by the Chief Secretary to the Treasury, Liam Byrne, during the Conservative Party Conference, 6 October 2009.

Particularly by comparison with the large pay cuts announced in Ireland (see Box 9.2), and relative to the large public spending cuts the government is expected to need to find (see Chapter 8), these measures seem relatively modest, saving at most £3 billion a year. In fact, the cuts in Ireland are on a scale not seen or probably contemplated in the UK since the 1931 Budget, when a 10–20% public sector pay cut was implemented. This provoked widespread unrest, including the famous Invergordon mutiny of around 1,000 sailors in the Atlantic Fleet.⁶ The deeply unpopular package of spending cuts unveiled in that year also helped to bring down the Labour government of Ramsay MacDonald and bring about his subsequent formation of a National Government.

What is striking about these pledges to get ‘tough’ with public sector pay is that they stress the advantage of pay cuts over cuts in the size of the public workforce. Perhaps this is because cuts in jobs must be assumed to go hand-in-hand with cuts in services in the absence of efficiency improvements on a scale that has proven elusive in the past.

With regard to public sector pay setting, one would usually expect the level of remuneration in the public sector to follow the trend for similarly-qualified workers in the private sector. If pay settlements happen to be lower in the public sector than in the private, it is likely to lead to recruitment problems and falls in staff quality and in the quality of services provided. We had reached that situation in some parts of the public sector by about the year 2000.⁷ Conversely, if remuneration in the public sector is too high, then all else equal, it might lead to excessive crowding out of skills for the private sector, wage inflation and an inappropriately higher burden for the taxpayer. This may be a problem now, in particular in regions outside London and the South-East.

These comments relate primarily to the medium term: they do not rule out some short-term divergence. In particular, when a recession hits an economy, there is no need from a labour market point of view for a government to cut public sector pay and shed jobs to mimic the response of private firms to a drop in demand. It may make sense for government to maintain pay levels in the public sector during the recession and only implement lower pay increases (to allow the private sector to catch up) once the recovery is properly underway. Conversely, we would not expect the public sector to increase pay faster during private sector boom years.

This is why decisions on pay need to be informed by a sense of where we are relative to the ‘correct’ long-term level.

Pay trends in public and private sectors

Comparing public and private sector remuneration is always a tricky business. The two sectors are different. Public sector staff have, on average, higher qualifications than those in the private sector, as they provide services that are skill-intensive (health, education etc.). As a result, raw comparisons between the two sectors will overestimate the public sector pay premium. Examples of misuse of these raw statistics abound. They were

⁶ A. Ereira, *The Invergordon Mutiny*, Routledge, London, 1981.

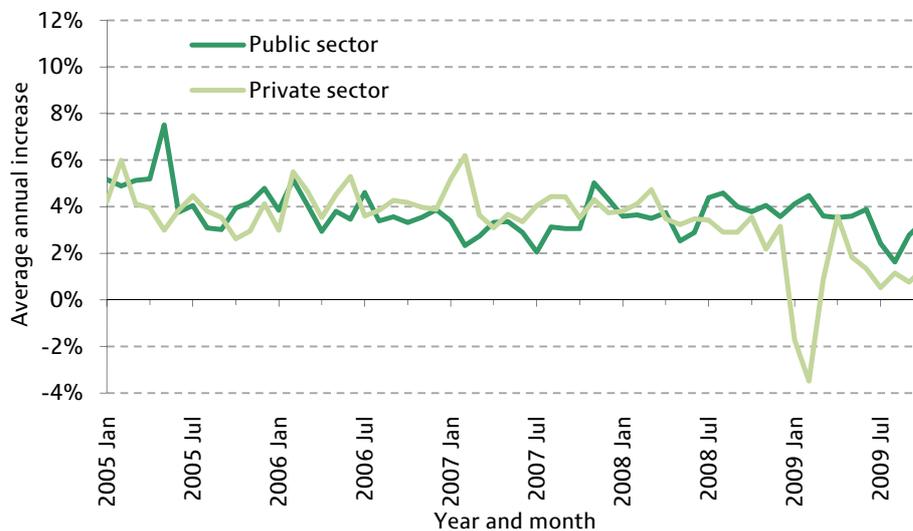
⁷ A. Bozio and P. Johnson, ‘Public sector pay and pensions’, in R. Chote, C. Emmerson, D. Miles and J. Shaw (eds), *The IFS Green Budget, January 2008*, IFS, London, January 2008, <http://www.ifs.org.uk/budgets/gb2008/08chap8.pdf>.

recently underlined by Ben Goldacre’s ‘Bad Science’ column in *The Guardian*, where he stressed how misleading comparing average public and private sector pay could be.⁸

That is why researchers take care to compare like with like, controlling for qualifications, age, experience and other characteristics likely to affect both wages and participation in the public workforce. Recent research by economists at IFS has improved this basic methodology (using data from the New Earnings Survey and the Annual Survey of Hours and Earnings), estimating public–private sector wage differentials and their changes over time.⁹ The results from this careful study show that on average ‘public sector pay differentials do not seem to depart strongly from zero’. Whereas the raw differential – not controlling for composition differences – suggests public sector premiums of 15% and 22%, respectively, for men and women in 2005–06, the more meaningful estimates are closer to 2% and 4%. Obviously, these are average figures that could easily hide groups of workers with large positive or negative wage differentials, but the overall finding – and the extent to which it is reduced by taking account of some observed differences in the composition of the public and private sector workforces – is nevertheless instructive.

These results are based on data gathered before the financial crisis and therefore might not reflect the latest changes. To gather more recent evidence, we present in Figure 9.4 the average monthly earnings growth in public and private sectors between January 2005 and October 2009. Before the crisis started, in 2006 and 2007, earnings growth in both sectors followed similar patterns, but in mid-2008 private sector earnings were hit by the recession, experiencing drops in average earnings of 2–3% for a couple of months – during the months when bonuses are usually paid – with a stabilisation thereafter. In contrast, average earnings in the public sector continued to grow at a similar rate to that before the crisis.

Figure 9.4. Growth in public and private sector pay since 2005

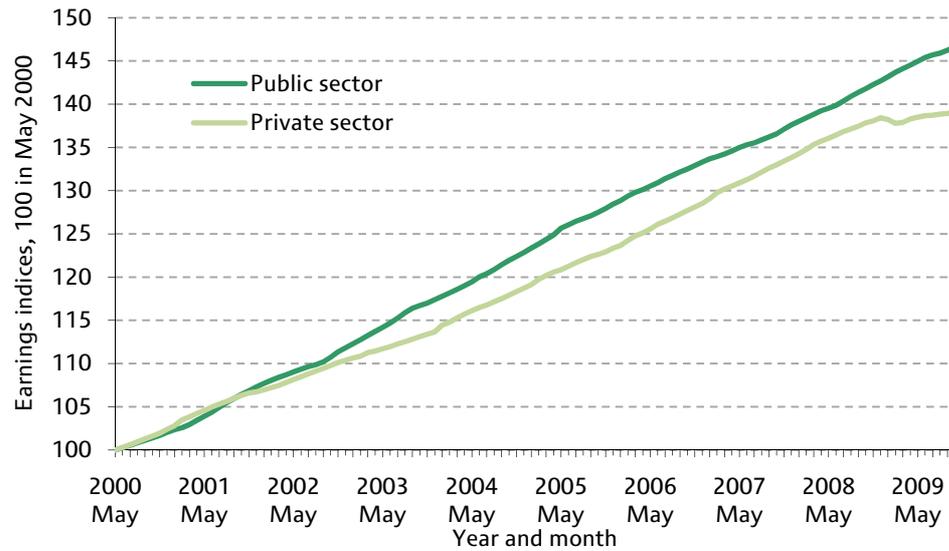


Source: ONS, <http://www.statistics.gov.uk/STATBASE/Product.asp?vlnk=9537> average earnings indices (AEI) not seasonally adjusted and including bonuses (series LNNI for the public sector and LNKX for the private sector).

