

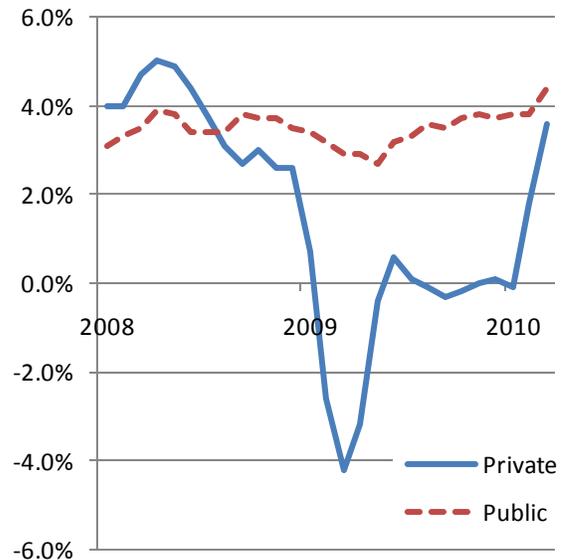
## Public sector pay

This is the third article in the Scrutiny Unit's occasional *Economics in Practice* series.<sup>1</sup> It focuses on some of the current issues surrounding public sector pay, and attempts to use economic concepts to explain what is happening, and what may happen in the future. In particular, what has been the impact of the recent recession on pay? And what are the prospects for public sector pay under the new Government? The notion of regionalising public sector pay negotiations is also explored.

### *The impact of the recession on pay*

During the *recession*,<sup>2</sup> which saw six consecutive quarters of negative growth in 2008 and 2009, *Gross Domestic Product* (GDP) fell, peak to trough, by 6.2%.<sup>3</sup> The latest Treasury forecasts suggest the UK will not return to the 2008 pre-recession level of output until mid-2012 (almost three years after the end of the recession), while the average of independent forecasters suggests it will not be until the start of 2013.<sup>4</sup> Professor David Bell from the University of Stirling points out in a recent article that economic theory indicates a fall in output means there will have been a comparable fall in the *factors of production*, which is primarily accounted for by wages. During the recession, in the private sector this has manifested itself in workers accepting wage cuts and freezes or being made redundant.<sup>5</sup> However, until now the effect on public sector pay has been less apparent (see chart alongside which shows monthly ONS average earnings data for the public and private sectors in the UK). This is at least in part due to the practice of multi-year pay deals, many of which were agreed before the recession hit. The former Labour Government's desire to not adversely affect the recovery in its infancy, and the risk for public sector worker unrest in the run-up to a General Election, were also likely to be key factors.

Average earnings (including bonuses) in the public and private sectors: monthly % change on previous year



Generally, in the long-term, one would expect the level of remuneration in the public sector to follow the trend for similarly-qualified workers in the private sector. This is because if pay settlements are lower in the public sector than in the private, it is likely to lead to recruitment problems and falls in staff quality and, in turn, the quality of services provided. Conversely, if remuneration in the public sector is too high then, all other things being equal, it might lead to excessive *crowding out* of skills for the private sector, wage inflation and an inappropriately higher burden on the taxpayer.<sup>6</sup>

The Institute for Fiscal Studies (IFS) states that although theory indicates public sector pay will follow private sector pay in the medium to longer-term, short-term divergences between public and private sector pay are not unusual. For example, during a recession there is not necessarily a need for a government to cut public sector pay and shed jobs solely to mimic the response of private firms to a drop in demand.<sup>7</sup> Indeed, it may make sense for government to maintain pay levels in the public

<sup>1</sup> The previous two articles, *Why is there public provision of healthcare?* and *What influences house prices and why do governments intervene?*, are available at: [http://dccc3.parliament.uk/committee/resources/Other\\_Practice/index.htm](http://dccc3.parliament.uk/committee/resources/Other_Practice/index.htm)

<sup>2</sup> Please note, definitions of italicised terms may be found in the Scrutiny Unit's [Economics Glossary](#).

<sup>3</sup> ONS database series ABMI

<sup>4</sup> "Recession and recovery", *Key Issues for the New Parliament 2010*, House of Commons Library Research, May 2010, p29

<sup>5</sup> Professor David Bell, *Budget Cuts and Public Sector Pay in Scotland*, May 2010

<sup>6</sup> IFS, *The IFS Green Budget*, February 2010, p219

<sup>7</sup> Primarily because, from a labour market point of view, the public sector is unlikely to suffer equivalent demand-side pressures.