⁸ B. Goldacre, ‘If you want to be trusted more: claim less’, *The Guardian*, 8 January 2010, <http://www.badscience.net/2010/01/if-you-want-to-be-trusted-more-claim-less/>. The example for the misuse of the statistics was the article ‘Public sector pay races ahead in recession’, *Sunday Times*, 3 January 2010, http://business.timesonline.co.uk/tol/business/industry_sectors/public_sector/article6974029.ece.

⁹ Page 13 of R. Disney and A. Gosling, ‘Changing public sector wage differentials in the UK’, IFS Working Paper WP08/02, 2008, <http://www.ifs.org.uk/publications/4117>.

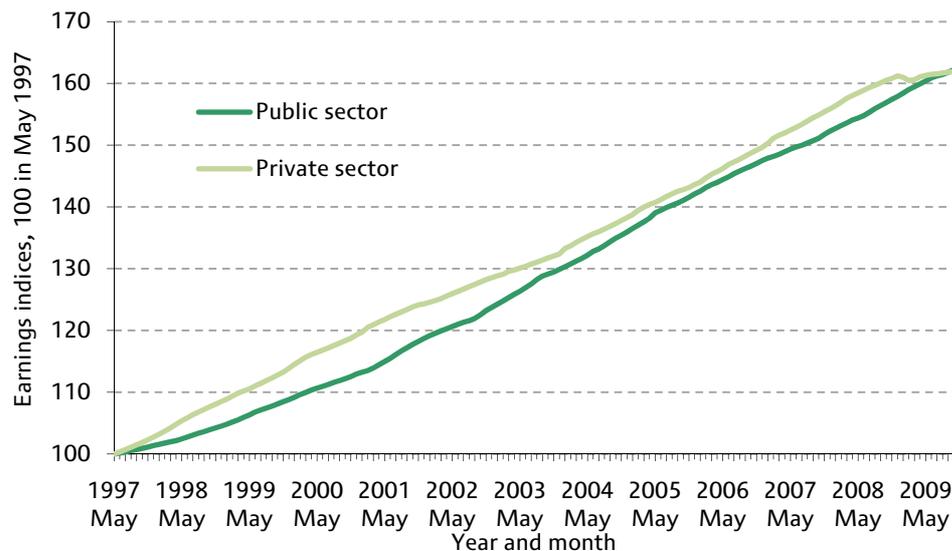
Figure 9.5. Trends in public and private sector earnings since 2000



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: As for Figure 9.4.

Figure 9.6. Trends in public and private sector earnings since 1997



Note: As for Figure 9.5.

Source: As for Figure 9.4.

The differential impact of the crisis on public and private sector earnings is put in longer-term perspective in Figure 9.5, where we plot average earnings since May 2000 in both sectors. The cumulated earnings growth since 2000 in the public sector is more than 5% higher than that in the private sector in October 2009. This gap has arisen due to particularly fast growth in the public sector in 2002 and 2003 and particularly slow growth in the private sector in 2008 and 2009.

But when comparing average earnings growth in the public and private sectors, the reference point of comparison is very important: given that public sector earnings tend to be countercyclical, periods of low growth are followed by periods of catch-up, and conversely. As a comparison to Figure 9.5, we plot in Figure 9.6 the trends in public and

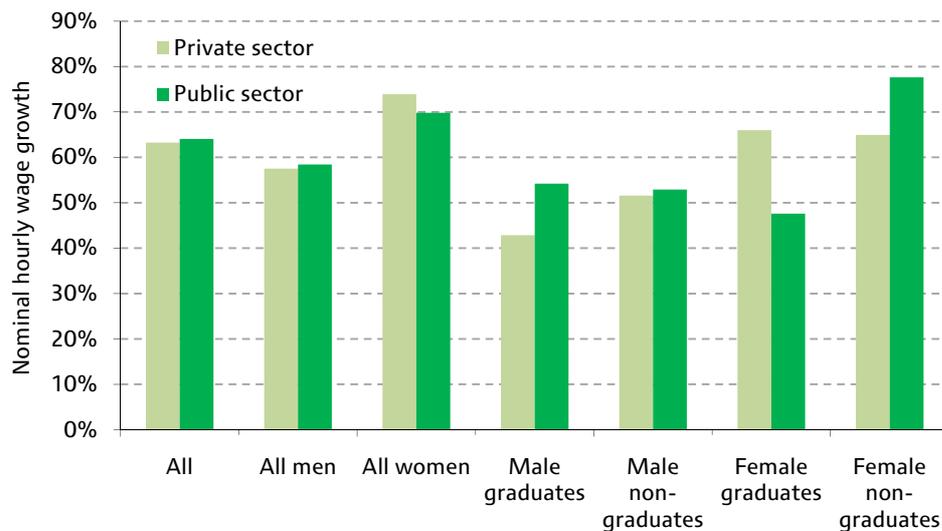
private sector pay since Labour took office in May 1997. This gives a distinctly different impression, with the drop in average earnings in the private sector during the financial crisis merely allowing the public sector to catch back up. By the end of 2009, cumulative average earnings growth since 1997 was slightly higher in the public sector than in the private sector for the first time.

Comparing public and private sector pay

These numbers are instructive but hide many other changes, including changes to the composition of the public and private sector workforces. Before comparing public and private sector pay levels, we first document these compositional changes.

Using data from the Labour Force Survey (LFS) up to September 2009, we compare in Figure 9.7 average nominal hourly wage growth from 1997 to 2009 in the public and private sectors by sex and education groups. The very similar average growths for the entire public and private sector (left-most bars) hides large variations across groups: male graduates have fared much better over the period in the public sector, whereas the opposite is true for female graduates, with those in the private sector having experienced an important catch-up in pay relative to their public sector counterparts. Amongst non-graduates, there has been higher wage growth for women in the public sector but almost no difference for men.

Figure 9.7. Average nominal hourly wage growth, 1997 to 2009



Source: Labour Force Survey, 1997 and 2009; authors' computations. We thank the UK Data Archive for providing the rights to use the Labour Force Survey (<http://www.data-archive.ac.uk/>).

These differences should be viewed in the context of large compositional changes in both sectors over the period, changes that are highlighted in Table 9.2. In 1997, workers in the public sector were already more likely to be women and graduates than in the private sector, but in the period up to 2009, the public sector has become even more female-dominated, especially with an increase in female graduates. The private sector has also attracted more graduates, but these are more likely to be men. These compositional changes are driven largely by the increase in numbers in health and education, where female graduates predominate.

Table 9.2. Changes in the composition of the public and private sectors, 1997 to 2009

	1997	2009	Difference (ppt)
<i>All</i>			
Male graduates	9.4%	13.4%	+4.0
Male non-graduates	41.7%	36.1%	-5.6
Female graduates	8.4%	12.9%	+4.5
Female non-graduates	40.5%	37.6%	-2.9
<i>Public sector</i>			
Male graduates	12.5%	15.1%	+2.6
Male non-graduates	25.5%	21.0%	-4.5
Female graduates	17.7%	23.8%	+6.1
Female non-graduates	44.3%	40.1%	-4.2
<i>Private sector</i>			
Male graduates	10.6%	17.3%	+6.6
Male non-graduates	48.5%	42.0%	-6.5
Female graduates	6.6%	11.3%	+4.7
Female non-graduates	34.3%	29.4%	-4.9

Source: As for Figure 9.7.

To give a better sense of how these composition changes affect our view of whether pay is higher or lower in the public sector, we present in Table 9.3 the results of a regression analysis which controls for the effects of sex, age, years of education and qualification on hourly wages. This is a simple procedure, which is not comparable to the much more sophisticated work of Disney and Gosling (2008) cited in Box 9.2. But it helps us see how the raw differential disappears when controlling for other characteristics.

The raw difference between average hourly wages in the two sectors is quite substantial and favours the public sector: on average, men working in the public sector have wages 19% higher than in the private sector, while women have 26% higher wages. Controlling only for years of education, these differentials are reduced to 12% and 17% respectively. This means that a large fraction of the raw differential is attributable to the fact that the public sector workforce tends to be more qualified than the average in the private sector,

Table 9.3. Estimating public sector wage differentials, 2006 to 2009

	Men	Women
Raw wage premium	+0.19 (0.008)	+0.26 (0.006)
Controlling for education	+0.12 (0.008)	+0.17 (0.006)
Controlling for education, age and qualification	+0.02 (0.007)	+0.07 (0.006)

Notes: The wage differentials are estimated by ordinary least squares (OLS), regressing log hourly wages on control variables for public sector, age left full-time education, highest qualification, age, age squared and interactions between age and age squared with age left full-time education. Standard errors are reported in parentheses.

Source: Authors' calculations using data from the Labour Force Survey, 2006–09.

largely reflecting differences in the type of services produced. When we also include controls for the age and qualification of the workforce, the differential drops to 2% for men and 7% for women. Disney and Gosling (2008)¹⁰ provide even lower estimates for 2006, as they are able to control for more differences in the characteristics of individuals between the two sectors, but the key results are unchanged: almost no wage premium for men and a small one for women. Interestingly, when we implemented the same procedure for data from 1997 to 2000, we got almost the same results – in other words, the changing composition of the sectors over time does not appear to have driven differences in differentials.

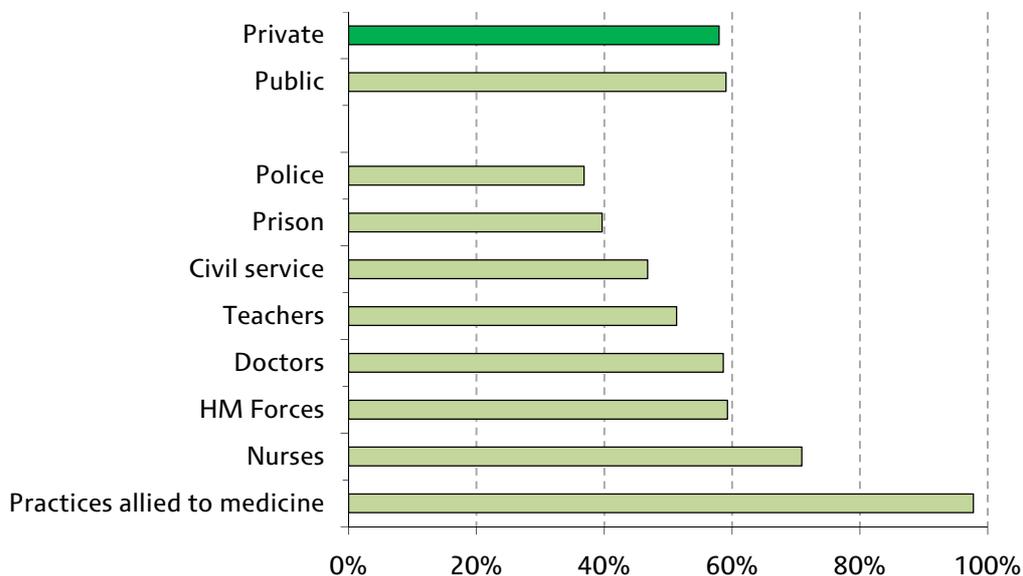
Public sector workforce is not homogeneous

Across different parts of the public sector workforce, recent pay experiences have been very different. Ideally, we would like to do the same exercise as in Table 9.3 for the different parts, but such an exercise would be very hard: there is no comparable labour market in the private sector for many of the groups in the public sector – there is no private sector army or police force, for example.

Figure 9.8 presents data from the LFS on specific public sector groups. Average earnings growth in the public sector has been very similar to that in the private sector, but this hides considerable variation, with NHS employees in particular having done very well in recent years. Again, these comparisons in terms of average earnings growth could well correspond to catch-up pay for groups where recruitment was difficult.

A particular feature of the aforementioned study by Disney and Gosling (2008) was that they actually used directly observable data on what jobs public sector workers actually move into, if they move to the private sector. Figure 9.9 illustrates their results with the

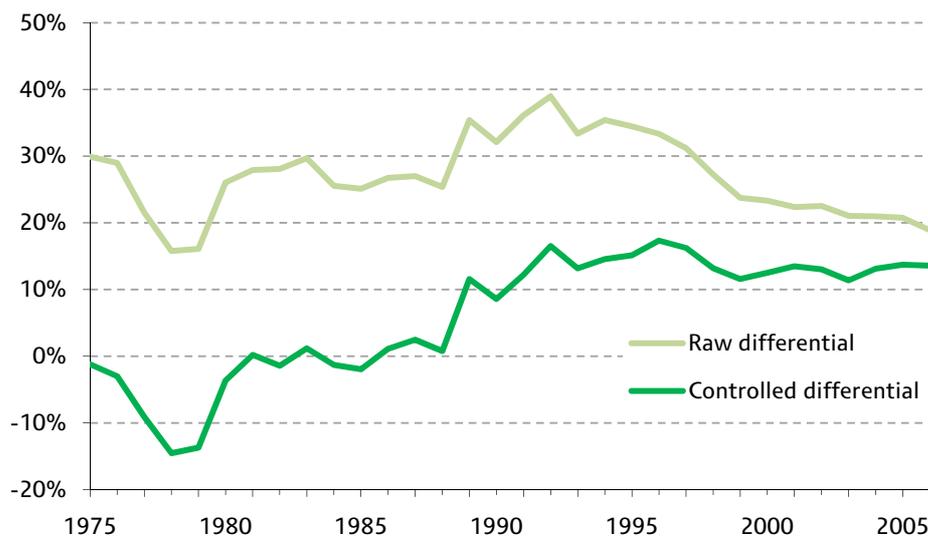
Figure 9.8. Average increase in nominal earnings, 1997 to 2009



Notes: 'Practices allied to medicine' are occupations such as medical radiographers and physiotherapists. Public sector groups are identified using SOC occupations.
Sources: Authors' calculations using Labour Force Survey data from 1997 and 2009.

¹⁰ R. Disney and A. Gosling, 'Changing public sector wage differentials in the UK', IFS Working Paper WP08/02, 2008, <http://www.ifs.org.uk/publications/4117>.