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sector during the recession (for example, in order to maintain consumption) and only implement lower pay increases to allow the private sector to catch up, once the recovery is properly underway. Equally, one would not expect the public sector to increase pay faster during 'boom' years.<sup>8</sup>

### **What will the new Government do?**

The new Government has confirmed that there will be wide-ranging spending cuts over the coming years in order to reduce the *budget deficit*, which was £156 billion in 2009/10 (11.1% of GDP).<sup>9</sup> In addition to direct cuts in public services and likely increases in taxes, bringing the budget deficit down will mean that the public sector will have to provide its services more efficiently.

It is currently unclear exactly how the Government's future programme of cuts will impact upon public sector pay and jobs. However, £6.25 billion of departmental spending reductions have been announced for this financial year. It is likely that more detail for future years will be outlined in the "emergency budget" on 22 June. The public sector wage bill stood at £174 billion in 2008 (30% of all government expenditure) and is therefore an inevitable target for savings.<sup>10</sup> Notably, prior to the election, all three of the main parties stressed the advantage of pay cuts over cuts in the size of the public workforce. This may be 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 proved elusive in the past.<sup>11</sup>

The IFS estimates that an immediate cut in public sector pay across the board of 5% would represent a reduction in earnings paid of approximately £7.5 billion per year. This is the level of public sector pay cuts that the Spanish Government has recently proposed, while the Government in Ireland has gone even further (5% on the first €30,000, 7.5% on the next €40,000 and 10% on the next €55,000). The IFS also estimates that, if *inflation* was running at 2% a year (the Government's 'target' level), 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 (although this would obviously be delivered less quickly than an immediate cut).<sup>12</sup> If inflation were to stay above the 2% target as it has been for 26 of the last 32 months (*CPI inflation* stood at 3.4% in May 2010) the real value of public sector pay would be eroded even further.

However, any Government savings may be lower than the total reduction in public sector earnings arising out of the pay cut because public sector workers pay tax on earnings received and may also receive benefits or tax credits as a result of the pay cut. The IFS therefore estimates that the net savings to the government from a 5% public sector pay cut would be approximately £5.5 billion per year as opposed to the gross reduction in earning of £7.5 billion. It may also be assumed that cutting the pay bill by a similar gross amount through job cuts would be expected to save the Government more if more workers gain alternative employment in the private sector (and thus continue paying tax) than remain unemployed and claiming benefits.<sup>13</sup>

### **Public sector pay and inflation**

The Government must also be mindful of the effect public sector pay policy may have on inflation. In 2007 the former Labour Government said that public sector pay should be "consistent" with its inflation target.<sup>14</sup> This was motivated by the worry that higher public pay settlements could have an inflationary effect in a number of ways: first by leading to actual higher wage settlements in the private sector; second by higher inflation expectations, which in turn would lead to firms seeking higher prices for their products and workers to seek larger wage increases; and third by increasing the level of demand in the economy.<sup>15</sup> Now the fear may be the threat of *deflation* from widespread

<sup>8</sup> IFS, *The IFS Green Budget*, February 2010, p219

<sup>9</sup> "Public Finances", *Economic Indicators*, House of Commons Library Research, June 2010, p15

<sup>10</sup> IFS, *The IFS Green Budget*, February 2010, p213

<sup>11</sup> *ibid.*, p219

<sup>12</sup> *ibid.*, pp226-7

<sup>13</sup> *ibid.*, pp227-9

<sup>14</sup> HM Treasury, *2007 Pre-Budget Report and Comprehensive Spending Review*, October 2007, p45

<sup>15</sup> "Public Sector Pay", House of Commons Library Standard Note SN/BT/4605, January 2008

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public sector wage cuts which could also influence future private sector wage settlements, and perhaps even more worryingly a reduction in overall consumption in the economy. Any negative effect on wages throughout the economy would also have a negative effect on the public finances due to reduced tax revenues.