Figure 9.9. Estimated wage premium for nurses



Note: The wage premium is estimated as the pay of nurses in the public sector relative to the pay of all workers who have ever been nurses.

Source: R. Disney and A. Gosling, 'Changing public sector wage differentials in the UK', IFS Working Paper WP08/02, 2008, <http://www.ifs.org.uk/publications/4117>.

case of nurses. The upper, light green line measures the raw differential between nurses' pay and the pay of former nurses who moved to the private sector. One can see a differential of 20% in favour of the public sector in 2006, down from around 30% in the early 1990s. The estimated wage premium for nurses in 2006 is closer to 10% when controlling for characteristics, as shown by the dark green line.

One interesting point that the authors underline is that there has been a decrease in the difference between the raw differential and the estimated wage premium, reflecting a change in the composition of public sector nurses in favour of higher-quality nurses, i.e. those with higher qualifications and more experience. So while the raw differential has fallen, the estimated premium has remained more stable, at least since the late 1980s. This highlights another margin of long-term response to variations in the public-private sector wage gap. If public sector pay remains too long at low levels compared with the private sector, the quality of staff that the public sector can attract is bound to fall. For instance, Nickell and Quintini (2002) have shown that the fall in relative wages for public sector teachers in the 1980s has led to a decline in average qualification of new entrants.¹¹ Conversely, if the public sector wage premium remains high for a long period, it will attract more qualified workers, at the expense of the private sector.

In addition, there have been contrasting practices in terms of recent pay settlements and the use of multi-year pay deals. Teachers and nurses, for instance, have had three-year deals from 2008–09 to 2010–11. What at first appeared to be relatively strict pay settlements now look more generous given the current economic situation. Headline pay increases are thus planned at 2.3% for teachers in 2010–11 and 2.25% for nurses,¹² far above the 1% cap in pay the government and opposition parties are suggesting. This will

¹¹ S. Nickell and C. Quintini, 'The consequences of the decline in public sector pay in Britain: a little bit of evidence', *Economic Journal*, 2002, 112, F107–F118.

¹² School Teachers' Review Body, *Eighteenth Report 2009*, http://www.ome.uk.com/STRB_Reports.aspx; annex A of NHS Pay Review Body, *Report 2009/10*, http://www.ome.uk.com/NHSPRB_Reports.aspx.

open the question of whether the government will have to renege on the three-year deals or offer lower deals later if these plans are carried forward. This situation illustrates perfectly the dangers of using multi-year awards that can provide greater certainty for employees and government, but which are bound to create tensions if the economic situation happens to diverge significantly from expectations.

Regional disparity

Relativities between public and private sector pay differ across regions. Private sector workers appear, if anything, to do slightly better than their public sector counterparts in London and the South-East. But public sector wages are high relative to private labour markets in regions distant from London. Table 9.4 presents evidence on this public-private regional pay differential, following the same methodology as used for Table 9.3, i.e. controlling for education, age and qualification. Raw differentials are again very large, from 10% for men in London to 31% for women in Wales, Scotland and Northern Ireland. Once differences in characteristics are accounted for, these differentials disappear in London and the South-East, where the public sector workers appear to be slightly less well paid than private sector employees with similar characteristics (although the differences are not statistically different from zero). In contrast, in the rest of the country, on average, public sector workers enjoy a wage premium of roughly 5% for men and 11–13% for women.

Table 9.4. Estimating public sector wage differentials by region, 2006 to 2009

Region	Men		Women	
	Raw differential	Estimated differential	Raw differential	Estimated differential
London	+0.099 (0.028)	−0.026 (0.025)	+0.145 (0.022)	−0.014 (0.020)
South-East	+0.153 (0.019)	−0.028 (0.017)	+0.193 (0.014)	+0.006 (0.013)
South-West	+0.184 (0.025)	+0.051 (0.022)	+0.273 (0.019)	+0.108 (0.019)
East of England and Midlands	+0.239 (0.017)	+0.055 (0.015)	+0.309 (0.013)	+0.111 (0.012)
North of England	+0.235 (0.015)	+0.048 (0.014)	+0.307 (0.011)	+0.126 (0.011)
Wales, Scotland, Northern Ireland	+0.243 (0.018)	+0.053 (0.016)	+0.310 (0.013)	+0.123 (0.012)

Notes: As for Table 9.3.

Sources: As for Table 9.3.

9.4 Cutting pay?

How much can be saved by cutting pay?

Above, we estimated a public sector wage premium of 2% for men and 7% for women, giving a weighted average across the entire public sector of just over 5%. A cut in public sector pay across the board of 5% would represent a reduction in earnings paid of roughly £7.5 billion per year. If inflation is running at 2% a year, then a pay freeze for

two-and-a-half years would bring a similar real-terms pay cut and a similar reduction in the public sector wage bill, though delivered less quickly.¹³ In the longer term, however, these pay cuts may need to be unwound in order to keep pace with renewed private sector earnings growth.

But note that so far we have been careful to describe a ‘reduction in earnings’ rather than a ‘saving to government’. The government would not benefit from the full reduction in public sector remuneration because public sector workers pay taxes on earnings received and may also receive benefits or tax credits. Work at IFS using our tax and benefit model, TAXBEN, has estimated that for every £1 cut in public sector earnings, public spending is reduced by £1.19 but the government would save only 73 pence once loss of taxes and increased spending on benefits and tax credits are taken into account. So real savings from a 5% public sector pay cut are closer to £5.5 billion per year. (See Box 9.3 for details.) Conversely, the real drop in net income for public sector workers as a result of a 5% cut in pay is less than it might appear from the drop in gross earnings.

So when the Conservatives and Liberal Democrats talk about a pay freeze saving £3 billion annually, this is a gross figure. The net figure, after taking account of changes to taxes and benefits, is more likely to be closer to £1.9 billion a year. This also appears to be the status of the government claim that its announced cap on public pay increases at 1% a

Box 9.3. The impact of public sector pay cuts on tax revenues

Mike Brewer, IFS

Almost all of the debate about the contribution that public sector pay restraint can make to solving the structural budget deficit overlooks the direct link between the level of public sector pay and tax revenues, and also the knock on impact on spending on means-tested benefits and tax credits. Quite simply, if public sector bodies pay their workers less, then they will pay less employers’ national insurance, and their employees will pay less income tax and employees’ national insurance, as well as possibly being entitled to larger amounts of tax credits or other means-tested benefits.

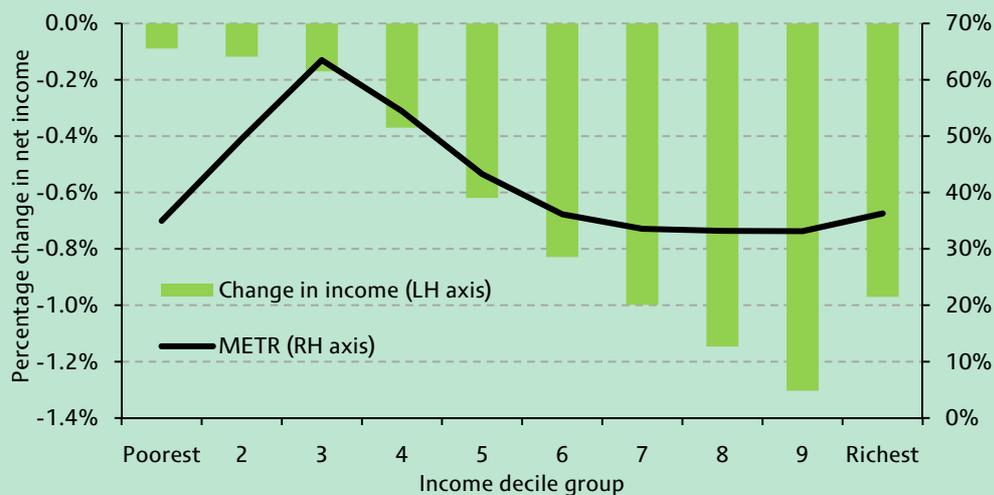
We have estimated the extent of this offset by combining data on public sector workers and their family circumstances from the LFS with the Institute’s tax and benefit model, TAXBEN.^a The estimates show that if all public sector workers had their pay cut by an illustrative 5%, then total gross wages would fall by £7.5 billion.^b However, the families of public sector workers will see their disposable income fall by a total of just £4.7 billion. This means that, on average, public sector workers face a Marginal Effective Tax Rate (METR)^c of 37%, and so 37% of the fall in the gross wage bill is offset by lower income tax and national insurance receipts, and by higher entitlements to means-tested tax credits and benefits.

If we include employer NI and public sector pensions, then an illustrative 5% cut in public sector workers’ wages would mean that wages fell by £7.5 billion, and public spending would fall by £8.9 billion after allowing for lower payments of employer NI (assumed to be 9.1% of all salaries) and reduced contributions to public sector pensions (assumed to be 10% of all salaries). However, tax revenues would fall, and entitlement to means-tested tax credits and benefits would rise, and the net effect is that the actual benefit to the Exchequer is only £5.5 billion, or 62% of the fall in public spending.^d

¹³ If one uses the CPI projections from the December 2009 PBR, the pay freeze would have to last three years, as the consumer price index is forecast to be below 2% in 2011–12 and 2012–13.

It is also possible to use these calculations to examine the impact of a fall in public sector pay on the distribution of income, and Figure 9.10 shows the average loss amongst working-age families in each decile group, having ranked families by their equivalised net income. It shows that the change would be roughly progressive, in that richer families would lose a greater share of their income than poorer families, on average, with the exception of the richest 10% of families. This reflects that public sector workers are more likely to be found in richer families than poorer families and that the tax and benefit system also compensates more for loss of earnings in lower deciles. The figure also shows the average METR faced by public sector workers in each decile group: it is highest (around 60%) in decile group 3, reflecting that workers in this decile group are particularly likely to be entitled to a means-tested tax credit or benefit.

Figure 9.10. Impact of illustrative 5% cut in public sector wages



Notes: Working-age families only. Income decile groups are derived by dividing all families (including pensioners) into 10 equal-sized groups according to income adjusted for family size using the McClements equivalence scale. Decile group 1 contains the poorest tenth of the population, decile group 2 the second poorest, and so on up to decile group 10, which contains the richest tenth.

Sources: Author's calculations based on the Labour Force Survey (the four quarters corresponding to 2007–08) and TAXBEN run on the 2009–10 tax and benefit system. A report due to be published by the Low Pay Commission in Spring 2010 explains how the LFS data were used in conjunction with TAXBEN.

a. The extension of TAXBEN to the LFS was partly financed by an as-yet unpublished project commissioned by the Low Pay Commission. Variables that are not in the LFS but are needed to estimate liability to taxes and entitlement to benefits were imputed from another survey (the Family Resources Survey) using a regression-based approach.

b. This is consistent with total public sector wages of £150 billion, although this estimate excludes some families. Note that this is not the best estimate of the public sector pay bill, which comes from administrative data. Rather, it is the estimate that comes from the household sample data on which we model the changes.

c. The marginal effective tax rate measures how much extra (or less) income tax and National Insurance a worker pays, and how much less (or more) tax credits or means-tested benefits a worker is entitled to after a small rise (or fall) in earnings. For example, in 2010–11, the METR will be 31% for someone who is liable to basic-rate income tax and the main rate of NI, 41% for someone who is liable to higher-rate income tax and the main rate of NI, and 70% for someone who is liable to basic-rate income tax and the main rate of NI and is on the main taper of the child or working tax credit. METRs are usually measures of the disincentive to earn more imposed by the tax and benefit system, but they are also good measures of the extent to which the tax and benefit system cushions workers against small falls in earnings, with high METRs meaning a large cushion.

d. This is unlikely to be the overall impact on the Exchequer after allowing for behavioural change. For example, the reduced income of the public sector workers might depress indirect tax receipts, and some of the public sector workers might change jobs or stop working altogether.

year in 2011–12 and 2012–13 would save £3.4 billion a year by 2012–13.¹⁴ The net saving is likely to be nearer £2.1 billion a year, and would be lower if the knock-on impact on indirect tax revenues were also included.

Cutting the pay bill by similar gross amount through job cuts would be expected to save the government more, as presumably more workers might be expected to be re-employed in the private sector and pay taxes than would enter unemployment and have to be paid benefits. The obvious difference is that it would imply clearer reductions in terms of public services (and hence be associated with other savings) than would be the case with public pay cuts.

In light of the evidence of the previous section, the wage premium enjoyed by public sector workers is overall rather small, at roughly 2% for men and 7% for women, giving a weighted average across the entire public sector of just over 5%. As such, there do not seem to be huge margins to cut public spending through cuts in pay, though £5.5 billion is not to be dismissed if it could be raised at relatively little political cost.

Given the evidence highlighted in Table 9.4, it may make sense for policymakers to differentiate any pay squeeze by region, offering non-zero growth to regions where public sector pay tends to lag behind private sector levels. In Table 9.5, we suggest two possible policies with such regional differentiation, depending on the overall scale of the squeeze the government would like to achieve. With a small overall pay increase, it is difficult to offer many variations in pay without offering real pay cuts to some. On the face of it, correcting for regional disparities in pay might be a task for the ‘good times’ rather than the ‘bad times’. On the other hand, if the government is going to have to annoy many public sector workers in any event, there may be a lower additional political cost to this desirable reform than there would be in normal times.

Table 9.5. Regional variations in public sector ‘freeze’: possible pay increases

Region	Share of the workforce	Policy 1	Policy 2
London	11.8%	2.0%	2.0%
South-East	17.8%	2.0%	2.0%
Rest of the country	70.4%	0.0%	0.5%
Total	100%	0.6%	0.9%

Sources: Authors’ calculations using weights from the Labour Force Survey.

‘Fat cats’ in the public sector

There has been much recent debate about so-called ‘fat cats’ in the public sector, variously defined as those earning more than £100,000, £150,000 or more than the Prime Minister (about £200,000). We offer no strong views as to whether there is a group of highly-paid individuals in the public sector who are overpaid, or indeed underpaid, relative to their private sector counterparts. But we can offer some observations that may be relevant to the debate.

The distribution of wages in the public sector is significantly more compressed than that in the private sector. In general, there are fewer who are very poorly paid and fewer who

¹⁴ Page 112 of HM Treasury, *Pre-Budget Report 2009*, December 2009, http://www.hm-treasury.gov.uk/prebud_pbr09_repindex.htm.

are exceptionally well paid. The public sector worker at the 95th percentile of the public sector wage distribution (for full-time males) earns 3.8 times the amount earned by his colleague at the 10th percentile. The private sector relativity is 4.7 times.¹⁵ This is a big difference between the sectors.