### **Senior Pay**

The pay of senior civil and other public servants looks to be a particular target for the new Government with the publication by the Cabinet Office of all those civil servants earning more than the Prime Minister, and the announcement of an independent review into disparities associated with public sector pay. One of the new Cabinet's first acts was to agree a cut in their own pay of 5%. Cutting the pay of the highest paid public servants will not in itself save a great deal of money. It is estimated that approximately 300 individuals in the public sector earn over £200,000,<sup>16</sup> while the Cabinet Office figures showed just over 150 current civil servants earned more than £150,000 a year – a 5% cut for all those in the latter category equates to a saving of approximately £1.3 million a year.<sup>17</sup> Thus, while ostensibly the publication of these figures is about increased transparency, it is also likely to be interpreted as symbolic of a new culture and attitude towards pay in the public sector more widely, and an implicit sign by the Government that it will be a key source of savings.

In terms of *inequality*, the distribution of wages in the public sector is significantly more compressed than the private sector – there are fewer who are very poorly paid and fewer who are very well paid. Furthermore, there are significant characteristic differences across different parts of the public sector for those with very high levels of pay. Those public sector bodies with the highest levels of senior pay are often those in most direct competition with the private sector for individuals with particular skills. For example, the BBC is unlikely to be considered a pure *price taker* as the wages it makes available may affect those offered elsewhere. Therefore a rational policy towards the highest paid in the public sector needs to take account of factors such as the degree of actual and potential competition with the private sector, and demand for specialised skills. An across-the-board pay policy for high earners in the public sector is unlikely to be effective.<sup>18</sup>

### **National pay bargaining or regional public sector pay?**

While many governments have examined the scope for decentralising public sector pay determination to increase local pay flexibility, it is difficult to find examples of regional pay bargaining being implemented and national pay bargaining consequently remains the norm. To some extent this is understandable. Governments are generally reluctant to delegate significant autonomy for pay determination to a lower organisational level because of the desire to maintain tight control of the public sector pay bill. However, there are clear *equity*, and perhaps efficiency, arguments for regionalising public sector pay.

There is some debate at the moment about the regional inequalities associated with public sector pay. Should a nurse in Newcastle, where the average house price is around £100,000, be paid the same as a nurse in London, where the average house price is closer to £250,000? Inequalities such as this have been leading to calls from some for public sector pay to reflect the cost of living and the labour market in each locality. Professor Alison Wolf of King's College London recently argued that national pay bargaining distorts local labour markets, causing a form of *market failure*, by pushing up private sector pay to unaffordable levels in the North and other regions which directly increases private sector employers' costs and reduces their ability to create jobs for local people – essentially *crowding out* private sector activity which in turn will adversely affect economic performance.<sup>19</sup> She also argues that national pay bargaining undermines public sector reform – for example in schools,

<sup>16</sup> IFS, *The IFS Green Budget*, February 2010, p232

<sup>17</sup> This is a very crude estimate based on the approximate median earnings of all full-time civil servants earning over £150,000 a year (list available at: <http://data.gov.uk/dataset/uk-civil-service-high-earners>) and should therefore be treated with a degree of caution.

<sup>18</sup> IFS, *The IFS Green Budget*, February 2010, p231

<sup>19</sup> "The Real north-south divide crippling Britain", *The Sunday Times*, 31 January 2010

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national pay rates for teachers mean schools with many disadvantaged pupils are unable to hire better teachers as they are unable to offer higher salaries or improved working conditions.<sup>20</sup>

The IFS recently found that for equivalent jobs, public sector pay was similar to that for the private sector in London and the South East, but substantially higher elsewhere. The table alongside shows that in London male public sector workers earn 2.6% less than their private sector counterparts, while in the North female public sector workers enjoy a 12.6% wage premium over female private sector workers in the region (note, the female differential is generally more pronounced because the gender pay gap is considerably larger in the private sector than in the public sector).

### Estimated public/private sector average pay differentials by region (2006-2009)

	Male	Female
London	-2.6%	-1.4%
South East	-2.8%	0.6%
South West	5.1%	10.8%
East the Midlands	5.5%	11.1%
North	4.8%	12.6%
Wales, Scotland and Northern Ireland	5.3%	12.3%

Source: IFS, *Green Budget*, February 2010, Table 9.4, page 226

Given the figures in the table above, it may seem sensible to argue for differentiating any pay squeeze by region, offering non-zero growth to regions where public sector pay tends to lag behind private sector levels and implementing relatively larger cuts elsewhere. Indeed on this basis, if appropriately targeted, locally differentiating public sector pay cuts could potentially enable larger savings<sup>21</sup> than blanket cuts while reducing the perceived market failure in local labour markets.