For those at the very top, representative data are hard to come by. But using data drawn from tax records in 2004–05,¹⁶ it is possible to get some indication of the occupations of the very highest earners. This is illustrated in Table 9.6, which is taken from recent work by IFS researchers.¹⁷ Nearly 70% of workers who are in the top 0.1% of taxpayers work in two sectors – ‘financial intermediation’ and ‘real estate, renting and other business activities’, neither of which is likely to include many public sector employees (ignoring

Table 9.6. Where do ‘fat cats’ work?

	All cats <i>All taxpayers</i>	Chubby cats <i>Top 10–1%</i>	Fat cats <i>Top 1–0.1%</i>	Obese cats <i>Top 0.1%</i>
Company directors	3.4%	9.7%	24.2%	34.6%
<i>Proportion who are:</i>				
Pensioners	22.6%	13.2%	14.5%	15.8%
Non-pensioners	77.4%	86.8%	85.5%	84.2%
<i>Working in following industries:</i>				
Agriculture, forestry and fishing	1.1%	0.6%	0.7%	0.9%
Mining and quarrying	0.2%	0.4%	0.5%	0.3%
Manufacturing	13.1%	14.6%	9.6%	5.9%
Electric, water or gas supply	0.4%	0.8%	0.3%	0.1%
Construction	8.1%	7.8%	4.5%	4.0%
Wholesale and retail trade	15.0%	10.7%	10.1%	8.2%
Hotels and restaurants	3.7%	1.3%	1.3%	0.9%
Transport, storage and comms.	6.3%	6.1%	3.8%	1.9%
Financial intermediation	4.3%	7.2%	16.0%	30.2%
Real estate, renting and other business activities	15.6%	21.5%	30.5%	38.5%
Public admin. and defence	5.5%	7.2%	1.0%	0.3%
Education	10.7%	11.1%	1.8%	0.3%
Health and social work	10.2%	6.8%	15.5%	3.6%
Other services	4.4%	3.4%	3.5%	4.0%
Other	1.2%	0.5%	0.8%	0.9%

Notes: All data are presented at the adult level and for Great Britain only. There were 46.8 million adults in Great Britain in 2004–05, and the numbers of adults in the richest bands have been calculated assuming that adults not represented in the SPI have incomes below the income tax personal allowance. Figures for the top 0.1% exclude ‘composite records’.

Source: Table 4 of M. Brewer, L. Sibieta and L. Wren-Lewis, *Racing Away? Income Inequality and the Evolution of High Incomes*, Briefing Note76, Institute for Fiscal Studies, London, 2008, <http://www.ifs.org.uk/publications/4108>.

¹⁵ Authors’ calculations based on 2006 to 2009 Labour Force Survey.

¹⁶ The Survey of Personal Incomes, SPI.

¹⁷ M. Brewer, L. Sibieta and L. Wren-Lewis, *Racing Away? Income Inequality and the Evolution of High Incomes*, Briefing Note76, Institute for Fiscal Studies, London, 2008, <http://www.ifs.org.uk/publications/4108>.

the more recent nationalisation of some financial services). Just over 4% of this very richest group were employed in public administration, education and health (compared with more than a quarter of the working population). Clearly, very few of the fattest of the fat cats work in the public sector – you would have needed a pre-tax income of more than £350,000 in 2004–05 to be in this category.

The picture is a bit different if we look at the fat, but not obese, cats who are not in the top 0.1% of taxpayers but are in the top 1% (i.e. had taxable incomes over about £100,000 in our 2004–05 data). In this case, health workers are actually over-represented: 10% of working taxpayers work in health and social work, but they accounted for more than 15% of the workers in the highest 1% of taxpayers (excluding the top 0.1%). This will be largely accounted for by the relatively high pay of doctors and some senior health service managers. Those in public administration and education are still significantly under-represented in this group.

If we now consider those who are merely chubby cats – those in the top 10% but outside the top 1% – we find a different picture again. Here, workers in education and public administration are slightly *over*-represented.

There are large differences across different parts of the public sector in those with very high levels of pay. Public sector bodies responsible for the majority of six-figure salaries may well be those in most direct competition with the private sector for individuals with particular skills (e.g. the BBC and some regulators). How exactly to take that into account will in itself vary between these different organisations. The BBC, for example, is a big enough player in its industry that it can hardly be considered a pure ‘price taker’ – the wages it makes available may affect those offered elsewhere. A rational policy towards the highest-paid needs to take account of such factors, the degree of actual and potential competition with the private sector, and demand for specialised skills. An across-the-board pay policy for those earning above a certain amount is unlikely to be good policy, and is unlikely to stick in the long run.

A related issue is the way in which pay is set for high earners. This differs across the public sector. For many high earners – including senior civil servants, very senior members of the armed forces, judges, MPs and senior managers in the NHS – the Senior Salaries Review Body takes evidence and makes recommendations (which government is not bound to follow). Even for these groups, the level of direct control from central government varies from very direct (for senior civil servants and senior members of military) to more arm’s length (in parts of the NHS). For many of the very highest earners in the public sector – in regulators, the BBC, the Bank of England, public corporations (such as Royal Mail and Channel 4) and local authorities – there is little or no real central oversight and control. These are in fact the areas where top salaries are highest, and have grown most quickly (as, among others, the Public Administration Committee has recognised¹⁸). These differences in pay-setting structures and pay levels have created some problems of comparability and recruitment even within the public sector itself – with, for example, differentials opening up between senior executives in regulators and local government on the one hand and senior civil servants on the other.

With regard to the public finances, if we define ‘fat cats’ as those earning more than £100,000 a year, the money raised by cutting their salaries is relatively limited. Press reports suggest that there are of the order of 300 individuals in the public sector earning

¹⁸ <http://www.publications.parliament.uk/pa/cm/cmpublicadm.htm>.

more than £200,000.¹⁹ Whatever the pros and cons of these salary levels, in the context of nearly 6 million public sector workers, 300 is a very small number indeed. A policy aimed at the highest-paid could only be worthwhile either if it were part of a longer-term restructuring of public sector pay in the face of evidence that top earners are paid more than necessary to recruit and retain those of appropriate quality, or as a way of making cuts or freezes for the majority of public sector workers more palatable. Either may be a plausible reason, though the evidence for the former is limited. (Indeed, such evidence as there is suggests that, for example, senior civil servants are paid rather less than those carrying out comparable jobs in the private sector.)²⁰ But proponents of such cuts should be clear about their reasons.

Finally, one area where most in the public sector, including higher earners, clearly do better than those in the private sector is in pension provision. Recent IFS work suggests that while over 80% of those in the public sector who are defined as being in social class 1 (professional and higher managerial workers) were members of defined benefit (DB) occupational schemes, this was true of only 40% of social class 1 private sector workers. (In fact, the proportionate difference is much bigger for lower-status workers, with coverage of 43% in the public sector and just 9% in the private sector for unskilled manual workers.)²¹ The same study suggests that it is also in the highest educational and occupational groups where the value of pension accruals particularly favours public sector workers. On average, the value to male senior managers or professionals in the public sector of a pension is nearly 27% of their pay. For similar private sector workers who are members of DB pension schemes, the average value of the pension is 22% of pay.

The Conservatives have explicitly proposed to cap the amount of pension that public sector employees can be entitled to in retirement at £50,000 p.a.²² Simply to impose a cap at the point at which that amount has been accrued would be odd. That is because it could mean that the value of a senior person's remuneration might fall in one year from say £200,000 (say pay of £160,000 plus pension accrual of £40,000) to £160,000 the next, if the £50,000 cap on pension value is reached. It makes more sense to reform public pensions more comprehensively, perhaps including a gradually reducing rate of accrual as salaries rise above a certain level.

In sum, there is no serious evidence that the very highest-paid employees in the public sector are overpaid relative to their private sector counterparts. Cutting their pay would have little immediate impact on the fiscal deficit. On the other hand, there are clearly considerable inconsistencies in the way pay is set, and the levels it has reached, in different parts of the public sector. There may be a case for clearer controls or oversight in some areas. It may also be that a wider policy of implementing public pay cuts or freezes would be made easier if the highest-paid were seen to be bearing their share of the pain. But we should be clear about the purpose of any such policy.

¹⁹ <http://www.telegraph.co.uk/news/newstopics/politics/6721771/300-public-sector-workers-earned-more-than-Prime-Minister.html>.

²⁰ See various evidence to, and reports of, the Senior Salaries Review Body, available at http://www.ome.uk.com/Senior_Salaries_Review_Body.aspx.

²¹ R. Disney, C. Emmerson and G. Tetlow, 'What is a public sector pension worth?', *Economic Journal*, 2009, 119, issue 541, <http://www.ifs.org.uk/publications/4666>.

²² George Osborne's speech to the Conservative Party Conference, 6 October 2009, http://www.conservatives.com/News/Speeches/2009/10/George_Osborne_We_will_lead_the_economy_out_of_crisis.aspx.

For pensions, on the other hand, the higher-paid in the public sector do fare well. But then, as we shall see in some detail in the next section, so do those in the rest of the public sector, and it makes more sense to see any policy through the lens of policy designed for public pensions as a whole rather than a particular group of the highest-paid.

9.5 Cutting pensions?

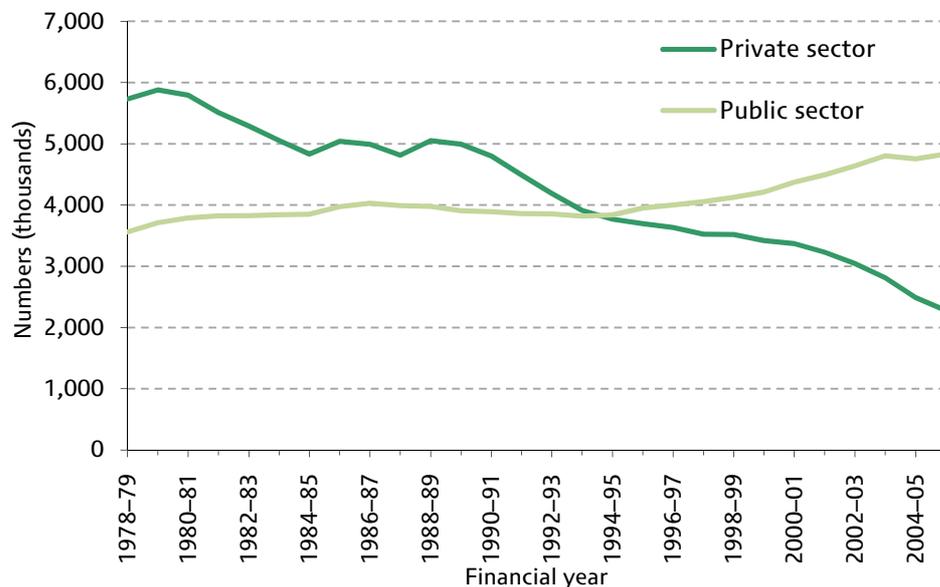
As we have seen in our discussion of the higher-paid, pensions play a very important part in the remuneration of workers in both the private and public sectors.

If, on average, pay is similar across public and private sectors, this is resoundingly not the case for pensions. Public sector workers:

- are much more likely than those in the private sector to enjoy membership of an occupational pension scheme, and particularly of a defined benefit pension scheme;
- have, on average, more generous pensions than those in the private sector who are members of a DB scheme;
- have seen the *relative* generosity of their pension provision improve over the past decade as private sector schemes have closed down and have seen their benefits cut.

The reduction in coverage of DB schemes in the private sector relative to the public sector is a long-term trend, which accelerated during the 2000s. This is illustrated in Figure 9.11.

Figure 9.11. Numbers of members of contracted-out defined benefit pension schemes by sector



Sources: Department for Work and Pensions, *Second Tier Pension Statistics*, <http://research.dwp.gov.uk/asd/tabtool.asp>; R. Disney, C. Emmerson and G. Tetlow, 'What is a public sector pension worth?', *Economic Journal*, 2009, 119, issue 541, <http://www.ifs.org.uk/publications/4666>.

Researchers at IFS have recently estimated the advantage public sector workers enjoy with their pension arrangements over their counterparts in the private sector. This shows not only that the coverage of defined benefit pensions is more extensive in the public sector, but also that the generosity of these pension schemes is higher.²³

Precise estimates of the coverage and value of pensions in public and private sectors vary. DWP data suggest²⁴ that in 2007:

- about 85% of public sector employees were members of an employer-sponsored pension scheme, 92% of whom were in DB schemes, so
 - 78% of all public sector workers were in a DB scheme;
- around 40% of private sector employees were members of an employer-sponsored pension scheme, of whom fewer than half were in a DB scheme, so
 - 15% of private sector workers were in a DB scheme.

Membership of private sector DB schemes continues to fall. Only 38% of schemes remain open to new members. Adair (now Lord) Turner's Pensions Commission took a gloomy view of the future of such provision in the private sector, concluding that membership of private sector DB schemes would fall towards 1.6 million (from 3.7 million in 2005) 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'.²⁵ There is no similar fall in the proportion of public sector workers in DB schemes. Coverage is the biggest difference between public and private sectors but it is not the only difference. The value of public sector schemes is, on average, greater for members than is the value of private sector schemes. Based on 2001 data, IFS research has suggested that:²⁶

- in the public sector, membership of a DB scheme was worth 26% of earnings, on average;
- in the private sector, membership of a DB scheme was worth 19% of earnings, on average.

There are two reasons for this difference in value. The first, naturally, is that scheme rules are different and, in particular, pensionable age remains lower in the public sector (at least for the majority who joined the sector before 2007). Secondly, and interestingly, the difference in part reflects different earnings trajectories in public and private sectors. Earnings tend to grow swiftly then tail off in the private sector whereas they tend to keep growing over the working life in public sector occupations, with the result that pension schemes based on the level of final salary are worth more in the public sector.

Putting these facts together, and taking account of differences in contributions, and the value of other pension contributions made into defined contribution schemes in the private sector, it is clear that the average value of pension provision in addition to salary

²³ R. Disney, C. Emmerson and G. Tetlow, 'What is a public sector pension worth?', *Economic Journal*, 2009, 119, issue 541, <http://www.ifs.org.uk/publications/4666>.

²⁴ Source: Pensions Policy Institute, *An Assessment of the Government's Reforms to Public Sector Pensions*, 2008, <http://www.pensionspolicyinstitute.org.uk/default.asp?p=12&publication=05&>.

²⁵ 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>.