However, despite the arguments for regional or even local pay bargaining there are a range of clear barriers. One fear among public sector organisations is of losing staff to employers who pay more. Organisations that sit just outside an existing boundary, such as for London weighting, often complain that it is hard to recruit as people are willing to travel over the boundary for extra money.

### Pay gap between Police Constable pay and regional median full-time earnings: 2009

North East	0.0%
North West	-5.5%
Yorkshire and The Humber	-5.1%
East Midlands	-6.7%
West Midlands	-5.3%
East	-11.0%
London	-26.1%
South East	-17.5%
South West	-6.2%
Wales	-0.5%
Scotland	-9.2%
Northern Ireland	-2.0%
UK	-12.1%

Source: Author's calculations based on ONS ASHE regional median earnings data and PNB pay settlements for Police Constables

Skills shortages may also become more apparent if local pay is not implemented by all public sector organisations in each area. For example, if the fire service chose to regionalise pay, thus significantly increasing pay in some regions, but the police service did not, it is possible that in the long-term in these regions more people would choose to train for and enter a career in the former rather than the latter. There are also significant increased *transaction costs* associated with negotiating local pay and condition. Public sector unions have argued against local pay bargaining on this basis, stating that it would be a "bureaucratic nightmare" which would then have to be replicated in every organisation.<sup>22</sup>

The figures in the table above also do not sufficiently depict contrasting inequalities for specific groups of public sector workers that would need to be considered in any system of local pay bargaining. For example, the table alongside shows the regional disparities in the pay of a Police

<sup>20</sup> *ibid.*

<sup>21</sup> For example, very crude estimates by the author (that should not be re-used) would suggest, based on London and the South East accounting for approximately 25% of the public sector workforce, that a pay cut of 8% for public sector workers outside London and the South East and a pay increase of 2.5% for those in this area would deliver greater saving than a 5% cut across the board.

<sup>22</sup> "Wrestling with pay", *Public Finance*, 5-11 March 2010, pp24-6

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Constable (which is set nationally at £22,680 on commencement of service,<sup>23</sup> with an additional London weighting of £2,220)<sup>24</sup> with the median full-time pay for all employees in each region. It is evident that Police Constables in London earn far less (-26%) than the regional average than compared with their colleagues in the North East (where Police Constables' pay is approximately the same as the regional average).

### **Conclusion**

It seems that while public sector pay has so far avoided the cuts seen in the private sector, this is likely to change. The cuts that the new Government plans in order to bring the budget deficit down will almost certainly affect public sector pay, be it in terms of actual pay cuts or wage freezes which will bring down earnings in real terms. It is important that any Government decisions on pay are also informed by a sense of where we are relative to the 'correct' long-term level in relation to the private sector and are not solely motivated by short term needs.

It may be argued that negotiating public sector pay locally is a useful tool for more efficiently and equitably enacting public sector wage cuts while simultaneously correcting some of the perceived market failures that exists as a result of national public sector pay bargaining. However, while there are clear arguments for regionalising public sector pay, setting it based on regional or local averages for public and private sector pay is unlikely to address effectively such failures unless the pay of public sector workers is analysed organisation-by-organisation, profession-by-profession, and job-by-job.

*Ed Beale, June 2010*

### **Further reading**

"Budget Cuts and Public Sector Pay in Scotland", Professor David Bell, Commissioned by the Scottish Parliament Finance Committee, May 2010

"Wrestling with pay", *Public Finance*, 5-11 March 2010

"Outsiders and Insiders: External Appointments to the Senior Civil Service", Seventh Report of Public Administration Select Committee of Session 2009–10, 2 February 2010

"Public Sector Pay and Pension", IFS, *The IFS Green Budget*, February 2010, Chapter 9

"The Real north-south divide crippling Britain", *The Sunday Times*, 31 January 2010

"Top Pay in the Public Sector", Sixth Report of Public Administration Select Committee of Session 2009–10, 21 December 2009

"Public Sector Pay", House of Commons Library Standard Note SN/BT/4605, January 2008

"Public Sector Spending and Regional Economic Development: Crowding Out or Adding Value?", CPPR, January 2006

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<sup>23</sup> Police Negotiating Board 2009 Circular 09/06

<sup>24</sup> Police Negotiating Board 2009 Circular 09/05