²⁶ R. Disney, C. Emmerson and G. Tetlow, 'What is a public sector pension worth?', *Economic Journal*, 2009, 119, issue 541, <http://www.ifs.org.uk/publications/4666>.

is much greater in the public than in the private sector. This difference has been estimated to be at least 12% of earnings.²⁷

Set against the small public–private wage differential, these are very big numbers. They suggest that on a like-for-like basis, taking account of pay and pensions, average remuneration in the public sector is at least 12% higher in the public sector than in the private sector.

Reforms

Limited reforms to the main public sector pension schemes – NHS, teachers, civil service and local government – were introduced variously in 2007 and 2008. The main effect of the reforms is to increase normal pension age from 60 to 65 in the first three of these, but *for new entrants only*. There were also changes limiting early retirement opportunities in the (funded) local government scheme (which already had a normal pension age of 65 but also an infamous *rule of 85* which allowed retirement with unreduced pensions from age 60 once age plus years of service summed to 85). The fact that for the three largest unfunded schemes only new entrants are affected means that there will still be 60-year-olds retiring from these schemes on full pensions well into the 2040s.

In addition, the civil service scheme is moving from a final salary to a career average basis – that is, pension will be calculated according to average salary rather than final salary.

Alongside a number of smaller changes – some improving benefit generosity – these reforms will reduce the generosity of these main public service schemes by, on average, about 3% of salary (for new joiners only) from about 23% of salary to 20% of salary. We should not forget also the smaller, but staggeringly generous, schemes covering the uniformed services – armed forces, police and fire – which even after reforms are worth a full 33% of salary for new joiners on average, and will continue to be worth 39% of salary to established members of the armed forces.²⁸

Another change to public schemes was (re)announced in the December 2009 PBR – the introduction of ‘cap and share’ arrangements for the four big schemes. Under these arrangements, initial expected cost increases – resulting from higher-than-expected pay increases or improved longevity – will be shared between public sector employers and employees, through higher contributions. Beyond a cap, all additional costs will be borne by higher employee contributions. (Current employee contribution rates are close to 6% in health, teachers and NHS schemes, and 3.5% in the civil service scheme.) The Treasury estimates this will ‘save’ £1 billion annually from 2012–13.²⁹

Going forward

All in all, these are very modest reforms which will, for new entrants only, close about half the gap between the average generosity of public and private sector schemes. They will not, of course, make any difference to the gap in coverage between public and private sector.

²⁷ Figure calculated in A. Bozio and P. Johnson, ‘Public sector pay and pensions’, in R. Chote, C. Emmerson, D. Miles and J. Shaw (eds), *The IFS Green Budget, January 2008*, IFS, London, January 2008, <http://www.ifs.org.uk/budgets/gb2008/08chap8.pdf>.

²⁸ Pages 15 and 16 of Pensions Policy Institute, *An Assessment of the Government’s Reforms to Public Sector Pensions*, 2008, <http://www.pensionspolicyinstitute.org.uk/default.asp?p=12&publication=05&>.

²⁹ Of course, this is not a real saving to the public finances over the long run – rather, more money will be raised from employee contributions in the short run in recognition of the fact that long-run pension liabilities will have risen.

The last-mentioned reform – cost sharing – may, though, point to one possible way forward for a government anxious to save money in the shorter term. We have seen that public and private sector pay are broadly in line with each other, but that pensions in the public sector are much more generous, in large part because of greater coverage. Cutting the future value of unfunded public pensions will improve the real state of the public finances in the long term, but will do nothing for the current deficit. But there is one policy alternative worth considering in the current context – a policy implemented in February 2009 by the Irish government – which is to increase the contributions that employees make now in respect of their future pensions. In funded schemes, such as the local government scheme, this would lead to a one-for-one reduction in current employer spending on pension contributions. In unfunded schemes, this increase in employee pension contributions would not in fact fund future pension payments. It would be like cutting wages in that it would reduce take-home pay (though, unlike a *sustained* pay cut, would not reduce future pension payments). But it could have three, largely presentational, advantages as a policy:

- First, it would make it much more evident to employees what the value of their pension is.
- Second, it is at least possible that it would be longer lasting in its effect than a simple pay cut. From a presentational point of view, headline pay would remain the same. This is purely presentational. But because the remuneration would more closely reflect actual value of the component parts, and because headline pay would not change in terms of comparisons made, a one-off effective cut could be sustainable.
- Third, in the longer run, this might make it easier for government to change future pension arrangements for public sector workers – reducing these employee contributions when it reduces the generosity of pension promises.

The amount of money available here depends on how big and how fast the government is willing to make the cuts. Something on the scale of the Irish change, which introduced a 7.5% pension levy on public sector workers, could raise up to £9 billion a year.³⁰ But, of course, that is because it would be a big hit on the incomes of public sector workers.

More fundamentally, there is a great deal of unfinished business in dealing with public sector pension schemes. There is no terribly good reason why public sector workers should be remunerated in such a different way from those in the private sector.³¹ It must be, at least in part, because the way we measure the state of the public finances simply does not take account of the cost of future promises made. They appear as a free good to government and employees alike.

³⁰ Box 9.3 shows that a 5% cut in wages would lead to a £7½ billion fall in the annual wage bill and a £5½ billion saving after taking into account the effect of the tax and benefit system. Scaling up to a 7.5% cut in wages suggests an £8¼ billion saving. But raising employee pension contributions (rather than cutting wages) would increase the short-term saving as these do not attract relief from employee NI.

³¹ One possibility is that public sector workers might be more risk averse than private sector workers and therefore the government could gain in paying public sector workers less in exchange for offering them higher pensions. But as set out above, the evidence suggests that public sector workers are paid similar amounts to their private sector counterparts.

9.6 Conclusion

Public sector pay, inevitably and rightly, accounts for a large proportion of public spending – about £174 billion a year in total including public corporations and £160 billion a year excluding them. It is inconceivable that fiscal retrenchment should not reduce the pay bill in real terms. The government could choose to achieve this by cutting the public sector workforce (and presumably delivering fewer or lower-quality services) or by paying public sector workers less (which, in time, would reduce their quality and thus, in time, the quality and/or quantity of services).

But there is also a question as to whether public employees are paid appropriately for the work they do now. At the aggregate level, public sector workers do not seem to be paid more than equivalent workers in the private sector. But average figures mask the fact that some groups do seem to be better-paid and have done particularly well in recent years and that the reverse is true for other groups. There is a strong case on efficiency grounds to sort out some of these anomalies, and in particular to deal with differences in the relative generosity of public sector pay in different regions of the country. But a careful and modulated approach is called for, certainly in the long run.

A short-term across-the-board pay freeze, or indeed cut, could save money in the short run and, in current labour market conditions, is unlikely to have detrimental effects. But history suggests that it would be unwound later and that reductions in the size of the public sector workforce are more likely to help deliver the sort of permanent reduction in public spending as a share of national income that the Treasury believes to be necessary to deliver the fiscal consolidation set out in the December 2009 Pre-Budget Report.

As regards public sector remuneration, what is actually required is a much clearer strategy to use the money spent on public sector pay and pensions more efficiently. There is still much to be done to iron out regional inconsistencies. But the most important anomaly remains the much greater value of pensions to public sector workers. Long-term reform needs to be embarked upon, but will not help the public finances in the short run. One alternative worthy of consideration would be an increase in employee pension contributions – but we should be clear that, in effect, this is just another way of implementing a pay cut.